OMBUDSMAN
for Banking Services and Investments | des Services Bancaires et d'Investissement

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# Approved Changes to OBSI's Suitability and Loss Assessment Process, and Summary of Public Comments

Following consultation on proposals set out in a discussion paper on May 10, 2012 OBSI's Board of Directors has approved the following changes to OBSI's investment suitability and loss assessment process:

1. Use common indices as performance benchmarks in most suitable performance comparisons.
2. Take fees and trading costs into account in all cases when making suitable performance comparisons.
3. As a general rule, add interest on compensable losses only if an Investigation Report (a final report where we recommend compensation) is issued, but not add interest on facilitated settlements. Generally, interest on recommended compensation would be calculated from the date the investor complained to their firm and is intended to compensate the investor for not having access to the compensation during lengthy delays in resolving the complaint.
4. Implement a self-imposed limitation period of six years from the time when we believe the investor knew or ought to have known there was a problem with their investments.
5. Provide working or at minimum clear and transparent printed versions of our loss calculation spreadsheets during our investigation.

This document summarizes the enhancements to the process and discusses key issues raised during the comment period. A table setting out stakeholder comments in full is provided as an attachment to this paper.

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## CONSULTATION BACKGROUND

In the majority of investment complaints we receive each year about advice-based accounts, investors complain that they received poor advice, their investments or investment strategies were unsuitable and/or that their investments did not perform as they expected. In such 'suitability' complaints, investors ask to be compensated for the investment losses they incurred.

In 2011 OBSI issued for public comment a consultation paper detailing our investment suitability and loss assessment process. After considering the feedback received, on May 10, 2012 we issued a second consultation paper detailing a series of proposed changes to our process.

During the most recent consultation period OBSI received nine written submissions from stakeholders. All submissions have been posted on our website. OBSI also participated in three consultation sessions: one organized by OBSI for the general public, and one organized by each of the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association of Canada (MFDA) for their members.

We have again found the consultation process to be informative and helpful, and are appreciative of all stakeholders who have taken the time to provide input, either written or by participating in one of the sessions.

In the coming months OBSI will publish on our website our revised methodology for suitability and loss assessment, based on the original consultation paper of May 2011 and incorporating the changes outlined above.

## STAKEHOLDER FEEDBACK

### 1) Use common indices as performance benchmarks in most suitable performance comparisons

*Stakeholder Comments:*
In written submissions, an investor rights organization was of the view that using indices in most instances was a step backward, in that OBSI's investor-specific approach to loss assessment is one of the strengths of the Canadian complaints system. It also believes that the methodology used in private settlements and court proceedings should not determine OBSI's loss assessment process.

An industry association indicated they generally support the use of common indices as they can increase the consistency, predictability and efficiency of the loss calculation process. Clarity as to which indices would be used was sought. Some industry stakeholders commented that where indices are used as performance benchmarks, the average performance of three to four comparable indices should be used where available.

Mutual fund dealers and their associations expressed concerns with using indices as benchmarks for suitable performance comparisons in their sector, both in written submissions and at the MFDA session. The problems that some identified with using indices included:

- Indices are less diversified than mutual funds
- Mutual funds have allocation restrictions that indices do not
- Fees and costs need to be calculated separately for indices
- Mutual fund dealers have traditionally used mutual funds as benchmarks when calculating losses in suitability cases using notional portfolios
- Indices can be more volatile than actively managed funds

Using baskets of mutual funds was suggested as an alternative approach.

At the MFDA and IIROC consultation sessions, some stakeholders argued that investors cannot "buy the index". There was also a discussion as to what constitutes a portfolio approach. Several participants noted that some of the securities in the S&P TSX Composite Index, for example, may be high-risk. At the public consultation session, one industry participant wondered whether OBSI recommends compensation based on the performance of an entire portfolio, or only its unsuitable investments.

*OBSI Response:*
The objective of OBSI's methodology is to reasonably estimate an investor's financial harm, if any, in a way that is as accurate and fair as possible and that minimizes '20/20' hindsight. We understand and acknowledge that in some instances, indices will outperform other suitable securities. In others, indices will underperform. However, OBSI believes that using common

indices in most cases will be the most objective approach. It will decrease debate over benchmark selection and increase the consistency, efficiency, and predictability of our process, which we believe is fair to both parties.

Firms and investors are inclined, perhaps understandably, to select benchmarks that best serve their interests. Often firms argue for alternative approaches that would have the effect of lowering compensation, and sometimes investors or investor advocates argue for approaches that would increase it. We have not experienced one of the parties to a complaint arguing for us to be flexible in our approach in such a way as would harm their own economic interest. By using common indices in most calculations, benchmark selection will be as objective and consistent as possible and we will minimize debate over benchmark selection, which is one of the leading causes of delays in resolving complaints that OBSI investigates.

By reducing debate, our internal efficiency will also be improved through the use of indices as it will take less time for OBSI's Investment Analysts to complete index-based loss calculations and make the necessary fee and trading cost adjustments than other approaches.

Using indices in most instances does not prevent us from addressing exceptional cases and we will still have the flexibility to use an investor's suitable investments, a firm's model portfolios or other performance benchmarks in the limited circumstances where it would be appropriate, such as when we cannot identify an index benchmark that would fairly and reasonably represent an investor's suitable investments.

In most instances, OBSI proposes to use the following indices for our suitable performance comparisons:

| Asset Type/Objective | Risk Level | Index |
|---|---|---|
| Equity/Growth | Medium | Canada – S&P TSX Composite<br>U.S. – S&P 500<br>Global – MSCI World<br>International – MSCI EAFE |
| Equity/Growth & Income | Medium | S&P TSX 60 |
| Bonds/Income | Low to Low-medium | DEX Universe Bond |
| Cash/Safety, Liquidity | Low | Cashable GICs |

In general, we will select and/or combine indices to reasonably represent the investor's actual geographic exposure. For example, if the investor was 50% invested in high-risk Canadian equities and 50% in high-risk U.S. equities, but should have been in medium-risk equities, we would allocate the suitable performance benchmark 50% to the S&P TSX Composite and 50% to the S&P 500 to represent medium-risk Canadian and U.S. equities respectively.

For suitable benchmark selection purposes, we make a particular distinction between income-producing equity and equity-like investments, and bonds:

- If the investor requires dependable income, and can accept only a low or low-moderate degree of risk, or if the 'income' is intended to be part of the fixed-income component of an account we would use the DEX Universe Bond Index.

- If it is apparent that the investor was willing and able to accept more risk in order to generate income by holding equities and/or to earn more tax-efficient income we would use the S&P TSX 60.

For example, consider an investor in his forties who is employed, with a medium risk tolerance and growth and income objectives. He will not need to draw income from his investments for 20 years or more. In this example, equity-based income-producing investments could be suitable. If he was unsuitably invested only in growth-oriented equity investments offering no income, we may compare the actual unsuitable investment performance to the S&P TSX 60 as a benchmark for income-producing equities that also offer the potential for growth. However, if the same investor required secure income or intended to reduce volatility by combining bonds and equities, we may combine the S&P TSX Composite with the DEX Universe Bond index.

Other indices may be used on an exception basis based on the particular facts or circumstances of each case. While we rarely need to use high-risk performance benchmarks, if an investor bought a high-risk, prospectus-exempt product and was not an accredited investor, for example, but was willing to accept high risk, we may compare the performance of the unsuitable exempt product to the performance of a high-risk performance benchmark like the S&P TSX Small-Cap index.

We acknowledge the mutual fund dealers' concerns around using indices when measuring the performance of suitable investments for the purposes of determining financial harm, if any, of mutual fund investors. With regards to the suggestions that mutual funds are more diverse and exhibit lower volatility than indices, we believe that it is entirely dependent on the mutual fund and index in question. We also do not believe that factoring fees and costs into index calculations will be too onerous.

We do note, however, that mutual funds typically use indices as their benchmarks. It makes sense and is consistent with the idea of making our calculations predictable and consistent to generally use the same mainstream benchmarks that mutual fund managers use.

With regards to "buying the index", OBSI does not use indices to specifically represent what the investor would have bought, but as reasonable indicators of the performance of suitable investments. We note that the indices we use are widely published, are commonly used by investment managers and mutual fund companies as performance benchmarks, and are often used by the courts as performance benchmarks in civil litigation. In addition, we agree that at times some of the securities included in the S&P TSX Composite Index could be considered high-risk. However, it is widely held that a broad index like the S&P TSX Composite is a reflection of the medium risk of the market overall.

We also accept that a portfolio-based approach to investing is an accepted method and commonly used by advisors. If there is evidence that a portfolio approach was taken with the accounts at the firm we will certainly consider it. We always look at both individual securities and the portfolio at the firm in our suitability assessments.

OBSI will consider the broader portfolio of investments held at the firm if the firm and/or advisor can demonstrate:

- A portfolio-based plan that was prepared.
- How it was reviewed and discussed with the investor.
- Any other related information such as the portfolio-level reporting that was provided by the firm or advisor to the investor.

In the absence of such information, we may calculate losses and compare performance on the unsuitable portion of the portfolio only, depending on the circumstances of the case.

Finally, we note that as with all of our procedures, we continually review our methodology to ensure that it is consistent with evolving industry practices. To that end, we will periodically assess the common indices we use as benchmarks to ensure they remain appropriate.

**2) Take fees and trading costs into account in all cases when making suitable performance comparisons**

*Stakeholder Comments:*
No objections were raised to the principle of this proposed change. A few commenters requested clarity around what fees and costs would be included in the calculation. The investor rights organization advocates for the costs associated with a non-actively managed index-investing strategy as opposed to a higher cost mutual fund, given than an index is the benchmark.

*OBSI Response:*
OBSI will incorporate the actual trading costs and/or typical fees associated with suitable securities where appropriate. If fees have not been incurred, we would not include them in our calculation. If we believe the fees incurred were unsuitable for the investor, we would include an appropriate fee in our calculation.

For clarity, the fees we incorporate may include:

- Front end or deferred sales charges
- Early redemption fees and switch fees
- Management expenses. We will apply a cost for mutual fund investors that approximates the MER they were likely to have incurred. For investors paying a managed account fee, we will incorporate actual fees incurred as applicable
- Trading commissions
- Administration or other account fees

We will generally calculate fees and costs that the investor was likely to have incurred.

**3) As a general rule, add interest on compensable losses only if an Investigation Report (a final report where we recommend compensation) is issued, but not add interest on facilitated settlements. Generally, interest on recommended compensation would be calculated from the date the investor complained to their firm and is intended to compensate the investor for not having access to the compensation during lengthy delays in resolving the complaint**

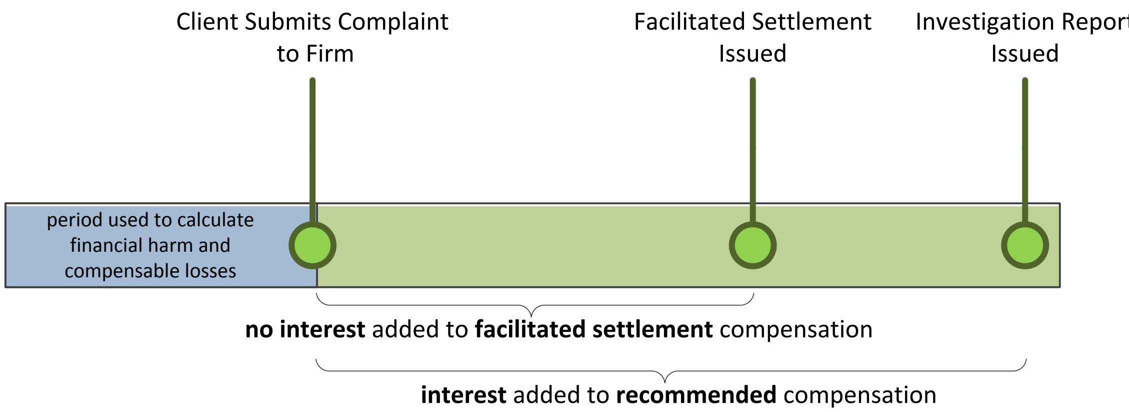
*Stakeholder Comments:*
The investor rights organization proposed adding interest from the end of the loss calculation until compensation is paid in all cases, noting that consumers are unconcerned with how their complaint is classified (Facilitated Settlement vs. Investigation Report). They point to this being consistent with the approach of the UK Financial Ombudsman Service (FOS). Some industry participants at both the IIROC and MFDA consultation session thought this proposal seemed "punitive." Several industry stakeholders commented in written submissions that calculating interest on compensable losses should not be used when suitable performance comparisons are made using indices as it would result in compensation beyond what the market would have provided. Others commented that interest should not be added where delays are caused by either OBSI or the investor.

*OBSI Response:*
We work with the investor and the firm to try to achieve a fair and reasonable solution that is timely. With a timely resolution, our experience shows that investors are generally unconcerned with the addition of interest, given that interest amounts are typically small.

In the cases when a timely resolution can't be reached and we find it necessary to draft a formal Investigation Report, the extended timeline generally leaves the investor without use of the compensable amount for a long period. Adding interest in these instances is not a punitive measure against the firm but is intended to compensate the investor for the loss of use of their money.

Concerns around the addition of interest when suitable performance comparisons are used to calculate compensable losses appear to be misplaced. While we will compare suitable to unsuitable performance from the date of the suitability problem, the interest amount that will be added to any compensable loss is from the date of the investor's complaint to the firm. We note that typically, suitable performance calculations end on or before the date of the investor's complaint to the firm.

There is no double counting in our calculations. To illustrate this, we use the following diagram to show a sample period when interest is calculated:




We agree that if the delays were caused by OBSI interest should not be calculated on that period.

**4) Implement a self-imposed limitation period of six years from the time when we believe the investor knew or ought to have known there was a problem with their investments**

*Stakeholder Comments:*
All stakeholders agreed with the fairness of introducing a self-imposed limit on the age of cases we would investigate, though there was disagreement on what that limit should be.

An investor advocate agreed with the six-year proposal. The investor rights organization felt that six years from the time an investor knew or ought to have known of the problem was fair, provided a subjective standard is used. Some industry stakeholders recommended that OBSI align with statutory requirements in each province and territory. Others noted that regulatory authorities have a seven-year document retention period and that OBSI should align with this.

An industry association requested clarity on whether the six-year time period applies to the length of time OBSI can look back at unsuitable investments when calculating compensable losses, or whether it applies to the time for bringing a complaint forward. An industry association and participating firm asserted that the level of knowledge and engagement of the investor should be taken into consideration when determining the cutoff date.

*OBSI Response:*
We have always considered the availability and reliability of evidence and the reasonability of investigating older complaints before we open a case for investigation. Despite this, we have proposed to formalize a time limit given the acknowledged problems associated with old evidence and the challenges it presents to achieving a fair and reasonable outcome.

OBSI's process is not a court proceeding so we are not subject to statutory limitation periods. We are also not a regulator. An Ombudsman's role is to investigate complaints with a view to resolving them in a manner that is fair and reasonable in all the circumstances. As an alternative dispute resolution organization – one that is national in scope – we continue to believe that a uniform self-imposed limitation period of six years from the time an investor knew or ought to have known there was a problem is appropriate.

The six-year limit pertains to the time an investor has to bring forward their complaint from the point that they knew or were in a position to know there was a problem. It does not apply to the period during which losses associated with unsuitable investments would be calculated.

The point when an investor knew or should have known that his or her investments were unsuitable and should have filed a complaint with the firm will differ for each investor. Similar to the factors we consider to determine an investor's responsibility, if any, for investment losses, the six-year limitation period will be evaluated considering factors such as:

- the nature of the relationship between the investor, the advisor and the firm
- the investor's level of investment experience, knowledge and sophistication
- the degree to which the investor trusted or relied on the advisor, including consideration of the skills, knowledge, expertise and services that the firm or advisor represented they would provide compared to the advice or services the investor actually received
- the timing, form and nature of the information provided to the investor and their ability to understand it
- whether and when the investor raised any concerns with the advisor or firm about the investments in the account, what advice they received and what action, if any, was taken

It is important to note that we will often need to open a file and begin an investigation before being able to determine that an investor took too long to complain.

**5) Provide working, or at minimum clear and transparent printed versions of our loss calculation spreadsheets during our investigation.**

*Stakeholder Comments:*
All industry stakeholders were supportive of this change, but some stakeholders noted that not all firms use Bloomberg terminals. Some requested that information as to how values in the spreadsheet are calculated would be needed to maximize the utility of the data. The investor rights organization and the investor advocate both stated that whatever information is provided to firms must be provided to investors as well.

*OBSI Response:*
With regard to the sharing of working versions of our loss calculation spreadsheets, the original proposal was not as precisely worded as it could have been. The proposal had said that firms would be provided with working versions of our loss calculation spreadsheets during our investigation. Some stakeholders took this to mean that investors would not be afforded the same opportunity, which was not our intent. It was always our intent that both firms and investors would have access to the same information as much as possible.

In our loss calculations, OBSI uses spreadsheets that directly pull information from a Bloomberg terminal. Where a Bloomberg terminal is involved we have determined that certain technical hurdles will be insurmountable for most investors and some firms. Therefore, while we will continue to explore the opportunity to provide working versions of our spreadsheets, at this time we will share printed versions of our calculations with both parties to a complaint that are as clear and transparent as possible so they can understand the calculations.

**Other Comments**

Many commenters submitted proposals on issues that fall outside of the consultation paper. Most comments not directly related to this consultation have not been included in this summary but have been taken under advisement by management and OBSI's Board of Directors. Nevertheless, OBSI would like to clarify some matters that were raised in written submissions and at the consultation sessions.

One industry association noted that at the consultation sessions OBSI representatives indicated at times that OBSI is "already doing this" and wondered why the items were characterized as proposals. To clarify, what OBSI representatives meant was that the actions contained in the proposals are already used *at times*. For instance, we have always used indices in some suitable performance calculations, though our preference had been to use an investor's actual suitable investments as a benchmark. Similarly, we did take fees and trading costs into account where possible but we did not do so for indices; we propose to include fees and trading costs in all calculations going forward. The proposals would be implemented in our standard policies and procedures.

One comment that we frequently hear, and which came up at the IIROC consultation session, was that OBSI should never go “beyond the KYC” (‘Know Your Client form’) during our investigation. Some industry stakeholders are of the view that it is a signed contract, and that if a investor didn’t understand or agree with its contents they shouldn’t have signed it. It is then stated that if an investor signed it then they bear full responsibility for any losses.

The KYC document is an important piece of evidence, but it is not a contract. The KYC information on an account opening form or a KYC update form summarizes the information an advisor collects in the Know Your Client process. If the investor agrees with the KYC information or provides information that is consistent with the KYC form, we will generally accept it.

However, investors sometimes tell us they did not know of or understand the information on the account application or KYC form and they signed it based on the trust they had in their advisor. We also hear that account applications or KYC forms are sometimes presented as an administrative matter of little importance. When the KYC information is in dispute or there’s an obvious disconnect between the information on the form and the investor’s personal and financial circumstances, we want to understand things like how the information on the form was gathered and documented, what the investor and advisor discussed, what the investor understood about the terms on the form, and how the form was presented and reviewed before it was signed. There may also be additional information or evidence that we need to consider to substantiate or refute what the parties tell us. After considering the evidence, process and circumstances of the complainant, we can form a view about whether the KYC form was reasonably accurate and reliable.

KYC collection is a process and the KYC form is merely a tool that an advisor uses in that process. When determining whether investments are suitable for an investor in the face of a complaint, no regulator, court or responsible firm limits their determination of the investor’s KYC information to a review of the KYC document.

At the IIROC consultation session and again in a written submission, one stakeholder said that where securities regulators have not found a suitability issue, OBSI should not find otherwise. As was clarified by an IIROC representative at the consultation session, just because a case isn’t pursued by IIROC (or another regulator) does not mean that a violation hasn’t occurred. The SRO and OBSI processes are also very different.

One stakeholder requested clarification as to how investor knowledge and responsibility may factor into the disclosure issue. The example given was if an advisor provides a full explanation of the risks to a knowledgeable investor, would this be reflected in the apportionment of losses due to an acknowledgement of some investor responsibility.

In the example provided, it is quite likely we would find the investor bears some responsibility. As the original consultation paper stated:

> *We will consider whether an investor had knowledge of an unsuitable investment or strategy early on or from the time of the recommendation, or was otherwise sufficiently knowledgeable to have known of the problem, and did not take reasonable steps to question and/or resolve it to limit potential financial harm. In this situation, we may find the investor contributed to the financial harm incurred. If so, we may apportion a percentage of the financial harm that the investor has incurred to the investor, reducing the compensation we would otherwise recommend they receive.*

The investor rights organization recommended that OBSI explicitly include the use of leverage as something we would look at in any suitability assessment. The use of leverage is indeed one of the issues we look at as part of our process.