



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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Director

Tyler Fleming
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July 25, 2011

Dear Mr. Fleming:

Re: OBSI Consultation Paper on Suitability and Loss Assessment Process

The IIAC appreciates the opportunity to comment on OBSI's Suitability and Loss Assessment Process (the "Process").

The IIAC and its members have been working with OBSI staff over the past two years to share information about how the industry and OBSI approach various elements of the Process, with a view to establishing standards that are understood and supported by all stakeholders. We hope that this public consultation process will provide a catalyst for the significant changes required to restore stakeholder confidence in OBSI.

Our comments relate to both the components of the Process, as described in the Consultation Paper, as well as certain important elements that affect the outcome of the suitability and loss assessment analysis that are not articulated in the Consultation Paper.

General

Our members have advised us that many of the steps in the Process as described in the Consultation Paper are reasonable, and reflect the steps undertaken by investment firms in dealing with client complaints.

However, the description of the Process only provides a general framework of how decisions are made by OBSI staff, and does not articulate the industry's primary concerns, which involve the decision making processes leading up to the loss calculation. Specifically we are concerned about how OBSI staff are empowered to substitute their judgment (with the benefit of hindsight), over that of trained industry

professionals who have often had long standing relationships with their clients, and who act pursuant to specific regulatory standards designed to protect investors.

OBSI staff conduct an after-the-fact reassessment of suitability, the risk of investments and the sophistication and responsibility of the investor. This reassessment is done with the benefit of information about market performance that was not available to the advisor at that time the investment decision was made. Compensation recommendations based on such knowledge are unlikely to be accepted by the firm, regardless of whether the actual quantitative calculation of compensation is based on sound principles.

The resulting impasse has led to undue delays for clients and firms in resolving certain claims, and has created a backlog of long standing cases. Files remain open, due in part to OBSI's reluctance to acknowledge the impasse and publish the case details pursuant to its prescribed process. Such delays undermine investor and industry confidence in the system, which was intended to be an alternative to the typically longer and more costly litigation process.

Procedural Fairness

We acknowledge and support OBSI's stated mandate to provide participants with a dispute resolution process that is a less formal and more timely and cost effective alternative to the court system. We are, however, concerned that the lack of procedural safeguards, and the wide discretion given to OBSI staff in applying or disregarding due process guidelines, creates a level of procedural unpredictability and inconsistency that can lead to unfair results.

Section 25 of the OBSI Terms of Reference sets out factors that "shall" be considered in determining a fair outcome. These factors include general principles of good business practice, law and regulatory practice and guidance. We believe these considerations, and associated practices should be more closely observed in the investigation and recommendation process.

In carrying out their duty to serve their clients, industry stakeholders are bound by regulatory standards from a variety of sources, as well as case law. When OBSI regards these standards and precedents as mere guidelines, and applies different, unpublished and inconsistent standards, the results for the investment advisor and dealer who have diligently observed their professional, legal and regulatory obligations can be unfair.

It is important that the regulatory and professional standards, including education and work experience requirements are considered when OBSI is reviewing each file. The judgment exercised by the investment advisors should not be easily dismissed or overridden by investigators without significant evidence showing that the investment advisor did not exercise reasonable judgment in the context of the information provided by the client, the relationship with the client and the information known about the investments at the time the investment decision was made (rather than in hindsight).

Regulatory and legal precedents, rules of evidence and limitation periods have been developed over many years by legal and regulatory experts to promote procedural fairness in respect of dispute resolution. For example, where cases are well past what would be heard under a statutory limitation period, issues around memory, credibility and lost evidence come into play, particularly when an investment advisor has left the firm.

In such circumstances, clients are afforded opportunities beyond what the law has determined to be fair, often to the detriment of advisors and firms. Without any reasonability standard imposed on clients in this regard, the balance of fairness is weighed heavily in favour of the client, often at the expense of the advisor and firm.

While OBSI staff may not be specifically bound by such procedural rules, they should be extremely cautious in waiving or varying them in the absence of compelling evidence that they are not appropriate under the circumstances.

One matter that the paper does not address is what happens when the firm and OBSI staff have a differing opinion on the outcome of an investigation. While the Terms of Reference indicate that if the firm does not comply with the compensation recommendation, the details of the dispute will be published, this is an extraordinary remedy that loses its effectiveness if used too often over time. We recommend creating other options, such as formal mediation, that would assist in reaching balanced outcomes.

In the absence of such options, difficult cases may stall indefinitely. This prejudices the investor, the firm, and the advisor, who all require timely resolution to pursue next steps. We understand there are several cases currently in this situation, some of which may be more than one year old. These cases should be dealt with immediately, as the credibility of the process erodes when files languish without resolution.

Know Your Client Determination

As noted in the Consultation Paper, the KYC form is a key document in assessing whether a client was suitably invested. The document forms the basis of the advisor – client relationship, and as such, must be given significant weight in OBSI's assessment of the suitability of investment decisions. Absent any clear evidence that the client's investments were not consistent with the KYC, or other documented investment directions made by the client, it is inappropriate and unfair for OBSI staff to unilaterally and retroactively change the context under which the advisor was making investment recommendations for their client.

In certain circumstances, OBSI staff appear to substitute their own assessment of the client's risk profile and investment objectives over those as accepted and often signed by the client in the KYC documents. This effectively absolves the client of any responsibility or accountability for the information they provided to the advisor, and for the fact that they acknowledged and may have actually physically signed off on such information.

Where the legitimacy of the objectives and risk tolerance agreed to in writing is challenged, the client should be held to a very high standard of proof before it is accepted that, despite the fact that they may have signed the form, they did not agree with the stated objectives or that the risk tolerance was not appropriate in the circumstances.

In circumstances where the KYC does not appear consistent with the investment decisions, we agree with the Process as described in the Consultation Paper. Matters relating to the client's investment experience and knowledge, history of investments, personal and financial circumstances and other documents that help establish the

context of the client relationship with the advisor and assess the circumstances and sophistication of the investor should be examined closely.

In such circumstances, it is important that OBSI have the appropriate expertise to ask the right questions when conducting interviews in order to elicit the relevant information from the advisor and client, in order to make a determination on these matters. It is the impression of the industry that considerable weight is given to the information provided in these interviews. Experienced investigators are very cautious about the reliability of such information, and take into account the limitations in its accuracy, given the passage of time, reliability of recollection and inherent bias of the person presenting the information.

Investigators must also be cautious in making credibility assessments, particularly given that the individuals being interviewed are often doing so via telephone rather than in person. These individuals are also not under oath and their evidence is not subject to certification of accuracy, truthfulness or completeness. Procedural safeguards are required to ensure credibility findings are properly tested.

In addition, appropriate expertise is required in interviewing third parties, particularly previous or current investment advisors, as they are likely to be in a conflict of interest position, vis-a-vis the client.

Suitability Analysis

The process of determining the suitability of an investment involves significant expertise, and is subject to professional judgment based on experience and training, as prescribed by industry regulations and standards. Even for those possessing the expertise and experience, ascertaining risk and suitability is a subjective exercise and cannot be reduced to a formula. In fact, it is unlikely that consensus could be achieved by experts on what would be the *specific* contents of a "suitable" portfolio. As such, second guessing *after the fact* by those who may or may not have such expertise, and are not bound by the regulatory framework, will generally not yield a result that represents the decision making framework at the time the investments were chosen. This retroactive second guessing can unfairly penalize an advisor who acted reasonably and within the regulatory framework in recommending an investment, and did so without pre-existing knowledge about actual future securities performance.

As such, the determination of suitability should be based on whether rules, laws or regulations in effect at the time that the investment recommendations were made were observed. In the absence of a violation of the regulations governing suitability, reassessment by OBSI staff should be supported by clear and compelling evidence that the suitability assessment was inappropriate at the time.

In respect of the suitability of specific products, we are concerned about the statement on page 7, which indicates that OBSI may disregard the investment objectives, strategies and risk ratings published in a mutual fund company's simplified prospectus. It is extremely inappropriate for OBSI staff to substitute its own judgment to override these ratings, particularly when the industry is bound to follow them in making their assessments.

We also seek clarification on the stated principle in the Consultation Paper that disclosure does not validate an unsuitable recommendation. It should be clear that, although such disclosure may not make the investment suitable, if full disclosure is followed by informed client consent and direction to make the investment, the client must bear responsibility for losses relating to that investment.

Determining Financial Harm and Compensation

Although the Consultation Paper indicates that there are a variety of alternative approaches to loss assessment, the Consultation Paper reaffirms OBSI's use of a notional portfolio approach as the primary method of ascertaining financial loss and determining compensation. We reiterate our position as stated in our letter to Doug Melville on June 20, 2010, that although this approach may be an appropriate means to calculate losses in certain circumstances, it should represent only one of several methodologies to be employed depending on the circumstances of the case.

In many situations, the notional portfolio methodology results in arbitrary outcomes that do not reasonably represent fair compensation for client losses, leading to outcomes that unfairly enrich the complainant. The approach lends itself to the use of hindsight to choose "benchmark" securities based on their performance (which can only be known after the fact) that would have placed clients in the same position as an index fund or some mix of securities that may not have been available to purchase, and/or which may have outperformed many other suitable securities or portfolios which might have been recommended. This post-facto guessing process does not appear to consider the many securities that fit the investor's risk profile, but may have gone down in value relative to the indices, or the implications of the timing of the buying and selling decisions. As such, the value of the Notional Portfolio approach as a predictive tool is questionable, and can easily result in an unreasonable calculation, given the wide range of performance by other securities that were suitable.

The limitations of the notional portfolio approach are exacerbated for claims older than two or three years, particularly if the market has been volatile in that period.

Our courts have recognized the limitations of this approach, only employing this methodology in limited circumstances to achieve a fair result. While in theory, applying a consistent methodology should lead to consistent results, the variability in performance of securities, timing considerations, and the complex nature of securities valuation not only results in inconsistency among cases, but also can result in unfair outcomes, depending on how benchmark securities are chosen.

A consistent standard of fairness in compensation recommendations can only be achieved by employing different methodologies that take into account the key differences between fact patterns, and apply the most appropriate model to the circumstances. This requires significant expertise on the part of investigators.

In our view, OBSI needs to acquire the appropriate expertise to expand the range of methodologies it uses in order to determine fair and appropriate compensation.

We reiterate that determining a fair outcome, which includes compensation, is highly dependent on the processes that lead up to the calculation of losses. Without addressing the issues relating to how discretion is exercised to evaluate the KYC

process and suitability determinations, the development of more appropriate compensation calculation tools will not result in materially better outcomes.

Thank you for considering our feedback on these issues. We believe it is critical to address the issues articulated by OBSI's stakeholder groups in order to ensure that such an important dispute resolution forum is supported by, and has the confidence of the industry and consumers alike. If you have any questions, or require further input, we would be pleased to meet with you.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'S. Copland', with a stylized flourish at the end.

Susan Copland