Process for Assessing Investment Suitability and Compensable Losses

INTRODUCTION

As an ombudsman office, our role is to investigate complaints 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, when determining what is fair, we must consider general principles of good financial services and business practices, the law, regulatory policies and guidance, and any applicable professional body standards, codes of practice or conduct.

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

Our process is intended to be informal so we can resolve complaints as quickly as possible. At the same time, we apply the appropriate amount of rigour to each of our investigations to ensure the results are fair to the parties.

If we conclude that an investor complaint does not have merit, we will explain our reasons to the investor and firm. If we conclude that an investor complaint has merit, we will determine what amount, if any, we believe the firm should compensate the investor.

SUITABILITY COMPLAINTS

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.

When making investment recommendations to their clients, investment advisors and their firms[1] have three main regulatory obligations:

1. They must learn each client's personal and financial circumstances, investment knowledge and experience, investment time horizon, investment objectives and risk tolerance (known as "Know Your Client" or "KYC" information).

2. They must know the risks and characteristics of the investments they are recommending (known as the "Know Your Product" rule).

3. The investments they recommend must be suitable for their clients given their KYC information.

However, advisors and firms are not responsible, and in fact are not permitted, to guarantee the performance of any investment that involves risk.

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[1] For the purposes of this document we use the terms "investment firm" and "firm" to refer to all OBSI Participating Firms including dealer members of the Mutual Fund Dealers Association (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC), exempt market dealers, portfolio managers and scholarship plan dealers. We use the terms "investment advisor" and "advisor" to refer to individual registrants such as IIROC Registered Representatives, MFDA Approved Persons, or registered dealing, advising, or associate advising representatives as defined in National Instrument 31-103.

CONTEXT UNDERLYING OBSI'S APPROACH

Since OBSI was formed and tasked with the resolution of investor complaints in 2002, we have constantly worked toward improving and standardizing our approach to suitability cases. We developed our approach not only with the benefit of first-hand investigation and case resolution experience, but also with guidance from external legal counsel. To respond to calls for greater efficiency and a consistent application of the approach to the increasing volume of investor complaints, we also established a separate team dedicated to provide consistent and high quality loss calculations for all investment complaints handled by OBSI. Beginning in 2011, we conducted an extensive two year consultation on our process for assessing investment suitability and calculating losses; after receiving extensive feedback from industry and investors, the Board approved the process outlined in this document.

The overall objective of OBSI's approach is to determine a reasonable estimate of the financial position the investor would be in if unsuitable investment advice had not been given and acted upon. Recommended compensation amounts can range from small to very large, in some cases approaching OBSI's compensation limit of $350,000. Therefore, investment firms often request a great deal of supporting detail and analytical rigour from OBSI to validate the compensation amounts we recommend. This is particularly true where extensive internal discussions among individuals within investment firms are required before a decision to accept or reject an OBSI recommendation is made.

Our goal is reasonably estimate an investor's compensable losses, if any, in a way that is as accurate and fair as possible and that minimizes '20/20' hindsight. For example, we specifically focus our calculations on unsuitable investments to minimize interference with the advisor's suitable recommendations. We always use historical data for the relevant time frame for our suitability assessments and suitable performance comparisons (also referred to as 'notional portfolios') so our assessments are made on the information that pertained at the time. Our methodology also contemplates a range of options, some of which involve using suitable performance comparisons and some of which do not.

PROCESS OVERVIEW

Step 1 – KYC Determination

Documents, such as KYC forms, are central to our investigation. However, in many suitability complaints, the investor complains that their KYC information was not accurately recorded, that they did not understand the KYC forms they signed, and/or that their advisor did not review the KYC forms or explain their significance. Therefore, we often need to collect and consider additional evidence by interviewing the parties and conducting research to determine if the KYC forms reflect the investor's actual KYC information during the period of time in question.

Step 2 – Suitability Analysis

We analyze the investments and strategies recommended by the advisor to determine if they were suitable for the investor based on their KYC information. If the investments were suitable, we will not recommend that the firm compensate the investor, even if the investor has incurred losses. The advisor's responsibility is to recommend suitable investments, not to guarantee performance. If we find the investments were unsuitable, we move on to determine if the investor incurred financial harm as a result.

Step 3 – Determining Financial Harm and Compensation

In most instances, we will compare the performance of the investor's unsuitable investments to the performance of common indices. However, if the circumstances warrant it, we have several other options for calculating whether an investor incurred financial harm as a result of unsuitable investments. If we determine that the investor did not incur financial harm, we conclude our investigation by explaining to the investor and the firm why we believe no compensation is warranted. If we determine that the investor incurred 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.

STEP 1 – KYC DETERMINATION

A. Review of Documents

The first step in our investigation is to examine all relevant documents, which typically include but are not limited to:

- new account application forms, and any updates;
- supplementary KYC collection documents, and any updates;
- financial plans and investment policy statements;
- disclosure documents signed by the investor and/or provided to the investor by the advisor;
- any other documents signed by and/or provided to the investor before, at the time, or after the advisor recommended that the investor buy, sell or hold an investment in their accounts;
- any documents or information relied on by the advisor in formulating their recommendation to the investor;
- the investor's account statements;
- any contemporaneous notes taken by the investor and advisor during the course of their relationship;
- any correspondence exchanged between the investor and advisor during the course of their relationship; and
- the firm's internal investigation file.

KEY PRINCIPLE

When reviewing KYC forms and other relevant documents, whether signed or not, we will consider when and how they were completed, whether copies were provided to the investor, and whether the wording on the documents is clear and expressed in terms that the investor was likely to understand.

B. Interviews

Interviews are a continuation of the evidence collection process. We are aware that the recollection of past conversations and events may be affected by the passage of time and the parties' self-interest, and we take this into account during our investigations. Nevertheless, such interviews often provide additional important information that needs to be considered to accurately assess the circumstances. We interview the investor, the advisor where possible[2], and other relevant individuals at the firm such as the branch manager and compliance officers, who may have information relevant to the complaint. The topics we discuss may include but are not limited to:

- the recorded KYC information and the process used to collect and discuss it;
- any documents or information that appear to support or contradict recorded KYC information;
- the investor's personal and financial circumstances, including their employment status and background, family circumstances, income, net worth, and how these circumstances may have changed over time;
- the investor's investment experience and knowledge;
- the investor's financial goals and objectives, liquidity requirements and time horizon for the investments in question;
- the investor's willingness and ability to take risks and bear losses;
- the advisor's recommendations and the reasons for them, the information the advisor relied on when making the recommendations, and the discussions the advisor had with the investor about the recommendations; and
- the information the advisor provided to the investor and the investor's understanding of it.

[2] We are sometimes unable to interview the advisor because they are no longer registered in the investment industry.

C. Other Evidence

When investors and advisors have conflicting recollections about their discussions, it may be necessary for us to collect and consider additional information. This may include reviewing and asking questions about previous or other investment account statements, employment, income tax and other financial statements. We may also interview third parties, such as previous or current investment advisors or other professionals who provided financial services to the investor and had knowledge of the investor's KYC information, or individuals who attended meetings between the investor and the advisor.

D. Reaching a Conclusion

In some cases, the evidence supports the documented KYC information. In other cases, the evidence indicates that the investor's actual KYC information was different from what was documented.

We note that an investor's KYC information may change over time. In some cases, the evidence may indicate that an investor has more than one set of investment objectives and risk tolerance parameters over the relevant time frame.

The determination of the investor's KYC information informs Step 2 of our process: an analysis of the suitability of the investor's investments and strategies.

STEP 2 – SUITABILITY ANALYSIS

When assessing suitability, we determine the risks and characteristics of the investor's investments and strategies at the time they were recommended and at appropriate intervals, and compare them to the investor's KYC information. Investments and strategies are suitable when they are consistent with the investor's KYC information.

KEY PRINCIPLE

Investment performance is not relevant to a suitability assessment. The fact that an investment has declined in value does not necessarily mean it's unsuitable. Similarly, an investment that has performed well is not necessarily suitable.

A. Determining Investment Characteristics and Risks

We consider the investment advisor's or firm's analysis, particularly any analysis conducted at the time of the recommendations, and the information they relied on in their assessment. In addition, we consider the firm's policies, procedures and guidelines for assessing securities, portfolios or strategies that were in effect at the time recommendations were made. We also consider the firm's definitions and security ratings, if any. Finally, we take into consideration any relevant regulatory guidance on specific investments and strategies.

In most cases, we also conduct an independent assessment of each security's characteristics and risk level at the time of the recommendations. We assess the profile of the account including such factors as its diversification and asset allocation as well as the complexity and risks of any accompanying strategy such as active trading strategies or the use of margin or leverage. Furthermore, we consider how the risks of a security or account may have evolved over time given changes to a security issuer's circumstances, and/or economic or market developments.

Example

Consider an investor with a medium risk tolerance whose account includes low-, medium-, and high-risk investments. We may find the high-risk investments exceeded the investor's risk tolerance.

While investments of different types can be combined to reduce the overall risk of an account, it's not a given that low-risk investments "offset" the risk of high-risk investments. If an advisor says they used a portfolio approach to achieve a medium risk level, we would ask to see supporting documents (such as an asset allocation plan) to show that the combination of investments at various risk levels was in keeping with the investor's medium risk tolerance. We would also ask whether the advisor explained to the investor that the account could contain some high-risk investments and that the investor was aware of – and understood – the implications.

With very few exceptions, when assessing mutual funds, we use the investment objectives, investment strategies (including the asset allocation), and risk ratings published in the mutual fund company's simplified prospectus.

For other types of securities, we review offering documents, annual reports, marketing materials, and any other relevant publications or information, and consider factors such as:

- the type of issuer, its size, industry sector and the nature of its business;
- the issuer's history, dividend or interest payment record, financial situation, and how it compares to other industry participants;
- any special characteristics or features of the security;
- the security's investment objective, underlying investments, projected returns, if any;
- the qualification of the issuer's management, its track record, and counterparty risk;
- issuer or third-party risk ratings and any available analyst reports;
- the costs of the security and the currency in which the security was purchased;
- relevant news releases, corporate, market, social or economic events;
- trading history, liquidity, price volatility; and
- risk measures such as beta and standard deviation.

We understand that an investment account may not always be exactly aligned with the investor's investment objective and risk tolerance parameters, and we will consider the cause (such as changing market values) as well as the degree and duration of any deviation.

B. Disclosure Doesn't Validate an Unsuitable Recommendation

Disclosing the risks and characteristics of a recommended investment or strategy is a key element of an investment advisor's and firm's responsibilities. However, disclosing information or providing investment literature does not override the advisor's obligation to recommend investments that are suitable for the investor. In other words, disclosure does not make an investment or strategy suitable if it's otherwise mismatched with the investor's objectives and risk tolerance.

KEY PRINCIPLE

Investors should be able to rely on their advisor and firm to make suitable investment recommendations without having to verify their suitability. However, we will consider an investor's level of investment knowledge and sophistication and their ability to make an informed assessment about their advisor's recommendations.

C. Making a Suitability Determination

If the evidence indicates that the investor's investments and/or strategies were suitable given their KYC information, then we will conclude our investigation and communicate our reasons to the investor and firm. In these circumstances, we would not move on to assess the investor's loss because the advisor is only responsible for recommending suitable investments and cannot guarantee the performance of any investment that involves risk.

If we determine that the investments and/or strategies were unsuitable for the investor, we then move to Step 3 of our suitability and loss assessment process: determining financial harm and compensation, if any.

STEP 3 – DETERMINING FINANCIAL HARM AND COMPENSATION

In cases where we conclude that the investments and/or strategies were unsuitable for the investor, we then determine what financial harm the investor suffered and what amount, if any, we believe the firm should compensate the investor.

KEY PRINCIPLE

If the investments and/or strategies the advisor recommended were unsuitable for the investor, we typically calculate the performance of the unsuitable investments and then the position the investor would have been in had they been suitably invested. If the investor's actual unsuitable investments performed worse than suitable investments would have, the difference is the investor's financial harm. Where the investor incurs financial harm, we determine whether the investor should bear some responsibility for the harm before making a final determination regarding the amount we believe the firm should compensate the investor.

Examples of Financial Harm Calculations

- If an investor lost $10,000 as a result of unsuitable investments, but would have lost only $6,000 on suitable investments, the investor's financial harm would be $4,000.
- If an investor lost $10,000 as a result of unsuitable investments, but would have gained $3,000 on suitable investments, the investor's financial harm would be $13,000.
- If an investor gained $10,000 as a result of unsuitable investments, but would have gained $15,000 on suitable investments, the investor's financial harm would be $5,000.
- If an investor lost $10,000 as a result of unsuitable investments, but would have lost $15,000 on suitable investments, the investor did not suffer financial harm.
- If an investor gained $10,000 as a result of unsuitable investments, but would have gained only $2,000 on suitable investments, the investor did not suffer financial harm.

A. Calculating Actual Investment Performance

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.

B. Suitable Performance Comparison

In most cases, to determine financial harm we compare the performance of the investor's unsuitable investments to the performance of common indices. In our calculations, we consider the timing of purchases, sells, deposits, withdrawals, and any applicable transaction fees or other costs.

The most frequently-used indices for our suitable performance comparisons are the following:

Asset Type / Objective	Risk Level	Index
Equity / Growth	Medium	Canada – S&P TSX Composite U.S. – S&P 500 Global – MSCI World 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

We take fees and trading costs into account in all instances of suitable performance comparisons. We will deduct total external fees and costs, like commissions, from both the actual unsuitable investment performance and suitable benchmark performance unless such costs would be unreasonable. We will also deduct embedded costs, like the appropriate mutual fund expense rate, from index benchmark performance.

In some limited circumstances, there are alternative approaches that we may take if the particular facts and circumstances of the case warrant it:

- *Previously held investments:* An investor may have been suitably invested until the advisor made an unsuitable recommendation. If we have reason to believe that the investor would have otherwise kept their original investments, we may calculate how the original investments would have performed if the investor had kept them, and compare the results to the actual performance of the unsuitable investments.

Example

Consider an investor who had been holding a 5-year Government of Canada bond ladder before the unsuitable recommendation. If we believe the investor would have continued to reinvest in 5-year Government of Canada bonds as each bond matured, we may calculate how the investor's previous bond portfolio would have performed, accounting for changing rates at each maturity date over the relevant time frame, and compare the result to the performance of the unsuitable investments to determine if there was any financial harm.

Other investments: If it's clear that the investor would have made a change to their investments, we may select other investments as suitable performance benchmarks to compare against the performance of the investor's actual unsuitable investments, carefully evaluating how the investor would have most likely invested. For example, if appropriate and possible, we might use as a benchmark actual suitable investments that were recommended to the investor by the advisor. If that's not possible or practical in the circumstances (for example, if using the investor's actual suitable investments would raise concentration issues), we may use other securities to represent the suitable investments.

C. Interest

If we cannot reasonably determine how an investor would have been suitably invested and a common index is not an appropriate benchmark, we may simply calculate interest at a reasonable rate on the amount invested.

Example

If the advisor recommended an unsuitable options strategy and the investor opened a new account with the firm only for that purpose, it would be difficult for us to determine how the investor would have otherwise invested. In this case, we may simply recommend the firm compensate the investor for their investment losses, if any, plus interest calculated using 90-day Canadian Treasury Bill rates.

D. Just Actual Losses

In some cases, we may find that an investor would not have made an investment if not for the advisor's unsuitable recommendation. In these cases, the investor is unlikely to have held any investments at all, so a performance comparison is unnecessary. In these circumstances, the actual losses incurred by the investor, if any, are the financial harm.

Example

Consider a situation where an advisor recommended an unsuitable leverage strategy and the investor borrowed $100,000 to invest. The investor would not have invested the $100,000 if the advisor had not recommended the strategy. Therefore, we don't compare the actual investment performance to a suitable alternative. Rather, if we calculate the investor lost $29,000 on the investments and they paid $7,500 in interest on the loan, their financial harm would be the sum of their losses and costs, or $36,500.

E. Investor Responsibility

We will consider whether or to what extent the investor should be held responsible for any financial harm incurred. In making this assessment, we consider 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 the decision to buy, sell or hold the unsuitable investment(s) was recommended by their advisor, or was initiated by the investor, and the extent of the discussions between them;
- 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;
- whether the investor ratified a purchase by continuing to hold an unsuitable investment after they knew it was not suitable; and
- any other actions the investor could have or should have taken to prevent or limit losses, taking into account the complexity or costs of such actions.

KEY PRINCIPLE

Firms and advisors are responsible for the financial harm caused by unsuitable recommendations. However, their responsibility for any financial harm incurred by an investor may end when the investor knew or should have known of the problem and was in a position to limit the losses incurred (see *Mitigating Losses* below). In some cases, the firm's responsibility for financial harm may be reduced to reflect how the investor contributed to the financial harm they incurred (see *Apportioning Financial Harm* below).

Apportioning Financial Harm

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.

Example

An advisor recommends a mutual fund to an investor and purchases it for the investor on a seven-year deferred sales charge (DSC) basis without disclosing or discussing the DSC implications or discussing other sales charge options. If the investor had a three-year investment time horizon, the DSC-based investment is not suitable. However, if the investor had previously purchased DSC mutual funds and knew of the implications of early redemptions, we may expect the investor to have objected or questioned the advisor about the DSC or other sales charge options. If the investor was equipped to ask or object but did not, we may apportion partial responsibility to the investor for the DSC fees they incurred, reducing the amount of compensation the firm should pay to the investor accordingly.

Mitigating Losses

We will consider whether there was a point in time when the investor became aware or should have become aware that an investment, portfolio or strategy was problematic and/or should have taken action to limit losses. If so, we consider:

- whether the investor raised their concerns with the advisor or firm and what advice they received;
- when the investor was in a position to take steps to limit financial harm; and
- what steps they took, if any, to mitigate the financial harm.

In some situations, we may determine that the investor did not know of the problem and/or was not in a position to limit their financial harm. In other cases, we may find an investor either knew or should have known there was a problem, even if they could not specifically characterize or describe it, and at a certain point in time (which we refer to as the mitigation date) should have taken steps to limit financial harm. In this situation, we will calculate financial harm up to the mitigation date and recommend the lesser of the financial harm up to the mitigation date or the date the investor sells their investments or transfers their portfolio to another firm.

Identifying a date when investors were in a position to mitigate their losses represents an important component of our determination of investor responsibility and the subsequent calculation of compensable losses.

Example

Consider an investor who has a growth objective and a medium risk tolerance, knows there will be some fluctuation in the value of their investments, but otherwise has limited investment knowledge. If the advisor recommends high-risk investments, the investor may not be able to differentiate these investments from medium-risk investments. In this scenario, we may determine that the firm should compensate the investor for all of the financial harm caused by the unsuitable investments.

If the investor becomes concerned about the degree of fluctuations they see in their account, and raises concern with the advisor who assures them that the investments are suitable, the firm will typically remain responsible for the financial harm the unsuitable investments caused.

However, if the degree of fluctuation is so great that it causes or should have caused the investor to question the advisor's assurance (for example, by seeking another opinion or otherwise checking into the suitability of their investments), we may determine that at a certain point in time (i.e. the mitigation date) the investor should have done something about the unsuitable investments and the investor should not be compensated for financial harm incurred after the mitigation date.

In some cases, we may determine that both mitigation and apportionment should apply.

F. Final Compensation Assessment

Using the above steps, we will determine what amount, if any, we believe the firm should compensate the investor.

In some cases we may recommend that the firm also pay the investor interest on the compensable losses we have calculated. As a general rule, we will 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. For example, if the investor complained in a timely manner, but it took our involvement and an undue period for the complaint to finally be resolved, we may include interest on the compensable losses from the date of the complaint to the date it's resolved based on the average 90-day Canadian Treasury Bill rate over the time frame.

During our investigation we will make our analysis and loss calculation spreadsheets available to either the firm or complainant if they request it.

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