Small Investor Protection Association

A Voice for the Small Investor

Comments on Proposed Amendments to IDA Complaint Handling Requirements

Client Complaint Handling Rule & Guidance Note and Amendments to By-Laws 19 and 37 and Policy No. 2

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Submitted by email to

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- AND -

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21 December 2007

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EXECUTIVE SUMMARY

I am pleased to submit comments on the amendments proposed by the Investment Dealers Association of Canada (IDA) to its Complaint Handling Requirements on behalf of the Small Investor Protection Association (SIPA).

In his recent address at Dialogue with the OSC 2007, OSC Chair, David Wilson, commented that *"enormous responsibility"* had been delegated to the IDA and the MFDA, as the frontline self-regulatory organizations, which oversee intermediary securities firms and their registered representatives. In the present instance, this responsibility is exercised by the IDA in its rule-making function through which it regulates the complaint handling practices of its Member firms in order *"to ensure the fair and prompt handling of client complaints."*

The present amendments take some steps in the direction of realizing this goal, especially with regard to timeliness and the provision of information to investors about the complaint process itself and their options for seeking restitution. While these are welcome developments, the present amendments do not go far enough towards ensuring the fairness of outcomes in the internal complaint process at IDA Member firms.

The main stated purpose of the present proposal is to *"promote the protection of investors, just and equitable principles of trade and high standards of operations, business conduct and ethics."*

To 'protect' means to defend or guard from injury, take care of, keep safe. 'Protection' thus implies 'protection from harm', which therefore also implies exposure to harm. In view of this, the implementation of investor protection measures in the dealer complaint process must be premised on a consideration of the risks and vulnerabilities to which investors are exposed. This is an essential aspect of the 'logic' of protection. The proposed amendments do not appear to reflect a sufficient awareness of these risks and vulnerabilities. I have appended several papers where I analyze these issues in detail.

Another aspect of protection is effective enforcement. There is no reference to enforcement in the current amendments. This raises concerns about the effectiveness of the new requirements in ensuring the fair and prompt handling of client complaints by IDA Member firms. A significant concern of SIPA is that while a number of the proposed amendments appear reasonable, the implication for failing to follow the requirements is unclear. Regulatory initiatives such as the present IDA proposal tend to create the impression that industry is well-regulated and that investors are protected. Nevertheless, the mere promulgation of rules and policies is insufficient to ensure fair dealing. As OSC Chair, David Wilson, stated in his November 2006 address at Dialogue with the OSC:

> *"You can have the best policies and the best regulations in the world,*
> *but if you don't enforce them effectively, they don't mean a damn thing."*

1. RELEVANT HISTORY / CONSULTATION

Relevant history

The "Relevant history" section of the amendments (II.A) notes that the present proposal is being introduced in response to concerns expressed by investors at the OSC Investor Town Hall in May 2005. Nevertheless, there have ongoing reports of investors experiencing difficulties in the restitution process for the past several years. At the 2005 Town Hall, former OSC Chair, David Brown, referred back to the hearings conducted by the Ontario legislature's Standing Committee on Finance and Economic Affairs in August 2004. He commented that testimony received by the Committee underscored the need for regulators to make it a greater priority to assist investors in obtaining restitution *"when they have been badly dealt with by the system."*

Prior to this, the OSC's Regulatory Burden Task Force heard complaints about the difficulties experienced by investors in obtaining fair and timely redress. The Task Force report was published in December 2003, but reflects input received during the 2001-02 period. The SIPA Five Year Review, published two months later, in February 2004 (link following), contains anecdotal reports of difficulties faced by investors in the complaint process going back to late 1990s. I would encourage the IDA to review the SIPA report, especially chapter 7 on Dispute Resolution.

www.sipa.ca/library/Documents/SIPA_Report_20040227.pdf

Although the OSC's Regulatory Burden Task Force did not address issues in connection with the dealer complaint process, it identified concerns relating to the IDA's arbitration program (pp. 18-19, link following). The reforms proposed by the Task Force would have helped to level the playing field for investors using the arbitration procedure, however, the recommended changes were never made.

http://www.osc.gov.on.ca/About/Governance/Accountability/ga_20031212_rbtf-rpt.pdf

With regard to the dealer complaint process, the IDA would have had occasion to discover problems involving delay and unfair decisions in the context of its regulatory reviews of client complaints. In August 2003, I asked an IDA Complaints Inquiries officer how often it happens that the IDA discovers evidence of wrong doing when the firm's compliance officer has said there is none—i.e. when the firm has communicated a *"no evidence of any wrong doing"* decision to the client in its final response. I was informed that with the complaints that proceed to the investigation stage, this is found *"very frequently".* My further discussions with dispute resolution professionals suggest a troubling incidence of the denial of meritorious complaints by investment firms. Also, in the past two years, the OBSI has overturned 50% of decisions by firms in its investment cases.

There are serious issues here that relate to fair dealing and investor protection. As mentioned above, an appreciation of these issues involves understanding the risks and vulnerabilities that affect investors in the dealer complaint process.

Consultation / Harmonization

If one takes into account the communications which have occurred over the past several years, either by investors directly or investor advocates, including SIPA, then in some sense there has been a process of consultation with the public about the present issue.

In November 2005, the Ontario Securities Commission announced the Investor Advisory Committee as one of its post-Town Hall initiatives, on which I have served for the past two years. One of the main purposes of the Committee was to provide advice and recommendations to the OSC on issues affecting the retail investor. The complaints process was identified as a key issue for examination by the Committee in the OSC's 2007 Annual Report.

It is clear from the submissions of other respondents to the present proposal that IDA Member firms have had the opportunity to provide input to the IDA regarding the current amendments. One respondent suggests that it might be of value *"for all participants involved in this dialogue to undertake a collaborative and holistic review of this issue."* This is an interesting suggestion, although any such review should include retail investors or those who represent their interests.

Another reason for considering such a collaborative discussion relates to the evident need for "harmonization". Several respondents to the present proposal, as well as myself, have noted differences between the IDA and MFDA complaint policy amendments and the consequent need to "harmonize" the two policies. The Canadian regulatory landscape is already affected by significant fragmentation involving 13 provincial/territorial Commissions, which reduces efficiency. It is problematic to find this also at the SRO level in the present case—with the consequent need for "harmonization" to deal with different regulatory approaches and perspectives. Nevertheless, this may present an opportunity for wider consultation and collaboration, with the proviso that retail investors should be included in the consultation process.

2. COMPLAINTS OFFICER / COMPLAINT PROCEDURES / 90-DAY TIMELINE

Designated complaints officer

The IDA is proposing that its Members should appoint an individual to act as a designated complaints officer (DCO) who will "oversee" and "manage" the firm's complaint handling process and act as a liaison with the IDA. Regarding the role and function of this individual, it needs to be kept in mind that the primary objective of the firm's complaint process is to resolve the client's complaint in a prompt and fair manner. An individual charged with exercising oversight of the realization of this goal by the firm's complaint personnel should receive specialized training in dispute resolution and ethics with the relevant certification. This requirement would help to secure one of the main purposes of the present proposal, which is to *"promote the protection of investors, just and equitable principles of trade and high standards of operations, business conduct and ethics."*

Complaint procedures / standards

The proposed rule would require firms to have *"written procedures to ensure that complaints are dealt with effectively, fairly and expeditiously."* It needs to be clarified whether the IDA will undertake to review and approve firms' complaint handling procedures and standards. With reference again to the above purpose of the current proposal: to *"promote the protection of investors, just and equitable principles of trade and high standards of operations, business conduct and ethics"*—this purpose will only be securely realized if the IDA undertakes to review and approve the complaint procedures and standards of its Member firms.

Complaint acknowledgement letter / 90-day timeline

The new rule states that a written explanation of the Member's complaint handling procedure and a copy of the IDA complaint process brochure is to be provided to the client at the time of account opening. The acknowledgement letter, sent to the client within five business days of receipt of a complaint, is to include reference (in the body of the letter) to the enclosed IDA brochure, the statutes of limitations in the brochure, and the 90-day timeline for the firm to provide a substantive response to the complaint.

Two points regarding the reference in the letter to the 90-day timeline.

It needs to be clarified that 90 days means 12 weeks (about 3 months), not 90 business days, which would be 18 weeks (about 4½ months). The timeline should be provided in weeks to avoid ambiguity with 'business days'.

The IDA proposal reviews the current timeframe provisions in the UK. The UK time limits are shorter as the firm must provide a final response within 8 weeks (2 months) at which point the complainant has the right to escalate their complaint to the Financial Ombudsman Service. The IDA is proposing a 90-day timeline for the firm to provide a final response to the complaint. Assuming this means 12 weeks, what is the reason for the longer timeline relative to the UK? In any case, the timeline in Canada should not be longer than 12 weeks.

In the acknowledgement letter, the client should not only be made aware of the statute of limitations, but also their right to access alternative dispute resolution procedures at the end of the 90-day period, irrespective of whether the firm has provided a final response. This also should be clearly stated in the IDA's complaint brochure.

The issue of when and how clients are provided with information about dispute resolution alternatives, and OBSI in particular, is considered in the independent review of OBSI by Navigator, posted at the OBSI website. The authors report finding that *"many [firms], as a matter of policy, do not make their customers aware of the existence of [OBSI] – until all internal avenues have been exhausted"* (p. 20). The report notes the importance of clients being informed about their right to escalate unresolved complaints to OBSI when they open a new account, when their complaint is first acknowledged, and again at the conclusion of the internal complaint process. The comments in section 6.6 on 'Participating firm referral' are relevant here.

Optional nature of internal ombudsman process offered by Member affiliate

A significant change in the current system is proposed in that clients would have the right to access alternative dispute resolution options after 90 days (assuming this means 12 weeks). In this context, the amendments propose to make optional the internal ombudsman review offered by an affiliate of the Member. SIPA agrees with this proposal as it would help to protect the investor's right to initiate civil action, which now must occur within a reduced two-year period in Ontario.

3. COMPLAINT SUBSTANTIVE RESPONSE LETTER

Requirement for a "Substantive" Response by the Firm

The undefined and indeterminate nature of the requirement for a "substantive" response is a significant concern from an investor protection standpoint. Moreover, it appears there may be a conflict of interest regarding this issue between firms and clients. In the present section, I will attempt to specify this more exactly and will identify the underlying principle, which has a bearing on the issue. My discussion is premised on the analysis of transparency in communications, discussed in the appended papers.

The word "substantive" is not defined in the amendments. What constitutes a "substantive" response, in contrast to one that fails in this regard? The lack of any further specification makes both the fulfillment of the requirement as well as its failure difficult to determine. An arbitrary element is thereby introduced, which has significant implications with regard to enforcement and investor protection.

To make clear the problematic nature of the issue, consider the following example. A poetry contest for longer compositions is announced. The only stated requirement in terms of the length of submissions is that poems should be "substantive." The question arises, what is the minimum qualifying length for entries: is it 300 lines? 600 lines? 900 lines? If "substantive" is not given further specification, it would be impossible to determine with any assurance, which poems qualified as entries and which did not. The requirement would thus be unenforceable or its enforcement would involve arbitrary decisions that could well be unfair to one or another of the entrants. One can see here how the lack of specificity in the formulation of the requirement contains the potential for arbitrariness and unfairness.

In my view, the proposed requirement for a "substantive" response contains an analogous deficiency. Nevertheless, I am not suggesting that the remedy for this deficiency should involve a quantitative specification as in the above example. The main purpose of my present remarks is to analyze the issue and indicate its implications for investor protection.

Regarding dealer/client conflict of interest on this issue, the MFDA policy amendments also proposed the requirement for a "substantive" response letter. Among the comments received by the MFDA, one firm objected that that in the event of litigation or even anticipated litigation. *"It is unfair to require members to make admissions in the complaint process that may cause prejudice in litigation."* One response to the present proposal makes a similar point.

In my own experience with the dealer complaint process (now resolved), it was explained at one point that the brevity of the firm's written responses may have been the result of respondents exercising caution so as not to prejudice themselves in the event the complaint later found its way into civil litigation.

In view of this, it appears there is a conflict of interest based on the fact that the client needs to make a properly informed decision whether or not to accept the firm's decision (which also involves consideration of whether the decision is accurate and fair). On the other hand, firms evidently have an interest in reticence relative to potential litigation. Nevertheless, this reticence may prejudice the client's ability to make a reasonable decision at the outcome of the complaint process.

A related issue concerns the fact that clients may unknowingly prejudice themselves in the context of bringing forward a written complaint. Discussions with dispute resolution professionals have confirmed that this occurs. Consideration should be given to including a disclaimer in the IDA brochure that clients should exercise caution, given that their written communications with the firm in the context of the complaint process may be prejudicial if they later proceed to litigation. One problem, however, is that by the time the client receives the IDA brochure in the firm's acknowledgement letter, they will already have come forward with a written complaint letter. This is another risk and vulnerability for clients who try to negotiate the dealer complaint process without counsel.

The investor protection issue that is in question here needs to be considered in relation to more fundamental principles. The concept of a principle-based approach in securities regulation is well understood by this point. A relevant instance of a more general principle in connection with the present issue would be the following:

> *A firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading.*

This is principle 7 from the 11 Principles of Business conduct endorsed by the UK's Financial Services Authority (as discussed in the Finance Canada paper, *"Creating a Canadian Advantage in Global Capital Markets,"* March 2007). Evidently a principle of this nature could be implemented in a variety of business contexts. It is not tied to particular kinds of transactions or dealings.

The relationship between the provision of information and investor protection is explicitly recognized by the International Organization of Securities Commissions (IOSCO) in its paper, *"Objectives and Principles of Securities Regulation,"* (May 2003):

> *Full disclosure of information material to investors' decisions is the most important means for ensuring investor protection. Investors are, thereby, better able to assess the potential risks and rewards of their investments and, thus, to protect their own interests.* (p. 5)

This way of formulating the disclosure principle relates it to its objective—investor protection. The obligation of the regulator to ensure disclosure was indicated by OSC Chair, David Wilson, in his remarks to the Economic Club of Toronto in April 2007:

> *Ours is a disclosure-based regime. The regulators' commitment to investors is: You are entitled to all the relevant facts.*

An example of the implementation of disclosure in regulatory policy would be Proposed Framework 81-406—the point of sale disclosure for mutual funds and segregated funds (link following). The introductory discussion on pp. 1-8 makes evident that disclosure is functioning here in relation to the investor's decision-making process.

http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20070615_81406-pos_en.pdf

If someone is going to be able to make a properly informed investment decision, the requisite information needs to be provided in advance of the decision being made—so that the decision will be properly grounded. This allows the client to make choices in a manner that is not prejudicial to the client's interests. Obviously, incomplete information increases the risk of detrimental decisions.

In the context of the internal complaint process, the mere fact that the client is free to accept or reject the firm's proposed resolution (or the firm's denial of their complaint) is meaningless if the client is not in a position to make a properly informed decision.

If the disclosure/investor protection principle is applied in the present instance, there would seem to be an obligation on the part of the service provider to put the client in the position of being able to make a properly informed decision—whether this relates to investment products or dispute resolution 'products' (see my application of consumer theory to the dealer complaint process in Appendix II).

The client also needs to be provided with information to make a properly informed decision at the outcome of the complaint process. This is not simply a matter of making the client aware of dispute resolution alternatives, although this is one component of relevant information. The most immediate decision facing the client at the end of the internal complaint process is whether or not to accept firm's proposed resolution (or denial).

In my view, the mere provision that the final response letter should be "substantive" and that it should include an "explanation" of the final decision does not sufficiently specify the nature and extent of the information to be provided. For example, many complaints are about suitability of investments. What are the criteria that relate to the consideration of whether an investment is suitable? If there is no disclosure or incomplete disclosure of these criteria in the firm's response letter, then the client will not be in a position to verify whether the firm has considered their complaint in an accurate and fair manner.

In my view, the proposed amendment—that the firm should provide a "substantive" response letter with an "explanation" of the final decision—does not mandate the requisite disclosure in support of the client's decision at the end of the complaint process. As a consequence, it does not provide the necessary protection to ensure fair dealing.

To test this, one could take the term "substantive" and translate it back into an investment context. Imagine that the point of sale disclosure framework was reduced to the mere requirement that mutual funds should make a "substantive" disclosure of information to investors.

4. SUMMARY

The following are the main issues referenced in the present submission.

1. A 'Designated Complaints Officer' if implemented should receive specialized training in dispute resolution and ethics with relevant certification.

2. The IDA should review and approve the complaint handling procedures and standards of its Member firms.

3. The specification of a 90-day timeline needs to be clarified. Weeks should be used instead of days to avoid confusion with 'business days'. The timeline should be 12 weeks.

4. In the acknowledgement letter, the client should be made aware of their right to access alternative dispute resolution procedures, including the OBSI, at the end of the 90-day period. This also should be clearly stated in the IDA's complaint brochure.

5. The internal ombudsman review offered by an affiliate of the Member should be optional as proposed.

6. The requirement that the firm should provide a "substantive" response letter and an "explanation" of their final decision needs considerable clarification in relation to the investor protection issues raised in my present submission.

7. Clients without counsel need to exercise caution in the dealer complaint process in the event their complaint later makes it way to litigation. The IDA should consider including a disclaimer about this in their brochure.

8. The enforcement implications for the failure to comply with the new requirements needs clarification. Otherwise how effective will the new provisions be in ensuring the fair and prompt handling of client complaints?

9. The further process of considering the proposed amendments should include consultation with SIPA and the OSC's Investor Advisory Committee.

APPENDIX I

The Fair Dealing Model of the Ontario Securities Commission and the Internal Complaint Process at Financial Service Providers

Pamela J. Reeve, Ph.D.

9 August 2004

The following paper (with minor amendments) was submitted to the Ontario Securities Commission in response to Request for Comment Notice #33-901 on *"The Fair Dealing Model: Concept Paper of the Ontario Securities Commission—January 2004."* The original version of the paper is posted at www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part3/Comments/33-901/com_20040809_33-901_pjreeve.pdf and www.sipa.ca/library/Documents/OSC-FDM-Reeve_040809.pdf

EXECUTIVE SUMMARY

The aim of the OSC's Fair Dealing Model (FDM) is to reform the way the retail investment industry is regulated, recognizing that a shift has occurred to an advice-based business model. In view of this, the regulatory focus in the FDM is the client/representative relationship rather than investment products and transactions. The FDM concept paper identifies three principles of fair dealing in its relationship-based approach:

1. Roles and responsibilities should be clearly allocated
2. All dealings between service providers and clients should be transparent
3. Any conflicts of interest should be managed to avoid self-serving outcomes

In the FDM concept paper, the principles of fair dealing are applied only to business relationships involving investment advice. Nevertheless, a client/representative relationship also occurs in the internal complaint process where an investor's complaint is reviewed by the firm's compliance officer or internal ombudsman. Considerations of fair dealing also apply to this relationship. The firm is providing a service, which has the aim of resolving the client's complaint. A financial transaction (redress) may be part of the outcome of such a review. At the conclusion of the process, the client must decide whether or not to accept the firm's decision and the compensation offered, if any.

In the present paper, I apply the principles of the Fair Dealing Model theory to the internal complaint process and discover significant problems involving the fundamentals of fair dealing, most notably, the presence of potential *conflict of interest* together with *lack of transparency* in communications. Moreover, these problems occur in a relationship where there is a significant imbalance in knowledge and power in favour of the firm.

The client may be unaware of the merit of their complaint, especially if it involves a complex issue such as suitability of investments. It has been recognized that there is a relatively low level of financial literacy among Canadian investors. Moreover, typically, the client will not be informed about applicable rules, regulations and standards of professional conduct. Nor does the firm provide this information in its written decision.

The client may be unaware of the adversarial nature of the situation and may rely on the firm's decision believing it has been reached through an independent and impartial investigation. Indeed, the firm may represent its complaint process in these terms. Nevertheless, opaqueness in the firm's response and the deficit in the client's financial understanding will significantly impede the client's ability to determine whether the firm's response is accurate and fair, creating a hazardous situation. At the outcome of the firm's review the client may be faced with the prospect of having to make a decision involving large sums of money. There are risks associated with such decisions just as there are risks associated with investment decisions. The regulators have an obligation to identify and mitigate these risks to protect the interests of the investing public.

9 August 2004

Mr. John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
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Toronto, ON M5H 3S8
Submitted by email to: jstevenson@osc.gov.on.ca

Dear Mr. Stevenson:

I appreciate the opportunity to submit comments on the Fair Dealing Model of the Ontario Securities Commission.

¶1. My overall impression is that the Fair Dealing Model makes a positive contribution to promoting fairness in business dealings in the investment industry—especially in its focus on relationships and in its more nuanced consideration of 'transparency'. The broadening of this concept allows consideration to be given to how decisions are made and how information is provided to the client in support of these decisions.

¶2. As an academic (in philosophy), I appreciate the systematic approach taken by the Fair Dealing Model in the way it determines the fairness of business conduct. A potential difficulty addressed by the model is that fairness is a higher order value or formal quality of judgments and conduct, rather than a measurable quantity or fact. In my view, the FDM takes the right approach in considering fairness relative to more concrete aspects of the relationships in question, such as responsibility for decisions, degree of reliance on the part of the client, transparency of communications, and conflict management. These fundamental elements (the core principles of the model) function as co-factors, which allow fairness (and correlatively unfairness) to be determined in an objective manner.

¶3. The Request for Comment notice indicates that the present concept paper, containing business conduct standards, is the first component of the Fair Dealing Model. My understanding is that these standards are designed to regulate relationships between clients and representatives relative to considerations of fairness—and, therefore, relative to the factors mentioned above. If these factors are impaired in a certain relationship, for example, if there was unmanaged conflict of interest, as well as lack of transparency in communications, then fair dealing would be questionable in that relationship.

¶4. The primary focus of the concept paper is the client/representative relationship at the investment level. Nevertheless, certain additional services are also provided by firms. In the case of a dispute arising at the investment level, a new relationship is formed—between the client and the firm's Compliance Officer. In some instances, where a client cannot accept the decision of the Compliance Officer, there is a further internal review by the firm's Ombudsman.

¶5. My comments on the Fair Dealing Model will consist of an analysis, within the framework of the model itself, of the client/representative relationship that occurs in the context of internal account reviews. In the event of a dispute between a client and his or her investment adviser, the firm's Compliance Department conducts a review to determine whether there has been wrong doing with regard to the adviser's handling of the client's accounts. The main consideration in my present analysis is whether the client/representative relationship in this context is objectively impaired relative to the factors that constitute fair dealing.

¶6. While this kind of relationship also falls within the scope of a model designed to regulate the business conduct of financial service providers, the Fair Dealing Model does not address relationships at this level in the current paper. Consideration of this relationship from a regulatory standpoint would seem especially important if the following factors were found to be present: a high degree of reliance on the part of the client, perhaps even at the fiduciary level, together with conflict of interest and lack of transparency in communications. These factors, however, need to be considered in the context of the relationship in question.

¶7. The Fair Dealing Model presents a spectrum of relationships at the investment level—from Self-Managed to Managed-For-You, with increasing degrees of reliance on the part of the client, together with increasingly stringent requirements with regard to conflict management. Whereas the client is free to choose the type of relationship at the investment level, this choice does not exist in a review of the client's accounts. Where in the above range should the client/representative relationship be situated in this case?

¶8. There is reason to believe that it should be classified along the same lines as the third kind of relationship at the investment level. The judgments that determine the outcome of the review are the sole responsibility of the firm's representative. The representative makes the decision and determines the outcome for the client. In view of this, I believe it would be correct to describe this relationship as 'Decided-For-You', equivalent to the Managed-For-You relationship at the investment level. This view is supported by a legal opinion I received on one occasion that the client/Compliance Officer relationship is fiduciary in nature.

¶9. At the same time, there would appear to be conflict of interest in this relationship (at least potentially) in that a representative of the firm is investigating the conduct of another representative of the firm and there are financial incentives associated with the outcome of the investigation.

¶10. The concept paper notes that reliance and duty in the Managed-For-You relationship are at a fiduciary level and states that this relationship "tolerates virtually no conflicts" (36) and that "no conflicts are permitted without the client's informed consent" (35). It seems problematic, therefore, that in the relationship that occurs in an internal account review, there is both a high degree of reliance by the client on the representative and potential conflict of interest. Evidently there is also lack of transparency in communications as I will discuss below.

¶11.One of the major goals of the Fair Dealing Model is to provide standards of business conduct that address conflicts of interest between clients and financial service providers. On p. 35 of the concept paper there is reference to "incentives," which may benefit the representative or the firm and may conflict with the interests of the client. The most obvious incentive at the investment level is profit. Obviously, in the context of an internal review of the client's accounts, the profit motive would operate in a different way than at the investment level. It would not be a question here of compensation driving behaviour, but of behaviour being driven by an interest in avoiding compensation, i.e. to the client.

¶12. The locus where interest would operate in this case is not investment advice, but the judgments made about the handling of the client's accounts. In the context of an internal review, the need to compensate the client would arise from a determination that there was evidence of wrong doing with regard to the professional services of the client's investment adviser. Conflict of interest arises in the event that such evidence is found, since there also is a financial incentive to reach a "no evidence of wrong doing" judgment.

¶13. In the Fair Dealing Model, the word "bias" is used to refer to "recommendations that are driven by compensation" (36). In the present context, bias would occur in judgments driven by an interest in *avoiding* compensation, i.e. to the client. Of course, if there is no evidence of wrong doing, then a judgment that reports this will not be biased. But, where bias exists, whether it is a matter of biased advice or biased judgments, the result is a self-serving outcome motivated by profit, which harms the interests of the client. Within the framework of the current model, such dealings are determined as objectively unfair.

¶14. Another consideration is that although conflict of interest is present, at least potentially, in an internal review, the process is represented to the client as an 'objective and impartial investigation'—as though conflict of interest either is not present or is fully managed by the firm. The word 'independent' may also be used, although clearly such independence is relative as long as the review is being conducted by a representative of the firm. Considered more generally, the firm is making judgments about its own dealings under conditions where there is a financial incentive to act in its own interests. Two considerations arise from this.

¶15. Representing the account review as an 'independent, objective, and impartial investigation' inevitably *positions* the client in a manner that is in the interests of the firm. If the client believes that the outcome has been reached through this kind of process, then the client will be more inclined to feel that the matter has been settled and will be less likely to question the decision in further reviews, e.g. by the regulator. Nevertheless, the client is not in a position to verify that the process is objective and impartial and so really this is just a claim.

¶16. Another consideration is that the construal of the process as independent, objective, and impartial *masks* the conflict of interest that is potentially present in this relationship from the client. In view of this, the use of these terms could give the client a sense of assurance about the fairness of the process, which may be unwarranted.

¶17. Observing that the client remains free to accept or reject the outcome of the review process does not address the problematic aspects of this relationship. Why should the client believe that the outcome of an objective and impartial investigation is unreliable? It may be that a "no evidence of wrong doing" (hence no compensation) judgment is not to the client's liking.

The question is whether clients should have reservations about *relying* on these judgments. Last fall, in the context of an article in the press on complaint procedures at investment firms, a lawyer made reference to the fact that firms know that many clients give up after receiving a letter from the Compliance Department denying any wrong doing. But, just giving up is not deciding properly. One concern is that it may not be possible for clients to make proper decisions about accepting or rejecting outcomes in the context of this relationship owing to a lack of transparency in the way judgments are communicated.

¶18. The concept paper states that "All dealings with retail investors should be transparent" (28). 'Transparent' and 'opaque' are metaphors with multiple applications. In the FDM, one meaning of 'transparent' refers to the provision of information relevant to making decisions about investments. It seems clear from the model that the investor's decision in the Advisory relationship is based on quite a lot of information, at least ideally, and that one purpose of the new regulations is to ensure this is provided. Moreover, conflict of interest relating to compensation is managed by disclosure requirements.

¶19. In the context of an internal account review, the only decision made by the client is whether or not to accept the outcome. The relationship with a representative at this level differs significantly from the Advisory relationship. In the latter, the investor makes the decision—in reliance on information provided by the adviser. In the Managed-For-You relationship, investment decisions are made for the investor by the adviser. Similarly, in an account review, the outcome is decided for the client by the representative. The client does not participate in making this decision, which is the sole responsibility of the representative. In the Advisory relationship, the reliance is partial, but in an account review relationship, evidently there is complete reliance on the judgment of the representative with regard to the substance of the decision. This is analogous to the reliance of the client on the adviser in the Managed-For-You relationship at the investment level.

¶20. There are disclosure requirements to manage conflict of interest at the investment level, and strict requirements in the Managed-For-You relationship. It does not appear, however, that there is any obligation or requirement on the part of the representative in an account review to disclose to the client any aspect of the decision-making process that could lead to self-serving outcomes. Obviously, if the representative was going to judge matters in a way that favoured the interests of the firm or the adviser at the expense of the client, then it would be self-defeating to disclose this to the client.

¶21. The following analysis will consider the judgments made in the context of internal account reviews according to the wider scope of the meaning of 'transparency' in the Fair Dealing Model (pp. 31-32). Specifically, it will consider how judgments are communicated to the client (their form) rather than what the judgments are about (their content).

¶22. With respect to content, the judgments are about various aspects of the handling of the client's accounts by the investment adviser relative to the concerns raised by the client.

¶23. With regard to form, there are two considerations: the specific kind of judgments made in a Compliance Department review and the nature of reasoned judgments more generally (according to the general form, 'It is reasonable to believe that X, given A,B,C').

¶24. I have had experience with three reviews of my accounts conducted by a large firm. In the context of the initial Compliance process, I requested a definition of 'compliance,' noting that this was a relational term that implies 'being in accordance with.' The Compliance Officer responded:

¶25. "Our process is to review a client's concerns to ensure of compliance in accordance with both the firm's standards and those established by the Regulators, i.e. the Investment Dealers Association."

¶26. The kind of judgment involved here occurs in several areas. For example, there are compliance officers in health care who oversee the compliance of hospitals with standards pertaining to medical treatment and patient care. The following is a simple example of a compliance-type judgment in the context of the food services industry.

¶27. I recently came across a notice of Impending Termination that had been left on the subway by a Pizza Pizza employee. The document states that on a certain day, the employee "was found eating food while on the production line of Waveside Pizza Pizza." It notes further that the conduct in question is a "food service health and safety violation" and also that it is contrary to "Park Policy and Procedure" and moreover that "it is considered theft." The document also states that in the context of the employee's training program, he would have been informed that "this behaviour is unacceptable."

¶28. This is a straightforward, objective determination of wrong doing in which there is consideration of the employee's conduct in relation to the applicable standards and regulations.

¶29. In the letters I have received at the conclusion of each review, the overall decision is formulated in terms of 'evidence of wrong doing.' On the basis of the above definition, evidence of wrong doing will consist of *evidence of non-compliance* relative to the applicable criteria: regulatory, institutional, and professional standards.

¶30. In a review of the client's accounts, the role of the firm's Compliance Officer (or Ombudsman if there is a further process) is to make such judgments in an objective and impartial manner, uninfluenced by the incentive to reach an outcome that serves the interests of the firm, i.e. avoiding compensation to the client.

¶31. The main focus with regard to transparency in this context would be how the conclusions of the representative are communicated to the client. Judging by the letters I have received, as well as information from other sources, it appears that written judgments are communicated in a manner that is highly opaque. The very general "comments" in these letters do not in any way resemble compliance-type judgments as defined and illustrated above. There is little or no reference to supporting data and documents nor is there any analysis in terms of applicable standards and regulations. Overall, there is no attempt to present decisions in relation to the compliance-type judgments that supposedly were made in reaching them. Considered more generally, the opinions regarding the various matters are not presented as reasoned judgments or the grounds are inadequate. I was informed by an IDA complaints officer that this kind of response, containing highly general, unsupported opinions, is typical of Compliance Department letters.

¶32. Under the circumstances, the client has no way of verifying the soundness of the conclusions or the fairness of the outcome. This problem may be illustrated as follows. If person A communicates to person B the judgment *"2+3=7"* then B will have been provided with the means of verifying the sum and will be able to recognize that it is wrong. But, if A merely says *"I have added two numbers and the sum is 7,"* then the wrongness of the sum will be undetectable. In this case, the result is communicated in a manner that is highly opaque relative to the way it has been reached. In fact, this is not disclosed at all. Based on this analysis, it is clear that communicating a decision in an account review, without disclosing how the decision was made, has the potential to mask bias and unfair outcomes from the client.

¶33. The specific meaning of transparency in this context would be 'disclosure of the grounds of judgment,' i.e. the provision of reasons, data, analysis, and reference to applicable criteria in support of judgments, ideally in a compliance-type form.

¶34. In a situation where a person was receiving a medical opinion, the transparency requirement could be less stringent because there is no incentive for a doctor to report one outcome to a patient rather than another. As the Fair Dealing Model recognizes, however, transparency issues are a consideration where advice (or in this case judgments) are subject to the influence of financial incentives.

¶35. The kind of deficiency noted above does not concern what is communicated (content), but how it is communicated (form). It may thus be referred to as a 'formal deficiency'. The judgments in question appear to be formally inadequate, not only relative to compliance-type judgments properly speaking, but also in relation to reasoned judgments more generally. With respect to the latter, there has been reference in the press recently to other occurrences of the same deficiency in a judicial context (in the article, "Back up your verdicts, judges warned in ruling," *Toronto Star,* May 29, 2004, A27, http://investorvoice.ca/PI/1025B.htm).

¶36. The article reports that in several recent cases, lower court decisions have been overturned "because of serious deficiencies in a trial judge's ruling." It is not a question here of a discovery of new facts or evidence (which would pertain to the content of the decision). Rather, the finding is that the decisions in question were inadequately explained and hence deficient in their reasoning. The evidence in this case is the transcript of the decision.

¶37. On the basis of the written responses I have received, as well as the above information from the IDA, it appears that the judgments communicated in the context of internal account reviews have a similar formal deficiency. Reasons or grounds for opinions either are not provided or they are insufficient to allow the client to verify the soundness of the judgments and the fairness of the overall outcome.

¶38. This problem is especially acute where the Compliance Officer (or Ombudsman) does not address certain concerns or questions at all in the written response. In one of my discussions with an IDA complaints officer, I was informed that in this case the client has to take their complaint to an external agency, such as the regulator, who can access the client's file [with the firm]—in order to find out how a question about their accounts has been addressed by the firm's Compliance Officer. In this case, the client's question has been "addressed" in a purely internal process in which the judgment about the issue has not been disclosed to the client at all.

¶39. Lack of transparency in the way judgments are communicated makes it necessary for the client to depend on the representative in accepting decisions. This is analogous to accepting a view about a matter on the basis of 'expert opinion'. In this case, one does not hold a view on the basis of one's own reasoning or because one has verified the reasoning of another. Rather, one accepts the opinion in reliance on the authority and expertise of the other person. It seems that such acceptance would be problematic in a relationship where there was no provision to manage conflict of interest.

¶40. The danger of harm in this context is analogous to the danger of harm in a judicial setting where improperly reasoned judgments can mask the miscarriage of justice. In overturning a recent trial decision (as reported in the above article), Justice John Laskin questioned the reliability of conclusions where supporting reasons were inadequate. It seems clear from the mathematical example, above, that in such cases the conclusion could be right—or, it could be wrong.

But, if the conclusion is wrong, this will not be apparent because its wrongness will be concealed by the fact that it has not been explained. This is clearly illustrated by the example, *"I have added two numbers and the sum is 7."* The reasoning is not provided and so the conclusion is unreliable. As Plato would say, the opinion is not 'tied down' with the reason why *(logos)* and hence is unstable (it could be right or wrong).

¶41. If inadequately reasoned trial judgments can mask wrongful convictions and acquittals then, analogously, inadequately reasoned judgments in account reviews can mask biased and unfair outcomes. This kind of transparency problem would be more pressing where there was a high degree of reliance on the part of the client as well as conflict of interest.

¶42. There are a number of reasons, therefore, to regard the client/representative relationship in the context of internal account reviews as being problematic in principle. The firm's representative has sole responsibility for determining the outcome in this relationship. In view of this, the relationship may be characterized as 'Decided-For-You'. There is potential conflict of interest in that "no evidence of wrong doing" judgments are associated with financial incentives. This conflict of interest is masked, but not managed, by referring to the review process as an independent, objective, and impartial investigation. Using these terms may lead the client to view the outcome as fair, yet the client is unable to verify this. The way the decision is communicated to the client does not reflect the compliance-type judgments that supposedly were made in reaching it. More generally, the comments and opinions presented in the written response are inadequately reasoned. This lack of transparency can mask biased judgments and unfair outcomes from the client.

¶43. I can appreciate that one of the goals of the Fair Dealing Model is to reduce the number of disputes by regulating relationships at the investment level. Nevertheless, it seems clear that regulating conflict of interest at this level will not *per se* manage conflict of interest in the context of internal account reviews.

¶44. While the client remains free to accept or reject the outcome of these reviews, the client's decision in this regard is not adequately supported by information provided by the representative in the written response. Nor, in my experience, was there any opportunity for discussion or clarification. Even where this is available, if the client's interests have not been properly considered in the judgments that have been made, the client would have to be able to discern this and ask the right questions. It seems problematic to expect that clients should have to defend their interests in this way.

¶45. My analysis of this relationship within the framework of the Fair Dealing Model indicates that clients are accepting formally opaque judgments about their accounts in a relationship where there is a high degree of reliance on the decision of the representative together with unmanaged conflict of interest. In view of this, it appears that the relationship in question is objectively impaired relative to the factors that constitute fair dealing. Since clients are vulnerable to harm in such relationships, I believe there are strong reasons for the Ontario Securities Commission to consider stricter standards of business conduct for firms that provide these services.

¶46. Although the outcome of my analysis is negative with respect to the client/ representative relationship in the internal complaint process, it has confirmed the theoretical value of the Fair Dealing Model itself. Working within the framework of the theory, it has been possible to apply the concepts and core principles of the model to a relationship not explicitly considered in the present concept paper. It has been possible, on this basis, to assess the fairness of business conduct in this relationship in an objective manner and in principle.

¶47. On a practical level, I believe the Fair Dealing Model makes an important contribution in proposing standards that align business practices in the investment industry with the values that structure a just society.

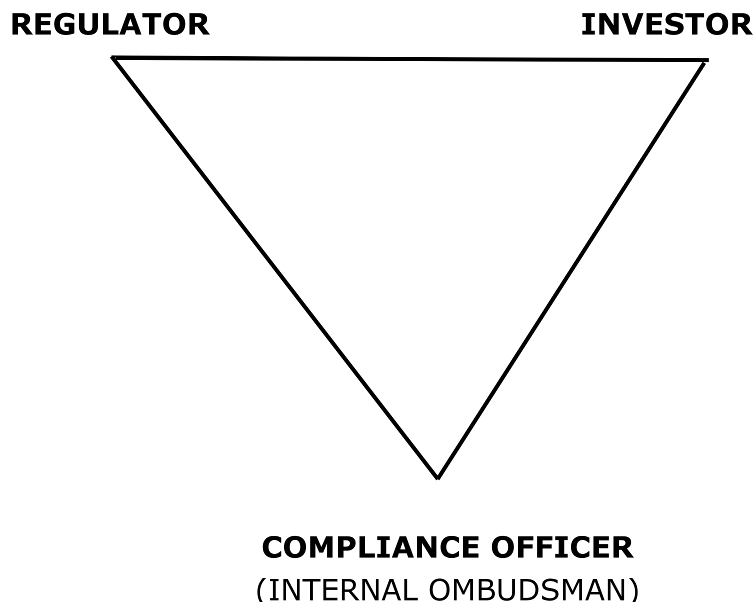
Yours truly,

Pamela J. Reeve

APPENDIX II

COMPLAINT HANDLING AT FINANCIAL SERVICE PROVIDERS

REGULATORY OVERSIGHT



COMPLIANCE OFFICER
(INTERNAL OMBUDSMAN)

Compliance Department reviews are a *regulated* service.
A firm's decision about the client's complaint is a *regulated* product
equivalent to a 'credence good' in other sectors.

DISCUSSION. The above diagram expands on the relationship analysis previously discussed in my Fair Dealing Model paper (9 AUG 04, posted at *www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part3/Comments/33-901/com_20040809_33-901_pjreeve.pdf).* My focus in that paper was the client/representative relationship, which occurs in a complaint process at a financial service provider. Nevertheless, a complete consideration of this relationship requires the inclusion of the regulator. A review of a client's complaint, conducted by a firm's Compliance Department, is a *regulated* service. Analogous to other sectors, the client in these circumstances may be considered a 'consumer' of a *regulated* product or service. The 'product' in this instance would be the decision, which is the outcome of the review of the client's complaint by the firm's Compliance Officer. The service and product in question are 'credence goods' in that the client is not in a position to evaluate the reliability of the service nor the credibility and fairness of the decision. The client/consumer is unable to know whether it is safe to consume the product, i.e. accept the decision, hence the need for *regulatory oversight.*

Just as consumers of tainted meat are exposed to a hazardous substance, clients in an internal complaint process are exposed to the hazard of accepting biased decisions, i.e. decisions 'contaminated' by self-interest. Self-serving outcomes are *undetectable* by the client, for one, because of lack of transparency in communications (detailed in my FDM analysis, ¶¶21-41). In the case of claims with substantive merit, the consequence of accepting biased decisions (equivalent to consuming tainted meat) is *unrecoverable financial loss.*

In exercising its public interest mandate, a regulator provides protection to the public from harmful products and practices. The need for this protection arises not only in circumstances involving actual harm, but also with the occurrence of the *conditions* of harm. A clear example of the latter case may be seen in the boil water advisory issued by health authorities in Vancouver in November 2006 following a heavy rainfall. The advisory in this case was not based on actual harm, but the occurrence of the *conditions* of harm. Application of the principles of the OSC's Fair Dealing Model to the internal complaint process demonstrates the occurrence of the *conditions* of harm. This is quite apart from existing case evidence, which indicates the occurrence of *actual harm.* In view of this, the OSC and SROs with oversight of the internal complaint process, should caution investors that the process is adversarial and advise them to seek an outside opinion on the merit of their complaint. This is consistent with the approach of informing investors to make them *"partners in their protection against unfair, improper or fraudulent practices"* (OSC, Goal 2, Statement of Priorities, 30 JUN 06). P. J. Reeve, 01 JAN 07

APPENDIX III

"Risks Inherent in the Complaint Process"

SIPA Sentinel
December 2006

The purpose of the current redress system is to provide the means for investors harmed by industry wrong doing to achieve fair and timely redress. The first step in this process is the internal complaint process with the firm. In some cases, the matter may be resolved with the client's investment advisor or branch manager. In other cases, the investor will need to contact the firm's Compliance Department.

Negotiating the internal complaint process at financial service providers is a perilous undertaking for many or even most investors. Exposure to risk is clearly recognized in an investment context, involving factors such as equity market risk and currency risk. Nevertheless significant exposure to risk also occurs within the redress system itself, especially at the most initial stage where the investor still has direct dealings with the firm.

My previous analysis of this issue in terms of the principles of the Fair Dealing Model of the Ontario Securities Commission is posted at the SIPA website *(www.sipa.ca/library/Documents/OSC-FDM-Reeve_040809.pdf).* In this paper, I apply the principles of the FDM to considering the client/ representative relationship in the internal complaint process. When factors such as the nature of the relationship, conflict of interest, and transparency are taken into account, it becomes evident that investors are exposed to significant risk of harm in this process.

The recently published Final Report of the Task Force to Modernize Securities Legislation in Canada, sponsored by the IDA, refers to a national investment literacy test that found that two-thirds of Canadians are *"functionally illiterate when it comes to investment knowledge"* (Final Report, p. 66). Normally this kind of statistic would be considered only in relation to investing. Nevertheless, financial literacy also has important implications for a client's negotiation of the internal complaint

process. Many investors in these circumstances will not have an accurate understanding of the merit of their claim beyond the fact that they have lost money.

The Ombudsman for Banking Services and Investments (OBSI) and IDA note that most of their complaints are about the suitability of investments. Suitability involves a relatively complex assessment involving consideration of the investor's age, net worth, investment objectives, and risk tolerance. Many investors will be unable to evaluate this on their own. As a consequence, investors with this kind of complaint will have to negotiate a firm's internal complaint process with an inadequate understanding of the merit of their claim. Unquestionably this will be problematic in an adversarial process where there is no third-party oversight.

Moreover, the investor may not even realize that the internal complaint process is adversarial. They may be referred to the firm's Compliance Department for consideration of their complaint. What is a Compliance Officer? This is someone who exercises an 'enforcement modality' within the firm. The professional obligations of a Compliance Officer relate to ensuring that the services of the firm's investment advisors conform to existing rules, regulations and standards. In view of this, a client with a complaint will see the Compliance Officer as exercising an enforcement function somewhat like a detective or police officer. The client will look to the Compliance Officer to investigate the complaint and determine whether wrong doing has occurred.

Understandably, the client will see the outcome of the Compliance Officer's investigation as reporting an objective determination and impartial decision about the matter. Should the client rely on this decision?

The OSC's Fair Dealing Model concept paper recognizes that investors must be provided with sufficient information to be able to decide properly about investment options. It also recognizes that disclosure is an important tool for managing conflict of interest. For example, requiring the advisor to inform the client of a range of fee options prevents the advisor from directing the client to a compensation option that favours his or her interests. The International Organization of Securities Commissions (IOSCO) also recognizes the connection between information and investor protection. Its "Objectives and Principles of Securities Regulation" (May 2003) states that: *"Full disclosure of information material to investor's decisions is the most important means for ensuring investor protection."*

Clearly, investors also need to make a decision at the outcome of the firm's internal complaint process, namely, whether or not to accept the firm's decision about their complaint. Nevertheless, the investor is not provided with information relating to the applicable rules, regulations, and standards. How can the investor protect his or her interests if the relevant criteria are not identified and if inadequate reasons are provided for the firm's decision? As mentioned above, many client complaints relate to the suitability of investments. How is the client to determine whether the firm's Compliance Officer has fairly considered all the relevant factors? Under the circumstances, clients are exposed to the hazard of accepting self-serving outcomes and abandoning complaints with substantive merit or accepting inadequate offers.

The current redress system offers various alternatives to clients who feel that the firm has not responded to their complaint in a satisfactory manner. How is the client to determine whether the firm's response is satisfactory? If the firm's Compliance Officer communicates that there is no evidence that the client's investments were inappropriate, how is the client to know whether to accept the decision?

Many of the issues that occur in a complaint context involve considerations similar to those that occur at the investment level: disclosure, management of conflict of interest, transparency in communications and investor education. Compliance Department reviews of client complaints are a regulated service. Are investors adequately protected from biased, self-serving outcomes in this context?

Not every claim has merit. But, given a claim with merit, the risk of accepting a biased decision is significant: unrecoverable financial loss. My recommendation to any investor going through an internal complaint process is to get an independent opinion on the merit of your claim.

Pamela J. Reeve, Ph.D.

APPENDIX IV

Pamela J. Reeve, Ph.D.

pj.reeve@utoronto.ca

20 June 2007

To: Member Commissions of the Canadian Securities Administrators (CSA):

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Registrar of Securities, Nunavut

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, ON M5H 3S8
By email to: *jstevenson@osc.gov.on.ca*

Anne-Marie Beaudoin, Directrice du secrétariat
Autorité des marchés financiers
Tour de la Bourse
800, square Victoria
C.P. 246, 22 étage
Montreal, PQ H4Z 1G3
By email to: *consultation-en-cours@lautorite.qc.ca*

Re: Canadian Securities Administrators (CSA) National Instrument 31-103 Registration Requirements (the Rule) and proposed Companion Policy 31-103 Registration Requirements (the Companion Policy)

Thank you for the opportunity to comment on NI 31-103.

¶1. The focus of my remarks will be sections 5.29 – 5.31 in the Rule on **Complaint Handling** and section 5.12 in the Companion Policy on **Client Complaints**. I will also refer to relevant passages in the Notice and Request for Comments (the Notice).

¶2. **Background.** In August 2004, I made a submission to the Ontario Securities Commission in response to its Request for Comments on its Fair Dealing Model Concept Paper. Currently these comments are posted at www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part3/Comments/33-901/com_20040809_33-901_pjreeve.pdf and www.sipa.ca/library/Documents/OSC-FDM-Reeve_ 040809.pdf. In this submission, I apply the principles of fair dealing to complaint handling at financial service providers. My conclusion is that investors are exposed to harm in the context of these dealings. Subsequently, I made submissions on this topic to the Senate of Canada and federal Department of Finance.

Notice & Request for Comments: Division 7: Complaint Handling

¶3. The Notice observes that the requirement for firms to implement policies and procedures to address client complaints is a new requirement in most CSA jurisdictions. It notes further that *“This requirement is in response to comments received from investors about the need for responsive complaint handling processes”* (Notice, p. 14). In view of this, a requirement is introduced in the current Rule that investment firms should internally review client complaints as per 5.29 and 5.31.

¶4. The Notice also states that the CSA reviewed *“the nature and scope of the market problems or risks”* in considering the addition or modification of registration requirements (p. 6).

Problems re: introduction of a requirement for an internal complaint process

¶5. **Alleged investor “need”.** The source of the above investor “comments” is not identified. The proposal of a regulatory requirement on the basis of such indeterminate comments is questionable. More precisely, investors with complaints are not in need of an adversarial complaint process, conducted by a party that is inevitably affected by conflict of interest (see ¶¶11-12 below). Investors do not need a complaint review process where they are inevitably disadvantaged by an imbalance in knowledge, power, and possibly other vulnerabilities (¶¶12-13). In view of this, the introduction of a requirement that firms should internally review client complaints cannot be justified in terms of investor needs.

¶6. **Absence of risk assessment.** There is no evidence that the CSA Member Commissions have considered or conducted an assessment of the risk of harm to investor interests in connection with the internal review of client complaints by investment firms.

¶7. The Notice states that the purpose of the registration requirements is to *"provide protection to investors from unfair, improper or fraudulent practices"* (p. 6). No such protection is provided by the proposed requirement. On the contrary, the requirement that firms should deal internally with client complaints and that investors should have to go through the internal complaint process before being able to access independent adjudication, exposes the investor to significant risks.

OBSI Statistics: 50% of decisions by investment industry overturned

¶8. Case-based statistics in the last two Annual Reports of the Ombudsman for Banking Services and Investments (2005 and 2006) give some indication of the risk faced by investors in the context of firms' internal complaint process.

¶9. In 2005, the OBSI recommended compensation in **50% of investment cases**. In 2006, OBSI recommended compensation in **51% of investment cases.** Regarding the 2005 figure, feedback from the OBSI indicates that in most cases, the client's complaint had **previously been denied** by the firm, i.e. with no offer of compensation. In some cases, the client would have been through two levels of internal review: first with the Compliance Department and then with the firm's internal Ombudsman.

¶10. The OBSI statistics shed light on the reliability of the **internal complaint process** at investment firms. According to these results (and the OBSI is an industry-funded organization), investors have only a **50% chance** of receiving a fair decision. A 50% rate of overturn suggests that internal decisions by firms are **unreliable.** Should clients accept these decisions? Judging by the outcome of OBSI reviews, the investor may as well flip a coin.

Further comments on proposed complaint handling requirement

¶11. **Conflict of interest.** The Rule obligates firms to manage conflict of interest. Clearly, the internal compliant process is inherently affected by conflict of interest. Firms are making judgments about their own dealings in circumstances where there is a financial incentive to act in their own interests, i.e. deny meritorious complaints or offer inadequate compensation. The 50% overturn rate of firms' decisions by the OBSI is evidence of this conflict of interest. The NI 31-103 requirement that firms should deal internally with client complaints exposes investors to the risk of harm arising from this conflict of interest. Investors should not be put in the position of having to **rely** on firms to self-manage conflict of interest in the complaint process. How would the client assess whether the firm is fulfilling its obligation? The client should not have to monitor this.

¶12. **Adversarial nature of the complaint process.** Regulatory insiders are aware that the internal complaint process is 'adversarial'. Yet, it is not identified as such to the client—either by firms or by the regulators. The complaint review process is presented as a dispute resolution 'service' or this is implied. The firm may even refer to it as an independent and impartial investigation. These representations do not alert the client to the adversarial nature of the complaint process and the need to protect their interests. Not being informed, the client may rely inappropriately on the firm's decision.

¶13. **Vulnerability of clients.** The proposed requirement that firms should deal with complaints internally in the first instance does not take into account the vulnerability of the client in this process. Clearly, there is a significant **imbalance in power** in a context where the client has direct dealings with the firm. Advantage could be taken of the client, especially seniors and those with disabilities or language problems.

This vulnerability is further amplified by an **asymmetry in knowledge.** It has been acknowledged that there is a relatively low level of financial literacy among Canadians. If this is problematic at the investment level, it is even more problematic in the complaint process, where the investor is not in a position to make an independent judgment about the fairness and accuracy of the firm's decision.

¶14. **Suitability.** The above vulnerabilities are even greater where the issue regards investment suitability. In 2005, the OBSI reported that 48% of complaint issues related to suitability and 49% in 2006. The client may only know that they have lost money. Assessment of suitability involves a relatively complex analysis that must take into account several factors (age, net worth, investment objective, timeline to retirement, risk level of investments, etc.). Clients should not be put in the position of having to rely on firms to conduct an objective and impartial review of suitability issues. The fact that most investors are unable to assess this for themselves, puts them at considerable risk in the internal complaint process where this is an issue.

¶15. **Current SRO oversight of the internal complaint process.** Provincial statutory regulators have delegated investor protection to self-regulatory organizations such as the Investment Dealers Association (IDA) and Mutual Fund Dealers Association of Canada (MFDA). SROs currently have oversight of internal complaint handling by their member firms. Fair dealing is not a new requirement. Firms already are required to conduct business in a manner that is fair, honest, and in good faith. What evidence is there that firms have been resolving client complaints fairly? In view of the OBSI results of the past two years, as well as other data, and the above risks and vulnerabilities, I have to question whether investors can rely on SROs to ensure fair dealing in the internal complaint process of their member firms.

¶16. In the final analysis, it is the investor, including seniors, who are exposed to risk in the internal complaint process. In the event that a meritorious complaint is decided unfairly by a firm and is accepted by the client, who may be a trusting senior, the harm suffered is unrecoverable financial loss and perhaps a diminished quality of life for years to come.

Summary

¶17. The proposed registration requirement that firms should deal internally with client complaints is introduced on the basis of a reference to unidentified investor comments. This is an inadequate basis for introducing a regulatory requirement for a complaint process that is questionable in the above respects.

¶18. The proposed requirement overlooks existing problems. A 50% overturn rate of firms' decisions by the OBSI indicates that the internal complaint process is unreliable.

¶19. There is evident **conflict of interest** on the part of firms and **multiple vulnerabilities** on the part of investors in the internal complaint process. This amounts to significant **risk of harm** to investors with meritorious complaints. This risk is amplified in the case of suitability and other complex issues where the uninformed client is put in the position of essentially having to guess whether the firm's decision is accurate and fair. Going through such a process serves no purpose that relates to investor protection, which is the stated aim of the Rule.

¶20. **The purpose of the National Instrument 31-103 Registration Requirements is to protect investors. This purpose is not served by the proposed requirement that firms should deal internally with client complaints.**

¶21. As long as the current system remains in place, investors going through the internal complaint process should be cautioned that the process is adversarial and should be advised to seek an outside opinion on the merit of their complaint.

Thank you for the opportunity to address the proposed Rule.

Yours truly,

Pamela J. Reeve, Ph.D.

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