



Canadian Foundation *for*
Advancement *of* Investor Rights

October 15, 2015

The Secretary
Ontario Securities Commission
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Sent via e-mail to: comments@osc.gov.on.ca

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RE: CSA Notice and Request for Comment on Proposed Amendments relating to Reports of Exempt Distribution

FAIR Canada is pleased to offer comments on the Proposed Amendments to National Instrument 45-106 Prospectus Exemptions (“Proposed Amendments”) published on August 13, 2015 that would introduce a new harmonized report of exempt distribution (the “Proposed Exempt Distribution Report”) and make related changes to Companion Policy 45-106CP Prospectus Exemptions (“45-106CP”) (the “Consultation Document”).

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

1. General Comments

- 1.1. FAIR Canada supports reforms to the Proposed Exempt Distribution Report and other related changes that will allow securities regulators to collect and publish information on the exempt market. FAIR Canada has observed that there is a lack of basic information required to understand this area of our capital markets and regulate effectively with sufficient data for sound policy decisions. Several academics and FAIR Canada have called on regulators to improve their understanding of the exempt

market by collecting better information and making that information public.¹

- 1.2. FAIR Canada supports the collection of better information about the use of capital-raising exemptions so that regulators and the public can better understand this area of our capital markets – thereby improving the policy-making process and facilitating more effective regulatory oversight of the exempt market, including compliance oversight. We also support the harmonization of the Proposed Exempt Distribution Report and encourage regulators to adopt filing methods that allow regulators, researchers and governments to easily utilize the data collected.
 - 1.3. FAIR Canada urges securities regulators to construct a regulatory framework for the exempt market that delivers strong investor protection while fostering efficient markets. Such a regulatory framework will facilitate true (i.e. quality) capital formation, resulting in lowered cost of capital and increased confidence in our markets. Confidence in our markets, including confidence that the markets are fair and that the rules are effectively enforced, is critical to long term capital formation and economic growth. Obtaining needed information about the exempt market is a necessary step in this process.
2. At the same time, securities regulators must also take measures to compel compliance with existing rules governing various prospectus exemptions, as non-compliance is a serious problem.² Non-compliance harms investors and weakens confidence in the exempt market and our capital markets generally. FAIR Canada is unaware of any published report from securities regulators indicating that the compliance problems they themselves identified have been adequately addressed.³ Therefore, additional resources must be brought to bear to ensure compliance with the existing and proposed rules, including that the required information in the Proposed Exempt Distribution Reports must be completed properly and filed with the appropriate provincial securities regulators. In addition, other tools at the disposal of regulators should not be disregarded. Securities regulators and governments need to recognize that disclosure will not

¹ Academic papers include Jack M. Mintz, “Muddling up the Market: New Exempt-Market Regulations May do More Harm than Good to the Integrity of Markets”, The University of Calgary School of Public Policy SPP Research Papers, v. 7 issue 35 (November 2014), available online at: <http://www.policyschool.ucalgary.ca/sites/default/files/research/mintz-muddlingmarket.pdf>; and Vijay Jog, “The Exempt Market in Canada: Empirics, Observations and Recommendations”, University of Calgary School of Public Policy SPP Research Papers, v. 8 issue (March 2015), available online at: <http://www.policyschool.ucalgary.ca/sites/default/files/research/exempt-markets-jog.pdf>. FAIR Canada has raised this issue in several of its submissions including its 2012 submission to the CSA on reforms to the accredited investor and minimum amount exemptions from consultation note 45-401 published November 10, 2011: available online at <http://faircanada.ca/wp-content/uploads/2011/01/120229-FAIR-Canada-submission-re-MA-AI-exemptions.pdf>.

² Saskatchewan Financial Services Commission Securities Division Staff Notice 45-704: Review of Offering Memorandums under NI 45-106 Prospectus and Registration Exemptions, (March 7, 2011), at p 2; Multilateral CSA Staff Notice 45-309: Guidance for Preparing and Filing an Offering Memorandum under National Instrument 45-106 Prospectus and Registration Exemptions, (April 26, 2013), at p 2 –11; CSA Staff Notice 31-334: CSA Review of Relationship Disclosure Practices, (July 18,2013); OSC Staff Notice 33-738: OSC Annual Report for Dealers, Advisers and Investment Fund Managers (2012), online: <http://www.osc.gov.on.ca/documents/en/Securities-Category3/sn_20121122_33-738_annual-rpt-dealers.pdf>; OSC Staff Notice 33-740: Report of the Results of the 2012 Targeted Review of Portfolio Managers and Exempt Market Dealers to Assess Compliance with The Know-Your-Client, Know-Your-Product and Suitability Obligations, (May 30, 2013); ASC Staff Notice 33-704: Review of Exempt Market Dealers, (January 12, 2012); and OSC Staff Notice 33-735: Sale of Exempt Securities to Non-Accredited Investors and in guidance issued in CSA Staff Notice 31-336 (May 2011).

³ Ibid. We refer you also to the following FAIR Canada submissions: Letter from FAIR Canada to the CSA dated May 28, 2014 regarding Proposed Amendments to the Minimum Amount and Accredited Investor Prospectus Exemptions; Letter from FAIR Canada to the CSA dated June 18, 2014 regarding the Offering Memorandum Prospectus Exemption and the Reports of Exempt Distribution; Letter from FAIR Canada to the OSC dated June 18, 2014 regarding Proposed Prospectus Exemptions and Reports of Exempt Distribution; and Letter from FAIR Canada to the Nova Scotia Securities Commission dated July 6, 2015 regarding Proposed Amendments to the Offering Memorandum Exemption; all available online at <http://faircanada.ca/standing-committee-review-of-osc/submissions/>.

be sufficient to provide the necessary level of protection to individual investors, whether accredited individual investors or other retail investors. Further measures are needed.⁴

3. Information Urgently Needed to Understand the Exempt Market

3.1. Information which would be valuable to the policy-making process, and for which data should be collected through the Proposed Exempt Distribution Reports, includes:

- How large is the exempt market in Canada? The numbers that are provided by securities regulators lack accuracy given that they include distributions of both public and private investment fund securities and also reflect purchases but not redemptions of investment fund securities.⁵
- While the overwhelming majority of capital in the exempt market is raised through the accredited investor exemption, how much of that was raised from individual investors as opposed to Canadian financial institutions, governments and governmental agencies, insurance companies, mutual funds, pooled funds and managed accounts or pension funds?
- What type of firms make up the investment fund category? How many investment funds make up this category? And how many investment funds raise capital in the exempt market in a given calendar year? Do any (and if so, what percentage) of these funds have CIPF or similar coverage in the event of insolvency? How many of these investment funds are alternative investment funds versus commodity pools versus closed-end (non-redeemable) funds versus mutual funds subject to NI 81-102?
- How much of the capital raised by reporting issuers in the exempt market (through the Accredited Investor exemption or all exemptions) came from individual investors and how

⁴ We express concern that despite serious deficiencies in compliance by exempt market dealers, including significant deficiencies in how they address conflicts of interest, and despite behavioural economics research indicating that disclosure is ineffective and may result in unintended and even perverse consequences, securities regulators have chosen to rely on disclosure – and more particularly, a risk acknowledgement form – as a key mechanism meant to protect investors in the exempt market. We urge the utilization of other measures to ensure adequate investor protection. It makes little sense to rely upon such disclosure in the absence of prior empirical testing to determine what impact (if any) it has on investor decision-making. Securities regulators should provide some evidence to support their belief that “the risk acknowledgement form is an important investor protection mechanism because it alerts investors of key risks that may be associated with securities purchased...” There will be significant negative consequences if securities regulators are wrong in ‘believing’ that risk acknowledgement forms provide some level of protection to investors, and those negative consequences will fall squarely on investors. See OSC Notice of Amendments published on February 19, 2015, at Appendix E, page 46, available online at http://www.osc.gov.on.ca/documents/en/Securities-Category4/ni_20150219_45-106_amendments.pdf. We have set out in our submission dated June 18, 2014 in response to Multilateral CSA Notice published March 20, 2014 (available online at: <http://faircanada.ca/wp-content/uploads/2011/01/140618-final-comments-to-CSA-re-OM-exemption-2.pdf>) and in our submission to the OSC dated June 18, 2014 in response to their Notice and Request for Comments published March 20, 2014 (available online at: <http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-submission-re-OSC-Proposed-Prospectus-Exemptions-v1.pdf>) comments to improve the proposed requirements so that investors will be better protected and the result will be more efficient markets in which investors have confidence. We urge you to give serious consideration to our recommendations. Similarly, given the widespread problems that regulators have uncovered with unqualified investors being sold exempt market products in reliance on the Accredited Investor exemption, third party independent certification (even if based on a financial test) should be required, in order to protect investors; see our submission, available online at <http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-comments-re-Proposed-Amendments-to-AI-MA-Exemptions.pdf> for further details

⁵ OSC Exempt Market Review OSC Notice 45-712, Appendix C – Capital Raising in Canada and the Ontario Exempt Market, at page 13, footnote 10, available online at https://www.osc.gov.on.ca/documents/en/Securities-Category4/sn_20130828_45-712_progress-report-c-capital-raising-canada.pdf.

much of the capital raised by non-reporting issuers (through the Accredited Investor exemption or all exemptions) came from individual investors? For example, in 2012, approximately 69% of the capital raised by issuers other than investment funds in Ontario was by non-reporting issuers (69% of the \$37 billion or \$25.5 billion). Of this \$25.5 billion, how much was raised from individual investors and what portion of that was raised by small and medium sized enterprises (SMEs) versus large issuers?

- What portion of the capital raised from accredited investors was for foreign reporting issuers or foreign non-reporting issuers? 10 percent, 20 percent, or more? Of this amount, how much came from individuals?
- What portion of the total capital raised from individual accredited investors was through registrants and what portion was through issuers directly? Where sales were conducted through registrants, how many of those registrants were members of a self-regulatory organization (“SRO”)?
- What is the median or average offering size for reporting issuers and for non-reporting issuers, and what is it for SMEs? What is the median or average amount of capital that they raise?
- What are the commissions or fees, on average, when an intermediary is used?
- What are the investment returns for investors, in particular individual accredited investors and other individual retail investors, in the exempt market? How much of the money raised resulted in positive returns for investors over a time period of one year, three years, five years and ten years? Were returns similar or different if the investment was in a reporting issuer, non-reporting issuer, listed issuer or SME?
- How many of the issuers were still in operation one year, three years, and five years subsequent to their capital raising activities in reliance on prospectus exemptions? Does the survival rate vary depending on the size of the issuer, whether it is a reporting issuer, or the industry it is in?
- Does the level of exempt market activity correlate with the level of activity of the public market?
- What is the prevalence and incidence of fraud in the exempt market? Does it vary by type of prospectus exemption relied upon? Type of issuer? What is the level of risk?

4. Comments on the Proposed Exempt Distribution Report

4.1. FAIR Canada makes the following comments about the information required in the Proposed Exempt Distribution Report :

- (i) *The size of the issuer* – FAIR Canada believes that the broad ranges used by Statistics Canada to define what are small businesses (0 to 99 employees, with micro-businesses being those with fewer than 5 employees), medium businesses (100 to 499 employees), and large business (500 or more employees) will not provide enough granular information for policy-making purposes or analysis. According to a media article, 98 per cent of employer businesses in Canada are small businesses.⁶ While these broad definitional categories are valid, more

⁶ CBC News “10 surprising stats about small businesses in Canada”, (October 17, 2011), available online at: <http://www.cbc.ca/news/business/10-surprising-stats-about-small-business-in-canada-1.1083238>.

specific information gathered within them could be very valuable to policy-making initiatives.

- (ii) *The type of investment funds* – It would be helpful to know what type of investment fund it is – a closed-end fund, an exchange traded fund, a commodity pool, a mutual fund subject to 81-102, or otherwise. We are concerned that the categories of “equity” versus “fixed income” etc. do not provide sufficient information to understand the investment fund issuer or this area of the exempt market. Please see our questions related to investment fund issuers, above in section 2.1.
- (iii) *Qualification as a Purchaser* - FAIR Canada does not believe it would be too onerous for the issuer or underwriter to identify all the categories (rather than only one) through which an individual qualifies as a purchaser under a given prospectus exemption (for example, categories within the family friends and business associates exemption, within the category “eligible investor” under the offering memorandum exemption or individual categories within the accredited investor exemption). This may be important information to gather for future policy-making initiatives with respect to individual investors. For example, did most individual investors qualify under the accredited investor exemption as a result of the financial asset test, the net asset test or the income test or all of the foregoing? If this information is not collected, we will not know.
- (iv) *Parent of issuer* - FAIR Canada believes that the issuer’s parent, if applicable, should be disclosed on the Proposed Exempt Distribution Report. Such information would be helpful to investors in the event of a future reorganization of the issuer or in the event of loss arising from insolvency of the subsidiary. We disagree that providing this information will be onerous. The issuer will know the information in each case and it should become known by the dealer in the course of fulfilling their know-your-product obligations.

4.2. FAIR Canada does not believe that the exempt distribution reports will be reviewed by many individual investors (whether accredited investors or other retail investors) *before* they make their investment. If the information being collected is also recognized as being information that would assist investors by:

- Providing them with useful information for performing due diligence about an issuer, and
- Leveling the playing field between investors and an issuer’s insiders and promoters,⁷

such information should be required to be provided to the investor *prior to* investing. This information will be far less useful after the investment has already been made. FAIR Canada therefore recommends that this information should be included in the Proposed Exempt Distribution Report but also should be made available in a format comprehensible to investors before they make their investment in a given issuer. Similarly, compensation paid by an issuer to a firm should be disclosed on the Proposed Exempt Distribution Report but the more detailed information as to how the firm compensates its employees on an individual basis should be disclosed to investors if such payments give rise to a conflict of interest or otherwise great incentives that are not in the best interests of the

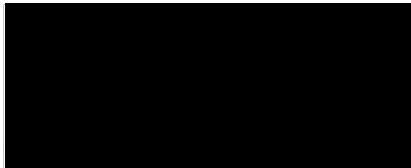
⁷ See the consultation document at page 7 re Item 5 information, which requires information that would provide an understanding of who controls the voting securities of the issuer and how much the management and principals of the issuer have invested in the business. Also contemplated is information as to the percentage of voting securities owned or controlled by directors, executive officers, control persons and promoters of the issuer (see question 6, at page 14).

investor.⁸

- 4.3. FAIR Canada recommends that the potential penalties for making a misrepresentation in the report should be specified at the top of the Proposed Exempt Distribution Report in addition to the bold warning that it is an offence to make a misrepresentation in the report. FAIR Canada also recommends that securities regulators and governments should ensure that there is an appropriate penalty for not completing the information and filing it on time (regardless of whether it is a “misrepresentation” under securities laws).

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Neil Gross at 416-214-3408/ neil.gross@faircanada.ca or Marian Passmore at 416-214-3441/ marian.passmore@faircanada.ca.

Sincerely,



Canadian Foundation for Advancement of Investor Rights

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

⁸ See discussion at Annex E, page 43-44 of the Consultation Document. We understand the “firm” in these instances are likely to be the exempt market dealers who are recommending the product to individual investors.