CFA Societies Canada

Canadian Advocacy Council

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December 16, 2020

VIA EMAIL

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Office of the Superintendent of Securities, Service NL
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Office of the Yukon Superintendent of Securities
Northwest Territories Office of the Superintendent of Securities
Nunavut Securities Office

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Dear Sirs/Mesdames:

Re: Proposed Amendments to National Instrument 45-106 Prospectus Exemptions and Proposed Changes to Companion Policy 45-106CP Prospectus Exemptions Relating to the Offering Memorandum Prospectus Exemption (collectively, the "Proposed Amendments")

The Canadian Advocacy Council of CFA Societies Canada[1] (the "CAC") appreciates the opportunity to provide the following comments on the Proposed Amendments.

We understand that the Proposed Amendments are intended to provide clarity and additional information on issuers engaged in "real estate activities" and those that are "collective investment vehicles" when they utilize the Offering Memorandum Prospectus Exemption ("OM Exemption") for distributing securities.

As CFA charterholders that hold investment decision-making roles, we often find that the fees, organizational disclosures, and investment risks and attributes set out in an offering memorandum ("OM") to be complicated, buried within other legal disclosures, and difficult for readers to understand in order to adequately evaluate a given investment opportunity. We agree there are several positive recommendations and prospective modifications to the OM disclosure in the Proposed Amendments, and we support the approach where disclosure is standardized across issuers and supplemented with industry specific information in Schedules to the greatest extent possible. We urge the CSA to continue to consider emphasizing clear and prominent fee and conflict disclosures upfront on the face pages of the OM as an important investor protection mechanism. We would encourage the CSA to also consider imposing a "plain language requirement" for specific portions of the OM, including the summary section, with cross references to where more detailed disclosures can be found in the document.

The notice accompanying the Proposed Amendments states that the OM Exemption is being used by larger and more complex issuers than originally contemplated. We believe the use of diagrams and tables, such as those that are already required for the "Use of Available Funds" disclosure, is more digestible for

[1] The CAC is an advocacy council for CFA Societies Canada, representing the 12 CFA Institute Member Societies across Canada and over 18,000 Canadian CFA charterholders. The council includes investment professionals across Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. Visit www.cfacanada.org to access the advocacy work of the CAC.
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investors than dense descriptive disclosure. Given the length and detailed nature of the prescribed form of OM, we would suggest mandating that issuers include an easily understandable organizational chart of their structure, showing the flow of fees and other funds upfront (currently, a description of the structure is required under Item 2.1 of Form 45-106F2). It is particularly important for issuers to be transparent about the amount, frequency and source of all fees that are payable in connection with the investment and the impact the payment of such fees will have on the net returns payable to the investors. Currently, fees paid to various services providers may be described throughout the document and thus it is difficult for investors to aggregate these costs in order to compare the total fees to other products or market norms.

The Proposed Amendments do not focus on the current "Use of Available Funds" chart in the OM. However, we believe this chart must also be improved in order to help investors understand the projected gross return of an investment and that, in some cases, the aggregate fees and costs associated with an investment could represent a large percentage of the aggregate capital raised, therefore substantially reducing the projected net return of such investment. Investors could then determine whether it will be difficult to earn a return on capital, or even a return of original capital, in the early years of an investment. This could also help with some confusion investors face from their client statements showing the investment at cost, which usually does not represent the redemption price. The chart should require an issuer to state the expected use of funds in both dollar terms and as a percentage of the amount raised. Such disclosure would also better represent the "J curve" of certain types of investments such as private equity funds (where certain vehicles tend to deliver negative returns in the early years).

We note that the Proposed Amendments have struck out disclosure in the OM to the effect that the available funds must be used for the disclosed purposes, and that if the funds may be reallocated, a statement would have been required indicating that funds would only be reallocated for sound business reasons. We are unsure of whether this removal means that such reallocation is no longer permitted and would appreciate confirmation of same.

We do not believe that the Proposed Amendments address all the concerns raised in Multilateral CSA Staff Notice 45-309 *Guidance for Preparing and Filing an Offering Memorandum under National Instrument 45-106 Prospectus and Registration Exemptions*. We have concerns about issuers with a practice of utilizing overly promotional marketing materials which is not consistent with the disclosure in the corresponding OM. We are aware that issuers often partner with exempt market dealers to promote an investment opportunity through investment seminars or presentation materials, and that those materials are often unbalanced and do not contain adequate conflict or risk disclosure.

Even though issuers are required in several jurisdictions to incorporate OM marketing materials by reference into the OM, stricter rules on the composition of marketing materials is required to ensure they are balanced. They need to contain key

material facts and disclosure about the investment structure, fees and risks. For example, while fees may be discussed at a high-level, the impact of the fees on the potential return of investment is usually not discussed, nor are any conflicts arising from related party involvement in the offering. For issuers with complex organizational structures or investment strategies, marketing materials may use terms such as "indirect exposure" to the underlying investment (particularly debt exposure) without detailing what that really means. In addition, marketing materials may describe the "aspirational" objective of the capital raise (e.g. to acquire and flip commercial property) but fail to disclose the current stage of the project and the steps required before a return on investment is realistic. Assumptions used should be clearly disclosed, and the timing and likelihood of these assumptions occurring should be indicated where possible. A description of the assumptions is particularly important in the current economic environment, where business plans might take longer to materialize. We understand the inherently promotional nature of marketing materials, but regulators must set out their expectations for balanced marketing materials specifically in connection with the use of the revised OM Exemption.

Clarity on regulatory expectations for these specific marketing materials would also assist exempt market dealers or other registrants reviewing such documents against their know-your-client, know-your-product and suitability obligations.

We are also supportive of harmonizing, when possible, prospectus exemptions across Canada for ease of use by registrants, investors and issuers and to reduce the possibility of regulatory arbitrage across jurisdictions. For example, the requirement to incorporate marketing materials into an OM as part of the OM Exemption is not uniform across Canada, providing less protection to some investors. In addition, the OM Exemption is not available in some jurisdictions for the distribution of securities of an investment fund, which has led to issuers located in those jurisdictions utilizing the OM Exemption where permitted (even if that was not the intention of the regulators) and simply providing the same OM to other investors using a different prospectus exemption. We encourage regulators to continue to try to provide uniform protections across the country to investors purchasing securities under the OM Exemption.

In order to help fulfil the stated purpose of providing more certainty to issuers on the disclosure expectations, if the Proposed Amendments are adopted it would be helpful to quickly publish regulatory guidance identifying any issues so that they can be corrected and avoided in a timely manner. An ongoing review of the effectiveness of the amendments will lead to collecting more data and potentially lead to enhanced oversight of specific requirements for the use of the OM Exemption.

Our specific comments related to the Proposed Amendments follow.

Issuers Engaged in Real Estate Activities

The Proposed Amendments would require issuers engaged in real estate activities to provide an independent appraisal of an interest in real property to the investor in the specified circumstances, including if the issuer intends to spend a material amount of the proceeds of the offering on an interest in real property. Such issuers would also need to add specific disclosure relating to the properties on a new Schedule 1 to Form 45-106F2, including information for those developing or operating real property.

We believe the definition of "real estate activities" is relatively clear, with the exception of the additional activities listed for the province of Quebec as exclusions, which is currently written as "the distribution of either of the following: (i) an investment contract that includes a real right of ownership in an immovable and a rental management agreement; or (ii) a securities of an issuer that owns an immovable giving the holder a right of exclusive use of a residential unit and a space in such immovable". We believe these phrases are ambiguous and open to interpretation, and thus would suggest some clarifications may be required.

We understand the purpose of the proposed requirement to provide an independent appraisal for real property. The Proposed Amendments suggest that an appraisal would be required if the issuer intends to spend "*a material amount of the proceeds*" (emphasis added) on an interest in real property. Different issuers and their managers may interpret the term "material" differently and/or too liberally, which presents risks to investors.

A single purpose vehicle making an investment in one property would likely meet this threshold and should be required to provide the suggested appraisal. However, as we are cognizant of the time and expense involved in obtaining independent appraisals, vehicles with different forms of investments or strategies would benefit from regulatory clarity on what "material" means in this context. We also query the benefit of providing hundreds of property appraisals for larger portfolios to the end investors, if "materiality" is not interpreted on a property-by-property basis but rather that a material amount of the proceeds are invested in one or more interests in real properties. For the later type of investment vehicle, it might suffice if a property appraisal were required for any one property that constituted a "material amount" (once defined) of the entire portfolio, or of a geographic region. Alternatively, appraisals could be provided on a rolling basis (e.g. obtaining an annual appraisal for 25% of the properties in the portfolio each year for four years until the entire portfolio is covered). Additional regulatory guidance on this point would help balance the cost burden with the benefits of additional transparency when warranted.

This requirement could be further expanded to require an appraisal within a shorter timeframe if there has been an event that has had a material adverse impact on the value of a property, but only in circumstances that in aggregate would have a

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material impact on the issuer's total portfolio. We anticipate this could be most useful for non-stabilized properties (such as those in development or pre-development). Such a requirement would deal with unforeseen market events, such as the expropriation of surrounding properties.

Item 3.1(k) in Schedule 1 would require disclosure, for real property that the issuer leases to others, of the occupancy level as at a date not more than 60 days before the date of the OM. We understand that different issuers have described the occupancy level of their investment properties differently from one another. Given that occupancy rates are a key metric reviewed by potential investors and that the methodology of the calculation and inputs into such rate are not standardized, we believe the CSA should mandate additional disclosure if this metric is included. Such disclosure should include the potential biases in presenting the information, which may otherwise understate the risk and inflate the prospects of the offering. For instance, certain issuers might report a tenant as "occupying" a property because the tenant is in place, but not because the tenant actually pays rent, as often landlords will offer free rent during the initial months of a lease to induce a tenant to move into their premises. The disclosure that a property is 100% occupied does not therefore necessarily mean that all tenants pay rent. For improved disclosure, we also believe that material rent abatements (duration and extent) granted by a landlord under certain circumstances (such as during the current pandemic) should be disclosed.

We strongly support the additional disclosures contemplated by the Proposed Amendments for related party transactions. It is important that investors be able to assess the validity of past transactions, the marketability of the underlying collateral and determine if the cost basis of the investment is subject to any bias. Item 7 of new Schedule 1 would require specific disclosure for each interest in real property for any transaction to which a related party was a party, including the amount and form of consideration. Issuers should also be required to disclose the basis or methodology of the amount of consideration, and whether an independent valuation was made available.

Issuers that are Collective Investment Vehicles

The Proposed Amendments would require collective investment vehicles to add specific disclosure on a new Schedule 2 to Form 45-106F2, including disclosure regarding the performance of the portfolio, in order to help provide prospective investors with additional information on the composition and performance of the portfolio.

We agree that disclosure of the performance of the portfolio is a useful metric to include in the OM, but note that in certain circumstances, absent regulatory guidance to the contrary, it may be necessary to update the document more frequently than would otherwise be the case if there has been a material change in the performance of the issuer leading to a potential misrepresentation in the OM if it is not updated or corrected.

For those issuers involved in factoring or otherwise holding receivables, the instructions could clarify that the information on the portfolio should include sufficient information on the unique or specific underlying business risks (e.g. with respect to potential non-payment of foreign receivables and /or the inability (or potential risks) in seeking recourse).

We think that additional guidance on the regulatory expectations for the preparation of performance numbers is important for issuers, particularly for those who may not have had to calculate performance numbers for distribution previously. CSA Staff Notice 31-325 *Marketing Practices of Portfolio Managers* contains good information on the potential use of hypothetical performance data, including the fact that such data should be restricted to investors known to have sophisticated investment knowledge, include clear and meaningful disclosure regarding the assumptions used to create the data, and clear disclosure of the risks and limitations of such data. The CSA should set out its expectations for the calculation and methodology used to present performance data over and above what is currently set out in the Proposed Amendments.

General Amendments

Other Proposed Amendments which would apply to all issuers using the OM Exemption are intended to address disclosure issues that staff have identified in their compliance reviews regarding offering memoranda.

We support the requirement to require the filed copy of an OM to allow for the searching of words electronically, which will be of assistance to investors and their advisors looking for key terms. We are also in favour of the new explicit requirement for an issuer to state on or close to the face page if they are disclosing a working capital deficiency as well as if they have paid dividends or distributions that exceeded cash flow from operations.

The Proposed Amendments include a new definition of a “related party”, which is key to some of the new disclosure requirements. Given the requirement to incorporate financial statements into the OM, we would recommend confirming that there are no gaps between the proposed definition and the definition of a related party under IAS 24 Related Party Disclosures, the purpose of which is in part to ensure disclosure draws the reader’s attention to the fact that an issuer’s financial position may be affected by the existence of related parties.

The Proposed Amendments would also require an offering memorandum to be updated to include interim financial reports for the most recently completed 6-month interim period where the distribution of securities under the offering memorandum is ongoing. While we are of the view that additional disclosure is generally beneficial for investors, we are concerned that given the time and costs involved in amending an offering memorandum frequently, the benefits to including such statements in the document may be outweighed by the burden placed on issuers. It may be possible as

an alternative to encourage issuers to make interim financial statements available to investors but not require such statements to be incorporated into the document as a condition of the OM Exemption.

Section 2.9 (13.2) of NI 45-106 would require an amendment to the OM if there is a material change with respect to the issuer after the certificate is signed but before the issuer accepts an agreement to purchase the security. We think the requirement should refer to either a material change with respect to the issuer or the securities being offered through the OM.

A new Item 2.8 in the Form will require specific information in tabular format for related party transactions, including a column for the amount and form of consideration exchanged in connection with the transfer. As noted above, it is important that investors be able to determine if the transaction was completed at a fair price or subject to any bias, and thus we would recommend an additional column where the basis for the consideration would be described, including the valuation methodology (e.g. price in the purchase and sale agreement, valued at NAV, carrying cost).

Under Item 3.1 “Compensation and Security Holdings of Certain Parties”, we think it would be helpful if the item clarified that trustees of issuers set up as trust should be required to disclose any ownership interest, which is of particular importance for mortgage or real estate investment vehicles with individual trustees.

We strongly support the enhanced disclosure that is proposed to be required under Item 3.3 “Penalties, Sanctions, Bankruptcy, Insolvency and Criminal or Quasi-Criminal Matters”. We note that Section 3.3(a) requires disclosure if certain sanctions or orders relating to, among other things, a contravention of securities legislation has occurred during the 10 preceding years with respect to a director, executive officer or control person of the issuer. We query whether the 10 year period is sufficient with respect to sanctions under securities legislation, and note that when an individual seeks registration with a securities regulatory authority, Item 13.1(d) of Form 33-109F4 *Registration of Individuals and Review of Permitted Individuals* requires the applicant to disclose whether they have <u>ever</u> been subject to any disciplinary proceedings or order resulting from disciplinary proceedings under securities or derivatives legislation.

Item 4.2 “Long Term Debt Securities” will require disclosure of the interest rate payable on the debt of the issuer. We recommend specifying whether the interest rate is fixed or variable directly within the table or a link to the section explaining the debt, which can help determine whether any such debt is subject to interest rate risk.

We strongly support the addition of the chart in Item 5A illustrating the issuer’s redemption and retraction history. An OM currently describes the rights of investors to redeem their securities and the potential gates and limitations thereon, however it does not provide investors with a sense of how often the gates or other limitations or full suspension have been used in the past. The chart will provide a clear, easy to read

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summary which potential investors can use when considering the implications on the liquidity of their own potential investment.

We are also supportive of the proposed new Item 5B to Form 45-106F2, as the source of funds for dividends and distributions is an important indicator of any possible cash flow constraints. The information will be able to help investors identify if the issuer is raising additional capital to fund existing distribution (or redemption) obligations, which can have a large impact on the issuer's future performance.

Concluding Remarks

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have and appreciate the time you are taking to consider our points of view. Please feel free to contact us at cac@cfacanada.org on this or any other issue in future.

(Signed) *The Canadian Advocacy Council of CFA Societies Canada*

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