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October 26, 2021

BY EMAIL

TO: British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
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 Superintendent of Securities, Service NL
Northwest Territories Office of the Superintendent of Securities
Office of the Yukon Superintendent of Securities
Superintendent of Securities, Nunavut

Attention:

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Re: Comments on Proposed Amendments to National Instrument 45-106 *Prospectus Exemptions* ("NI 45-106") to introduce the Listed Issuer Financing Exemption (the "Proposed Rule")

I am submitting these brief comments on the proposal to amend NI 45-106 to add the listed issuer financing exemption described in the CSA Notice and Request for Comments dated July 28, 2021 (the "CSA Notice"). I write on my own behalf because I believe the proposed new exemption is inconsistent with the protection of investors intended by Canadian securities laws when issuers seek funds from the public and should be withdrawn.

The Proposed Rule

The Proposed Rule would create an exemption from the prospectus requirements that would permit an issuer which has been a reporting issuer for twelve months and has equity securities listed on a Canadian stock exchange to make a public offering of securities of the listed class, or of securities convertible into listed securities, to raise up to $5 million or ten per cent of the aggregate market value of its listed securities to a maximum of $10 million, subject to a dilution limit of 100 per cent, within any twelve month period. Instead of a prospectus, the issuer would have to file, but not deliver to investors who purchase its shares, a short offering document ("financing document") disclosing how it intends to use the funds it raises and any other material facts not previously disclosed in its continuous disclosure filings. If the financing document or the issuer's current continuous disclosure documents contain a misrepresentation, purchasers will be entitled to rescind the purchase agreement and receive back their money or to bring an action for damages under the statutory secondary market civil liability regime. They would also be entitled to sell the purchased shares without the hold period required for securities purchased in other prospectus-exempt capital raising distributions of securities. The issuer would not be required to sell the securities through an underwriter and it would have to file a report of the exempt distribution, but without the list of purchasers required for other exempt distributions.

Market Integrity

The Proposed Rule would create an exemption allowing a public offering of securities without either a prospectus or a hold period. Since 1978,[1] the distribution of securities by issuers under Canadian securities laws has been premised on the closed system proposed by the Ontario Securities Commission ("OSC") in 1970,[2] which, in general terms, requires either a prospectus or a hold period when an issuer raises capital by selling its securities. Securities regulators have over the years considered developing an integrated disclosure system to replace this closed system based on the continuous disclosure required of reporting issuers. However, except for a cursory reference to alternative frameworks proposed for discussion in 2000 and 2002, which were withdrawn, the CSA Notice contains no discussion of the implications of the proposed exemption for the closed system, the regulatory disclosure system in current securities laws, or even whether revision of this system is again under consideration. Before a change like the one proposed is adopted, a full public discussion of the current system and the revisions to it that are implied by the Proposed Rule should be pursued through the notice and comment process.

The purpose of the Proposed Rule is to benefit small issuers by enabling them to raise significant amounts through a public offering, with some limitations on the amount and purpose of an offering. Specified maximum amounts are intended to enable a small issuer to obtain

[1] See *Securities Act*, 1978, S.O. 1978, c. 47.
[2] *Report of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements* (February 1970) (the "Merger Study").

sufficient funds for operations over the succeeding year. Securities sold under the exemption would be freely tradeable because the hold period may deter participation by investors, as it has been said to do in private placements. The hold period, however, was never intended to protect these initial purchasers. Rather, it was intended to protect public investors against an indirect public distribution, a so-called "two-step" distribution or "backdoor" underwriting, in which subsequent purchasers would receive neither prospectus level disclosure nor the withdrawal rights and civil remedies available to them in a prospectus offering.

The proposed amendments to Companion Policy CP 45-106 address the potential for backdoor underwritings by stating that resales in a two-step distribution would be integrated with the distribution and the initial purchaser would be required to register as an underwriter because the initial purchase was made with a view to distribution. This would resurrect the concept of investment intent for purposes of distributions of securities. The concept of investment intent, however, is unclear in application; every purchaser buys with a view to the possibility of reselling the purchased security at some point and intentions concerning timing may change. The closed system was adopted, in part, to do away with uncertainties concerning the application of the investment intent concept to private placements and the opportunities for indirect public distributions.[3] As the proposed additions to CP 45-106 recognize, the Proposed Rule would again provide an avenue for such backdoor underwritings, subject to the regulatory difficulties that existed in 1970.

Because the Proposed Rule would create such opportunities, monitoring by securities regulators of offerings made under the new exemption would be required to ensure against indirect distributions and other potential abuses. For example, the proposed exemption does not specify the nature or number of investors who may purchase securities. An issuer may sell shares to any investor without regard to the investor's knowledge or sophistication; purchasers may include a large number of retail investors or a small group of knowledgeable purchasers. Although the issuer must file a report of the distribution with securities regulators, the list of purchasers required for other exempt offerings need not be included because there are no eligibility requirements for purchasing investors. The reporting form does not otherwise require disclosure of the number of purchasers. Providing a list of purchasers would not impose an onerous obligation on issuers, as a purchase agreement granting a contractual right of rescission to each purchaser is required by the Proposed Rule. Requiring filing of a list of purchasers would facilitate monitoring of the use of this proposed exemption to detect and address abuses.

The CSA Notice, however, contains no information concerning securities regulators' intentions with respect to monitoring its use. If the Proposed Rule is adopted, a monitoring programme should accompany it. Public knowledge that offerings under the exemption will be closely reviewed by CSA members might itself help to deter abuses.

Investor Protection

The proposed exemption omits most of the investor protection provided under a prospectus and in existing prospectus exemptions. Similar capital raising exemptions are limited to persons who can fend for themselves (accredited investors) or have a close personal or business relationship with a director, executive officer or control person of the issuer that is

[3] See Merger Study, c. 5.

expected to protect them against abuse. Other exempt private sales are conditioned on the nature of the purchaser, impose minimum or maximum limits on the amount unsophisticated investors may invest and require delivery of an offering memorandum to each purchaser and a risk acknowledgment form to be signed by the purchaser. In addition, some preclude advertising and solicitation.

The proposed exemption would have no similar protections. It would permit sales of securities to anyone, in any amount up to the $5 million or $10 million maximum. The CSA Notice characterizes the ability of unsophisticated retail investors to participate in these exempt distributions as a benefit to them. As the intended beneficiaries of the Proposed Rule are small issuers in need of capital to enable them to continue to carry on their business, the proposed exemption would permit such retail investors to invest in issuers at the riskier end of the issuer spectrum, but without the protections that accompany existing exemptions or a prospectus distribution. For example, they need not be specifically informed of the risks associated with these investments, as the risk acknowledgment under the offering memorandum and crowdfunding exemptions requires. Nor would the Proposed Rule require delivery of the financing document to investors, as must occur under the offering memorandum exemption and with a prospectus. While the financing document must be filed and available electronically, retail investors are not likely to access or read it. Nor is it reasonable to expect unsophisticated retail investors to read the issuer's continuous disclosure file on which the use of a short financing document is premised, even if they are aware of SEDAR, which is itself questionable.

Although a public offering under the proposed exemption would otherwise be similar to a short form prospectus offering,[4] the Proposed Rule would remove the gatekeeper protection that exists with a short form prospectus. It would not require an underwriter or dealer, thus eliminating their due diligence review. It would also not require the issuer's auditor to consent to the current use of the issuer's audited financial statements, thus also eliminating the protection that the auditor's review may provide.[5] In addition, the prior review by securities regulators that is required for a prospectus would not be required for a financing document under the Proposed Rule. As the OSC states in Appendix E to the CSA Notice, the lack of underwriter's due diligence, and auditor's review, as well as prior regulatory review, may reduce the quality of the issuer's disclosure in connection with its offering. Foregoing these protections to reduce costs to small issuers will exacerbate the risks to investors who purchase their securities.

As the crowdfunding exemption permits a form of public offering to retail investors by a listed issuer, a comparison with the conditions for use of that exemption is illuminating. Under the crowdfunding exemption, the maximum amount raised in an offering cannot exceed $1.5 million, a non-accredited investor may not be allowed to purchase securities at a cost more than $2,500 in a single offering or more than $25,000 ($10,000 in Ontario) in any twelve month period, and the issuer cannot advertise or solicit purchases, other than informing investors of the dealer (funding portal) through whom its securities may be purchased. None of these limitations, nor similar ones, are in the Proposed Rule.

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[4] CSA Notice, Appendix E, p. 36.

[5] Presumably this is the reason for precluding incorporation by reference of the issuer's continuous disclosure in the financing document, as is required with a short form prospectus.

In addition, under the crowdfunding exemption, securities must be distributed through a single dealer that serves as a funding portal and exercises gatekeeper responsibilities, including reviewing the crowdfunding disclosure document and other issuer documents for accuracy and completeness, providing them to investors, and holding the investors' funds until the conditions of closing the distribution are satisfied.[6] The funding portal dealer is thus obligated to fulfil a subordinate regulatory gatekeeping role in crowdfunding distributions. Again, no similar gatekeeping functions would be required under the Proposed Rule.

A crowdfunding issuer must also provide civil remedies equivalent to those in a prospectus offering. The crowdfunding rule, NI 45-108, gives purchasers a contractual 48-hour right of withdrawal and contractual rights to rescission or damages for a misrepresentation in the issuer's offering document or continuous disclosure documents that it incorporates by reference. The Proposed Rule would require only a contractual right of rescission. It would not allow purchasers a right of withdrawal and it provides only for secondary market liability against the issuer, if the issuer's financing document or continuous disclosure documents contain a misrepresentation.

The CSA Notice explains its rationale for limiting purchasers' damage remedy to secondary market liability. It says that secondary market civil liability would put purchasers "on the same footing" as investors in the secondary market, that is, on a stock exchange, presumably because the proposed exemption is premised on the issuer's continuous disclosure. Purchasers in a listed issuer exempt offering, however, are not like those on a stock exchange. Purchases in an exempt offering would be directly from the issuer under a purchase agreement. Unlike in a stock exchange transaction, the issuer receives the investors' funds.

The CSA Notice recognizes this fact in connection with the requirement for a contractual right of rescission; it explains that this right "ensures that the issuer is not unfairly enriched as a result of its misrepresentation". It does not treat the right of action for damages in the same way because of a concern that doing so, "applying primary liability", as it says, "would increase underwriter due diligence costs and result in a much longer offering document" (even though the Proposed Rule itself would require neither).[7]

The Proposed Rule would thus allow the issuer to be "unfairly enriched" at the expense of the investors who purchase its securities. This unfairness is recognized in the existing statutory secondary market liability regime, which excludes prospectus liability. Purchasers in a prospectus offering have a direct statutory remedy for damages against the issuer for the amount of their purchase because the funds paid by investors are received by the issuer. This amount cannot be recovered under secondary market liability, which imposes a liability limit for issuers of five per cent of the issuer's market capitalization, in part because the issuer does not receive funds from investors who purchase in the secondary market.

The unfairness of the secondary market damage remedy under the Proposed Rule is illustrated by the following example. If an issuer with a market capitalization of $100 million raises the maximum $10 million permitted under the Proposed Rule (assuming the "aggregate

[6] These conditions are specified in NI 45-108, s. 6.
[7] CSA Notice, p. 5.

market value" of the issuer's listed securities under the Proposed Rule is also $100 million[8]), its maximum liability in a class action for damages on behalf of the purchasers would be $5 million. The purchasers would not be able to recover more than half of their investment. In fact, they would recover less, as any recovery would have to be shared with other investors who purchased the issuer's shares in the secondary market (on the stock exchange) during the period of the misrepresentation.

The CSA's rationale for this treatment has not been adopted in other exemptions that, like a short form prospectus, take into account the issuer's continuous disclosure. Canadian securities acts grant purchasers of securities prospectus remedies against an issuer that uses an offering memorandum in an exempt offering. The crowdfunding rule, NI 45-108, requires a crowdfunding issuer to provide equivalent contractual rights to both rescission and damages, as well as a right of withdrawal. The damage liability provisions of the Proposed Rule simply cannot be justified.

If the Proposed Rule is adopted, purchasers should be entitled to a right of withdrawal and prospectus-equivalent rights to rescission and damages in the event of a misrepresentation.[9] Indeed, it would be desirable to extend such liability to the issuer's directors and officers, as was recommended for offering memorandums by Ontario's Capital Markets Modernization Task Force.[10]

Conclusion

The Proposed Rule is intended to make Canadian markets more efficient by assisting small issuers to raise capital. In its desire to further this goal, it would trade off the protection of investors in a manner that is inconsistent with the existing regulatory regime and that creates a new avenue for abuse by persons who seek to exploit gaps for their own ends. It thus may have the effect of undermining the perceived integrity of our securities markets and the confidence of investors who participate in them. For the reasons outlined above, the Proposed Rule should be withdrawn.

Yours respectfully,

Philip Anisman

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[8] This would likely not occur, as the calculation of an issuer's market capitalization (e.g., Ont. Reg. 1015, s. 249) will likely differ from a determination of the aggregate market value of the issuer's listed equity securities on the date the issuer issues a news release announcing the offering (Proposed Rule, s. 5A.2(1)(f)). The Proposed Rule does not define how this value is to be calculated.

[9] See Capital Markets Modernization Task Force, *Final Report* (January 2021), p. 38.

[10] *Ibid*., p. 55.