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Ontario Securities Commission
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Attention: John Stevenson, Secretary to the Commission

Dear Sirs,

Please find enclosed comments with regard to crowd funding and possible changes to Canada's exempt markets.

Current Landscape

The current capital markets model has resulted in Public companies raising funds in one of two ways: either through a Registrant or through an exempt offering directly to the public. More and more, Public companies are choosing the second path (as shown by statistics) for two reasons, speed and cost.

Why? Over the past number of years regulators have worked hard to put in place rules and practices to protect the average investor and to make sure investors have access to proper advice and information around investments. In fact, with the current implementation of the new CRM (Client Relationship Model) rules, we are taking yet another step.

This, however, has resulted in an unexpected side effect – Cost. To implement and run the more robust systems has raised the cost of channeling underwriting through Registrants to the point where Public companies are actively arranging their affairs to avoid these new rules and regulations.

This additional cost has also affected investors such that sophisticated investors are also arranging their investments to avoid the new rules and regulations.

Overriding Goal

The overriding goal for regulators should be to find a balance between protecting the public and the cost of regulations (or that protection). A secondary goal should be to foster the health of the capital markets.

The Problem – Responsibility

Unfortunately, instead of a balance, the current system has resulted in a "have your cake and eat it too" paradigm. While regulators are continuing to perfect the registrant model for distribution of securities to the public (and take comfort in the idea that this should protect the public), they are enabling the exempt markets which are almost completely replacing the registrant system. How much protection is being afforded the investing public when for some number of years the exempt system has been responsible for 90+% of capital raised by SME's? The current system has also resulted in quiet "finger pointing" which no one so far has called out. The question which needs to be asked is "Who is responsible for looking after investors in the exempt markets?"

Current Players

- *Stock Exchanges*

  With the Maple Deal, stock exchanges in Canada took yet another step towards independence and their status as "for profit" organizations and away from the role of an institution serving the greater good. In addition, they are not governed by IIROC and so are not included in the scope of new distribution rules. Let's simplify their business for clarity. Exchanges earn a majority of their revenues from listing fees which they collect from their customers, the listed companies. As long as those companies have money in their treasuries the Exchanges are happy and if asked they would perhaps admit that they are far more concerned about preserving and enhancing the ability of their customers to raise funds than they are about caring for the investing public. In fact, I think they would suggest it is regulators who are responsible for the investing public and not companies. A good example of this is the lack of exchange rules around "fair" distribution of securities. Exchanges have no investor priority rules or rules around conflict of interest with regard to allocating share distributions.

- *Public Companies*

  Public companies are focused on driving the success of their business. They see the Capital markets as a key resource in that effort. They do not see themselves in the role of advising the public and if asked they would also suggest that role falls to the regulators. Their interaction with the markets is very mechanical. Ask the investor for money, get him to check the right boxes on the form, don't ask any questions and cash the cheque. Make the whole exercise as cheap and as fast as possible. They do not treat their interaction with investors as a relationship and take no responsibility for investor outcomes.

- *Exempt Dealers*

  I mention Exempt Dealers solely because they are a good example of the two paths the markets are headed down. Exempt dealers could easily exist inside the current IIROC system except that it would cost more to meet the rules and regulations. Why are we building a system to protect the public and then a second system to bypass it?

- *Finders*

  Of all the players in the system, finders are by far the most challenging. They are the unregistered registrants of the exempt markets. Finders are individuals or organizations who "steer" investors to public companies for a commission. They follow none of the rules because they are either not subject to them or because the risk of being caught is so small compared to the reward. They openly "coach" investors on how to qualify for offerings and provide "additional" sales information since their only consideration is getting paid and they will probably never speak to most investors again. Public companies claim they act independent of the company allowing the company to disavow any responsibility for any "sale materials or advice". They are paid commission and agent's warrants in the same amount and form as a registrant.

  When I mention their existence to experts south of the border, I get stares of disbelief, after all I am told, anyone who acts in furtherance of a trade has to be registered. Not in Canada I tell them, where "soliciting" and "recommending" have been carefully pulled apart so that it is not "advising" with regard to an investment to simply "point out" the amazing opportunity.

  Finders are the grease that makes the exempt market work. They keep the hands of the public companies and the exchanges clean by allowing them to claim that investors just stumbled upon the company, that the only information that <u>they</u> provided was access to news and SEDAR filings, that they did not make any promises to investors or coach investors on how to qualify and that their only responsibility is to check that the subscription form is filled out correctly.

- *Registrants*

  Registrants are unfortunately left to clean up the mess. CSA (Canadian Securities Administrators) and IIROC (Investment Industry Regulatory Organization of Canada) have recently introduced "enhanced suitability" rules which include the requirement for dealers to advise their clients as to the suitability of exempt investments at the time they are deposited into the client's account. I say unfortunately because the horse has already left the barn. The investor has already been sold the securities and it is too little a lot too late to suggest that investors are somehow served by advice after the fact.

  Regulators need to decide whether the cost of regulation is worth it or not. If it is then we need to make sure those selling investments are subject to supervision by a regulator or self-regulator organization who has the time and resources to supervise and make sure the investments being sold aren't given an alternate path.

- *Public*

  The public unfortunately are often the greatest losers in this confusing landscape. They don't really know who to believe, they feel if they don't "play ball" they will miss out and when something goes wrong they find everyone "points the finger".

Tackling the Issue (Request for Comments Section 3, 4, 5.3, 6, 8)

How do we make sure the public get access to investments AND good advice?

This is by far the most difficult issue to deal with.

This conundrum really arose out of the Tech boom when regulators discovered that companies were using exempt issuances to allow high net worth investors and insiders to buy up the best underwritings without the general public ever getting a chance to participate. Regulators tried to address this inequity by lowering standards for individual investors and giving them better access.

Unfortunately this approach has not worked as:

- Investors now get less advice than they ever have around what are often sophisticated, high risk investments;
- Companies, who have no obligation to clients, now place their stock wherever they please, often to insiders with no regard to client priority and;
- A whole industry of non-licensed "middle men" and discount dealers has emerged to enable the exempt market which now represents more than 90+% of underwritings

So how do we fix things?

I think the OSC's comment paper asks a number of good questions which help if we answer them, along with a careful focus on investors and a look at what other countries are doing.

Redefine the Exempt Market

<u>A number of countries have found the answer to exempt markets is to raise the standard not lower it.</u> The answer to putting high net worth individuals on an even footing with investors is to force them down into the retail channel the regulators have carefully built to protect the public and out of the exempt channel. This retail channel is not unlike an insurance pool where unless a majority of people participate to diversify costs, the system doesn't work. I know sophisticated investors often don't need the protection but if they are allowed to bypass it then the cost of providing it for the average investor rises to the point of making it intolerable for public companies especially when they can access large investors and insiders independent of it.

In addition, when these investors exist in a separate pool devoid of client priority or conflict of interest rules, it is inevitable that they will put sufficient pressure on the process to turn it to their advantage. If you want the average investor to have a chance, you have to level the playing field and introduce an independent arbiter.

The institutional market would continue to exist but with a standard perhaps defined as "distributions of more than $250,000 each to less than 25 corporations with net assets of greater than $10 million". The oversight required by commissions would shrink measurably and players would be far enough beyond any means test that they would be clearly capable of looking after themselves. This mimics what many other countries have done including the US where a QIB (Qualified Institutional Buyer) is a corporation (not an individual) with net assets between $25 and $100 million depending on the type of entity.

Stop Public companies from paying non-registrants for capital raising activities

<u>I cannot stress this point enough.</u> It is completely absurd to allow public companies to pay non-registered entities (finders) commissions and agent's warrants for help with capital raising activities. The greatest encouragement you can offer participants in the system to follow the rules and foster trust in the capital markets is to only allow them to be paid if they do so. If you allow people to access the rewards of the business without taking an equal dose of responsibility you compromise everything we are all working towards. Many investors would not be lead astray in the exempt markets if it were not for Finders and public companies need to bear responsibility for not using them. Remember, payroll taxes are not consistently remitted because every employee makes it a priority; they are consistently remitted because, if not, CRA looks to the company and its directors for the money!

Solicitation is Recommending!

It is also absurd to suggest that "pointing out" investments can be separated from recommending. In the US the logic is simple, if you weren't trying to get the investor to buy the investment you would not point it out. Financings are by their very nature <u>a solicitation and a recommendation</u>. Regulators and SRO's need to treat them as such and make sure investors have access to proper advice around them through full service advisors. Second, unlike trading the public markets where you have access to all available choices, if you are a dealer only providing underwritings someone has chosen (a limited selection) then the client's assumption that you like (recommend) the investments being offered is correct (after all why did you recommend some and not others). Let's stop being cute - trading services can be independent of advice; distributions cannot. Public companies and registrants who do not provide advice need to stop soliciting (recommending) underwriting OR they need to acknowledge the assumed recommendation and do the proper KYC and suitability work.

Require distributors to be registered and take responsibility

Some would argue that the former points are self-serving and are designed to create an oligopoly for investment firms. They are to some degree. But that is not to say I am not willing to share the playing field.

The key point I am trying to make is that everyone who distributes securities to the public needs to be responsible to the investor. If the exempt market were realigned as above then public companies would be in most cases distributing exempt product to registered (institutional) entities for which there is a separate exemption.

For the rest of the distributions, if public companies want to distribute themselves, then I would be open to it as long as they register with IIROC as dealers and take the same responsibility for investors as the rest of the players on the field - the same responsibility for qualifying investors, the same responsibility for suitability, and the same responsibility for the process and materials used in the distribution.

Public companies will argue that if the measures I am suggesting were implemented they would lose access to an important source of capital. This is a shallow and misleading argument. The capital is still available. What they are really arguing is that they would lose the ability to distribute to the public with no consequences or responsibility and they would lose the cost savings that are driven by end running the carefully designed checks and balances which exist as part of the dealer system.

Often regulators think about the role of an agent as simply a source of advice

IIROC members are valued by regulators as a source of client advice. This sometimes results though in other key benefits being ignored. In a brokered exempt placement, the dealer has a say in the format and terms of the subscription agreement, a key element in representing and protecting the client. Also, the dealer has the right to ask questions of the company and receive information to use in its advice to the client, another key element of being in a position to counsel the client if asked. These are only two of the many advantages to the client which flow out of a dealer's involvement.

Most clients would not attempt to close a real estate transaction without a lawyer or purchase a business without an accountant's help. Regulators need to take stock of the fact that most clients need representation with regard to the process (outside of advice) of purchasing a placement and that public companies are NOT currently required to make any efforts to act in a fair and reasonable manner towards the clients.

As a dealer we are routinely told by companies that, in a non-brokered deal, we have no right to make demands on behalf of our clients. In fact, on rare occasions, I have been asked by a company for the identity of our client and then been told that our client will not be able to purchase any of the placement because they are not liked by management (something that could not happen in a brokered placement).

Expansion of the Exempt Market

If the exempt market is to be expanded and current types of disclosure are going to be waived to "Democratize" the system then surely the safest way to do this is inside the IIROC full service forum which contains numerous other investor support mechanisms. Full service IIROC dealers are required to give advice around every investment. They are in a position to help investors conduct the correct research before making a decision. They have access to SEDAR and can answer questions around company disclosure and information.

This forum could include other players, as has been previously suggested (although they will probably cry foul when asked to step up to the plate of responsibility like everyone else). We would be in favour of increasing the access by the general public to exempt products, but suggest the only responsible way to do this is inside the protected full service dealer based channel and not in the "free for all" non-registrant channel.

Align Regulators

One of the other critical issues facing regulators is alignment. Regulators work well together when there is a direct line of delegation. As an example, when CSA is coaching IIROC on what their expectations are around new dealer regulations. Where the system does not work is when the regulators and SRO's are trying to manage their own direct reports. In this area resources are different, expectations are misaligned, and outcomes vary widely.

I think this stems from two issues:

The first is based on the fact that it is easier to tell someone to do something than it is to do it yourself. IIROC has been told by securities commissions to audit all of it members on a certain schedule. IIROC works very hard to maintain this schedule. The securities commissions also have direct reports and audit staff. If one were to look at provincial securities commission's record of maintaining a similar schedule (or any schedule) the record would be poor at best.

The OSC and the CSA need to include, as a primary goal, the idea that all capital markets need to be a level playing field. Not just with regard to desired outcomes, which leave far too much room for "tried hard", but with regard to day to day reality. At this point in time, as pointed out earlier, there is a huge difference in the responsibility and standards market participants are held too and it is creating significant disruption in the economy and in the functionality of the Capital Markets. The OSC and the CSA need to find a way to treat everyone with an even hand and eliminate the regulator "dodges" which exist due to time and resource constraints.

Perhaps the idea, that the OSC and CSA should regulate market participants and trading platforms solely through SRO's, needs to be reconsidered. With no direct reports, resources could be focused and regulators might avoid a large part of the conflict which is causing the huge inequities which currently exist.

Secondly, regulators need to work harder at not allowing various special interest groups to "end run" the carefully crafted channels that have been put in place over many decades or if they feel those channels are not working, then we need to fix them.

Of course, it is cheaper and faster to close underwritings with no due diligence or inquiries. Public companies and exchanges complain that they need better access to the public through the exempt market. What they are really saying is "it is cheaper and faster to raise money when we don't have to write any disclosure, when nobody reviews the project, when no one reviews or takes responsibility for the suitability of the investment for the investor and his/her circumstances" AND THEY ARE RIGHT! If you tell IIROC dealers that we can run the system as "buyers beware" then we can do it really fast and cheap too!

<u>The exempt market needs to be viewed as a channel which bypasses all the normal and reasonable protections put in place for most investors. This special market needs to exist only for participants who are registered in their own rights and where their own governance standards serve to enforce fair and conflict free behaviour.</u>

If regulators want faster, cheaper and more available then let's build that option inside the current dealer system. It is a dangerous (and unfair) cheat to suggest that the public is being protected by the current full service dealer system and those registrants diligently working inside it, while at the same time expanding an alternate channel with none of the same protections in the name of "faster and cheaper" for the benefit of market participants who if asked would deny any responsibility for the investing public.

Crowd Funding (Request for Comments Section 5)

Crowd funding is a passing fad which has no place in the markets. It has the potential to cause the same headaches for the OSC that small charities cause for CRA. When small amounts of money are raised by small, badly organized corporations, problems arise:

- First, by the time the costs of raising capital (including organizers costs) are accounted for there is a real danger there will be nothing left (charity collection agents sometimes take as much as 50%)
- Second, because the amounts are so small, investors rarely complain and complaints are difficult to manage
- Third, infrastructure costs will quickly bury investors (because no CDS members would be involved), investments would have to be evidenced by physical certificates at a cost of $40-110 per cert, transfer agents will insist on medallion guarantees for transfers which no one will provide, etc.

In addition:

- How will authorities manage the advisors involved in soliciting the clients? (because there are always advisors involved!)
- Who will manage which clients should and should not be involved?

In the mid 80's stock exchanges went through a fairly drawn out process to weed out those issuers who were raising money for projects which were not commercially viable. This effort has improved things but not to the point where it would be hard to point out issuers who have raised money to pay themselves a salary. At least with investment dealers taking some responsibility for underwritings this has been minimized.

Crowd funding would throw the doors open again. Perpetual Energy machines would quickly pop up and the unsophisticated would soon be parted from their money through portals making outrageous claims.

Who will be the control on this new arena? Can this <u>realistically</u> be managed? Securities regulators are already spread thin with most provincial registrants only reviewed periodically (many registrants have never seen a regulatory audit in spite of years of business).

Lastly, industry has spent many hours deciding who should have access to the greater public and who should be confined to their circle of friends and family. Being a public issuer has become very inexpensive through efforts around capital pools and opportunities to RTO. SME's need to avail themselves of these existing facilities instead of inventing new forums outside of the well thought out current models.

With the other far larger issues in the markets, I would suggest this will quickly become a headache for regulators and a distraction from more pressing issues.

Need for Exempt Market Data (Request for Comments Section 7)

Data is clearly a necessity when it comes to making good decisions. It also serves a secondary key purpose. It forces industry participants to be "on the record". We think it is entirely reasonable to ask public companies to file <u>ELECTRONIC</u> information on each placement or capital raising activity they undertake. We also think it is reasonable to ask the exchanges to do the same and by doing so make them responsible for the degree to which their members comply.

We would suggest this information should include:

- The number of "placees", their names and the amounts purchased
- The materials each investor received and the time and place the materials were available
- The exemption used by each investor and any efforts to confirm their compliance with the terms of the exemption
- Whether any external agents were involved in either making "placees" aware of the placement or in soliciting (finding) investors
- Any relationship the agents have to the company or its management
- The details of any work the agents have done previously for the company

- Any relationship the agents have to the company or its management
- The details of any work the agents have done previously for the company
- The details of any work the agents have done for related companies
- The details of any fees that were paid for advice around the distribution or finding investors
- The details of any fees paid to the agents for other services to the company
- The total amount of fees earned by the agent for similar work in the preceding 12 months

Due to the arms-length nature of the relationship and the fact that IIROC members are reviewed independently, we would suggest this information only be collected from companies and exchanges.

A Warning

There is a tipping point, past which, so much business will have gravitated to the channels outside the dealers that there is not enough business to sustain the dealer channel. In these markets, I would submit we have already passed this point (supported by the current round of consolidation we are experiencing). Clearly, the future landscape will be a result of choices the regulators make going forward. Commissions need to understand however, that once the damage to the channel reaches a certain point, their opportunity to use it as part of a client solution will have passed and they will have lost the ability to re-level the playing field.

I hope my comments cause the OSC to pause and consider how the markets work as a whole. I would be happy to provide further feedback on any of the issues I have raised. Please do not hesitate to follow up at your convenience.

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