FAIR | Canadian Foundation *for* Advancement *of* Investor Rights

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RE: OSC Exempt Market Review: OSC Staff Consultation Paper 45-710 Considerations for New Capital Raising Prospectus Exemptions

FAIR Canada is pleased to offer comments on Ontario Securities Commission ("**OSC**") Staff Consultation Paper 45-710 (the "**Consultation Paper**") on considerations for new capital raising prospectus exemptions, namely a crowdfunding exemption; an offering memorandum exemption, and exemptions based on sophistication and on registrant advice.

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.

FAIR Canada Executive Summary

1. FAIR Canada's comments in response to CSA Staff Consultation Note 45-401 noted the lack of data regarding the exempt market which prevents key information from forming part of the policy-making process, the serious compliance concerns that are known, a perception of weak enforcement which harms investors and weakens confidence in exempt market investing, and the lack of a sound rationale for the accredited investor and minimum amount exemptions. Our concerns remain and we urge caution in expanding the exempt market in the absence of necessary empirical information.

2. Need for Empirical Data: FAIR Canada sets out, in section 2 below, the type of empirical data that is needs to inform the policy-making process. There is a surprising lack of empirical data on the exempt market upon which to base policy decisions. We fully supports the OSC's suggestion that it mandate electronic filing of the reports and amending the reports to require additional information, in order to obtain needed information upon which to base policy development.

3. True Capital Formation Requires Focus on Market Efficiency and Investor Protection: FAIR Canada is of the view that the policy objective of increasing the amount of capital

raised from the exempt market for businesses, particularly SMEs, must be accomplished in a manner that protects investors, otherwise real capital formation, where monies are invested in productive assets (leading to increased jobs and economic growth), will not occur. Simply increasing the gross dollar amount of capital raised in the exempt market can be illusory, pointless and even destructive to the ability to raise capital for SMEs.

4. FAIR Canada believes that the OSC's focus should be on the quality of capital formation given its mandate "to foster fair and efficient capital markets and confidence in capital markets". In order to foster "fair and efficient capital markets", the OSC must have regard to the quality or efficiency of the market, rather than simply the amount of capital raised.

5. A regulatory framework which provides for strong investor protection and efficient markets will also facilitate true (i.e. quality) capital formation, resulting in lowering the cost of capital and increased confidence in our markets. Instead of viewing investor protection mechanisms as getting in the way of capital raising efforts, they should be seen as essential features of a properly designed regulatory framework.

6. Resolving Compliance Problems Critical: The lack of compliance with rules governing the various exemptions is a critical issue that needs to be resolved in order for there to be adequate investor protection. Non-compliance with the rules, weak enforcement, and a perception of weak enforcement (including difficulties for investors to obtain recovery of any funds) harms investors and weakens confidence in the exempt market and our capital markets. Confidence in our markets, including confidence that the markets are fair and that the rules are effectively enforced, is critical to capital formation.

7. FAIR Canada urges the OSC to ensure that the OSC has adequate resources in order to have robust compliance with respect to issuers and registrants who operate in the exempt market. Absent real compliance and sufficient punishment for those who do not comply, broadening the exemptions that can be relied upon to raise capital will simply result in greater investor harm.

8. How to Assess Prospectus Exemptions: FAIR Canada believes that any proposed prospectus exemption should be assessed according to whether it would foster fair and efficient capital markets and confidence in capital markets and provide adequate protection to investors. Does the exemption promote informational symmetry between issuer and investor and the ability of the market participants to use that information effectively so as to make informed decisions? Or does the proposed exemption increase informational asymmetry, discourage signalling (is there price discovery through published pre-trade and post trade information) and encourage unsophisticated investors who lack investment knowledge (about the exempt product at issue) to participate? Moreover, is there effective oversight, enforcement and procedural fairness to ensure that investors are adequately protected?

9. Do Not Implement Crowdfunding: FAIR Canada believes that permitting equity crowdfunding will pose great harm to investors and FAIR Canada recommends that Canadian governments and securities regulators decline to introduce it on the basis that it is too risky for investors and will undermine investor confidence in the Canadian capital markets. FAIR Canada believes that the existing crowdfunding concept results in too large a degree of informational asymmetry and too great a risk of fraud and potential for investor harm and, therefore, will not result in efficient markets nor the desired benefits that its proponents would argue it will achieve.

10. No Evidence of Purported Benefits of Crowdfunding: FAIR Canada also believes that there is little evidence that crowdfunding will result in the purported benefits – that is, improved capital formation, with resulting job creation and improved economic output. The lowering of investor protections with the resultant likely increase in fraud has the real possibility of hurting legitimate businesses by increasing the cost of capital while making it easy for fraudsters and scammers to make off with investor's funds.

11. Crowdfunding a Top Investor Threat: The North American Securities Administrators Association, which represents U.S. state and Canadian provincial securities regulators, has listed crowdfunding and internet offers as one of its Top Investor Threats in its 2012 NASAA Enforcement Report.

12. Democratization Amounts to Removing Investor Protections: The Consultation Paper sets out the argument made by proponents of crowdfunding that it will provide investors with more access to investment opportunities through the exempt market and thereby "democratize the exempt market". The term "democratize" is generally used to refer to the transition from an authoritarian to a democratic political regime. The proponents of crowdfunding and expanding the exemptions available in the exempt market use this euphemistic term instead of being more candid. What they really mean is remove investor protection from people who are unsophisticated investors with less wealth so that they can make more money selling high risk unregulated products to them. What should concern securities regulators is not whether something is "accessible" to everyone or "democratic", but whether it is designed so that the market is efficient and investors are adequately protected. Moreover, all investors are currently able to access SMEs through the public markets, mainly on venture exchanges where there are greater investor protections than are contemplated with the crowdfunding concept.

13. Exempt Market Not Suitable for Many Retail Investors: FAIR Canada is of the view that, for many retail investors, investing in the exempt market would not be suitable given the lack of liquidity and the higher risk that are associated with the vast majority of its investments. The fact that there is an aging demographic, a decline of pension plans and the increasing need to save for one's own retirement, coupled with increasing complexity and amounts of information does not lead to a need for more investing in

higher risk unregulated or poorly regulated products in the exempt market by seniors or baby boomers, as a group

14. If Crowdfunding to be Introduced, More Measures Required: While FAIR Canada does not support the introduction of crowdfunding, if it is nonetheless introduced a number of measures need to be taken to reduce the harm that is likely to occur.

15. Do Not Introduce an OM Exemption in Ontario: FAIR Canada is strongly of the view that an OM exemption should not be adopted in Ontario. We question whether the issuers the OSC has targeted to assist through this consultation, particularly SMEs, have the requisite sophistication and resources available to comply with the OM concept idea and note significant non-compliance by EMDs and with prospectus exemptions generally. In our view, the introduction of an OM exemption in Ontario has not been suggested to meet an investor need, is unprincipled, would reduce investor protection, and undermine confidence in the Ontario capital markets.

16. Assessing Prospectus Exemptions: In FAIR Canada's view, in evaluating the appropriateness of prospectus exemptions, it is important to clarify the products and distribution channels to which exemptions would apply. Our understanding is that the risks posed to investors vary considerably depending on: (i) whether the security is that of a listed issuer or not; (ii) whether the seller is a member of a self-regulatory organization (i.e. the Investment Industry Regulatory Organization of Canada ("**IIROC**")); and (iii) whether the security is straightforward or complex. We believe that exemptions based upon sophistication and advice must specifically consider the aforementioned factors in order to ensure an appropriate level of investor protection.

17. Given FAIR Canada's principled opposition to the accredited investor exemption (as currently defined), we do not agree that consistency with the accredited investor exemption is a basis for ignoring the different risks posed by different types of issuers and securities.

18. Complex Products: FAIR Canada is of the view that risks to investors are increased when the security being sold is complex. We recommend that the considerations for prospectus exemptions based on sophistication and advice only apply to non-complex products absent a separate consultation to consider the appropriateness of offering complex products to retail investors in the exempt market.

19. Investor Sophistication – Knowledge and Experience: FAIR Canada agrees that an investor's knowledge of an investment as a result of his/her education or work experience and investment knowledge and experience is a more appropriate test for investment sophistication than a test that simply looks at income or net worth of a certain minimum amount. We believe that the premise of this proposed exemption is conceptually sound and provides a reasonable justification for not providing the full protection of registrant involvement and prospectus-level disclosure.

20. FAIR Canada encourages the OSC to consider whether one year of relevant experience in the investment industry is a sufficiently long period of time within which to acquire the knowledge and sophistication to enable an investor to understand the risks and characteristics of exempt market distributions. We suggest that two or three years might be a more appropriate amount of time to gain the requisite experience. In FAIR Canada's view, the relevant work experience could be expanded to also include experience as an investor.

21. Accredit Sophisticated Investors: FAIR Canada recommends that, in place of (or in addition to) the proposed education qualifications, the OSC consider an accreditation program to accredit sophisticated investors. Such a program could be tailored and designed to ensure that individuals who wish to invest in the exempt market are fully aware of the reduced protections afforded in the exempt market and their rights, and that they meet a minimum level of investment knowledge.

22. Exemption Based on Advice: In principle, FAIR Canada believes that an exemption based on the provision of advice by an investment dealer, in conjunction with investment knowledge could provide an appropriate level of protection for investors. We stress that compliance efforts will be essential to ensure that the above conditions are met.

23. FAIR Canada agrees that it would be inappropriate to extend the proposed registrant advice exemption to exempt market dealers, particularly in light of significant compliance issues observed in relation to some such registrants.

1. General Comments

Pressures to Expand Exempt Market

1.1. As explained in the Consultation Paper, the current consultation arises as a result of feedback received from the November 10, 2011 CSA Staff Consultation Note 45-401, Review of Minimum Amount and Accredited Investor Exemptions. As stated in the Consultation Paper: "Given the feedback received during the first consultation, the OSC decided to expand the focus of our review to consider whether there was potential to foster greater access by start-ups and small and medium sized enterprises[1] (SMEs) to capital markets while maintaining appropriate investor protection."[2] The review of the exempt market was thus broadened to consider whether the OSC should introduce any new prospectus exemptions that may assist capital raising for business enterprises while still protecting investors.[3]

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[1] The definition of a SME is all small and medium sized enterprises which have less than 500 employees and less than $50 million in revenues; see http://www.tpsgc-pwgsc.gc.ca/app-acq/pme-sme/importance-eng.html.

[2] OSC Exempt Market Review, "OSC Staff Consultation Paper 45-710 – Considerations for New Capital Raising Prospectus Exemptions" (December 14, 2012), at page 4.

[3] *Ibid.*, at page 4 and at 23: "One of our goals is to consider whether any new prospectus exemptions could improve capital raising options available to SMEs without unduly compromising investor protection." Also see OSC Staff Notice 45-707, at page 1.

1.2. The feedback on CSA Staff Consultation Note 45-401 expressed a wide range of views and diverse opinions.[4] **FAIR Canada's comments noted the lack of data regarding the exempt market which prevents key information from forming part of the policy-making process, the serious compliance concerns that are known, a perception of weak enforcement which harms investors and weakens confidence in exempt market investing, and the lack of a sound rationale for the accredited investor and minimum amount exemptions.** Our concerns remain and we urge caution in expanding the exempt market in the absence of necessary empirical information, which we will expand upon below (for example, about the extent of fraud or losses suffered with various existing prospectus exemptions or the amount of capital raised by SMEs from individual (retail) accredited investors using the accredited investor exemption).

Developments in the United States – The JOBS Act

1.3. With the economy continuing to struggle in both the United States and Canada subsequent to the 2008 financial crisis, the idea of relaxing existing securities requirements or introducing new exemptions in order to facilitate capital raising has gathered political momentum. In the United States, political pressure led to the passing of the Jumpstart Our Business Startups Act (or the JOBS Act). It appears that there is similar political pressure in Ontario and other provinces. In Ontario, OSC Staff Notice 45-707, *OSC Broadening Scope of Review of Prospectus Exemptions* dated June 7, 2012, notified stakeholders (among other things) that the OSC was considering introducing new exemptions and would consider developments in other jurisdictions, and in particular, would consider developments in the U.S. with respect to capital raising contained in the JOBS Act, thereby raising the idea of relaxing capital raising requirements and introducing equity crowdfunding into Canada.

Objectives of the Exempt Market Review:

Objective 1: Focus on Capital Raising

1.4. The title of the Consultation Paper indicates that the focus of this review is increasing the ability of market participants to raise capital. The Consultation Paper sets out the objectives of the policy review: "...to consider how to regulate the exempt market in a manner that:

- Enhances its role in raising capital for businesses, particularly SMEs,
- Provides retail investors with greater access to investment opportunities without compromising investor protection, and
- Better aligns the interests of issuers and investors."[5]

[4] See summary of Feedback in OSC Staff Notice 45-707, OSC Broadening Scope of Review of Prospectus Exemptions (June 7, 2012) at page 2 to 3.

[5] *Supra* note 2, at page 4.

1.5. ***Policy Objective*** – *Raising Capital*: FAIR Canada is of the view that the policy objective of increasing the amount of capital raised from the exempt market for businesses, particularly SMEs, must be accomplished in a manner that protects investors, otherwise real capital formation, where monies are invested in productive assets (leading to increased jobs and economic growth), will not occur. Instead, funds raised will be diverted away from productive uses, through fraud or other wrongdoing, destroying capital and resulting in an increase in the cost of capital – the opposite of what is intended. Simply increasing the gross dollar amount of capital raised in the exempt market can be illusory, pointless and even destructive to the ability to raise capital for SMEs.

1.6. ***True Capital Formation*** - The need for investor protection in order to facilitate true capital formation was aptly described by Commissioner Luis Aguilar in his speech to the AICPA Conference on Current WEC and PCAOB Developments this past December 3, 2012:

> Capital formation is much more than just capital raising. By itself, selling a bond or a share of stock doesn't add a thing to the real economy, no matter how quickly or cheaply you do it. True capital formation requires that the capital raised be invested in productive assets – like a factory, store, or new technology – or otherwise used to make a business more productive. The more productive those assets are, the greater the capital formation from the investment – and, importantly, the more jobs created.
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> Unfortunately, the reverse is true as well: When investor funds are diverted away from productive uses, capital is destroyed. Scam artists and promoters can be very effective at raising money, but accounting frauds, ponzi schemes, and "casino capitalism" are the black holes of capital formation. They attract investment dollars and make them disappear. We see this again and again in cases brought by the SEC and other regulators: All too often, by the time the fraudster is caught, investor funds have been dissipated and the defendant is judgment-proof. The result is that investors are left holding the proverbial bag – their money lost and their dreams shattered.
>
> My experience as an SEC Commissioner make it clear to me that rules to promote full and fair disclosure, reliable information, and accountability for market participants are absolutely necessary. When properly enforced, such rules help to deter fraud, protect investors and enable true capital formation.[6]

1.7. ***Quality of Capital Formation*** - FAIR Canada believes that the OSC's focus should be on the quality of capital formation given its mandate "to foster fair and efficient capital markets and confidence in capital markets". In order to foster "fair and efficient capital markets", the OSC must have regard to the quality or efficiency of the market, rather than simply the amount of capital raised. While proponents of crowdfunding and other exemptions cite the amount of capital raised as an indication of success, FAIR Canada believes that other measures are better indicators of success or lack of success (what was the amount of true capital formation), such as:

- How much of the money raised from retail investors was misappropriated through fraud or other wrongdoing?

[6] Speech by Commissioner Luis Aguilar, "Capital Formation from the Investor's Perspective" (December 3, 2012), online: <http://www.sec.gov/news/speech/2012/spch120312laa.htm>.

- How much of the money raised by SMEs resulted in positive returns for investors, one, three and five years later? What are the returns for investors, and in particular, retail investors, in the exempt market more generally?
- Has money raised in the exempt market from retail investors been efficiently allocated to create jobs and growth or has the exempt market been inefficient in capital formation?

1.8. FAIR Canada believes that the focus of regulatory efforts should be on providing a regulatory framework which allows for strong investor protection and efficient markets, rather than, as stated by the OSC staff in the Consultation Paper, "One of our goals is to consider whether any new prospectus exemptions could improve capital raising options available to SMEs without unduly compromising investor protection."[7]

1.9. ***Investor Protection Promotes Capital Formation*** - **FAIR Canada is of the view that a regulatory framework which provides for strong investor protection and efficient markets will also facilitate true (i.e. quality) capital formation, resulting in lowering the cost of capital and increased confidence in our markets. Instead of viewing investor protection mechanisms as getting in the way of capital raising efforts, they should be seen as essential features of a properly designed regulatory framework**.[8]

1.10. An efficient market will be one where there is accuracy in pricing. Informational symmetry and the ability of market participants to use that information effectively will promote efficiency of markets. Prospectus exemptions should be designed to promote the aforementioned characteristics.

1.11. Commissioner Aguilar sets out the manner in which investor protection promotes true capital formation. He states that it does so by:

- Firstly, providing investors with the confidence they need to invest – they must have confidence that the markets are fair and that the rules are effectively enforced, and that the information is meaningful, accurate and complete;
- Secondly, requiring that investment decisions be based on reliable and useful information so that investors can better price risk and determine value – the essential thing is that investors are fully informed of the risks, so that they can decide where, when and how to put their money to work
- Thirdly, allowing widespread access to reliable financial information lowers the cost of capital by reducing the risk premiums demanded by investors. Investors will bid-up the price of quality investments, lowering the cost of capital for such issuers.[9]

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[7] *Supra* note 2, at page 23.

[8] Researchers in law and economics posit that strong regulation, mainly governing IPOs, is a prerequisite to the establishment of a sound equity market. See Black, B.S. (2001). "The Legal and Institutional Preconditions for Strong Securities Markets." UCLA Law Review 48: 781-858; and La Porta, R., F. Lopez-De-Silanes and A. Shleifer (2006). "What Works in Securities Laws?" The Journal of Finance 61 (1): 1-32.

[9] *Supra* note 6, at page 2.

1.12. ***Undermine Regulated Markets*** - FAIR Canada also believes that the OSC should be cognisant of the fact that encouraging capital formation in the unregulated exempt market rather than through the regulated public markets impedes the transparency of the marketplace, thereby reducing efficiency. One of the three central objectives of securities regulation identified by IOSCO in its "Objectives and Principles of Securities Regulation" is "...to ensure that markets are fair, efficient and transparent."[10]

Objective 2: Access to Investment Opportunities by Investors

1.13. FAIR Canada notes that one of the objectives of the policy review is to provide retail investors with greater access to investment opportunities without compromising investor protection. However, there is little or no empirical information as to (a) whether retail investors know or understand what the exempt market is and the level of risk associated with the exempt market, and in particular, investing in SMEs; or (b) how many retail investors have had positive returns through investing in the exempt market (and in particular, with SMEs); (c) whether investors wish to invest in the exempt market; or (d) whether these exempt products are sold (rather than bought).

1.14. FAIR Canada is of the view that, for many retail investors, investing in the exempt market would not be suitable given the lack of liquidity and the higher risk that are associated with the vast majority of its investments. For those investors for whom high risk products are suitable, there are already many high risk investment products that are prospectus qualified from which investors can choose which are subject to greater regulatory oversight.

1.15. The Consultation Paper lists a set of factors which makes it "worthwhile to consider whether investors should have greater access to a wider range of investments, including investments in the exempt market."[11] These factors are:

a. Changing investor profile – as the baby boomers move into retirement, there will be a shift in investment focus whereby "some investors may seek a broader range of investment opportunities".

b. Availability of information on the internet – there is more information available on the internet so more investors can do their own research on investment opportunities rather than rely on investment professionals and more transactions occur over the internet.

c. Greater self-reliance in retirement – with the reduction in defined benefit pension plans, investors must increasingly rely on their own investments and savings to meet their retirement goals, which "arguably results in a greater need for the availability of diverse investment opportunities and strategies."

[10] International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation* (June 2010), online: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>, at page 6.

[11] *Supra* note 2, at page 24.

1.16. FAIR Canada does not see any of these factors as resulting in a need for investors to have greater access to the unregulated exempt market. The fact that there is an aging demographic, a decline of pension plans and the increasing need to save for one's own retirement, coupled with increasing complexity and amounts of information does not lead to a need for more investing in higher risk unregulated or poorly regulated products in the exempt market by seniors or baby boomers, as a group.

1.17. While investors may be tempted by sales pitches about the purported higher returns (and downplayed risks) associated with exempt market products given their need to accumulate adequate retirement savings, increasing access to such products may not lead to improved outcomes for retail investors. In fact, it is likely to lead to greater losses and loss of retirement savings.

1.18. ***Internet*** - In addition, the fact that more information is available on the internet has not resulted in a marked reduction in the amount of trust and reliance placed on financial intermediaries by retail investors. In fact, given the increasingly complex nature of financial products, many investors have become more reliant on intermediaries to provide them with advice.

1.19. The internet is a great source of information, particularly when it comes from reliable sources. Do regulators seriously suggest that unsophisticated investors should rely on "information" posted on the internet by unregulated persons or about unregulated products? Does posting information on the internet somehow increase the accuracy or truthfulness of the information? Or is the internet the greatest boon to fraud in this century?

1.20. The idea of increasing the choice of products available to investors and increasing access to those products is often argued by industry stakeholders and at first glance, sounds appealing. However, what is really being sought is a relaxed of the securities regulations by receiving an exemption from the protections provided by a prospectus that has been vetted by securities regulators and the ability to sell securities that are often opaque to a greater number of individuals who lack the expertise or information necessary to make an informed decision. In light of the fact that many exempt market securities products have low liquidity and high risk, we question whether such products are suitable for many retail investors, especially seniors, to purchase and that greater access would lead to better outcomes.

1.21. The idea of greater access for investors or greater choice of products for investors is a convenient argument for those stakeholders who want securities regulations relaxed in their favour. Like mutual funds, most exempt market products for retail investors are sold rather than purchased.

Objective 3: Better Aligns the Interests of Issuers and Investors

1.22. Very little is said about this policy objective in the Consultation Paper. It appears to be a factor that will be considered while pursuing the main objective of fostering capital raising.[12]

1.23. FAIR Canada believes that any proposed prospectus exemption should be assessed according to whether it would foster fair and efficient capital markets and confidence in capital markets and provide adequate protection to investors. Does the exemption promote informational symmetry between issuer and investor and the ability of the market participants to use that information effectively so as to make informed decisions? **Or does the proposed exemption increase informational asymmetry, discourage signalling (is there price discovery through published pre-trade and post trade information) and encourage unsophisticated investors who lack investment knowledge (about the exempt product at issue) to participate? Moreover, is there effective oversight, enforcement and procedural fairness to ensure that investors are adequately protected?**

2. Empirical Data on Exempt Market Needed

2.1. FAIR Canada agrees with the OSC that data on exempt market activity is necessary to inform decisions about regulatory changes to the exempt market.[13] We commend the OSC for providing the exempt market statistics to stakeholders that are found at Appendix C to the Consultation Paper.

2.2. **We fully support the OSC's suggestion that it mandate electronic filing of the reports on exempt distributions and amending the reports to require additional information.**

2.3. As discussed above, there is no public information available currently on the amount of capital raised from individual investors in the exempt market including the amount raised by SMEs from individual investors. **FAIR Canada recommends that information collected should include the size of the issuer (in addition to the additional information sought as listed on page 40 of the Consultation Paper) as well as the type of investor so that this information can be ascertained.**

2.4. ***Need for Empirical Data*** - FAIR Canada in its submission on the Accredited Investor Exemption, recommended that the CSA publish available information and initiate a comprehensive study of the exempt market to identify areas of high risk to investors. We believe it is extremely important to identify where investor losses are occurring and the causes of such losses, in order for regulation to focus on areas of higher risk.[14] If the information is not available to CSA members, we continue to recommend that research be

[12] See, for example, *supra* note 2, at page 23.
[13] *Supra* note 2, at page 39.
[14] See paragraph 2.2 of FAIR Canada's submission to the CSA re Review of Minimum Amount and Accredited Investor Exemptions (February 29, 2012), available online <http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/com_20120229_45-401_fair.pdf>.

undertaken to aid in assessing which parts of the exempt market are highest risk and in need of reform.

2.5. FAIR Canada agrees with the OSC Consultation Paper that the experience of the other CSA jurisdictions with certain prospectus exemptions that the OSC is considering is extremely important. FAIR Canada looks forward to reviewing any analysis of data from other CSA jurisdictions as to their experience with the offering memorandum prospectus exemption and the "friends and family" prospectus examination, and in particular the level of investor protection afforded under those exemptions, especially in light of the serious compliance deficiencies that have been noted with prospectus exemptions in those jurisdictions. More detailed comments on these deficiencies will be provided in section 5 regarding an OM Exemption.

2.6. Other information which would be valuable to the policy-making process includes:

- What portion of the exempt market is sold to retail investors through registrants who are members of a self-regulatory organization ("**SRO**") versus sold by registrants who are not members of a SRO?
- How much of the capital raised by reporting issuers in the exempt market came from individual investors and how much of the capital raised by non-reporting issuers in the exempt market came from individual investors? And what portion of this was for SMEs? For example 76% of the capital raised by non-investment funds ($28 billion out of the 87 billion) was raised by non-reporting issuers. How much of the $28 billion would be raised by SMEs and how much of that raised by SMEs was from individual accredited investors?
- How much of the capital raised from individual investors was for foreign (U.S. and other) reporting issuers or foreign non-reporting issuers?
- What portion of the accredited investor capital raised ($73 billion in 2011) came from institutional investors, permitted clients and how much came from individual investors?
- How much of the $59 billion of investment fund capital raised is simply monies that was subsequently redeemed (i.e. simply monies put in and then taken out a short time later)? We understand that in some cases large sums of money were invested in a collective investment fund only to be taken out a short time later.
- What type of firms make up the investment fund category? And how many funds make up this category? Do any of these firms have CIPF or similar coverage in the event of insolvency?
- How much of the money raised from retail investors was misappropriated through fraud or other wrongdoing?
- What portion of the known fraud that occurred in the exempt market was recovered for investors and from whom and through what mechanisms did they obtain recovery (partial or otherwise)?

- How much of the money raised by SMEs resulted in positive returns for investors, one, three and five years later? What are the returns for investors, and in particular, retail investors, in the exempt market more generally?
- How many of the SMEs that raised money through the exempt market, were still in operation, one year, three years and five years later.

SMEs in Canada

2.7. FAIR Canada fully recognizes that SMEs play an important role in Canada's economy. As noted by the Consultation Paper, SMEs accounted for over 54% of Canada's Gross Domestic Product (GDP) (and 40% in Ontario), in 2005 and accounted for 54% of Canadian job creation between 2001 and 2010. The ability of SMEs to obtain access to finance is often cited as an important factor which may limit their growth.

2.8. It should also be noted that SMEs suffer from high failure rates, with only one in five new firms surviving to their tenth birthday and the average length of life for new firms across all industries is about six years.[15]

2.9. While substantial new firms enter the marketplace each year, many of these firms exit quickly. Failure rates among entrants are extremely high. Some 40% have exited by their second birthday, and about 75% fail by their eighth birthday. On average, mean survival time is about six years, while the median length of life is approximately three years. The early years are the most difficult for entrants. Failure rates are high in the first years of life, but these failure rates decline as firms mature. The probability that a new firm will not live past its first birthday is 23%.[16]

2.10. Thus, investing in start-up businesses is high risk, given the high failure rate. The profitability of such enterprises is a separate area issue discussed below.

Costs of Accessing Capital for SMEs

2.11. FAIR Canada notes that the Consultation Paper does not cite any information on the costs for SMEs to access capital using the existing avenues that are available to them (such as a traditional IPO, backdoor listing such as a reverse takeover or reverse merger, OM exemption route available in some CSA jurisdictions, debt financing, traditional bank loans, angel investors or otherwise). **It appears that there is little empirical evidence of the effects of regulatory constraints on the ability of SMEs to raise capital in a timely and efficient manner.**[17] Is there any evidence that regulatory oversight unduly impedes access to capital, and if so, what is it? What led some SMEs to become public listed companies and others to not go this route? This type of information would be useful for informing the public policy process regarding the exempt market.

[15] Statistics Canada, available online at http://www.statcan.gc.ca/pub/61-526-x/61-526-x1999001-eng.pdf.
[16] *Ibid*.
[17] Ceclie Carpentier and Jean-Marc Suret, "Entrepreneurial Equity Financing and Securities Regulation: an Empirical Analysis" (July 5, 2010) at page 2.

2.12. How do the costs of complying with securities regulatory requirements for accessing capital compare to other costs of raising capital, such as investment banking fees or other administrative costs? What are the interest rates charged by financial institutions for SMEs? Should regulators put more resources into exploring ways to reduce the costs of raising capital in the regulated market?

What Do Investors Earn in Returns from Investing in SMEs?

2.13. Information regarding the returns that investors have obtained through investing in SMEs is relevant to any consideration of broadening the prospectus exemptions in order to allow SMEs to attempt to raise more capital and when considering broadening access by investors to SMEs in the non-public markets.

2.14. Recent empirical studies have been conducted by Cecile Carpentier and Jean-Marc Suret, professors, members of the Chair in Entrepreneurship and Innovation at Laval University. In one study, using a sample of Canadian reverse mergers (mainly on the TSX-V) over a period of two decades involving SMEs, the professors conclude as follows:

> Several researchers and professional associations contend that the securities regulation is too restrictive and unduly impedes the development of new ventures.... Concomitantly, regulators and many scholars argue that without strong listing and disclosure requirements, a lemon market will emerge, where only firms of poor quality will list... . We analyze these two perspectives in a context of lax minimal requirements where firms can list using an RM with minimal disclosure.
>
> The companies using RMs are predominantly very small, have weak growth, generally provide investors with negative returns and frequently delist. They fail to significantly increase their performance and equity size after the listing. This is especially true for the smallest companies, for which the proportion of success is very low compared with the high failure rate. Our results indicate that managers use RMS to list lower quality companies without real growth opportunities, which do not survive in the market. Investing in those firms provides very low rates of return. This indicates that investors fail to accurately appraise the value of RM firms. **Our observations are definitely not in line with the propositions that the securities regulation should be changed to allow the financing of entrepreneurial ventures. Our results confirm the lemon proposition ...We show that a lemon market can emerge when the rules governing small business equity financing are largely relaxed. ...Individual investors seem unable to correctly invest in small emerging firms. This last result is particularly important because the investors involved in the financing of RM firms are considered by the regulators as "accredited investors". They exhibit considerable revenues or net assets, and they are assumed to be able to invest wisely without the advice of professionals**.[18] [our emphasis]

[18] *Ibid.*, at page 20-21.

2.15. The study found that investors obtained very poor returns, were not able to set correct prices in the market nor were they able to deal with the high level of information asymmetry in the market.[19]

2.16. Another study by Carpentier, Jean-Francois L'Her and Jean-Marc Suret looks at the investor experience with SMEs. It analyzes equity offerings (SMEs who list on a public venture market at a pre-revenue stage with small assets and capitalization) launched by public SMEs in Canada, from 1993 to 2003.[20] The findings in the paper include:

- Managers issue equity before a large decrease in operating income and operating profitability – thereby exploiting information asymmetry by deciding to issue equity when their stock is overvalued
- Relative operating performance is worse three years after the issue than in the year of the issue. "This observation is consistent with the proposition that the quality of small public firms seeking outside equity is lower than the quality of similar firms that are not seeking such financing."
- Most investors that buy shares experienced, on average, huge abnormal negative returns.
- Possible explanations for why investors continue to fail to learn that such investments are poor investment decisions include:
  - Lack of empirical evidence about this market so people are not generally aware of the low performance of listed SMEs
  - Lack of sufficient information to assess the true quality of issuers can be part of the explanation for investors' *interest* in these stocks
  - Lack of rationality of investors – "**It seems that investors consider these shares to be similar to lottery tickets, and accept a negative average return because some of these shares can produce huge gains**. ... In a limited number of cases, ...issuers provide investors with exceptional returns....Indeed, the TSXV trumpets the success stories in its publications, indicating for example that several companies have exhibited huge annual returns reaching 6,100% for the year 2006. ...**However, this situation can explain why investors with a preference for positive skewness continue to invest in this category of issues, even if the average expected return is negative**. The three elements presented above are not exclusive...However, more research is needed."[21](page 22-23)

2.17. In a study on the return on private investment in small public entities, the professors examined 2,987 traditional private placements by Canadian small public firms over a

[19] *Supra* note 17, at page 1.
[20] Cecile Carpentier, Jean-Francois L'Her, and Jean-Marc Suret, "Seasoned Equity Offerings by Small and Medium Sized Enterprises" (December 23, 2009), available online at <http://ssrn.com/abstract=1447521>.
[21] *Ibid*. at pages 22-23.

decade sold to accredited investors.[22] They found that private placement issuers offer, on average, poor returns. They found that institutional investors are involved in only 15.91% of the largest private investment in public equity investments ("**PIPEs**") and probably in even fewer of the smaller PIPEs. The results they obtain suggest that investors in small firms can be overly optimistic and attribute unrealistically high valuations to hard-to-value growth firms that engage in intense investing activity.

2.18. **The studies referred to above suggest that proposed exemptions must be devised that allow for:**

(1) information symmetry,

(2) more publically available information about the performance of investments in SMEs, both listed and unlisted investments, and

(3) sufficient information to investors so that they can make more informed decisions about whether to purchase the investment given its price, costs, risk and/or value.

3. Compliance with Securities Requirements Critical to Investor Protection and Quality Capital Formation

3.1. FAIR Canada commented in its submission on the accredited investor exemption that compliance with criteria for relying on a given exemption needs to be addressed and that the current system is not able to protect investors given the self-policing nature of the system.

3.2. In FAIR Canada's submission on CSA Multilateral Instrument 45-311, *Exemptions from Certain Financial Statement Related Requirements in the Offering Memorandum Exemption to Facilitate Access to Capital by Small Businesses*[23], we call for a critical review of the level of investor protection afforded under the OM exemption in the participating jurisdictions, given the high level of non-compliance that numerous CSA notices and reviews have indicated.

3.3. The lack of compliance with rules governing the various exemptions is a critical issue that needs to be resolved in order for there to be adequate investor protection. Non-compliance with the rules, weak enforcement, a perception of weak enforcement, and difficulties for investors to obtain recovery of any funds generally harms investors and weakens confidence in the exempt market and our capital markets. Confidence in our markets, including confidence that the markets are fair and that the rules are effectively enforced, is critical to capital formation.

3.4. **FAIR Canada urges the OSC to ensure that the OSC has adequate resources in order to have robust compliance with respect to issuers and registrants who operate in the exempt market. Absent real compliance and sufficient punishment for those who do not**

[22] Cecile Carpentier, Jean-Francois L'Her and Jean-Marc Suret, "The return on private investment in small public entities", available online at <http://ssrn.com/abstract=1712481>.

[23] FAIR Canada submission dated February 20, 2013, available online at http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-comments-re-Certain-OM-Exemptions.pdf.

comply, broadening the exemptions that can be relied upon to raise capital will simply result in greater investor harm.

3.5. FAIR Canada recommends that compliance would likely be improved if registrants were made aware that they will be subject to an on-site review at some point in time, regardless of whether they are selected for a review based on the risk-based approach currently in use at the OSC. A risk-based approach determines areas of risk through sending out a questionnaire to registrants and therefore relies on self-reporting to identify firms that are high risk. While this is supplemented by other methods[24] (such as random selection, of for-cause reviews based on complaints or referrals from other OSC branches, SRO or other regulator), we wonder whether it could be augmented with other sources of information and other risk analytics.[25] We recommend that benchmarking to other leading jurisdictions be undertaken. The Hong Kong Securities and Futures Commission's approach suggests that each firm is reviewed at some point of time.[26]

3.6. ***OSC Review of EMDs*** - The review of Exempt Market Dealers (EMDs) resulted in a finding of a number of serious deficiencies which included:

- Inadequate compliance systems and CCOs not adequately performing responsibilities;
- Conflicts of interest when selling securities or related or connected issuers;
- Misuse of the accredit investor exemption;
- Unsuitable investments and failure to meet KYC, KYP and suitability obligations;
- Commingling and inappropriate use of investor monies;
- Inadequate supervision of dealing representatives; and
- Not disclosing outside business activities.

3.7. ***OSC Sweep of EMDs*** - As a result of the above-noted deficiencies, in June 2012 the OSC did a sweep of over 85 EMDs and PMs to assess compliance. In addition, a sample of a dealer's or adviser's clients were also contacted as part of the review process. We hope that the results of the compliance sweep will be released in the near future, and will be released before any decision on expanding exemptions in the exempt market is made. The results of this sweep will likely be critical to informing the policy-making process with respect to broadening exemptions.

4. Equity Crowdfunding – A Bad Idea Whose Time Has Come?

4.1. **FAIR Canada believes that permitting equity crowdfunding will pose great harm to investors and FAIR Canada recommends that Canadian governments and securities**

[24] 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>.

[25] See how the SEC selects its examination priorities in www.sec.gov/news/press/2013/2013-26.htm.

[26] Hong Kong Securities and Futures Commission, Supervisory Approach, online: <http://www.sfc.hk/web/EN/regulatory-functions/intermediaries/supervision/supervisory-approach.html>.

regulators decline to introduce it on the basis that it is too risky for investors and will undermine investor confidence in the Canadian capital markets.

4.2. ***Crowdfunding a Top Threat*** - The North American Securities Administrators Association, which represents U.S. state and Canadian provincial securities regulators, has listed crowdfunding and internet offers as one of its Top Investor Threats in its 2012 NASAA Enforcement Report. The Report states: "The 2012 JOBS Act makes significant changes to the methods start-up businesses and entrepreneurs may employ to bring their ventures to the investing market, and investors must be wary of the attendant risks....Even when the relaxed rules and registration exemptions are effective, they will not make investments in small businesses less risky – just more prevalent. And the JOBS Act provisions do not eliminate fraud, an unfortunate common feature of Internet securities activity."

4.3. NASAA's concerns remain today. In a recent statement NASAA's president stated: "Our concerns about the fraud potential facing investors and entrepreneurs related to crowd funding are unchanged. For crowd funding to have the best opportunity to realize the potential its proponents promised, the SEC must take the time necessary to ensure a reasonable balance between investor protection and the needs of industry."[27]

4.4. ***Outgoing SEC Chair Rejects Crowdfunding Legacy*** - Shortly before she stepped down as SEC Chair on December 10, 2012, SEC Chairwoman Mary Shapiro delayed the implementation of a rule to remove the ban on general solicitation for certain issuers (otherwise known as crowdfunding), out of concern that such a rule would tarnish her legacy as a pro-investor leader of the agency and did not afford stakeholders an appropriate consultation period.

4.5. ***Evidence of Benefits Lacking*** - **FAIR Canada also believes that there is little evidence that crowdfunding will result in the purported benefits – that is, improved capital formation, with resulting job creation and improved economic output.**[28] There are no provisions in the concept proposal that incentivize SMEs to use any capital that may be raised to expand their business or create jobs in Ontario or Canada. The lowering of investor protections with the resultant likely increase in fraud has the real possibility of hurting legitimate businesses by increasing the cost of capital while making it easy for fraudsters and scammers to make off with investor's funds.

4.6. FAIR Canada urges regulators and governments to examine the underlying reasons why certain SMEs are said to have difficulty in accessing capital and assess whether the crowdfunding concept will end up helping or hurting capital formation. As stated by Barbara Roper of the Consumer Federation of America recently: The thing about

[27] Advocates urge SEC to propose crowd-funding rules, by Mark Schoeff Jr., Investment News, Febrauary 24, 2013.

[28] Public Statement by Commissioner: Investor Protection is Needed for True Capital Formation: Views on the JOBS Act by Commissioner Luis A. Aguilar (March 16, 2012). While the comments are based on the analysis of the House Bill rather than the JOBS Act legislation that was passed in April, the analysis is still relevant.

crowdfunding is that it brings together unsophisticated issuers with unsophisticated investors...What could possibly go wrong?"[29]

Consultation Question: Would a crowdfunding exemption be useful for issuers, particularly SMEs, in raising capital?

4.7. There is insufficient evidence to determine whether the crowdfunding concept would result in the desired result of increased real capital formation but, as discussed above, FAIR Canada believes that securities regulators should focus on their mandate of fostering fair and efficient markets and adequate investor protection, as this will result in the conditions for improved capital formation.

4.8. FAIR Canada believes that the existing crowdfunding concept results in too large a degree of informational asymmetry and too great a risk of fraud and potential for investor harm and, therefore, will not result in efficient markets nor the desired benefits that its proponents would argue it will achieve. FAIR Canada agrees with the following assessment:

> Crowdfunding of equity capital for start-ups is one of a handful of jewels in the crown of the JOBS Act....But the crowdfunding jewel is fool's gold ...As a savvy tech entrepreneur told me the other day, "I love crowdfunding: it is cheap money for me. I know it is not good for the investors". That is the problem: **crowdfunding will at best be good only for the entrepreneurs and middlemen, paid for by unwitting consumers who simply cannot know enough about the highly risky ventures or the highly complex venture investing process to make informed investment decisions**.[30]

Consultation Question: Have we recognized the potential benefits of this exemption for investors?

4.9. The Consultation Paper sets out the argument made by proponents of crowdfunding that it will provide investors with more access to investment opportunities through the exempt market and thereby "democratize the exempt market". The Consultation Paper states:

> Crowdfunding may provide investors that do not qualify as accredited investors opportunities to invest in the exempt market. This would democratize the exempt market so that investment opportunities can be accessed by all investors, not just those with a high income or net worth. In particular, it would allow retail investors to participate to a limited extent, in start-ups and SMEs.

4.10. FAIR Canada believes that "democratization" really means eliminating fundamental investor protections and is not a principle that should guide securities regulators. Firstly, the accredited investor exemption, which uses income or net worth as a proxy for investor

[29] Crowdfunding' Rules Are Unlikely to Meet Deadline, by Robb Madelbaum, New York Times, December 26, 2012, available online at www.nytimes.com/2012/12/27/business/smallbusiness/why-the-sec-is-likely-to-miss....

[30] Daniel Isenberg, "The Road to Crowdfunding Hell" (April 23, 2012), online: <http://blogs.hbr.org/cs/2012/04/the_road_to_crowdfunding_hell.html >.

sophistication, is currently under review. FAIR Canada believes that wealth is a poor proxy for sophistication and discusses this issue in more length in paragraph 6.2 and section 7. Secondly, what should concern securities regulators is not whether something is "accessible" to everyone or "democratic", but whether it is designed so that the market is efficient and investors are adequately protected. Thirdly, all investors are currently able to access SMEs through the public markets, mainly on venture exchanges where there are greater investor protections than are contemplated with the crowdfunding concept.

4.11. The great majority of companies listed on the TSXV and even TSX are SMEs and hundreds (if not more) of these need to raise money. Long time financier Ned Goodman estimates that nearly half of the 1,310 junior mining companies listed on the TSX-V could go under due to a lack of access to capital.[31]

4.12. The term "democratize" is generally used to refer to the transition from an authoritarian to a democratic political regime. And sounds like motherhood. The proponents of crowdfunding and expanding the exemptions available in the exempt market use this euphemistic term instead of being more candid. What they really mean is remove investor protection from people who are unsophisticated investors with less wealth so that they can make more money selling high risk unregulated products to them.

4.13. FAIR Canada believes that the existing prospectus exemption that is available in Ontario (the private issuer exemption) which limits investment in non-public start-ups and SMEs to those individuals who have a close relationship with the issuer is the appropriate bounds for access to start-ups and SMEs. The close relationship with the issuer under this exemption allows for some nexus such that the individuals may perhaps have the means to extract sufficient knowledge in order to gain the informational symmetry that is required to properly price and evaluate the securities being offered.

4.14. The studies that are referred to in section 2 above by Carpentier and Suret do not support further relaxation of securities regulations to allow more financing of unregulated SMEs by retail investors given their inability to accurately appraise the correct price of the securities offered and their tendency to exhibit a preference for positive skewness when investing in SMEs, where they seek outsized returns or lottery style earnings.

Consultation Question: What would motivate an investor to make an investment through crowdfunding?

4.15. FAIR Canada believes that research is needed to fully answer this question. Having said that, the existing research suggests that investors who exhibit positive skewness will be attracted to crowdfunding. Retail investors who are not aware of the high rate of failure of SMEs may also unwittingly be attracted to such an investment. Truly sophisticated investors are unlikely to use crowdfunding as an investment as they will know that be aware of the lack of necessary information to make an informed investment decision. Sophisticated investors may also determine that SMEs which have a greater probability of

[31] BNN, "Junior mining companies face extinction: Goodman" (March 6, 2013), online: <http://www.bnn.ca/News/2013/3/6/Junior-mining-companies-face-extinction-Goodman.aspx>.

success will have been able to obtain capital through other means (such as angel investors, reverse merger, bank loan, private issuer exemption, etc) and will not seek to invest in the lower quality SMEs that will have resorted to crowdfunding for capital.

4.16. **"Crowdfunding or Fraudfunding?"** - Thomas Lee Hazen at the University of North Carolina has examined the JOBS Act legislation and has commented on who it would attract: "…the solicitation of small investors is likely to attract more unsophisticated investors who are in need of the investor protection provisions generally found in the securities laws. It also is likely to attract investors with limited funds who cannot tolerate high investment risk, even for small amounts of money.[32]

Consultation Question: Can investor protection concerns associated with crowdfunding be addressed and, if so, how?

4.17. FAIR Canada does not believe that investor protection concerns associated with crowdfunding can be adequately addressed and this is one of the major reasons why we recommend that crowdfunding not be introduced.

4.18. Equity crowdfunding has too many fundamental problems which lead to a lack of investor protection, including:

a. Investors will be strangers who will have no information about the company except unverified information provided by the company as mandated by the regulator. Given the complexities of investing in early stage companies, it is not possible to standardize the investment process in a way that would be understandable and useful for retail investors. There will be a huge amount of informational asymmetry.[33]

b. Investors will want a return on their investment, unlike in the crowdfunding donation model or project funding in exchange for samples where investors' expectations of return are minimal at best.[34]

c. As discussed above, retail investors are likely not aware that investing in start-ups and SMEs is highly risky given their high failure rate and that return on investments in SMEs is poor.

d. Investors tend to have unrealistic return expectations and will not be aware of the low probably of return with SMEs:

   ▪ When asked what they think the annual rate of return on the average investment portfolio is today, 12% of Canadians gave a realistic estimate, 29% provided unrealistic estimates and 59% explicitly chose not to hazard a guess.

[32] Thomas Lee Hazen, "Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must be Conditioned On Meaningful Disclsoure", at page 1766, available online at http://ssrn.com/abstract=1954040.
[33] *Supra* note 30.
[34] *Supra* note 30.

- Results were similar when asked about the annual rate of return on their personal investment portfolio: 17% of investors had realistic expectations, 33% had unrealistic expectations and 51% of respondents said they did not know.

- Looking at the results against the *Investment Knowledge Index*, almost one-quarter (24%) of high-knowledge investors had realistic expectations of the annual rate of return on their personal investment portfolio, while 16% of medium-knowledge and 9% of low-knowledge investors had realistic expectations.[35]

e. Given that small amounts that will be invested by any one investor, there is not sufficient economic rationale to do the due diligence that sophisticated investors (for example, angel investors) would engage in before making a decision to invest or not. Due diligence on a company not known except through the information provided on the internet through the portal will also not be practical.

f. While proponents suggest that the crowd will be able to detect fraud and weed out the bad actors, existing research suggests that many retail investors are not able to adequately detect fraud and instead, become victims of fraud at an alarming rate. **The CSA's November 2011 through February 2012 BlueHedge Investments public education initiative demonstrated that "investors remain vulnerable to online investment fraud. Internet ads and unsolicited emails posted during the online campaign enticed many visitors to a phoney scam website set up by the regulators."[36]**

According to the CSA members' new release, "Potential investors need to be more wary when dealing with investment opportunities they see advertised online."[37] Further, it stated:

> During the 10-week campaign, the BlueHedge website received almost 18,000 visits from across Canada with 71 per cent of those arriving to the site because they clicked on online ads, many of which were featured on popular search engine sites. As well, regulators found that more than 10 per cent of those who received unsolicited emails from BlueHedge opened the emails, and of those, almost 13 per cent clicked on the provided BlueHedge links.[38]

g. Crowdfunding proponents believe that complexity and expense of the investment process can be solved through allowing investors to watch whether the "crowd" invests in a given venture and then jump in as well before the offering closes. When people have invested hundreds of thousands, how can it possibly go wrong?

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[35] Innovative Research Group, "2012 CSA Investor Index" (October 16, 2012), online: <http://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL_EN.pdf> at page 64.

[36] Canadian Securities Administrators, "Online Fraud Awareness Campaign Confirms Investors' Vulnerability" (March 6, 2013), online: <http://www.sfsc.gov.sk.ca/Default.aspx?DN=4dbd3b54-b532-4a90-9658-a8c97bc03b80>.

[37] *Ibid.*

[38] *Ibid.*

Unfortunately, the crowd can be wrong and no one will find out about the mistake for a considerable amount of time and until it is too late.[39] As stated by Isenberg:

> "I did my Ph.D. degree in social psychology studying the behaviour of groups, and group irrationality is well-documented – crowds are "wise" only in a very limited set of circumstances. As often as not, crowds bring us tulip crazes, subprime meltdowns, the Kitty Genovese …scandal, Salem witch trials and other tragedies. Crowdfunding advocates claim that social media will self-correct the madness of crowds, but this seems to me highly suspect."

h. Compliance with the regulatory requirements imposed may be difficult, if not impossible to adequately supervise and police. Without effective compliance and enforcement of the rules, there will not be adequate investor protection. For example, the concept proposal does not adequately address how the portal will ensure that the investment limits per individual are not exceeded. What is the point of regulatory requirements if there is virtually no real ability to supervise and police? In such circumstances regulatory requirements simply create the perception of investor protection and allow regulators to avoid responsibility.

i. Small amounts invested per investor will not deter scammers as crowdfunding offers the potential for raising large amounts of money. However, the relatively small amount invested per person will be a barrier to commencing any sort of action to recover lost funds. In addition, by the time the investor knows that something is amiss, the money will have been misappropriated and will be very difficult to locate, let alone, recover. Finally, given that some crowdfunding efforts will be modest and there will be modest potential damages, the economics of bringing such a claim and the adequacy of the economic incentives available to plaintiff law firms to bring suits will limit the ability to obtain a remedy.[40] Poor enforcement will weaken investor protection and decrease confidence in our markets.

j. Many investors will assume (wrongly) that if the portal is a registrant, and issuers are required to disclose information to potential investors (the "information statement"), then it cannot be that risky. Most investors will not grasp that the level of due diligence will not have been as great as with a prospectus offering. Boiler plate statements like "you could lose all of your investment" will not resonate with investors.

Consultation Question: What measures, if any, would be the most effective at reducing the risk of potential abuse and fraud?

4.19. While FAIR Canada does not support the introduction of crowdfunding, if it is nonetheless introduced a number of measures need to be taken to reduce the harm that is likely to occur. For example, the funding portal should be required to supervise and certify

[39] *Supra* note 30.
[40] *Supra* note 32, at page 1759.

offerings, with recourse against the fund portal for fraud and misrepresentation. Investors should have a statutory right to sue for misrepresentation against the issuer and the portal. Such a right should include the right to commence a class action to seek recovery due to misrepresentation or fraud against the issuer, its principals and the portal.

4.20. ***Disciplinary History*** - The issuer, its directors and officers should have to disclose whether they have been the subject of any regulatory or criminal proceeding (not limited to securities matters), as a first step to reduce the risk of fraud.[41]

4.21. ***Investment Limits*** - FAIR Canada does not believe that investment limits are adequate measures to reduce the risk of abuse and fraud. Firstly, such limits will be difficult if not impossible to police. Secondly, "…fraud in small packages can be just as effective and damaging to the victims, many of whom may be least able to bear the risk of even a small investment in a speculative business."[42] Thirdly, limiting offerings to small amounts per investor will not deter scammers from taking advantage of investors via crowdfunding, as discussed above.

Consultation Question: Are there concerns with retail investors making investments that are illiquid with very limited options for monetizing their investments?

4.22. Typically retail investors do not want to make investments that are illiquid given that access to their capital if often required. Thus, illiquid investments are often not suitable investments for retail investors. Given that the portal does not have to determine the suitability of an investment for a given individual, retail investors may end up putting their entire yearly investment into an illiquid and highly risky venture.

Consultation Question: If we determine that crowdfunding may be appropriate for our market, should we consider introducing it on a trial or limited basis? For example, should we consider introducing it for a particular industry sector, for a limited time period or through a specific portal?

4.23. If the OSC proceeds to introduce crowdfunding into Ontario, then it should be done on a trial basis, through a single portal, under additional conditions set out below that are not contained in the Consultation Paper.

(1) There must be meaningful disclosure provided to investors about the issuer and reliable financial information so that the large degree of informational asymmetry between issuers and crowdfunding investors can be narrowed, both at the time of issue and going forward.

(2) Gatekeepers should be utilized to produce safeguards into the system. For example, financial statements should be required to be produced in accordance

[41] Background checks are a vital first step given that media reports suggest that individuals who have been banned from the securities industry are involved with crowdfunding portals. See David Baines, "Crowd-funding: Mad money finds a new outlet", Vancouver Sun October 17, 2012.

[42] *Supra* note 32, at page 1766.

with Canadian GAPP applicable to publicly accountable enterprises and should be required to be audited.

(3) The portal should be required to perform certain due diligence about the issuer and on the disclosure contained in the information statement, and should certify the information being provided to investors.

(4) The funding portal should be required to help issuers prevent mistakes and errors as to disclosure and to guide issuers as to what is appropriate and necessary to disclose to potential investors.

(5) Funding portals should be expected to attempt to actively prevent fraud from taking place including through the conducting of background checks and to be vigilant for the potential dilution or shareholder oppression.

(6) The funding portal should be required to carry fidelity insurance to provide coverage from fraud or dishonest acts of its employees and professional liability insurance to cover errors and omissions in respect of its obligations.

(7) The funding portal should be required to review the promotional and marketing material of the issuer that is on the portal's website and the funding portal should be included in the statutory liability regime for such statements.

(8) The funding portal should be required to notify the crowd about any claims that have occurred as a result of fraud or other wrongdoing. They should have to post notifications about recent (suspected) frauds and track rates of return.

(9) The information statement provided to investors should be required to be filed with the OSC.

(10) Investment limits should be based upon the income of the individual investor, or, if they choose not to provide their annual income, based upon the average median income level in Canada. The $10,000 limit is higher than the typical annual RRSP investment of $2,830 of the median Canadian retail investor.[43] Otherwise, the retail investor could be encouraged to place more than their usual annual savings in a high-risk and illiquid investment.

(11) Investment limits should be enforced using personal identification data which must be filed with securities regulators.

(12) The risk acknowledgement to be signed by the investor, should be proceeded by an interactive knowledge quiz which informs investors of the high risk of failure of start-ups and SMEs in Canada, which informs them of the average poor returns that SMEs provide, and provides them with information about how the investment may not be accurately priced, is likely illiquid and that their

[43] The median RRSP contribution in Canada in 2011 was $2,830; the median RRSP contribution in Ontario in 2011 was $2,900. See online: <http://www.statcan.gc.ca/daily-quotidien/130211/dq130211a-eng.htm>. The average RRSP contribution in Ontario in 2011 was just under $6,000 – see http://www.statcan.gc.ca/daily-quotidien/111202/t111202b1-eng.htm.

investment may be lost due to fraud, with very limited remedies available to them.

(13) The issuer should have to state the intended use of the funds, and have continuous disclosure obligations that go beyond than simply filing annual financial statements. Material changes and material developments (including actual use of the funds in a manner different that disclosed in the information statement) should trigger disclosure to shareholders.

(14) The principals of the issuer should have to disclose if they have any investment in the entity so that prospective investors can determine if they have any "skin in the game". They should also have to disclose if they sell their shares or otherwise redeem their investment in the entity.

(15) Investors should be given anti-dilution protection, tag-along rights and pre-emptive rights. However, the ability of retail investors to understand and rationally employ these rights in order to protect themselves is highly questionable. Isenberg addresses this point directly when he states: "Many of the key concepts – such as implied valuation, liquidation preferences, minority protections, information rights, tagalong provisions, first refusal rights, anti-liquidation, reverse vesting, to name just a few- take years to grasp, let alone learn how to use."[44] If the OSC proceeds with crowdfunding, provisions should be in place to protect investors from having their rights and the value of their investments diluted by future capital raising initiatives.

5. Offering Memorandum

Consultation Question: Should an OM exemption be adopted in Ontario? If so, why?

5.1. **No. We are strongly of the view that an OM exemption should not be adopted in Ontario.**

5.2. ***Widespread Compliance Issues*** - We outline below significant OM exemption compliance issues in other Canadian jurisdictions, and we anticipate similar compliance issues and outright frauds under the OM prospectus exemption under exploration by the OSC. In particular, we question whether the issuers the OSC has targeted to assist through this consultation, particularly SMEs, have the requisite sophistication and resources available to comply with the OM concept idea outlined in Appendix A to the Consultation Paper.

5.3. FAIR Canada does not believe that adding a prospectus exemption based solely on the needs of issuers, but without any rational assessment of the needs of consumers, and absent the protection of registrant involvement and prospectus-level disclosure, would be contrary to the OSC's twin mandates of providing investor protection and fair and efficient markets. **In our view, the introduction of an OM exemption in Ontario has not been suggested to meet an investor need, is unprincipled, would reduce investor protection, and undermine confidence in the Ontario capital markets.**

[44] *Supra* note 30.

5.4. If the OSC determines that it believes that such an exemption would afford an adequate level of protection for investors, FAIR Canada recommends that the OSC require issuers to file OMs and that the OSC review the OM for compliance prior to permitting reliance on an OM exemption for a distribution.

Consultation Question: Should there be any monetary limits on this exemption? If so, should those limits be in addition to any limits imposed under any crowdfunding exemption?

5.5. FAIR Canada does not believe the exemption should be adopted in Ontario.

5.6. ***Monetary Limits*** - If the OSC determines that it believes that such an exemption would afford an adequate level of protection for investors, we recommend that there should be monetary limits on this exemption. FAIR Canada believes that the proposed limits,

i. a $1.5 million limit on the amount of capital that can be raised under this exemption in a 12-month period, and

ii. a limit on a purchaser's investment in a particular distribution of $2,500 under this exemption and a limit of $10,000 in total under this exemption in any calendar year

would not be appropriate under such an exemption.

5.7. As noted above in section 4.23, we believe that investment limits should be based upon the income of the individual investor, or, if they choose not to provide their annual income, based upon the average median income level in Canada. The $10,000 limit is higher than the typical annual RRSP investment of $2,830 of the median retail investor.[45] Otherwise, the retail investor could be encouraged to place more than their usual annual savings in a high-risk and illiquid investment.

5.8. However, we are concerned whether such limits, absent greater compliance efforts, will provide any meaningful protection for investors. In the Consultation Paper, the OSC notes that it recognizes that an investment limit presents difficulties with compliance and suggests an alternative proposal which would require the investor to self-certify that he/she is within the investment limits and has not exceeded the annual threshold. **In light of the evidence of significant non-compliance with the accredited investor exemption, FAIR Canada questions the value of self-certification, particularly in instances where sales representatives tell consumers that certain documents are mere formalities.**

5.9. In our view, some sort of registry or centralized database maintained by the OSC, perhaps in addition to self-certification, would guard against some abuse of such limits. Registrants should have a responsibility to ensure compliance with the investment limits.

[45] *Supra* note 43.

Consultation Question: Should a purchaser be required to receive investment advice from an adviser in order to rely on this exemption?

Consultation Question: Should we require registrant involvement as a condition of this exemption? If so, what category of registration should be required?

5.10. FAIR Canada believes that, in order to rely on this exemption, a purchaser should be required to receive investment advice from a registrant who has an obligation (either statutorily or contractually) to act in the client's best interest.

5.11. FAIR Canada recommends that the registrant be required to be an IIROC member to provide investors with the additional protections associated with SRO membership.

Consultation Question: Should there be mandatory disclosure required in an OM? If so, what level of disclosure should be required?

5.12. We strongly oppose the introduction of an OM exemption. Prospectus-like information should be required to be provided.

5.13. ***Significant Non-compliance with OM Exemption in other Canadian Jurisdictions*** - Numerous CSA-member notices and reviews indicate a high level of non-compliance with the OM exemption. For example, Saskatchewan's Financial Services Commission Securities Division's (now the Financial and Consumer Affairs Authority, the "**Saskatchewan Authority**") Staff Notice 45-704 noted that during its detailed review of non-qualifying issuers' OMs, "[s]taff identified **material disclosure deficiencies in all of the OMs reviewed**. In general, **the OMs were poorly prepared and did not provide the disclosure required**."[47] [emphasis added]

5.14. The Saskatchewan Authority also found considerable non-compliance with financial statement requirements, including non-provision of financial statements in the OM.[48] Furthermore, the Saskatchewan Authority identified significant investor rights issues in its notice.

5.15. ***CSA Notice on Deficiencies*** - The CSA has also issued a staff notice outlining common deficiencies, including:

- failing to file a copy of the OM with the relevant securities regulator or filing late;
- making distributions using a stale-dated OM;
- using an incorrect form of update;
- failing to include sufficient information to enable investors to make an informed investment decision;
- inadequate disclosure about the issuer's business (particularly new entities);

[47] Saskatchewan Financial Services Commission Securities Division Staff Notice 45-704 Review of Offering Memorandums under NI 45-106 *Prospectus and Registration Exemptions* (last amended March 7, 2011) at page 2.
[48] Staff Notice 45-704 at page 5.

- failing to provide balanced disclosure;
- inadequate disclosure of available funds and use of available funds;
- inappropriate reallocation of available funds;
- omission of key terms of material agreements;
- omission of compensation disclosure;
- inadequate disclosure of management experience;
- dissemination of material forward-looking information not included in the OM;
- omission of required interim financial reports;
- omission of key elements of financial statements;
- failure to obtain required audits;
- omission of required audit reports or including non-compliant audit reports;
- inappropriate use of a Notice to Reader cautioning that financial statements may not be appropriate for their purposes;
- failure to prepare financial statements in accordance with appropriate accounting principles; and
- improper certification of the OM.[49]

5.16. In light of the volume and seriousness of compliance issues related to the OM exemption, FAIR Canada questions why members of the CSA would prioritize an initiative to lessen disclosure to investors.

5.17. ***OSC Report on EMD Non-Compliance*** - The OSC has also identified practices of concern relating to EMDs in its 2012 Annual Summary Report[50] (the "**OSC Summary Report**"). The OSC Summary Report noted that its

> EMD reviews focused on areas that we found to be problematic in recent years, including
>
> - inadequate compliance systems and supervision
> - inadequate collection and documentation of KYC information
> - failure to assess the suitability of trades and selling unsuitable investments
> - insufficient product due diligence (KYP)
> - failure to identify and respond to conflicts of interest, and
> - improper reliance on the accredited investor exemption.[51]

[49] Multilateral CSA Staff Notice 45-309 *Guidance for Preparing and Filing an Offering Memorandum* under National Instrument 45-106 *Prospectus and Registration Exemptions* at pages 2 – 11.
[50] *Supra* note 24.
[51] *Supra* note 24, at pages 49 - 50

5.18. Further, the trends in deficiencies identified during the reviews of EMDs covered in the OSC Summary Report included:

- Inadequate compliance systems and CCOs not adequately performing responsibilities;
- Conflicts of interest when selling securities of related or commented issuers;
- Misuse of the accredited investor exemption;
- Unsuitable investments and failure to meet KYC, KYP and suitability obligations;
- Inappropriate use of investor monies;
- Inadequate supervision of dealing representatives; and
- Not disclosing outside business activities.

5.19. In light of the seriousness and extent of the deficiencies identified during the OSC's reviews, FAIR Canada does not believe that it would be appropriate to introduce an OM exemption in Ontario.

5.20. ***Lack of Meaningful Data*** - As discussed above, FAIR Canada recommends that the CSA prioritize the undertaking of empirical research to determine the incidence of fraud, misrepresentation and resulting losses suffered by investors as a result of investing in securities through purported reliance upon the OM exemption. FAIR Canada notes that no such empirical data is currently available despite the serious compliance deficiencies noted above.

5.21. FAIR Canada does not believe that it would be in the interests of investors, and would not be in accordance with the OSC's investor protection mandate, to broaden the base of investors who could be harmed by widespread non-compliance with exemption requirements.

5.22. In light of the serious deficiencies highlighted above, FAIR Canada strongly opposes the introduction of an OM exemption in Ontario.

6. Sophistication and Advice

6.1. In FAIR Canada's view, in evaluating the appropriateness of prospectus exemptions, it is important to clarify the products and distribution channels to which exemptions would apply. Our understanding is that the risks posed to investors vary considerably depending on: (i) whether the security is that of a listed issuer or not; (ii) whether the seller is a member of a self-regulatory organization (i.e. IIROC); and (iii) whether the security is straightforward or complex. We believe that exemptions based upon sophistication and advice must specifically consider the aforementioned factors in order to ensure an appropriate level of investor protection.

6.2. In Appendix B to the Consultation Paper, the OSC provides suggestions in its explanatory notes that it does not differentiate between types of issuers and types of securities in its concept idea for a prospectus exemption based on an investor's investment knowledge in

order to be consistent with the accredited investor exemption. **Given FAIR Canada's principled opposition to use of the accredited investor exemption, we do not agree that consistency with the accredited investor exemption is a basis for ignoring the different risks posed by different types of issuers and securities.**

Complex Products

6.3. **FAIR Canada is of the view that risks to investors are increased when the security being sold is complex. We recommend that the considerations for prospectus exemptions based on sophistication and advice only apply to non-complex products absent a separate consultation to consider the appropriateness of offering complex products to retail investors in the exempt market.**

Non-complex securities of issuers listed on one or more Canadian exchanges, sold through an SRO-member intermediary

6.4. FAIR Canada has previously suggested that, for investments in non-complex securities of issuers that are listed on one or more Canadian exchanges, sold through an SRO (i.e. IIROC or the Mutual Fund Dealers Association of Canada) member, it would be appropriate to permit prospective investors who meet the existing definition of "accredited investor" where a registrant has a duty to act in the best interest of the client.

Non-complex securities of issuers listed on one or more Canadian exchanges, sold through a non-SRO-member intermediary AND non-complex securities of issuers not listed on a Canadian exchange, sold through an SRO-member intermediary

6.5. With respect to securities of issuers listed on one or more Canadian exchanges, sold through a non-SRO-member intermediary and securities of issuers not listed on a Canadian exchange, sold through an SRO-member intermediary, FAIR Canada recommends that both the investment knowledge and the registrant advice provisions (as discussed below) apply.

Non-complex securities of issuers not listed on a Canadian exchange, sold through a non-SRO member intermediary

6.6. FAIR Canada recommends that for securities of issuers not listed on a Canadian exchange, sold through a non-SRO member intermediary, both the investment knowledge and registrant advice requirements apply (as discussed below) and in addition that independent certification of the investment knowledge be required.

7. Investment Knowledge

7.1. FAIR Canada agrees that an investor's knowledge of an investment as a result of his/her education or work experience and investment knowledge and experience is a more appropriate test for investment sophistication than income or net worth of a certain minimum amount. We believe that the premise of this proposed exemption is

conceptually sound and provides a reasonable justification for not providing the full protection of registrant involvement and prospectus-level disclosure.

7.2. Sophistication is important as a principle underlying the exemption in that investor sophistication contributes to a more level playing field between issuer and investor, potentially reducing opportunities for fraud, impropriety or unfairness.

7.3. The OSC's concept idea with respect to the exploration of a prospectus exemption based on investment knowledge would require an investor to satisfy two conditions:

i) relevant work experience – the investor must have worked in the investment industry for at least one year in a position that requires knowledge of securities investments; and

ii) relevant education qualification – the investor must have earned or received one of the following:

a. a Chartered Financial Analyst designation (CFA Charter);

b. a Chartered Investment Manager designation (CIM designation); or

c. a Master in Business Administration degree (MBA) from an accredited university.

Relevant Work Experience

7.4. FAIR Canada encourages the OSC to consider whether one year of relevant experience in the investment industry is a sufficiently long period of time within which to acquire the knowledge and sophistication to enable an investor to understand the risks and characteristics of exempt market distributions. We suggest that two or three years might be a more appropriate amount of time to gain the requisite experience.

7.5. In FAIR Canada's view, the relevant work experience could be expanded to also include experience as an investor. We appreciate the OSC's concerns that transaction size and frequency may not be indicators of investment sophistication and could provide an incentive to make poor investment decisions solely to qualify under the exemption. However, we maintain that actual investing experience would be the most appropriate basis upon which to assess sophistication. In our view an objective, qualitative measure of investing experience would be a rational, principled basis upon which to build an exemption.

Relevant Education Qualification

7.6. FAIR Canada suggests that the above education qualifications are costly to obtain. Further, an MBA does not necessarily entail a significant amount of education with respect to investing. This may lead to under- and over-inclusion of investors under such an exemption.

7.7. FAIR Canada recommends that, in place of (or in addition to) the proposed education qualifications, the OSC consider an accreditation program to accredit sophisticated

investors. Such a program could be tailored and designed to ensure that individuals who wish to invest in the exempt market are fully aware of the reduced protections afforded in the exempt market and their rights, and that they meet a minimum level of investment knowledge. A standardized test could ensure that potential accredited investors have a minimum level of understanding with respect to the exempt market and investing generally. Further, such a program would address the OSC's concerns (as outlined in the Consultation Paper) that the relevant work experience assessment will require subjective determinations. It would also address the challenges, raised by the OSC in the Consultation Paper, of defining relevant work experience and educational qualifications in a manner that is neither over- nor under-inclusive.

7.8. An accreditation program could be offered by a reputable financial services education provider, such as the Canadian Securities Institute, for a reasonable fee. This would be a more objective and accessible way for potential exempt market investors to access the market and would better ensure that such investors have a minimum level of investment sophistication.

7.9. Alternatively, the OSC could permit completion of the Canadian Securities Course or the equivalent in other OECD jurisdictions to satisfy the education requirement.

7.10. **We recommend that such a program replace the current accredited investor exemption.**

Consultation Question: Are there sufficient investor protections built into this exemption?

7.11. No. As discussed above in section 6, FAIR Canada believes that the type of issuer and the type of security are relevant to determining whether a sufficient amount of investor protection is built into an exemption. As also outlined in section 6, SRO membership is also relevant. Further, we question whether one year of experience would ensure that a given individual has a minimum acceptable level of sophistication to invest in the exempt market.

Consultation Question: Should we require an investor to satisfy both a relevant work experience condition and an educational qualification condition or would one suffice?

7.12. Both relevant work experience and education should be required. Additionally, FAIR Canada recommends further requirements dependent upon the type of issuer and the type of security as discussed in section 6.

Consultation Question: How should we define the relevant work experience criteria?

7.13. See above at paragraphs 7.4 to 7.5.

Consultation Question: What educational qualifications should be met? Should we broaden the relevant educational qualifications?

7.14. See above at paragraphs 7.6 to 7.10.

8. Registrant Advice

8.1. In the Consultation Paper, the OSC suggests a concept idea for a broader exemption based on the provision of advice. It contemplates a prospectus exemption for a distribution to an investor where:

(i) an investment dealer is providing advice to the investor in connection with the distribution;

(ii) the investment dealer has an ongoing relationship with the investor;

(iii) the investment dealer has contractually agreed that it has a fiduciary duty to act in the best interests of the investor; and

(iv) the investment dealer is not providing advice in connection with a distribution of securities of a "related issuer" or a "connected issuer" of the investment dealer. Accordingly, the investment dealer must not be otherwise acting for the issuer or in connection with the distribution.

8.2. In principle, FAIR Canada believes that an exemption based on the provision of advice by an investment dealer, in conjunction with investment knowledge as discussed above in section 6 could provide an appropriate level of protection for investors. We stress that compliance efforts will be essential to ensure that the above conditions are met.

8.3. FAIR Canada's support for such an exemption is contingent on the following:

8.3.1. In order for investment dealers to rely on an exemption based on the provision of advice, the investment dealer/representative must have a high level of familiarity with the security to be distributed (KYP guidance by IIROC would be an appropriate standard) and must also have knowledge about and experience in the industry associated with the distribution.

8.3.2. There must be an adequate deterrent effect, such as suspension or loss of registration for intentional or reckless non-compliance that could, or does, harm investors.

8.3.3. Conflicts of interest, particularly third party incentives, must be avoided. FAIR Canada believes that the OSC must ensure that conflicts of interest do not colour the registrant's advice to clients. This would include commission payments, finders' fees, and etcetera. Disclosure is an inadequate means of managing conflicts of interest.

8.4. Please see section 6 for our recommendations based upon the type of issuer, type of security and involvement of an SRO member.

8.5. FAIR Canada agrees that it would be inappropriate to extend the exemption to exempt market dealers ("**EMDs**"), particularly in light of significant compliance issues observed in relation to some such registrants.

Consultation Question: Should we consider a new prospectus exemption that is based on advice provided by a registrant? If so:

Do you agree with limiting this exemption to a situation where the registrant has a fiduciary duty to act in the best interests of the client?

8.6. Absolutely. FAIR Canada supports a prospectus exemption on the basis of registration plus a duty to act in the best interest of the client.

Do you agree that this type of exemption should be limited to certain types of registrants (e.g., investment dealers) or should this exemption be available for another type of registrant (e.g., an EMD)?

8.7. Yes. Given the significant compliance issues and concerning trends identified with certain types of EMDs, FAIR Canada agrees that this type of exemption should be limited to investment dealers.

Should this type of exemption be available for registrants that sell securities of "related issuers" or "connected issuers" (which would raise conflict of interest concerns, as explained in National Instrument 33-105 Underwriting Conflicts and Part 13 of NI 31-103)? If so, would this be consistent with the registrant being subject to a fiduciary duty to the client?

8.8. No. Permitting registrants that sell securities of "related issuers" or "connected issuers in reliance on such an exemption would be inconsistent with the registrant being subject to a fiduciary duty to the client.

Would exempting the issuer from a disclosure obligation have implications for a registrant's ability to conduct a meaningful KYP and suitability review?

8.9. FAIR Canada would expect registrants to only advise clients to purchase securities that are in their best interests, consistent with the fiduciary duty owed to the client. If the registrant were unable to conduct a meaningful KYP and suitability review, they would not be permitted to rely upon this exemption.

Do you agree that a registrant should be required to have an ongoing relationship with the client?

8.10. Yes.

Should there be any restrictions on the type of security that could be purchased? For example, should this exemption be available for purchases of securities of investment funds and/or complex products (including securitized products and derivatives)?

8.11. Yes. See discussion above in section 6.

9. Private Issuer Exemption

Consultation Question: Is the 50 security holder limit under the private issuer exemption too restrictive? If so, what limit would be appropriate? Please explain.

9.1. No. The limit of 50 security holders is a threshold that has been historically used to reflect the number of individuals who would fall with the requisite categories and thereby have some relationship with the issuer such that they may possibly extract the necessary information such that they would not be a large level of informational asymmetry and reduce the likelihood of fraud since they would know the principals of the issuer.

9.2. FAIR Canada does not agree that accredited investors should be a category that qualifies under the private issuer exemption given our views on that AI exemption, which we have discussed elsewhere.

9.3. We note that there has been some misuse of the private issuer exemption by streaming investments through single-purpose holding companies.[52]

Consultation Question: Should the OSC consider re-introducing the closely held issuer exemption in addition, or as an n alternative, to the private issuer exemption? If yes, should the conditions be changed?

9.4. No. The closely held issuer exemption does not afford sufficient protection to investors and will hinder the efficient raising of capital given that it allows for securities to be sold to the public without the protections of a prospectus. As discussed above, the amount of informational asymmetry will be great as opposed to the private issuer exemption that limits solicitations to those why may fit the exemption such as close friends and certain family of the principals and persons having common interests such as directors, officers, founders or control persons.

9.5. We note that the OSC Staff Notice 45-702, Frequently Asked Questions indicates that it was going to complete an economic analysis of the effect of the rule on small business financing. If this economic analysis was undertaken, FAIR Canada recommends that it be publicly disclosed in order to inform the policy-making process as it would shed light on the experience of the closely held issuer exemption.

Consultation Question: Should the OSC consider adopting a family exemption, that allows for securities to be issued to an unlimited number of family members of the directors, executive officers or control persons of the issuer or its affiliates?

9.6. No. FAIR Canada sees no valid rationale for introducing this exemption in Ontario and believes the reason provided for not introducing it, is as valid today as it was in 2004: "Ontario is not adopting the family, friends and business associates exemption as we do not believe that an exemption that allows securities to be issued to an unlimited group of non-accredited investors is appropriate for the Ontario market."

[52] See for example, Re Wilby, Alberta Securities Commission, 2010 (2010) ABASC 121) where such a structure was found to be "wholly inconsistent with the purpose and spirit of the private company exemption."

9.7. FAIR Canada requests that data on the experience of other CSA jurisdictions with respect to the family and friends exemption be made public before considering the adoption of it in Ontario.

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 Ermanno Pascutto at 416-214-3443 (ermanno.pascutto@faircanada.ca) or Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca).

Sincerely,

Canadian Foundation for Advancement of Investor Rights