

June 17, 2014

**BY EMAIL**

The Secretary  
Ontario Securities Commission  
20 Queen Street West  
22nd Floor  
Toronto, Ontario M5H 3S8  
Email: [comments@osc.gov.on.ca](mailto:comments@osc.gov.on.ca)

Dear Sirs/Mesdames:

**Re: Proposed Amendments to NI 45-106 *Prospectus and Registration Exemptions*, Companion Policy 45-106CP *Prospectus and Registration Exemptions*, Proposed Amendments to OSC Rule 45-501 *Ontario Prospectus and Registration Exemptions*, Proposed NI 45-108 *Crowdfunding*, Companion Policy 45-108CP *Crowdfunding*, Proposed Form 45-106F10 *Report of Exempt Distribution for Investment Fund Issuers (Alberta, New Brunswick, Ontario and Saskatchewan)* and Form 45-106F11 *Report of Exempt Distribution for Issuers other than Investment Funds (Alberta, New Brunswick, Ontario and Saskatchewan)* (the “Notice”)**

The Canadian Advocacy Council<sup>1</sup> for Canadian CFA Institute<sup>2</sup> Societies (the CAC) appreciates the opportunity to comment on the Notice and wishes to provide some general comments and respond to the following specific questions set out in the Notice.

We support regulatory measures designed to assist the capital raising needs of Canadian issuers while strongly emphasizing investor protection. Investor protection in the exempt market is best enhanced by providing clear risk disclosures, taking some steps to verify eligibility to participate in the market, and implementing a best interest standard on all registrants.

We are of the view that it is important, to the extent possible, to harmonize the capital raising exemptions across all Canadian jurisdictions. It is becoming increasingly confusing for issuers, advisors, dealers and investors to determine whether or not a

---

<sup>1</sup>The CAC represents the 13,000 Canadian members of CFA Institute and its 12 Member Societies across Canada. The CAC membership includes portfolio managers, analysts and other investment professionals in Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. See the CAC's website at <http://www.cfasociety.org/cac>. Our Code of Ethics and Standards of Professional Conduct can be found at <http://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx>.

<sup>2</sup> CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 119,000 members in 147 countries and territories, including 112,000 CFA charterholders, and 143 member societies. For more information, visit [www.cfainstitute.org](http://www.cfainstitute.org).

prospectus exemption is available to an issuer or purchaser in a particular province or territory, which has a negative impact on the efficiency of our markets.

### **OM Prospectus Exemption**

#### *Issuer qualification criteria*

*2. We have concerns with permitting non-reporting issuers to raise an unlimited amount of capital in reliance on the OM Prospectus Exemption. Should we impose a cap or limit on the amount that a non-reporting issuer can raise under the exemption? If so, what should that limit be and for what period of time? For example, should there be a “lifetime” limit or a limit for a specific period of time, such as a calendar year?*

In the interests of harmonization, we do not believe the OSC should impose a limit on the amount that a non-reporting issuer can raise under the exemption. However, if a limit were to be imposed, we believe the limit must be high enough to substantially assist most issuers to expand their operations while still ensuring investors receive adequate protection through a robust disclosure document.

#### *Types of securities*

*5. We are proposing to specify types of securities that may not be distributed under the OM Prospectus Exemption, rather than limit the distribution of securities to a defined group of permitted securities. Do you agree with this approach? Should we exclude other types of securities as well?*

We believe that it would be preferable to include a list of securities which are permitted to be distributed under the OM Prospectus Exemption, similar to the list proposed to be permitted for the crowdfunding exemption. It is possible to structure a product that did not technically meet the definition of an excluded security, thereby permitting the distribution of complex or novel securities under the exemption.

#### *Investor qualifications – definition of eligible investor*

*10. We have proposed changing the \$400,000 net asset test for individual eligible investors so that the value of the individual’s primary residence is excluded, and the threshold is reduced to \$250,000. We have concerns that permitting individuals to include the value of their primary residence in determining net assets may result in investors qualifying as eligible investors based on the relatively illiquid value of their home. This may put these investors at risk, particularly if they do not have other assets. Do you agree with excluding the value of the investor’s primary residence from the net asset test? Do you agree with lowering the threshold as proposed?*

The net asset amount should exclude the value of the principal residence for individual investors, as such assets are illiquid. If the initial \$400,000 investment was intended and

initially thought only to include liquid investments, then the threshold can remain as is. However, if it was recognized that the limit also included illiquid assets but now only liquid assets are intended to be included in the definition, the net asset threshold can be lowered as a result.

*11. An investor may qualify as an eligible investor by obtaining advice from an eligibility advisor that is a registered investment dealer (a member of the Investment Industry Regulatory Organization of Canada). Is this an appropriate basis for an investor to qualify as an eligible investor? Should the category of registrants qualified to act as an eligibility advisor be expanded to include EMDs?*

While investors may seek and receive advice from registered investment dealers in connection with privately placed securities, such dealers would only be responsible for ensuring that their suitability, KYC and KYP obligations are fulfilled. We wish to stress the importance of implementing a statutory best interest standard on all registrants providing advice. We support the CSA initiative that is currently underway reviewing the best interest standard, and strongly support the implementation of such a standard including with respect to providing advice on privately placed securities. Such a standard would help ensure that an investment under the OM exemption is in fact in a client's best interests, and would help mitigate concerns relating to the ability of an investor to qualify as an eligible investor. If such a standard was implemented and applicable to EMDs the category of registrants qualified to act as an eligibility advisor could be expanded to include EMDs.

#### *Investment limits*

*12. Do you support the proposed investment limits on the amounts that individual investors can invest under the OM Prospectus Exemption? In our view, limits on both eligible and non-eligible investors are appropriate to limit the amount of money that retail investors invest in the exempt market. Are the proposed investment limits appropriate?*

We believe there should be investment limits for both eligible and non-eligible investors, however we do not think there is sufficient reason to exclude non-individual investors from these limits as well. The investment limit is one investor protection measure utilized to mitigate the fact that securities are distributed in the absence of a prospectus, and those concerns are equally applicable to non-individuals such as small, closely held corporations. It is also possible that entities could be used as a means to circumvent the restrictions, and thus the annual investment limit should apply to those entities as well.

We note, however, that it may be appropriate for a retail security holder to invest more than \$10,000 per year (or \$30,000 if an eligible investor) under the OM exemption, based on that individual's personal financial circumstances, current portfolio, investment objective, time horizon and risk tolerance level. Conversely, such limits may be too high for investors with a smaller portfolio and low risk tolerance. We do not believe that possessing investable assets above a certain threshold implies sophistication, lottery winnings and inheritances being just two examples of how that threshold could be reached by

unsophisticated investors. We do not believe that either an asset test or an income test is sufficient to determine which investors have better access to information and are sophisticated enough to not require as much protection as others.

### **FFBA Prospectus Exemption**

We support the adoption of the FFBA Prospectus Exemption, as family members and close personal friends are an important financing source for many small businesses. The additional guidance proposed in the Companion Policy with respect to the meaning of “close personal friend” will be helpful, and should be adopted by other jurisdictions.

#### *Offering parameters*

2. *Should there be an overall limit on the amount of capital that can be raised by an issuer under the FFBA Prospectus Exemption?*

In the interests of harmonization, we do not believe the OSC should impose a limit on the amount that an issuer can raise under the FFBA Prospectus Exemption.

#### *Investment limits*

4. *Should there be limits on the size of each investment made by an individual under the FFBA Prospectus Exemption or an annual limit on the amount that can be invested?*

Unless limits are imposed by other Canadian jurisdictions as well, we do not believe there should be a limit on the size of an investment made by an individual or an annual limit on the amount that can be invested under the FFBA Prospectus Exemption.

#### *Reporting of distribution*

6. *We believe it is important to obtain additional information in Form 45-106F11 to assist in monitoring compliance with and use of the FFBA Prospectus Exemption. Form 45-106F11 would require disclosure of the person at the issuer with whom the investor has a relationship. This additional information is provided in a schedule to Form 45-106F11 that does not appear on the public record. Do you agree that collecting this information would be useful and appropriate?*

We agree that the proposed additional information to be included in the exempt trade report will be useful information for the regulators and should not be burdensome for issuers to provide. In addition, investors should be required to identify (through a “check the box” mechanism) whether or not the registrant, if any, involved in the trade recommended the investor borrow money for purposes of making the investment.

**Existing Security Holder Prospectus Exemption**

As a general comment, the \$15,000 annual limit (absent advice from a registered investment dealer) may not be an appropriate limit. Investors are not otherwise limited to investing any particular amount on the secondary market. Consideration could be given to imposing an aggregate limit on an issuer basis, restricting the amount that an issuer could raise using the exemption on an annual basis. We would only support such a restriction, however, if it were adopted in the other Canadian jurisdictions as well.

*Issuer qualification criteria*

*1. Do you agree with allowing any issuer listed on the TSX, TSXV and CSE to use the Existing Security Holder Prospectus Exemption?*

We agree that any issuer listed on the TSX, TSXV or the CSE should be allowed to use the exemption as such markets have a disclosure regime, and we understand one of the reasons for the exemption is to permit issuers to raise capital without incurring the significant costs of a supplemental disclosure document. The proposed individual investment limit of \$15,000 per investor (if no suitability advice from an investment dealer is obtained) would likely make the exemption unattractive to issuers listed on more senior markets.

*Offering parameters*

*2. Do you agree that the offer must be made to all security holders and on a pro rata basis? Do you agree that these conditions support the fair treatment of all security holders?*

We agree that the offer should be made to all security holders on a pro rata basis to support fair treatment. Requiring the offer to be made on a pro rata basis could help alleviate concerns that an investor could purchase a nominal number of shares prior to the announcement of the issue where such investor might not exercise the appropriate level of due diligence for a more substantial investment in the issuer. The number of new shares an investor can acquire under the exemption should be tied to their existing holdings. We note that given the \$15,000 individual investment limit it is unlikely that the resulting issue will apply on a pro rata basis to all holders.

*3. Do you agree that it is not necessary to differentiate between a security holder that bought securities in the secondary market one day before the announcement of the offering and a security holder that bought the securities some longer period before the announcement of the offering?*

We believe there is a reason to differentiate between a security holder that bought securities in the secondary market one day before the announcement of the offering and a security holder that bought the securities some longer period before the announcement of the offering. While a current security holder would theoretically have a greater motivation

to engage in due diligence on their investee issuers, it may not be possible to do so if securities are held for only one day. We believe investors should be required to hold the securities for a minimum of one calendar quarter such that they would have access to current financial information about the issuer. In addition, by holding securities of an issuer over one or more reporting periods, an investor will have the opportunity to experience the volatility of the security's price on the exchange, and the issuer's track record of disclosure and shareholder communications.

#### *Resale restrictions*

#### *4. Should securities distributed under the Existing Security Holder Prospectus Exemption be freely tradeable?*

A four month hold period will help discourage retail investors from using the exemption for speculation purposes, particularly with respect to securities of more junior issuers.

#### **Crowdfunding Prospectus Exemption**

As an introductory comment, the crowdfunding proposal obviously represents a departure from the current regulatory model, where selling securities to the public requires a prospectus or an exemption, which are only available in limited circumstances, usually to certain types of investors. Many market participants agree that crowdfunding investment decisions are based mostly on emotions. These two conditions combined could result in a precarious situation for investor protection, and we believe these facts need to be taken into account when finalizing any crowdfunding rules.

It will be important, to the extent possible, to harmonize the requirements of this new exemption across jurisdictions. Given the small amounts of capital that can be raised, both by issuers and the individual limits placed on investors themselves, we do not think it will be economically feasible for issuers to raise capital based on this exemption if the terms are different in various jurisdictions. As a result of investor protection concerns, the use of the exemption will require strict monitoring and enforcement of the conditions of the exemption.

#### *Issuer qualification criteria*

#### *1. Should the availability of the Crowdfunding Prospectus Exemption be restricted to non-reporting issuers?*

The Crowdfunding Prospectus Exemption should be restricted to non-reporting issuers. If the new exemption is intended to address a funding gap for small and medium sized issuers, there should not be a need for those issuers already subject to an expensive continuous disclosure regime to raise money through this exemption. In addition, it could be confusing for people investing in more than one issuer through the portal if issuers have different reporting requirements. They may not understand the difference between the reporting obligations of a reporting issuer and a non-reporting issuer. As an example, if an

investor purchases the securities of a reporting issuer through the portal as their first investment, they might come to expect every issuer in which they invest through the portal to have a robust continuous disclosure regime, which would not be the case for the investment they next make in a non-reporting issuer.

*3. The Crowdfunding Prospectus Exemption would require that a majority of the issuer's directors be resident in Canada. One of the key objectives of our crowdfunding initiative is to facilitate capital raising for Canadian issuers. We also think this requirement would reduce the risk to investors. Would this requirement be appropriate and consistent with these objectives?*

We agree that requiring a majority of the issuer's directors be resident in Canada will help the objective of ensuring the initiative is aimed at facilitating capital raising for Canadian issuers. It is important to continue to permit some of the directors to be non-residents to help ensure that each issuer can structure its internal affairs appropriately and encourage participation by the directors best suited for the particular issuer and industry.

#### *Offering parameters*

*4. The Crowdfunding Prospectus Exemption would impose a \$1.5 million limit on the amount that can be raised under the exemption by the issuer, an affiliate of the issuer, and an issuer engaged in a common enterprise with the issuer or with an affiliate of the issuer, during the period commencing 12 months prior to the issuer's current offering. Is \$1.5 million an appropriate limit? Should amounts raised by an affiliate of the issuer or an issuer engaged in a common enterprise with the issuer or with an affiliate of the issuer be subject to the limit? Is the 12 month period prior to the issuer's current offering an appropriate period of time to which the limit should apply?*

We think a limit of \$1.5-\$3 million could be sufficient for issuers to raise start-up capital while still offering some level of investor protection, however the appropriate limits will be industry specific (for example, technology start-ups are quite capital intensive). More information could be required in order to determine if the limits should vary depending on the industry classification of the issuer. In all circumstances, if the maximum limit is too low, it could set up an issuer for failure before it has even begun operations. If the maximum limit is too high, however, given the proposed \$2,500 individual investor limit, an offering could result in an unworkable number of small investors, and the costs of communicating with such investors could be untenable.

#### *Investment limits*

*7. The Crowdfunding Prospectus Exemption would prohibit an investor from investing more than \$2,500 in a single investment under the exemption and more than \$10,000 in total under the exemption in a calendar year. An accredited investor can invest an unlimited amount in an issuer under the AI Exemption. Should there be separate investment limits for accredited investors who invest through the portal?*

We do not think that there should be separate investment limits for accredited investors who invest through the portal. Simply being an accredited investor is not in all cases a proxy for investor sophistication. Possessing investable assets above a certain threshold may not imply familiarity with investments, as the threshold could be reached through inheritances and lottery winnings, as examples. Neither an asset test nor an income test is sufficient to determine which investors have better access to information and are sophisticated enough not to require as much protection as others.

### *Other*

#### *12. Are there other requirements that should be imposed to protect investors?*

The proposed requirements for registered portals and the caps on investment are important safeguards, but additional restrictions could be considered specifically to address concerns relating to investors with low financial literacy and/or minimal investment experience. Timely and effective enforcement will also be key to mitigating the risk of abuse and fraud. Staff of the OSC should monitor, in particular, that the requisite financial reports are provided in a timely fashion and completed as required.

Although issuers could be expected to seek additional financing, many commentators have noted a “Series A crunch”, referring to the problems faced by start-ups when attempting to secure the next level of financing once the initial seed capital is obtained<sup>3</sup>. We believe that any difficulty in achieving the next level of financing might make it even more difficult for investors to dispose of their securities due to the expected lack of any secondary market. As a result, the terms of the exemption should address the resale market, specifically, whether portals are responsible or permitted to maintain a secondary market, as well as specifically advise investors on the portal (who may not be familiar with the resale requirements in other forms of private placements) to whom these securities can be sold, and a description of the proposed hold periods.

In order to help mitigate the risk of fraud, issuers could be required to disclose information with respect to persons with signing authority over the financial accounts of the issuer (if it differs from the principals, directors, etc. for whom disclosure is otherwise required).

The founders of the issuer could be required to escrow their existing securities for a period of time, in order to ensure they retain a substantial stake in the issuer. The resulting ownership structure after completion of the capital raising through the exemption should be disclosed.

With respect to disclosure requirements, unique obligations may be required in order to provide investors with tangible, relevant information on the issuer without requiring the issuer in all cases to provide expensive, audited financial statements. For example, the issuer could be required to post tax returns or assessments (redacted as needed to protect confidential information) as a method of confirming revenue (or the lack thereof).

---

<sup>3</sup> Ross S Weinstein, “Crowdfunding in the U.S. and Abroad: What to Expect When You’re Expecting” (2013) 46 Cornell Int’l LJ 427.

We support the CSA initiative that is underway with respect to potentially imposing a statutory best interest duty on registrants, and strongly support imposing such a duty on registered dealers providing advice to clients, including exempt market dealers providing advice on privately placed securities. Retail investors rely primarily on their advisers to let them know if an investment is appropriate for their level of risk tolerance. Even though it is proposed that investors sign a risk acknowledgement form, investors assume that their advisers are looking out for their best interests. If such a standard were formally implemented, it would help to ensure that an investment in privately placed securities under the Crowdfunding Prospectus Exemption is in fact in a client's best interests, which would materially enhance investor protection.

*Additional portal obligations*

*14. Do you think an international background check should be required to be performed by the portal on issuers, directors, executive officers, promoters and control persons to verify the qualifications, reputation and track record of the parties involved in the offering?*

Given the likelihood that investors purchasing securities in reliance on the crowdfunding exemption will not have extensive investment experience, it is very important for portals to have the primary due diligence responsibility relating to the issuers "listed" on the portal, including the responsibility to compete domestic background checks. To the extent any directors, officers, promoters or control persons are non-residents of Canada, international background checks should also be required. Due to the costs and time delays that such checks may entail, it may not be necessary to run international background checks on every resident Canadian.

*Other*

*17. Are there other requirements that should be imposed on portals to protect the interests of investors?*

The portals could be required to assist issuers in providing registrar and transfer agent type functions to help issuers monitor and communicate with their security holders, particularly as it relates to social media communications.

When the exemption is utilized by start-up or smaller companies in the growth phase, it is likely that the capital raising sought by the exemption will not be isolated financing, and companies will likely seek additional funds through alternative methods concurrently or shortly thereafter<sup>4</sup>. Investors may not be cognizant of the fact that each additional financing will dilute their investment, and thus the risk warning (or other warning prominently displayed by the portal) should specifically address the risk of dilution due to additional financings, whether through the portal or otherwise. Issuers should be required to notify investors through the portal of any additional financings.

---

<sup>4</sup> Ibid.

*Proposed Reports*

*2. Should any of the information requested through the Proposed Reports not be required to be provided? Is there any alternative or additional information that should be provided that is not referred to in the Proposed Reports?*

The additional information required for the OSC to better understand the profile of issuers and investors in the exempt market should be balanced with privacy requirements on behalf of individual investors as well as in recognition of the fact that private issuers might not otherwise be required to provide certain information to the regulators. For example, we do not see the connection between the use of a prospectus exemption and the age range of an investor. Such information would typically be available to registrants who are required to have complete KYC information, but not necessarily collected in the ordinary course by issuers, particularly non-resident issuers. Similarly, we do not believe information such as the assets under management and service provider information for investment funds is related to the criteria for any prospectus exemption and should not be required for the report.

**Concluding Remarks**

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have and appreciate the time you are taking to consider our points of view. Please feel free to contact us at [chair@cfaadvocacy.ca](mailto:chair@cfaadvocacy.ca) on this or any other issue in future.

(Signed) *Ada Litvinov*

**Ada Litvinov, CFA**  
**Chair, Canadian Advocacy Council**