



Canadian Foundation *for*  
Advancement *of* Investor Rights  
Fondation canadienne *pour* l'avancement  
*des* droits *des* investisseurs

September 8, 2017

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

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**RE: CSA Multilateral Notice and Request for Comment – Proposed Amendments to National Instrument 45-106 Prospectus Exemptions relating to Reports of Exempt Distribution**

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FAIR Canada is pleased to offer comments on the Proposed Amendments to National Instrument 45-106 Prospectus Exemptions published on June 8, 2017 that would amend the report of exempt distribution set out in Form 45-106F1 *Report of Exempt Distribution*.

FAIR Canada is a national, charitable organization dedicated to putting investors first. As a voice for

Canadian investors, FAIR Canada is committed to advocating for stronger investor protection in securities regulation. Visit [www.faircanada.ca](http://www.faircanada.ca) for more information.

## 1. General Comments

- 1.1. FAIR Canada is concerned about the CSA's overall regulatory focus relating to the exempt market. The changes currently proposed indicate that the CSA continues to focus on alleviating regulatory burden for exempt market participants rather than taking action to respond to well-documented and extensive problems associated with the exempt market. Addressing these problems must be made a CSA priority. In particular the unacceptable level of non-compliance by exempt market participants and lack of adequate information about the exempt market must be addressed immediately.<sup>1</sup>
- 1.2. With respect to the proposed changes to Item 10 of Form 45-106F1 *Report of Exempt Distribution*, FAIR Canada has a comment on the proposed change allowing agents to sign the certification, which is discussed below.

### **Poor Compliance with Existing Rules**

- 1.3. Regulators must take measures to compel compliance with the existing rules that govern prospectus exemptions, as non-compliance is a serious and persistent problem. Non-compliance harms investors and weakens confidence in the exempt market and our capital markets generally. Regulatory resources must be deployed and applied to ensure compliance with existing rules – there is little point in having rules if they are consistently disregarded. In addition, simply placing a heavy emphasis on disclosure cannot provide adequate protection to individual investors.<sup>2</sup>
- 1.4. Recent reports by CSA members summarizing compliance reviews have emphasized that non-compliance in the exempt market continues to be commonplace. For example, the Alberta Securities Commission's Notice 33-705 *Exempt Market Dealer Sweep* from May 2017 provided results from a sweep of exempt market dealers identifying numerous compliance deficiencies.<sup>3</sup>

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<sup>1</sup> See FAIR Canada, "Re: CSA Notice and Request for Comment on Proposed Amendments relating to Reports of Exempt Distribution" (October 15, 2015), online: <<https://faircanada.ca/wp-content/uploads/2015/10/151015-CSA-Re-Proposed-Exempt-Distribution-Reports-final-signed.pdf>>.

<sup>2</sup> Behavioural economics research indicates that disclosure is ineffective and may result in unintended and even perverse consequences. Firms and their representatives are responsible for ensuring that Know Your Client, Know Your Product and other rules are met so that the product sale is suitable. In addition, the risk acknowledgement form often does not work and cannot be relied upon as a key mechanism to protect investors in the exempt market. We urge the utilization of other measures to ensure adequate investor protection.

<sup>3</sup> Alberta Securities Commission Notice 33-705 *Exempt Market Dealer Sweep* (May 10, 2017), online: <[http://www.albertasecurities.com/Regulatory%20Instruments/5331553%20\\_%20EMD\\_Project\\_Staff\\_Notice%2033-705.pdf](http://www.albertasecurities.com/Regulatory%20Instruments/5331553%20_%20EMD_Project_Staff_Notice%2033-705.pdf)> [ASC Sweep]. Out of 69 firms that were reviewed by ASC staff (of which 66 were completed), regulatory action or other steps were taken in 26 cases. In addition, "[ASC staff] identified deficiencies in compliance with regulatory obligations in all areas tested" at 3.

The OSC also produced a report in July 2017 identifying “current trends in deficiencies from compliance reviews” of exempt market dealers.<sup>4</sup>

1.5. The ASC report details numerous failures that range from the nature of the compliance system in place at firms to specific compliance deficiencies related to KYC (Know Your Client) and KYP (Know Your Product) obligations.<sup>5</sup> The ASC report also highlights a number of other serious issues including:

- Investors with low or medium risk tolerances being invested in high risk exempt market securities without adequate explanation of suitability;
- Investment objectives and time horizons of clients not being consistent with the product;
- Failure to conduct adequate suitability assessments for elderly investors and other vulnerable clients;
- Failure of firms to require clients to disclose whether they were borrowing funds to invest;
- Unsubstantiated claims, misleading information, and inadequate policies, procedures and oversight related to marketing materials;
- Deficiencies with the Relationship Disclosure Information;
- Inadequate identification and response to conflicts of interest, and inadequate conflicts of interest policies and procedures;
- Non-registrants performing registerable activities.<sup>6</sup>

1.6. The OSC’s Annual Summary Report for Dealers, Advisers and Investment Fund Managers identifies some of the same compliance deficiencies raised by the ASC, such as non-registrants trading in securities without being registered to do so, firms not maintaining adequate books and records demonstrating they have conducted their own product due diligence, and registrants processing trades that exceeded the investment limit for the investor.<sup>7</sup>

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<sup>4</sup> OSC Staff Notice 33-748 *Annual Summary Report for Dealers, Advisers and Investment Fund Managers* (July 11, 2017) [OSC Report for Dealers]. The British Columbia Securities Commission also produced a report in June 2014, *Private Placement Review Program*. The Report stated: “staff found that companies have a poor understanding of the exemptions, do not keep adequate records of their private placements, and use professional advisors who do not have specialized knowledge of the securities industry and the private placement market” at 6.

<sup>5</sup> See ASC sweep at 5-6 and 11-12. Issues with the compliance systems include the failure of the chief compliance officers to adequately perform responsibilities, as well as weaknesses in documenting compliance with internal controls, policies and procedures. Compliance deficiencies related to KYC included inadequate collection and documentation of KYC information and circumvention of the \$10,000 cap applicable to non-eligible investors, while those related to KYP included firms not performing adequate assessment of products recommended to clients.

<sup>6</sup> ASC sweep at 20-21, 23-29.

<sup>7</sup> ASC sweep at 48, 51.

- 1.7. The OSC Report also found that dealers were asking their clients to complete incorrect risk acknowledgment forms, with some dealers changing the language of the form despite the wording of these forms being prescribed.<sup>8</sup>
- 1.8. Finally, the OSC Report revealed inadequate collection and documentation of information by registrants demonstrating they took reasonable steps to confirm the purchaser met the conditions of the prospectus exemption they were relying on. There were also instances where the family, friends and business associate (“FFBA”) exemption was not being used appropriately – for example, some dealers used this exemption when their client only knew a principal of the issuer through social media or if the client was employed by the issuer.<sup>9</sup> FAIR Canada warned the OSC when it proposed to add the FFBA exemption of its likely abuse. Such a compliance finding, therefore, comes as no surprise.
- 1.9. The conclusive findings of these two reports demonstrate the unacceptable level of general non-compliance and the broad range of specific compliance deficiencies that continue to be prevalent in the exempt market. FAIR Canada is concerned that, instead of focusing on dedicating compliance/enforcement resources to appropriately address these compliance deficiencies and examining the root or systemic causes that lead to such disregard for the rules, regulators continue to place their efforts on streamlining exempt market requirements. FAIR Canada believes it is incumbent upon CSA members to proactively apply regulatory resources, including enforcement, to address these serious and ongoing compliance concerns. In addition, the appropriateness of certain prospectus exemptions should be rethought.

### **Lack of Information**

- 1.10. Regulators must make obtaining information about the exempt market a priority, as this information is crucial to understanding the exempt market, facilitating more effective regulatory oversight of the exempt market and improving analysis for policy development purposes. Several academics, along with FAIR Canada, have called on regulators to improve their understanding of the exempt market by collecting better information and making that information public.<sup>10</sup>

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<sup>8</sup> OSC Report for Dealers at 53.

<sup>9</sup> OSC Report for Dealers at 52.

<sup>10</sup> Academic papers include Jack M. Mintz, “Muddling up the Market: New Exempt-Market Regulations May do More Harm than Good to the Integrity of Markets”, The University of Calgary School of Public Policy SPP Research Papers, v. 7 issue 35 (November 2014), available online: <<http://www.policyschool.ucalgary.ca/sites/default/files/research/mintz-mudlingmarket.pdf>>; and Vijay Jog, “The Exempt Market in Canada: Empirics, Observations and Recommendations”, University of Calgary School of Public Policy SPP Research Papers, v. 8 issue (March 2015), online: <<http://www.policyschool.ucalgary.ca/sites/default/files/research/exemptmarkets-jog.pdf>>. FAIR Canada has raised this issue in several of its submissions including its 2012 submission to the CSA on reforms to the accredited investor and minimum amount exemptions from consultation note 45-401 published November 10, 2011, online: <<http://faircanada.ca/wp-content/uploads/2011/01/120229-FAIR-Canada-submission-re-MA-AI-exemptions.pdf>> as well as “Re: CSA Notice and Request for Comment on Proposed Amendments relating to Reports of Exempt Distribution” (October 15, 2015), online: <<https://faircanada.ca/wp-content/uploads/2015/10/151015-CSA-Re-Proposed-Exempt-Distribution-Reports-final-signed.pdf>>. See more recently, Jeffrey MacIntosh “Enforcement Issues Associated with Prospectus Exemptions in Canada”, University of Calgary School of Public Policy SPP Research Papers, v 10: 18 (August 2017), though FAIR Canada does not support one of the conclusions presented in this paper, that an SRO be created.

- 1.11. It is important that information is collected and analyzed regarding the recently introduced prospectus exemptions, particularly before more reduction of regulatory burden is contemplated or occurs in the exempt market. We do not know how investors have fared since these new exemptions were introduced, though we do know that firms continue to display non-compliance in many areas. The non-compliance cited above exposes investors to unacceptable risks and/or harm.
- 1.12. As the OSC's 2017 Ontario Exempt Market Report indicates, only certain prospectus exemptions trigger a requirement to file a report, which means that the information gathered from the filings does not represent all exempt market activity.<sup>11</sup> The OSC states in the Exempt Market Report that the information gap is worse for small businesses because there are limited or no reporting requirements, with highly fragmented financing sources. The result in the Report is an attempt to analyze small issuers in the exempt market based on the overall correlation between issuer and offering size.<sup>12</sup> This is inadequate: more needs to be done to obtain concrete information and understand small issuers in the exempt market, especially considering the "notable increase in small Canadian issuer activity within the Ontario exempt market in 2016".<sup>13</sup> More information is also needed to fill in the significant gaps that exist with respect to information on participants in the exempt market that are not small issuers.
- 1.13. Another area of information gathering regulators must focus on are empirical studies relating to the exempt market, as these can be a crucial tool to understanding how investors can be protected. Regulators should analyze how investors are interacting with the exempt market and the kinds of decisions they are making in order to ensure that the exempt market is not exposing them to unnecessary risk and that investor protection mechanisms, such as the risk acknowledgement form, are actually serving the purpose for which they were designed.
- 1.14. Information is also needed as to what kind of returns investors are obtaining through their exempt market investments. For example, are investors obtaining positive returns? FAIR Canada reiterates its call for call for CSA members to conduct empirical studies relating to investors and the exempt market.<sup>14</sup>

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<sup>11</sup> OSC Staff Notice 45-715 *2017 Ontario Exempt Market Report* (June 2017), online: <[http://www.osc.gov.on.ca/documents/en/Securities-Category4/rule\\_20170615\\_45-715\\_exempt-market.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category4/rule_20170615_45-715_exempt-market.pdf)> at 4 [OSC Exempt Market Report].

<sup>12</sup> OSC Exempt Market Report at 15.

<sup>13</sup> OSC Exempt Market Report at 16. In addition, although the OSC notes that small issuers account for less than \$300 million (or 1%) of gross proceeds raised in Ontario's exempt market, the OSC estimates that small issuers represented approximately 57% of Canadian issuers involved in Ontario's exempt market between 2014 and 2016: see OSC Exempt Market Report at 15.

<sup>14</sup> See FAIR Canada, "OSC Exempt Market Review: OSC Staff Consultation Paper 45-710 Considerations for New Capital Raising Prospectus Exemptions" (March 8, 2013), online: <<http://faircanada.ca/wp-content/uploads/2013/03/130308.2-draft-submission-re-OSC-exempt-market-review.pdf>> and FAIR Canada, "Ontario Securities Commission Notice and Request for Comments on Introduction of Proposed Prospectus Exemptions and Proposed Reports of Exempt Distribution in Ontario" (June 18, 2014), online: <<http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-submission-re-OSC-Proposed-Prospectus-Exemptions-v1.pdf>> at para 1:10>.

## 2. Specific Comments related to Current Proposal

- 2.1. The proposed amendments to Item 10 – Certification of Form 45-106F1 would permit an authorized agent to certify the truth and, to the extent required, completeness of the information provided in the report on behalf of the issuer, underwriter or investment fund manager. We would like to see language added to the certificate expressly confirming the authority of the agent to act on behalf of and bind the issuer, underwriter or investment fund manager by completing the certificate. For instance, the wording, “on behalf of the issuer/underwriter/investment fund manager” could be modified to read “pursuant to authority to act on behalf of the issuer/underwriter/investment fund manager” so that certificate wording would begin: “By completing the information below, I certify, pursuant to authority to act on behalf of the issuer/underwriter/investment fund manager...”

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 Frank Allen at 416-214-3443/frank.allen@faircanada.ca or Marian Passmore at 416-214-3441/marian.passmore@faircanada.ca.

Yours Truly,



Canadian Foundation for Advancement of Investor Rights