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

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Alberta Securities Commission
Autorité des marchés financiers
Financial and Consumer Affairs Authority of Saskatchewan

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RE: Multilateral CSA Notice of Publication and Request for Comment Proposed Amendments to National Instrument 45-106 *Prospectus and Registration Exemptions* Relating to the Offering Memorandum Exemption and in Alberta, New Brunswick and Saskatchewan, Reports of Exempt Distribution dated March 20, 2014 (the "CSA Notice")

FAIR Canada is pleased to offer comments to the Alberta Securities Commission ("**ASC**") , Autorité des marchés financiers ("**AMF**"), Financial and Consumer Affairs Authority of Saskatchewan ("**FCAA**") and the New Brunswick Financial and Consumer Services Commission ("**FCNB**") (the "**Participating Jurisdictions**") on their proposed amendments to the offering memorandum ("**OM**") prospectus exemption ("**OM Exemption**") in section 2.9 of National Instrument 45-106 ("**NI 45-106**") and the ASC, FCAA and FCNB's proposed forms of report of exempt distribution ("**Exempt Distribution Reports**").

FAIR Canada is a national, charitable 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.

1. Executive Summary

Reconsider the Use of the OM Exemption

1.1. FAIR Canada recommends that a critical review be undertaken by the Participating Jurisdictions regarding the level of investor protection afforded under the OM Exemption, particularly in light of the serious compliance issues observed. FAIR Canada believes that a properly-reformed Accredited Investor Exemption as we have discussed in a recent comment letter[1], along with the other existing exemptions would allow issuers to raise sufficient capital while adequately protecting investors.

1.2. Numerous Canadian Securities Administrators ("**CSA**") member notices and reviews indicate a high level of non-compliance with the OM Exemption. CSA member reviews also indicate an unacceptable level of non-compliance by Exempt Market Dealers ("**EMDs**") with relationship disclosure and suitability obligations, including both Know-Your-Product and Know-Your-Client.

1.3. In light of the volume and seriousness of compliance issues related to the OM Exemption, FAIR Canada questions why members of the CSA do not undertake more fundamental reforms of the exempt market in order to ensure adequate investor protection. FAIR Canada does not believe that the proposed investment limits or the risk acknowledgement form will adequately protect retail investors from harm.

1.4. It is also important to note that no empirical evidence has been published demonstrating that the OM Exemption's availability actually helps start-ups or SMEs reduce the cost of raising capital or helps increase the amount of capital they raise. Rather, the evidence shows that start-ups and SME's infrequently use the OM Exemption.[2]

1.5. FAIR Canada believes that the mandate of regulators to provide fair and efficient markets and adequate investor protection requires that securities regulators consider removing the OM Exemption rather than moving simply forward with the proposed amendments contemplated (such as new investment limits, and certain ongoing disclosure).

1.6. If the OM Exemption is not eliminated, then, at a minimum, CSA members should immediately amend the OM Exemption so that issuers are required to file OMs and have those OMs reviewed for compliance prior to permitting reliance on an OM for a distribution to investors. FAIR Canada also recommends that CSA members conduct focused, risk-based examinations of those firms and/or individual registrants that have been registered for more than three years but have not yet been examined, similar to the examinations being proposed by the SEC.[3] Our understanding is that many EMDs have yet to be audited by a securities regulator. We also urge CSA Members to consider our comments on the proposed amendments, as discussed in section 3 below.

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[1] FAIR Canada letter to CSA dated May 28, 2014 re Proposed Amendments to the Minimum Amount and Accredited Investor Prospectus Exemptions.

[2] The Introduction of Proposed Prospectus Exemptions and Proposed Reports of Exempt Distribution in Ontario, Supplement to the OSC Bulletin dated March 20, 2041 (the "OSC Notice"), at page 9.

[3] National Exam Program Office of Compliance Inspections and Examinations, Examination Priorities for 2014,January 9, 2014, available online at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf at page 5.

1.7. FAIR Canada cautions that if the OM Exemption is introduced in Ontario, investors in other jurisdictions will be affected because, once introduced, we anticipate that more issuers will seek to raise capital through the OM Exemption given that they will be able to access the Ontario market with the same offering document. In light of this fact, CSA members will need to increase their oversight and policing of their respective exempt markets in order to adequately protect the investing public.

1.8. In the OSC's "Exempt Market Study On Crowdfunding", people surveyed who expressed an interest in investing in small and medium enterprises ("**SMEs**") indicated that they would prefer to make such investments through the use of a financial advisor.[4] However, an expectations gap exists. Retail investors expect registrants will act in their best interests, but this is not required for registrants under present laws and regulations.

1.9. FAIR Canada believes that a statutory best interests standard would help to ensure investors are protected from recommendations to purchase securities that are inappropriate, and would provide investors with a better chance for redress in the event of mis-selling. While there are considerable compliance concerns relating to the exempt market (as noted above), we believe that a best interests standard, if implemented and enforced, would improve investor protection in Canada.

2. General Comments on Offering Memorandum Exemption

Widespread Non-Compliance

2.1. Numerous CSA-member notices and reviews indicate a high level of non-compliance with the OM Exemption. CSA-member reviews also indicate an unacceptable level of non-compliance by EMDs with relationship disclosure and suitability obligations (both Know-Your-Product and Know-Your-Client). For example, Saskatchewan's Financial Services Commission Securities Division's (now the FCAA) 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**."[5] [emphasis added]

2.2. Staff Notice 45-704 also found considerable non-compliance with financial statement requirements, including non-provision of financial statements in the OM.[6] Furthermore, it identified significant investor rights issues.

2.3. *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;

[4] OSC Exempt Market Review, OSC Notice 45-712, Appendix B – Investor Survey Report, Exempt Market Study on Crowdfunding, Prepared for the Ontario Securities Commission by Edwin L. Weinstein, PhD, May 28, 2013, at page 21.

[5] 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.

[6] Staff Notice 45-704 at page 5.

- failing to include sufficient information to enable investors to make an informed investment decision;
- inadequate disclosure about the issuer's business (particularly new entities);
- 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.[7]

2.4. *CSA Report on Non-Compliance by EMDs and PMs* – CSA-member reviews also indicate an unacceptable level of non-compliance by EMDs with relationship disclosure, and suitability obligations, both Know-Your-Product and Know-Your-Client. The CSA identified practices of concern relating to EMDs in its CSA Staff Notice 31-334 CSA Review of Relationship Disclosure Practices ("CSA Staff Notice 31-334")[8].

2.5. CSA Staff Notice 31-334 explained that the noted deficiencies may lead clients to:

- Misunderstand the type of services and investment products the registered firm offers and is authorized and able to provide
- Incorrectly gauge the level of risk of an investment product or strategy
- Not be aware of the fees and costs associated with an investment product or account
- Not be aware of conflicts of interest between the registered firm and the client.

2.6. Deficiencies included the following:

- 41% of EMDs were deficient in describing the risks to a client of using borrowed money.
- 39% of registered firms did not disclose the information that they must collected about clients as required by section 13.2 of NI 31-103 (Know-your-Client).
- 35% of registered firms did not state the obligation to assess whether a purchase or sale of a security is suitable for a client (firms are required to deliver a statement to

[7] 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.

[8] CSA Staff Notice 31-334 CSA Review of Relationship Disclosure Practices dated July 18, 2013.

clients that the firm has an obligation to assess whether a purchase or sale of a security is suitable for a client)

- 33% of registered firms did not provide the required description of the content and frequency of reporting for each account or portfolio of a client, including EMDs not providing quarterly account reporting on the basis they did not have client "accounts" but rather offered a transactional service only.
- 32% of registered firms did not adequately describe the types of risks that a client should consider including some EMDs not providing risk disclosure or referring clients to the risks discussed in the issuer's offering documents.
- 22% of registered firms did not adequately provide a description the nature or type of account that the client has with the firm including some EMDs thinking they were not required to disclose the information since their relationship with the client existed only on a transactional basis.
- 21% deficient in describing conflicts of interest, including:
    - Registered firms considering themselves to operate independently, and assumed that they did not have relationships that could potentially present a conflict of interest requiring disclosure, but this was not the case;
    - Registered firms indicated that their policies and procedures manual or other internal policies described their conflicts, but acknowledged that they did not disclose these conflicts to clients;
    - EMDs indicated that the issuer's offering documents adequately described the conflicts of interest but this was not the case;
    - Registered firms disclosed that they had conflicts, but they did not describe the conflicts or explain how they were addressing them.
    - Registered firms provided an insufficient or unclear explanation about their conflicts and did not discuss the potential impact on clients.
    - Registered firms disclosed the conflicts of interest at the individual dealing or advising level, but did not consider and disclose conflicts of interest at the firm level. It goes on to state: "In particular, EMDs must also consider the conflicts of interest that exist when selling securities of related or connected issuers. Where EMDs can address the conflict by disclosure, they should ensure that they adequately disclose the nature and extent of the conflict to clients."[9]
- 16% of registered firms regarding disclosure of costs.
- 11% of registered firms regarding identifying the products or services the registered firm offers.

  and

- 6% of registered firms regarding the compensation paid for different types of products including some EMDs failing to disclose and explain the commissions or compensation they receive and the dealing representative receive.

[9] CSA Staff Notice 31-334, CSA Review of Relationship Disclosure Practices, July 18, 2013 at page 9.

2.7. *OSC Report on EMD Non-Compliance* - The OSC has also identified practices of concern relating to EMDs in its 2012 Annual Summary Report[10] (the "**OSC Summary Report**").

2.8. The OSC Summary Report noted that its EMD reviews focused on areas 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.[11]

2.9. 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 connected 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.

Experience of CSA Jurisdictions with the OM Exemption

2.10. Some limited information about Alberta's experience with the OM Exemption has been published. Appendix B to the CSA Notice includes the following information about the use of the OM Exemption in Alberta:

- It is the second most frequently used prospectus exemption representing 3.8% of the total of the value of the securities distributed;
- It is used almost exclusively by non-reporting issuers. Seventy percent of the issuers (155) self-reported their industry category as real estate or mortgage-investment corporations (MIC);
- "…there are a few issuer groups raising the majority of the funds under the OM Exemption in Alberta. Some of these large issuers have "in-house" exempt market dealers selling the securities on their behalf"[12] and
- There have been "....numerous complaints from investors that have invested significant amounts under the OM Exemption and incurred significant losses."

[10] 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>.
[11] OSC Summary Report at pages 49 – 50.
[12] CSA March 20, 2014 Notice at Annex B, page 3.

2.11. While this information is helpful, it does not provide sufficient data upon which to make an informed policy-decision. Further information about the Participating Jurisdictions' experience with the OM Exemption needs to be obtained and made public including:

- How many complaints were there about an investment made through the OM Exemption?
- How many of those complaints resulted in active investigations?
- What were the purported losses suffered by investors?
- How do the losses compare to the amount of capital raised including by start-ups and SMEs? and
- How many completed enforcement cases involve purported reliance on the OM Exemption, what were the losses incurred by investors in those proceedings, and what proportion of the losses were recovered, if any?

2.12. FAIR Canada continues to recommend that securities regulators 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.[13]

Risk Acknowledgement Forms Not Enough

2.13. FAIR Canada believes that the risk acknowledgement form does little to help protect investors, given the widespread compliance issues and the lack of effective oversight that the CSA and the OSC have noted. More fundamental reform of the exempt market is needed. If the risk acknowledgement form is provided to the investor after they have decided to invest (that is, as they are completing the paperwork), it is not clear that it will provide meaningful protection for investors. Many behavioural biases, including confirmation bias, affect investor decision-making and the design and timing of information profoundly affects its impact and effect. We have seen no evidence that these considerations factored into the design of the risk acknowledgement form. Moreover, we do not understand why all the Participating Jurisdictions did not harmonize to the more recently designed form that the OSC and the FCNB propose to use.

2.14. FAIR Canada also recommends that CSA members gather information on whether the risk acknowledgement form actually can, and does, help investors make better investment decisions. To that end, FAIR Canada recommends that CSA members: (a) obtain information on the investor experience with risk acknowledgement forms in the exempt market, and in particular with the OM Exemption; (b) publish information disclosing the effectiveness of the use of such forms in light of existing complaints, investigations and enforcement proceedings where such forms were used; and (c) conduct investor testing on the risk acknowledgement form to see whether it actually helps investors make better investment decisions. Additionally, rather than working towards a harmonized risk acknowledgement form in a later phase, CSA members need to prioritize empirical research and investor testing of the forms and consider whether other, stronger investor protection measures are needed.

[13] FAIR Canada has raised this issue in earlier comment letter to securities regulators. See our comment letter to the OSC dated March 8, 2013 in response to its concept proposal consultation published December 14, 2012 (OSC Staff Consultation Paper 45-710 Considerations for New Capital Raising Prospectus Exemptions) and in our comment letter to Participating Jurisdictions on Multilateral CSA Notice 45-311 dated February 20, 2013.

2.15. Some other observations that FAIR Canada has made regarding the risk acknowledgement form (Form 45-106F4) are:

- Why does the form not include a section to be completed by the person involved in selling these securities (as does Form 45-106F13) and why does neither require the salesperson's certification or attestation to his or her specific obligations to the purchaser?
- Why is there no required disclosure regarding the conflicts of interest present in the sale of securities of related or connected issuers?
- Why is there no required disclosure setting out any referral fees that have been paid in the sales process?
- Why is there no explanation of the specific securities protections that are absent given that it is a prospectus-exempt security?
- Why does the form not alert the investor to the suitability obligations that are owed to them by a registrant selling them a prospectus-exempt security and why does the form fail to remind registrants of their obligations (especially in light of the evidence that registrants are often unaware of their KYP and KYC obligations)?
- Why does the form not alert the investor to what the exemption requirements are and the registrant's duty to ensure the investor meets those requirements?
- Why is there no warning to the investor that if the sale of the prospectus-exempt security is not made through a registrant who has KYP obligations, then the investor will need to do their own due diligence on the seller and the investment in order to determine whether it is a legitimate investment or not?

[paragraph 2.16 and 2.17 omitted intentionally]

2.18. FAIR Canada urges securities regulators to recognize that the risk acknowledgement form currently in use does not provide adequate investor protection.

OM Exemption's Purpose Not Being Fulfilled

2.19. The OM exemption was introduced as a proposed prospectus exemption in 2001 in British Columbia and Alberta, as part of a joint initiative to introduce Multilateral Instrument 45-103 Capital Raising Exemptions. The reason for the introduction of the multilateral instrument was to facilitate capital raising for SMEs:

> The Alberta and British Columbia Securities Commissions announced today proposed new capital raising rules which will make it easier for businesses to raise money from investors in the two provinces.
>
> The new rules are the product of a joint project of the two commissions undertaken in response to industry comments that the cost of raising money is too high, especially for small and medium-sized businesses.

> The new rules will make it easier and less expensive for issuers to raise capital in Alberta and British Columbia and should particularly benefit small business," said ASC Chair Stephen Sibold.[14]

2.20. Some provinces and territories joined Alberta and BC in implementing MI 45-103 (including Manitoba, Newfoundland and Labrador, Northwest Territories, Nova Scotia, Nunavut, PEI and Saskatchewan). However, Ontario did not do so. The OSC publicly stated it had concerns with both the BC model and the Alberta model when National Instrument 45-106 was introduced, stating: "...both models of this exemption may place investors in Ontario at risk as the offering memorandum is a non-vetted prospectus-like document provided to non-accredited investors who may not have the ability to withstand financial loss. This maintains the status quo in Ontario."[15]

2.21. In FAIR Canada's view, the Participating Jurisdictions should more fundamentally review the OM Exemption and ask whether it should remain available given that it has not been used frequently by start-ups and SMEs[16] while there has been widespread non-compliance with the OM Exemption requirements and with the know-your-client and know-your product suitability obligations of EMDs when relying on this exemption.

2.22. In light of the volume and seriousness of compliance issues related to the OM Exemption, FAIR Canada questions why members of the CSA would not undertake more fundamental reforms of the exempt market in order to ensure adequate investor protection, including revoking this exemption altogether.

2.23. FAIR Canada believes the mandate of regulators to provide fair and efficient markets and adequate investor protection requires that securities regulators consider removing the OM Exemption rather than moving forward with the proposed amendments contemplated (such as new investment limits, and certain ongoing disclosure).

2.24. If the OM Exemption is not eliminated, then, at a minimum, CSA members should amend the exemption so that issuers are required to file OMs and have those OMs reviewed for compliance prior to permitting reliance on an OM for a distribution to investors. FAIR Canada also recommends that CSA members conduct focused, risk-based examinations of those firms and/or individual registrants that have been registered for more than three years but have not yet been examined, similar to the examinations being proposed by the SEC.[17] Our understanding is that many EMDs have yet to be audited by a securities regulator. The Participating Jurisdictions need to make the investor protection concerns arising from the above-noted Staff Notices a top priority and be transparent in how they will address them. We also urge CSA Members to consider our comments on the proposed amendments, as discussed in section 3 below.

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[14] BCSC 2011/44, September 27, 2001 "New Rules in Alberta and British Columbia Give Businesses Greater Access to Capital" at page 1.

[15] Page 14 of OSC Staff Consultation Paper 45-710.

[16] See page 9 of the OSC Notice which states "We note that the existing OM Prospectus Exemption available in other CSA Jurisdictions has not been frequently used by start-ups and SMEs."

[17] National Exam Program Office of Compliance Inspections and Examinations, Examination Priorities for 2014,January 9, 2014, available online at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf at page 5.

2.25. FAIR Canada cautions that if an OM Exemption is introduced in Ontario, it will also likely affect investors in other jurisdictions because, once introduced, more issuers will seek to raise capital through the OM Exemption given that they will be able to access the Ontario market with the same offering document. In light of this fact, CSA members will need to increase their oversight and policing of their respective exempt markets in order to adequately protect the investing public.

3. FAIR Canada's Comments on the Proposed Amendments in the Notice

Eligible Investor Test

3.1. The CSA Notice states that the AMF, ASC, and FCAA are not currently proposing any change to the "eligible investor" definition. An eligible investor includes (among other criteria) a person whose:

(i) net assets, alone or with a spouse, in the case of an individual, exceed $400,000
(ii) net income before taxes exceeded $75,000 in each of the two most recent calendar years and who reasonably expects to exceed that income level in the current calendar year, or
(iii) net income before taxes, alone or with a spouse, in the case of an individual, exceeded $125,00 in each of the two most recent calendar years and who reasonably expects to exceed that income in the current calendar year.

3.2. The CSA Notice indicates that they considered excluding a person's principal residence from the calculation of net assets but decided not to do so. They mention that based on Statistics Canada data, very few investors would qualify without including the principal residence.

3.3. FAIR Canada sees this reasoning as flawed. If you exclude the principal residence of course fewer investors will qualify; however, the appropriate comparison should be to the number of individuals who qualified when the OM Exemption was first implemented as the net asset and net income tests have not been adjusted for inflation despite the passage of a considerable amount of time.

3.4. FAIR Canada notes that the net income and net asset tests have not been revised upwards for inflation despite the fact that they have been in place for over a decade in many of the CSA member jurisdictions. Through inaction, therefore, the number of individual Canadians who will qualify as "eligible investors" will have risen significantly. FAIR Canada recommends that the income and asset levels be adjusted accordingly and revised on a periodic basis.

3.5. The CSA Notice indicates that the AMF, ASC and FCAA considered excluding the principal residence and adjusting the net asset threshold in order to "reduce the risk to individuals with incomes below $75,000 mortgaging their homes to invest in exempt market securities". However, they decided not to do so based on the following stated factors: (i) they have introduced a $30,000 investment cap to limit the potential exposure of an investor to a risky investment; (ii) excluding the principal residence (home) may treat investors with similar net worth differently depending upon the types of assets they choose to hold; and (iii) implications to capital raising. Presumably, also, the above-noted concern about reducing the number of investors who might qualify factored into the decision.

3.6. FAIR Canada is of the view that the net asset test should not include the equity in a person's primary residence because their home is an illiquid asset and because it's unlikely to be viewed as just another financial asset by the individual. A person's home is not merely something that "they choose to hold", and including it in their net assets may put these investors at risk, especially if they lack other assets. Finally, given the value of people's homes in the major cities in Canada, including such an asset would make millions of Canadians "eligible investors" somewhat artificially.

3.7. FAIR Canada believes that the AMF, ASC and FCAA should exclude the principal residence in order to improve investor protection. They should not simply "conduct further research and analysis in respect of the implication of excluding principal residence." Securities regulators must consider the implications of allowing retail investors to put their home equity at risk through investments in high-risk exempt market investments. The analysis should not simply involve determining how much additional capital might be raised from investors if more of them qualify.

3.8. Finally, FAIR Canada recommends that in addition to ensuring that pension assets of a retail investor are not included in the calculation of net assets (our position in response to Question 5(c)[18]), a person's RRSP and RESP assets should also be excluded. This would result in a net asset calculation that better represents the portion of an investor's net worth that they can afford to place at risk, and from which they might better be able to bear a loss. Pension assets are not liquid, their expected value may depend on many factors (including how many years of service the person has, how many years the person ends up living, whether a surviving spouse is entitled to any continuing pension amount upon the death of the plan member, etc.), and they are not assets that an individual can afford to lose.

Annual Limits on Distributions to Investors

3.9. Currently, there are no limits if a person is an "eligible investor". For non-eligible investors there is a $10,000 per distribution limit. Non-eligible investors can circumvent the per distribution limit by making successive investments in the same or related issuers. To address this concern, the AMF, ASC and FCAA are proposing an aggregate limit of $10,000 for non-eligible investors and $30,000 for individual eligible investors in any issuer in a 12-month period. Investments made under other prospectus exemptions would not be counted in the limit nor would it apply to accredited investors or individuals investing under the FFBA exemption.

3.10. FAIR Canada's comments on the proposed new investment limits are as follows;

(i) The purchaser investment limits are arbitrary amounts based on insufficient data and are not appropriate (although better than having no limits or allowing per distribution limits).

(ii) The limits should be based on a calendar year to make it easier for investors to keep track of the limits;

(iii) The size of the investment bears no relationship to the size of an individual's existing portfolio of investments and will likely lead to a risk of overconcentration and lack of diversification.

[18] Question 5(c) asks: "Should pensions be included in the net asset test under the OM Exemption? Please provide the basis for your answer".

(iv) The investment limits bear no real relationship to the income of the individual investor. The $10,000 limit for non-eligible investors is higher than the typical annual RRSP investment of $2,930 (the national median contribution).[19] The average contribution was approximately $6,000.[20] The average contribution less average withdrawal per tax free savings account ("TFSA") was $2,741 in 2011. Is it appropriate from a public policy perspective to encourage relatively large investments in high-risk investments when the median contribution to one's retirement savings is much lower? The limits may result in retail investors being encouraged to place more than their usual annual retirement savings into a high-risk and illiquid investment.

(v) Research commissioned by the Ontario Securities Commission found that Canadians' median savings and investments (including RRSPs but excluding home) are about $45,000.[21] Almost 6 out of 10 respondents were found to have less than $50,000 in savings and investments.[22] The investment of $10,000 in am OM Exempt offering would represent a significant portion of these individuals' savings.

(vi) In addition to relatively low savings rates, "[o]ne-quarter of family units had lines of credit in 2012... The median line of credit debt was $15,000 in 2012."[23] Further, "[a]bout 40% of Canadian family units carried an outstanding balance on their credit cards in 2012... The median amount was $3,000 in 2012..."[24].

While the $10,000 limit for non-eligible investor and $30,000 limit for eligible investors are intended to limit the amount individuals could lose, we question whether most Canadians can, in fact, afford to lose this much.

Ensuring Adherence to the Investment Limits

3.11. FAIR Canada is of the view that the proposed method to ensure that the investment limits are not exceeded will not be effective. Firstly, while securities regulators rightly should place responsibility on registrants to ensure compliance with the investment limits, this will not prevent the limits from being exceeded due to the following: (i) the misalignment of incentives (that is, the frequency of conflicts of interest between that of the seller and the retail investor), (ii) the fact that the requirement to ensure compliance is not in the rules but in the proposed amendments to the Companion Policy, (iii) the general low level of compliance by EMDs with such requirements; (iv) the practical difficulties in monitoring that registrants are compliant; and (v) lack of any real repercussions to the EMD should the limit be exceeded.

3.12. Securities regulators also should not rely on self-certification through a risk acknowledgement form (as proposed by Form 45-106F13) to ensure that the investor is within the investment limits and has not exceeded the annual threshold. FAIR Canada questions the value of self-certification in light of the evidence of significant non-compliance with the accredited investor exemption, including instances where sales representatives tell individuals that the documents are mere

[19] See Statistics Canada, Registered retirement savings plan contributions, 2012 released March 25, 2014.
[20] http://www.statcan.gc.ca/daily-quotidien/140325/t140325b001-eng.htm
[21] Brondesbury exempt market survey at page 9.
[22] Brondesbury exempt market at page 9.
[23] http://www.statcan.gc.ca/daily-quotidien/140225/dq140225b-eng.htm
[24] http://www.statcan.gc.ca/daily-quotidien/140225/dq140225b-eng.htm

formalities, and the suggestion through the above-noted Alberta OM data of non-compliance with the existing eligible investor qualifying criteria.

3.13. FAIR Canada recommends that there be a registry or database maintained by the CSA, perhaps in addition to self-certification and registrant responsibilities, tracking the amounts invested by a given purchaser in order to guard against abuse of the limits.

Revising the Offering Memorandum Disclosure

3.14. Many retail investors are unable to understand the disclosure that is provided to them, so the provision of an Offering Memorandum, even if fully compliant, may not lead to an informed investment decision. Many retail investors lack sufficient financial literacy to be proficient in financial matters (that is, to understand an investment's costs, risks and features) and many do not read or pay sufficient attention to the disclosure provided, often because they simply rely on their advisor to tell them what they should know or because the sales process encourages them to regard disclosure as an inconsequential formality. While (improved, plain language) disclosure is beneficial, it cannot be viewed in isolation from the behavioural effects of the sales process. It also cannot be viewed as an antidote to incentives for mis-selling that exist. We also note that changes to the OM form disclosure are being left to a "second phase". FAIR Canada believes that critical investor protection aspects should be dealt with at this phase of reform, and not left to a later date

Marketing Materials

3.15. The Participating Jurisdictions have proposed that any marketing materials used in connection with a distribution under the OM Exemption be incorporated by reference into the OM so that there is statutory liability for a misrepresentation.

3.16. FAIR Canada believes that this is an important requirement as many retail investors will place great reliance on the marketing materials and verbal representations of the seller. A statutory or contractual right of action should flow from the marketing materials as well as the OM. The following steps also need to be taken in order to prevent investor harm:

- Make clear the regulators' expectations regarding the types of advertising and marketing that it will permit versus what it will not. For example, the regulator should not allow marketing to misuse hypothetical data, portray misleading returns or make misleading statements about the investment's tax efficiency.
- The regulator should not permit misleading marketing and advertising to be cured through fine print disclosure on the materials, since the expectation that such disclosure will be read is low.
- The regulator should require a description in marketing materials of the key risks associated with the investment.
- The regulator needs to take strong action against those who do not comply rather than simply requiring the issuer to amend the materials, remove the materials, amend their policies and procedures or retrain their staff.

The practical inability of an investor (or investors) to recover their losses in the event of fraud or other misconduct means that misrepresentations in marketing materials need to be prevented at the outset.

Ongoing Annual Disclosure

3.18. The CSA Notice indicates that many issuers using the OM Exemption are not organized under business corporation statutes and are not subject to an annual financial statement requirement. Without financial statements, security holders are unable to assess how the financing proceeds have been used.

3.19. Accordingly, the Participating Jurisdictions have proposed a requirement that an issuer relying on the OM Exemption prepare annual financial statements within 120 days of its financial year end and that there be discussion of the use of proceeds accompanying the financial statements. The proposal involves a required filing of the financial statements and use of proceeds disclosure along with access for security holders but otherwise not making the disclosure publicly available. Such disclosure would be required until the earlier of the issuer (1) becoming a reporting issuer or (2) ceasing to carry on business. The OSC and FCNB proposal involves delivery of the documents to securities regulatory authorities.

3.20. The reasons provided for this ongoing disclosure is to introduce accountability to issuers that rely on the OM Exemption with respect to the use of proceeds and reduce incentives to use a non-corporate structure to avoid reporting obligations. The proposal is for audited financial statements prepared in accordance with International Financial Reporting Standards.

3.21. We support disclosure in the OM of the use of aggregate proceeds raised by the issuer and we support disclosure of audited financial statements within 120 days from year end. However, we question whether there will be compliance with such requirements and whether it will ensure sufficient accountability to retail investors who become the issuer's security-holders.

3.22. We would also refer the Participating Jurisdictions to our letter dated February 20, 2013 (in response to Multilateral CSA Notice 45-311), which sets out our position on financial statements.[25] FAIR Canada believes the provision of audited financial statements is required prior to investing so that investors have needed information to help make an informed investment decision. We question assertions that the cost of preparing audited financial statements is prohibitively expensive for capital raising, since there is an absence of empirical data supporting those assertions. Given that it appears many issuers using the OM Exemption are not organized under business corporations statutes and are not subject to an annual financial statement requirement[26], it is essential that this be required under the OM Exemption prior to an individual investing.

3.23. FAIR Canada requests that the ASC, AMF, and FCAA explain why they are not requiring that an issuer using the OM Exemption provide notice of certain material changes (such as fundamental change, significant change to issuer's capital structure, major reorganization, and take-over bid) to its security holders, within a certain number of days of occurrence unlike FCNB.

[25] Available online at http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-comments-re-Certain-OM-Exemptions.pdf

[26] See CSA Notice dated March 20, 2014 at page 6.

Reports of Exempt Distribution

3.24. We have noted in this and in previous submissions on the exempt market that there is very limited available data upon which important policies are being determined regarding proposed prospectus exemptions or the reform of existing prospectus exemptions. Decisions are being made based upon insufficient data. That being said, FAIR Canada supports improvements to the ability to monitor use of capital-raising exemptions and the parties involved in them so as to better inform policy-making. We support amendments to Reports of Exempt Distribution and other necessary changes in order to collect better information and support the publication of this information in order to improve the policy-making process. We note that the ASC, FCAA and FCNB are harmonizing their Exempt Distribution Reports with that of the OSC. We encourage all members of the CSA to harmonize the form to that being proposed by the OSC.

3.25. FAIR Canada urges all securities regulators to require the collection of the needed information through the Exempt Distribution Reports, and to harmonize so that the greater amount of necessary information can be obtained. FAIR Canada also strongly urges all jurisdictions to implement any necessary technology changes so as to require and obtain the information electronically. This will allow for the easier manipulation and use of such data.

4. Statutory Best Interests Standard Required

4.1. FAIR Canada believes that a statutory best interests standard would help to ensure investors are protected from recommendations to purchase securities that are inappropriate, and would provide investors with a better chance for redress in the event of mis-selling.

4.2. While there are considerable compliance concerns relating to the exempt market (as noted above), we believe that a best interests standard, if implemented and enforced, would improve investor protection in Canada. We recognize this would involve considerable changes relating to mis-aligned incentives, conflicts of interest and existing remuneration structures (such as high up-front commissions, finder's fees, and referral fees), but we believe that such a standard is necessary, and it is what investors expect. If such a statutory obligation were required, issues such as when it would be suitable for an individual eligible investor who is not an accredited investor and not eligible to invest under the FFBA exemption to invest more than $30,000 per year (as asked in Question 2 of the CSA Notice) would be obviated.[27]

4.3. FAIR Canada believes that, in order to rely on a retail investor qualifying as an eligible investor by obtaining advice from an eligibility advisor, the retail investor 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 interests. In addition, to qualify, the registrant must have recommended that the proposed exempt investment be in the best interests of the retail investor ("eligible investor"). The Participating Jurisdictions should monitor the use of this qualifying criterion through requiring the provision of information to the relevant securities regulator on the use of this qualifying criterion including the name of the registrant who provided the investment advice.

4.4. FAIR Canada recommends that the "eligibility adviser" be required to be a registrant who is an IIROC member so that investors are afforded the additional protections associated with SRO

[27] See Question 2 on page 9 of the CSA Notice.

membership. FAIR Canada would not support expansion of the category of registrants qualified to act as an eligibility advisor to include EMDs given (1) they are not members of an SRO; (2) the EMD may be subject to conflicts of interest which would result in skewed advice that is not in the best interests of the client nor suitable for the client; and (3) the low level of compliance with existing know-your-client and know-your-product obligations and client relationship disclosure obligations observed by compliance sweeps of EMDs.

4.5. Finally, FAIR Canada recommends that it be made clear to retail investors, registrants and issuers that the advice needs to be obtained from a registrant that is at an IIROC member given that retail investors will not understand (nor may EMDs and issuers) that advice from an "investment dealer" means an IIROC-member dealer.

4.6. The time has long passed since days when investment products were simple enough that most lawyers and accountants had sufficient knowledge, without special training, to advise clients on the products' attributes and risks. Today's investment products tend to be complex and sophisticated, and it is no longer appropriate to allow lawyers and accountants in general practice, or in specialties other than securities practice, to act as "eligibility advisers".[28]

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 Neil Gross at 416-214-3408 (neil.gross@faircanada.ca) or Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca).

Sincerely,

Canadian Foundation for Advancement of Investor Rights

[28] See Question 6 of the CSA Notice, at page 9.