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

June 18, 2014

The Secretary
Ontario Securities Commission
20 Queen Street West
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Toronto, Ontario M5H 3S8
Sent via e-mail to: comments@osc.gov.on.ca

**RE: Ontario Securities Commission Notice and Request for Comments on Introduction of Proposed Prospectus Exemptions and Proposed Reports of Exempt Distribution in Ontario**

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FAIR Canada is pleased to offer comments on Ontario Securities Commission ("**OSC**") Notice and Request for Comments on Introduction of Proposed Prospectus Exemptions and Proposed Reports of Exempt Distribution in Ontario (the "**Notice**"), published on March 20, 2014.

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:

### The Proposed Crowdfunding Exemption

1.1. **FAIR Canada does not support the introduction of a Crowdfunding Exemption.** We believe the model is flawed and presents significant potential for serious investor harm. FAIR Canada is concerned that Canadian securities regulators (and securities regulators around the world) will be unable to regulate crowdfunding. The internet does not abide by jurisdictional borders. The introduction of a crowdfunding exemption will send a message to Canadian investors that investing online in an unknown start-up company is a legitimate investment opportunity.

1.2. It is widely accepted that many (possibly most) investors will lose money by investing in crowdfunding. It is unclear whether the purported benefits of crowdfunding will outweigh the costs. The economic benefits of crowdfunding are unproven. As a result, FAIR Canada believes that it is incumbent upon securities regulators who are intent on implementing such an exemption to **do so in a way that affords the highest level of investor protection possible**. This is the best chance of serving the interests of both investors and issuers.

1.3. FAIR Canada is concerned that investment limits will be of limited effect in reducing the risk of abuse and fraud. We also believe that for legitimate offerings, investment limits are necessary to reduce losses.

1.4. The underlying premise of crowdfunding is that small and medium enterprises ("**SMEs**") can meet their capital-raising needs by sourcing a small amount of money from a large number of people. We recommend that the OSC **decrease the individual investor limits to $500 or less per offering and $5,000 in total** under the crowdfunding exemption. The current proposed limits are not small amounts for most retail investors.

1.5. FAIR Canada is concerned that adequate mechanisms have not been set out that will ensure adherence to the investor investment limits or the offering limit. FAIR Canada recommends the use of a centralized database to verify aggregate investment amounts rather than reliance upon self-certification.

1.6. FAIR Canada notes that, while suitability is a low threshold (we believe a best interest duty is necessary), investors could benefit from some form of advice with respect to crowdfunding offers. This could provide more protection than arbitrary investment limits as proposed, by ensuring that any crowdfunding investments do not make up a disproportionate amount of an investor's portfolio. We recommend that the OSC examine whether a suitability element should be added to the exemption in the interests of investor protection and in light of research which demonstrates demand for it.

1.7. In light of academic research, FAIR Canada calls into question the "wisdom of the crowd", and suggests that crowdfunding investors may often fail to properly evaluate a crowdfunding offering, be subject to herding influences, and make 'impulse-purchase'-like decisions.

1.8. FAIR Canada is concerned that many investors will not understand the liquidity constraints of crowdfunding investments and will be 'squeezed out' of any profits in the rare event that they happen to invest in a successful equity crowdfunding offering. We recommend that the OSC prescribe basic mandatory protections for crowdfunding investors, including tag-along and pre-emptive rights.

1.9. It is essential that the advertising and marketing be limited to the registered portal so that regulators have some ability to provide oversight and monitoring of the advertising through the portal. While we anticipate there may be significant compliance concerns relating to advertising and soliciting, we view this to be an essential investor protection element of the crowdfunding proposal. FAIR Canada is concerned about the implications of proposed advertising and general solicitation provisions and we make specific recommendations to address these provisions.

1.10. FAIR Canada has asked various regulators for their research in respect of risk acknowledgement forms and understands that, despite their widespread use, regulators have not conducted research on investor use, investor understanding, utility or design of risk warning documents. We recommend that securities regulators test the risk acknowledgement form with investors prior to implementing the proposed crowdfunding exemption to ensure that it serves the purpose for which it was intended.

1.11. Additionally, we recommend that all portals have minimum requirements to provide risk warnings to investors prior to the point of sale. We also recommend that portals be required to provide an interactive basic knowledge tutorial that investors must complete in order to view offerings.

1.12. FAIR Canada agrees that it is vitally important that an issuer may not (directly or indirectly) pay a commission, finder's fee, referral fee or similar payment to any person in connection with an offering under the exemption, other than to a portal.

1.13. FAIR Canada recommends that concurrent capital raising under other exemptions should be prohibited during a crowdfunding distribution period. We further recommend a cooling-off period between offerings made through different prospectus exemptions.

1.14. FAIR Canada is concerned that some of the language proposed for the crowdfunding offering document is unclear or may be misleading. We make specific recommendations below in section 16.

1.15. FAIR Canada recommends that the right of action for misrepresentation be available against issuers, management, directors and portals. We also recommend that the crowdfunding offering document incorporate by reference other marketing material and continuous disclosure (for reporting issuers). We also recommend that the limitation period be two years from the date on which the claim became discoverable.

1.16. FAIR Canada also suggests that issuers be required to track employment levels and innovation developments of issuers who use the crowdfunding exemption and report them to securities regulators.

1.17. FAIR Canada fully supports the restriction that a registered funding portal will not be permitted to obtain dual registration in another registration category.

1.18. FAIR Canada opposes the proposed rule that would allow the portal to accept securities from SMEs and start-ups as payment (even if this payment was limited to 10%). This inevitably gives rise to conflicts of interest and, given the important obligations imposed on portals, we do not believe regulators should condone such conflicts.

1.19. FAIR Canada believes that self-regulatory organization ("**SRO**") membership should be required for crowdfunding portals.

1.20. FAIR Canada supports the proposed requirements for crowdfunding portals to complete due diligence. It is essential that portals be required to conduct background checks on issuers and their directors, executive officers, control persons and promoters. It is also essential that due diligence be conducted on the issuer's business.

1.21. FAIR Canada recommends that funding portals have obligations with respect to investor complaints, including participation in the Ombudsman for Banking Services and Investments. Portals should be required to have a formalized process for receiving complaints and tracking them. FAIR Canada suggests that funding portals have an obligation to report potential fraud to police and securities regulatory authorities and notify investors on their portals as appropriate.

1.22. Additionally, we recommend that portals be required to be transparent about capital raised, success rates, instances of fraud, etc. We are concerned that the rare successful businesses will garner a disproportionate amount of public attention and believe that complete information regarding failure rates and the amount of investor losses must also be reported to the relevant regulators and made publicly available.

**The Proposed Offering Memorandum ("OM") Exemption**

1.23. FAIR Canada is opposed to the introduction of the proposed Offering Memorandum Exemption (the "**OM Exemption**") in Ontario at the present time. 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 in Ontario (the Private Issuer Exemption and the Founder, Control Person and Family Exemption) and a properly conceived Existing Security Holder Exemption would allow for the ability of issuers to raise sufficient capital while adequately protecting investors.

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

1.25. In light of the volume and seriousness of compliance issues related to the exempt market in Ontario and in other CSA jurisdictions, FAIR Canada questions why securities regulators do not undertake more fundamental reforms of the exempt market in order to ensure adequate investor protection prior to expanding the exempt market through the introduction of new prospectus exemptions.

1.26. It is also important to note that no empirical evidence has been published demonstrating that the OM Exemption's availability in other jurisdictions in Canada actually helps start-ups or SMEs reduce the cost of raising capital or increase the amount of capital that they raise. Rather, the OSC indicates in the Notice that the OM Exemption has not been frequently used by start-ups and SMEs.[2]

1.27. FAIR Canada believes the mandate of regulators to provide fair and efficient markets and adequate investor protection requires that the OSC defer introduction of the OM Exemption until adequate investor protection can be provided by the regulatory framework. Accordingly, FAIR Canada does not support the introduction of an OM Exemption in Ontario at the present time.

1.28. FAIR Canada also recommends that the OSC heighten its oversight of exempt market participants and that it 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 what is being proposed by the SEC.[3] Our understanding is that many EMDs have yet to be audited by the OSC.

1.29. If the OM Exemption is nonetheless introduced into Ontario, FAIR Canada urges the OSC to require issuers to file OMs and have those OMs reviewed for compliance prior to permitting reliance on an OM Exemption for distribution to investors. We also urge the OSC to consider our comments on its proposed OM Exemption, as discussed below at section 32, in response to specific consultation questions.

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

[2] (2014) 37 OSCB (Supp-3) at page 9.

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

1.30. 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 and the OSC will need to increase their oversight and policing of their respective exempt markets in order to adequately protect the investing public.

**The Proposed Family, Friends and Business Associates Exemption**

1.31. FAIR Canada is of the view that the Private Issuer Exemption and the Founder, Control Person and Family Exemption are sufficient to capture all individuals who would perhaps have the requisite nexus to a start-up or SME so as to potentially mitigate the risks of the investment through the knowledge of the issuer's principals (and their capabilities and level of trustworthiness) as well as those individuals who possibly have access to information about the issuer in order to make an informed decision.

1.32. We do not believe there a valid rationale for introducing the proposed Family, Friends and Business Associates ("**FFBA**") Exemption which includes a much broader list of more remote family members as well as close personal friends or close business associates. We suspect that there are many abuses of the FFBA Exemption in the exempt market (and provide some examples of these abuses at sections 46 below) and that how issuers and/or registrants determine who is a "close personal friend" or close business associate" is extremely difficult to police and is widely abused. The inability to contain who constitutes a "close personal friend" or "close business associate" makes oversight of this exemption unworkable.

1.33. In our comments on OSC Staff Consultation Paper 45-710, FAIR Canada requested that data on the experience of the other CSA jurisdictions with respect to the FFBA Exemption be made public before considering the adoption of it in Ontario. FAIR Canada respectfully requests that such information be published so that it can be considered and commented upon by stakeholders before the OSC makes a policy determination as to whether to introduce this exemption in Ontario.

1.34. Given that a FFBA Exemption is premised on the theory that those close to the promoter can gauge that person's trustworthiness, if many cases that involve serious investor harm also involve perpetrators who target friends and family, the rationale for this exemption merits closer review and it should not be introduced until such a review has been completed and published and stakeholder feedback has been solicited on it.

**The Proposed Existing Security Holder Exemption**

1.35. FAIR Canada supports allowing listed issuers the ability to raise money by distributing securities to their existing security holders provided shareholders are given adequate notice and disclosure, time to consider the offering and ability to participate in the offering. Further the rules should include protections to avoid abuse including making offers on a pro-rata basis consistent with investors' existing shareholdings.

1.36. In particular, FAIR Canada recommends that the model require the following additional key components in order to prevent abuse by market players at the expense of investors and thus provide adequate investor protection:

- The investor should have the ability to purchase additional shares consistent with their existing shareholdings. (For example, if an investor holds 10,000 shares, they can purchase up to an additional 10,000 (instead of an arbitrary $15,000 limit absent advice regarding the suitability of the investment or no limit if advice as to suitability is provided). The limit should be based on a shareholder's holdings on the "record date".
- The "record date" should be 30 days prior to the date of the announcement to prevent potential abuse by market participants.
- The private placement rules of the TSXV should be made an integral part of the proposed exemption so as to be enforceable by the regulators.
- There should be an aggregate limit on the amount raised to no more than 25% of the number of the existing outstanding securities of the class to be issued in any twelve month period (similar to a rights offering exemption).
- The announcement should disclose the holdings of insiders and whether the insiders intend to subscribe for the offering in full or in part. Insiders should not be permitted to subscribe for the offering unless they have disclosed an intention to subscribe in the announcement.

**Exempt Market Needs Best Interest Standard**

1.37. Retail investors expect registrants to act in their best interests, but this is not required for registrants under present laws and regulations. An expectations gap exists.

1.38. FAIR Canada believes that a statutory best interest 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. 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.

**More Information Needed to Make Sound Policy Decisions: Exempt Distribution Reports**

1.39. FAIR Canada suggests that the OSC take a cautious approach in considering the implementation of new prospectus exemptions in the absence of necessary data in order to make an informed and sound policy decision and in light of the significant investor protection concerns that have been identified.

1.40. We have noted in this and previous submissions on the exempt market that important policies are being determined regarding proposed prospectus exemptions or the reform of existing prospectus exemptions without sufficient data. That 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 in future. 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 Alberta Securities Commission, Financial and Consumer Affairs Authority of Saskatchewan and the Financial and

Consumer Services Commission of New Brunswick are harmonizing their Exempt Distribution Reports with that of the OSC. We encourage all members of the CSA to harmonize the form with that of the OSC.

1.41. FAIR Canada urges all securities regulators to collect 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.

**Need for Consistency in the Approach to Policy-Making**

1.42. In FAIR Canada's view, finite regulatory resources should be used to focus on initiatives that provide for strong investor protection as these would support true capital formation and fair and efficient markets. Meaningful investor protection initiatives, such as the implementation of a best interest standard and a ban on conflicted sales commissions, are essential protections that are missing from the current regulatory framework for both private and public equity investments.

1.43. FAIR Canada is surprised at how quickly the crowdfunding initiative has moved from the idea stage to proposed regulations. Despite a lack of evidence, Canadian securities regulators have seen fit to steam forward with unproven rules that are widely acknowledged to cause investor losses. We are concerned that in their haste, securities regulators may have failed to consider how this grand experiment will reflect on the policymaking process a few years down the road.

1.44. FAIR Canada notes that crowdfunding has moved abruptly from an idea to concrete rules. We have found some of the comments, rationales, or explanations for certain provisions to be unclear or lacking. The consultation period has not allowed adequate time for a thorough discussion (including in-depth roundtables) to discuss the implications of specific provisions being proposed.

1.45. We have difficulty understanding why the thorough, methodical, research-based approach that has been applied in important investor-protection matters has been cast aside with respect to crowdfunding and other proposed exemptions. If regulatory capacity for swift action exists, it ought to be deployed to address investor-protection concerns rather than capital-raising desires.

1.46. FAIR Canada urges the OSC to reconsider its timeline of having the rules finalized and implemented by as early as the first quarter of 2015.[4] FAIR Canada recommends that if the OSC does proceed to implement the proposed prospectus exemptions, that they each include a sunset clause to ensure they are reviewed with the benefit of better information inputs, after a two year time period.

[4] See Speech by Howard Wetston, "Capital Formation in Ontario" (June 2, 2014), available online: <http://www.osc.gov.on.ca/en/NewsEvents_sp_20140602_hw-capital-formation.htm> at page 10.

**PROPOSED CROWDFUNDING EXEMPTION**

> *Crowdfunding of equity capital for start-ups is one of a handful of jewels in the crown of the JOBS Act....But the crowdfunding jewel is fool's gold ...As a savvy tech entrepreneur told me the other day, "I love crowdfunding: it is cheap money for me. I know it is not good for the investors". That is the problem:* ***crowdfunding will at best be good only for the entrepreneurs and middlemen, paid for by unwitting consumers who simply cannot know enough about the highly risky ventures or the highly complex venture investing process to make informed investment decisions***.[5]

## 2. FAIR Canada Opposes Crowdfunding

2.1. Crowdfunding is a method of funding a project or venture through small amounts of money raised from a potentially large number of people over the internet via an internet portal acting as intermediary.[6] There are numerous models of crowdfunding, including the donation model, the reward model, the pre-purchase model, the peer-to-peer lending model, and the securities-based model. Our crowdfunding comments in this letter focus on the securities-based model, as this is the crowdfunding model that will generally involve a distribution of securities.

2.2. **FAIR Canada does not support the introduction of a Crowdfunding Exemption. We believe the model is flawed and presents significant potential for serious investor harm.** The expected return of a crowdfunding investment is extremely low due to the many barriers small investors face: high business risk; low survival rate of SMEs/new firms; absence of professional support often provided to new entrants by venture capitalists; incompetent management; bad ideas; poor valuation; bad luck; lack of exits; potential dilution; and outright fraud and misappropriation. It is an understatement to say that the deck is stacked against crowdfunding investors.

2.3. In FAIR Canada's view, finite regulatory resources should be used to focus on initiatives that provide for strong investor protection as these are the initiatives that support true capital formation and fair and efficient markets. FAIR Canada made submissions to this effect to the Autorité des marchés financiers and the OSC in March 2013.

2.4. Such initiatives also foster investor confidence in those markets. Meaningful investor protection initiatives, such as the implementation of a best interest standard and a ban on conflicted sales commissions, would provide stronger investor protection. These are essential protections that are missing from the current regulatory framework for both private and public equity investments. These protections would confer real benefits to investors and the Canadian economy by providing optimal outcomes (through the receipt of unconflicted advice in investors' best interests) at a lower cost to investors.

2.5. FAIR Canada is surprised at how quickly the crowdfunding initiative has moved from the idea stage to proposed regulations. Despite a lack of evidence, Canada's securities regulators have seen fit to

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

[6] Policy Statement to Regulation 45-108 Respecting Crowdfunding. Available online at: <http://www.lautorite.qc.ca/files//pdf/reglementation/valeurs-mobilieres/45-108/2014-03-20/2014mars20-45-108-ig-cons-en.pdf>.

steam forward with unproven rules that are widely acknowledged to cause investor losses. We are concerned that in their haste, securities regulators may have failed to consider how this grand experiment will reflect on the policymaking process a few years down the road.

2.6. We have difficulty understanding why the thorough, methodical, research-based approach that has been applied in important investor-protection matters has been cast aside with respect to crowdfunding and other exempt market initiatives. The need to foster capital raising for fledgling businesses is no more urgent or important than the need to protect investors. If anything, regulatory capacity for swift action should be deployed in response to investor protection concerns. FAIR Canada recommends that the OSC apply a consistent approach to policy-making. We also suggest that the OSC reconsider its timeline of having the rules finalized and implemented by as early as the first quarter of 2015.[7]

2.7. Given the experimental nature of equity crowdfunding regulation, if the OSC proceeds with the introduction of a crowdfunding exemption, **we strongly urge that a sunset clause of two years be included**. This would ensure that the appropriateness of and experience with the crowdfunding exemption is reconsidered once some insight has been gained into its operation and effect.

2.8. FAIR Canada notes that crowdfunding has moved abruptly from an idea to concrete rules. While the OSC (in cooperation with other Canadian securities regulators) has provided detailed rules, we have found some of the comments, rationales, or explanations for certain provisions to be unclear or lacking. The consultation period has not allowed adequate time for a thorough discussion (including in-depth roundtables) to discuss the implications of specific provisions. FAIR Canada has attempted to canvass the proposals, academic research, investor advocates' positions (both in Canada and internationally), and other sources but have felt this process to be rushed.

2.9. An absence of comments on particular proposed crowdfunding rules in this comment letter should not be construed as support. We have attempted to comment on those aspects of the proposed crowdfunding exemption that are of greatest importance to investor protection, but have not commented on every aspect relevant to retail investors. We reserve the right to make further submissions regarding the very detailed proposed rules going forward. We are concerned that the speed at which this initiative is progressing is providing inadequate time for reflection and consideration of the implications of the proposals.

## 3. The Internet

> Governments of the Industrial World, you weary giants of flesh and steel, I come from Cyberspace, the new home of Mind.... You have no sovereignty where we gather.
>
> …You have no moral right to rule us nor do you possess any methods of enforcement we have true reason to fear.
>
> … Cyberspace does not lie within your borders. Do not think that you can build it, as though it were a public construction project. You cannot. It is an act of nature and it grows itself through our collective actions.[8]

[7] *Supra* note 5.

[8] John Perry Barlow, "A Cyberspace Independence Declaration" (February 9, 1996), available online: <https://w2.eff.org/Censorship/Internet_censorship_bills/barlow_0296.declaration>.

3.1. The results of the CSA's BlueHedge Investments campaign demonstrated Canadians' vulnerability to online investment fraud. Bill Rice, Chair of the CSA, was quoted as saying "Our recent campaign showed us that people are willing to click on online ads and open emails touting investment opportunities from unknown sources... Potential investors need to be more wary when dealing with investment opportunities they see advertised online."[9]

3.2. FAIR Canada is concerned that Canadian securities regulators (and securities regulators around the world) will be unable to regulate crowdfunding. The proposed crowdfunding rules are premised upon regulated registered portals operating online and facilitating investments by retail investors. But what ability do regulators have to prevent unregistered portals from also offering (or purportedly offering) investments to Canadians? And what assurance is there that Canadians will know they should make crowdfunding investments only through registered portals?

3.3. Will Canadian regulators know who is behind the operation of unregulated portals or other issuers who offer securities on the internet offside the rules? What jurisdiction (if any) do Canadian regulators have over websites hosted in other countries? How speedily can they be shut down? Are Canadian police forces equipped to assist? In the event securities regulators are unable to prevent online offerings from issuers who do not meet the qualification criteria, what are their options for enforcement action? The practical implications make success in these cases highly unlikely. How will regulators prevent these offerings from being sold to Canadians? Do securities regulators have sufficient enforcement power to deter non-compliance?

3.4. The internet does not abide by jurisdictional borders. Equity crowdfunding offerings will not be limited to the rules prescribed in the Notice. While we expect that public education is a planned element of this initiative, FAIR Canada is aware that investor education takes considerable time and presents challenges, and we do not believe that investor education will be able to address these real and pressing concerns.

3.5. FAIR Canada believes, therefore, that it is extremely naïve to think the proposed crowdfunding rules will have any real effect at all. In fact, the only thing they are likely to accomplish is a watering down of the critical message that the internet is not a safe place for investors.

3.6. The introduction of a crowdfunding exemption will send a message to Canadian investors that investing online in an unknown start-up company is a legitimate investment opportunity. Given the limited effect of noble investor education efforts to date, we seriously question whether securities regulators will be able to convey to ordinary investors the delineation between regulated crowdfunding offerings (for example, through registered portals) and non-compliant offerings. Canadians are generally uninformed about securities regulation (many do not know of their provincial or territorial securities regulator and the majority do not check registration[10]). We have no reason to believe that the situation will be any different with respect to the proposed exemptions and this will lead to susceptibility to fraudulent offerings.

3.7. Permitting capital-raising by SMEs on the internet will increase the pool of unsuspecting investors vulnerable to frauds. The North American Securities Administrators Association ("**NASAA**") listed

[9] Financial and Consumer Affairs Authority, Press Release: Online Fraud Awareness Campaign Confirms Investors' Vulnerability (March 6, 2012), available online: <http://www.sfsc.gov.sk.ca/Default.aspx?DN=4dbd3b54-b532-4a90-9658-a8c97bc03b80>.

[10] The CSA's 2012 Investor Index found that 39% of Canadians know that there is a provincial or territorial government agency responsible for regulating financial investments in their province or territory. It also found that 60% of people with a financial advisor had never done any form of background check on their advisor.

crowdfunding as its top new threat to investors in 2012.[11] The following year, crowdfunding was listed as one of NASAA's new top threats to small business and increased actions or enforcement efforts relating to crowdfunding were noted.[12]

## 4. Economic Benefits Uncertain

4.1. Crowdfunding is hailed as a tool to boost the economy and create jobs, by providing financing to small- and medium-sized entities[13] which then will create jobs and spur innovation. According to the Notice, both the proposed crowdfunding exemption is "intended to facilitate capital raising for all issuers."

4.2. Failure rates of SMEs are high. Recent Canadian data shows that while approximately 70% of SMEs survive for two years[14,15] only about 50% of small businesses (fewer than 250 employees) survive for five years.[16] Other research has found that the average (mean) survival time for new firms (not necessarily SMEs) is six years, while the median survival time is three years.[17] We expect businesses that use equity crowdfunding (rather than bank loans or self-funding) could have even lower odds of success due to moral hazard and other factors. Odds of survival, let alone profit, are against SMEs. We recognize that owners and principals of start-ups and SMEs take considerable risk in trying to create successful businesses. However, we are concerned that small investors who invest in crowdfunded offerings will be exposed to extreme risk without having the same access to information and decision-making power.

4.3. It is widely accepted that many (possibly most) investors will lose money by investing in crowdfunding. It is unclear whether the purported benefits of crowdfunding will outweigh the costs. A preliminary academic exploration of the underlying economics of crowdfunding notes that:

> Despite the best efforts of policy makers and platform designers, there will surely be spectacular failures. Funders will lose significant sums, not only to fraud, but also to incompetent managers, bad ideas, and bad luck… The growing pains experienced by the equity-based crowdfunding industry will be even more dramatic and severe than in the non-equity setting. Throughout the mayhem, policy makers will be faced with the question of whether, in the long term, the benefit from the private gains from trade (cash for equity) as well as from the social gains due to spillovers and other externalities will outweigh these significant costs.[18]

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[11] North American Securities Administrators Association, "NASAA Enforcement Report" (October 2012), available online: <http://www.nasaa.org/wp-content/uploads/2012/10/2012-Enforcement-Report-on-2011-Data.pdf>.

[12] North American Securities Administrators Association, "NASAA Enforcement Report 2013 Report on 2012 Data" (October 2013), available online: <http://www.nasaa.org/wp-content/uploads/2013/10/2013-Enforcement-Report-on-2012-data.pdf>.

[13] An SME is a business establishment with 1 to 499 paid employees, more specifically: a small business has 1 to 99 paid employees and a medium-sized business has 100 to 499 paid employees. See <http://www.ic.gc.ca/eic/site/061.nsf/eng/02834.html>.

[14] Industry Canada, "Key Small Business Statistics – August 2013" (Date modified: 2013-09-13), available online: <http://www.ic.gc.ca/eic/site/061.nsf/eng/02808.html>. See also Business Development Bank of Canada, "SMEs at a Glance" (August 2011), available online: <http://www.bdc.ca/EN/Documents/other/SMEsAtAGlance-Summer%202011.pdf>.

[15] Industry Canada, "Archived - Key Small Business Statistics – July 2012" (Date modified: 2013-09-20), available online: <http://www.ic.gc.ca/eic/site/061.nsf/eng/02717.html>.

[16] *Ibid*.

[17] Statistics Canada, "Failure Rates for New Canadian Firms: New Perspectives on Entry and Exit" (2000), available online: <http://publications.gc.ca/Collection/Statcan/61-526-XIE/61-526-XIE1999001.pdf>.

[18] Ajay Agrawal, Christian Catalini, Avi Goldfarb, "Some Simple Economics of Crowdfunding" (June 1, 2013) at pages 37-38.

4.4. **The economic benefits of crowdfunding are unproven**. As stated by a Deutsche Bank report, "...it remains to be seen whether crowdfunding will achieve a scale that results in positive macro-economic spillover effects, such as a rising number of company start-ups and an attendant increase in positive employment effects."[19]

4.5. The introduction of equity crowdfunding is very much an experiment, one with uncertain outcomes and real, clear risks. **As a result, FAIR Canada believes that it is incumbent upon securities regulators who are intent on implementing such an exemption to do so in a way that affords the highest level of investor protection possible. This is the best chance of serving the interests of both investors and issuers**, by attempting to foster a sufficient level of confidence in investors to encourage them to continue to supply capital to SMEs. If inadequate protections are implemented, retail investors will be harmed and eventually SMEs will be forced to find other willing providers of capital.

## 5. Can Crowdfunding Investors Afford to Lose Their Investment?

5.1. FAIR Canada is concerned that investment limits will have little effect in reducing the risk of abuse and fraud. Firstly, such limits will be difficult if not impossible to police and, to FAIR Canada's knowledge, no method of enforcing the limits has yet been put forward by Canadian regulators. Secondly, "…fraud in small packages can be just as effective and damaging to the victims, many of whom may be least able to bear the risk of even a small investment in a speculative business."[20] Thirdly, limiting offerings to small amounts per investor will not deter scammers from taking advantage of investors via crowdfunding, particularly since fraudsters will have no reason to comply with the offering size limits of the Proposed Exemptions.

5.2. We believe that for legitimate offerings, investment limits are necessary to reduce potential investor losses. We recommend that the OSC **decrease the individual investor limits to $500 or less per investment and $5,000 in total under the crowdfunding exemption**. There is no reason to believe limits of this size will be ineffective in meeting the goal of raising capital for SMEs; but such limits may be the best available means of mitigating the risk of harm that crowdfunding poses if regulators insist on implementing such exemptions.

5.3. According to a National Crowdfunding Association of Canada ("**NCFA**") survey of representatives of start-ups and/or SMEs, 85% of respondents agreed or strongly agreed that the statement "Investors can lose all their money" accurately states an investor risk inherent in crowdfunding.[21] FAIR Canada questions where retail investors will draw funds from in order to invest in equity crowdfunding. We do not believe that equity crowdfunding is intended to attract funding that would otherwise have been invested as retirement or other long-term savings. However, it is unclear whether investors' funds will be redirected from other discretionary spending or will come from funds that could otherwise have been directed to less-risky retirement savings or paying down debt.

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[19] Thomas F. Dapp and Christoph Laskawi, "Crowdfunding - Does crowd euphoria impair risk consciousness?" (May 23, 2014), at page 13.

[20] Thomas Lee Hazen, "Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must be Conditioned On Meaningful Disclosure" (May 20, 2012), at page 1766, available online: <http://ssrn.com/abstract=1954040>.

[21] National Crowdfunding Association of Canada, "National Crowdfunding Survey Data Results – Summary of raw results" (April 24, 2013), available online: <http://ncfacanada.org/national-crowdfunding-survey-data-results-summary-of-raw-results/>.

5.4. Thomas Lee Hazen at the University of North Carolina has examined the JOBS Act legislation and has commented on who it would attract: "…the solicitation of small investors is likely to attract more unsophisticated investors who are in need of the investor protection provisions generally found in the securities laws. It also is likely to attract investors with limited funds who cannot tolerate high investment risk, even for small amounts of money."[22]

5.5. We are concerned that, currently, many retail investors do not understand the risks associated with crowdfunding. The OSC's Exempt Market Study on Crowdfunding found that "[w]hile it is clear that investing via crowdfunding is more likely as risk tolerance increases, we are concerned with the high proportion of low risk people who might potentially invest via crowdfunding. In our view, the survey made the risks quite visible and explicit leaving us to wonder how they concluded that crowdfunding was appropriate for them."[23] We question whether investor education efforts (on portals or elsewhere) could effectively address this concern. We are not optimistic that they can or will.

5.6. The 2012 CSA Investor Index also found that 58% of Canadians do not understand the fundamental principle of risk-reward tradeoff and found that only 12% of Canadians have realistic expectations of market returns. Only 9% of low knowledge investors were found to have realistic market expectations.[24]

5.7. The proposed crowdfunding investment limits per investor are $2,500 in a single investment and $10,000 in total under the exemption per calendar year. These limits are stated to be "low" in the Notice[25], but they may be too high for many of the investors targeted by crowdfunding. Given that there are numerous other prospectus exemptions available to wealthy investors[26], we believe that serious consideration should be given to lowering these limits.

5.8. We note that in 2012, "...the median contribution [to registered retirement savings plans] was $2,930..."[27] The average contribution was approximately $6,000.[28] The average net contribution per tax free savings account was $2,741 in 2011.

5.9. Research commissioned by the OSC found that Canadians' median savings and investments (including RRSPs but excluding home) are about $45,000.[29] Almost 6 out of 10 respondents were found to have less than $50,000 in savings and investments.[30] The investment of $10,000 in crowdfunding investments would represent a significant portion of these individuals' savings.

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[22] *Supra* note 21 at page 1766.
[23] *Supra* note 4 at page 34.
[24] Innovative Research Group, "2012 CSA Investor Index" (October 16, 2012), available online: <https://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL_EN.pdf>.
[25] Key Provisions of the Proposed Crowdfunding Prospectus Exemption at page D-15.
[26] We note that FAIR Canada opposes certain prospectus exemptions that rely on wealth as a proxy for sophistication. We refer readers to other submissions we have made in response to other exempt market consultations, most recently the accredited investor exemption. See http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-comments-re-Proposed-Amendments-to-AI-MA-Exemptions.pdf.
[27] Statistics Canada, "Registered retirement savings plan contributions, 2012" (Date modified: 2014-03-25), available online: <http://www.statcan.gc.ca/daily-quotidien/140325/dq140325b-eng.htm>.
[28] Statistics Canada, "Table 1 – Registered retirement savings plan contributors – Canada, provinces and territories" (Date modified: 2014-03-25), available online: <http://www.statcan.gc.ca/daily-quotidien/140325/t140325b001-eng.htm>.
[29] *Supra* note 4 at page 9.
[30] *Ibid*.

5.10. 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."[31] 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..."[32]

5.11. While the $2,500 per investment and $10,000 total annual crowdfunding limits per investor are intended to limit the amount individuals could lose, we question whether most Canadians can, in fact, afford to lose this much.

5.12. Given that the underlying premise of crowdfunding is that SMEs can meet their capital-raising needs by sourcing a small amount of money from a large number of people, FAIR Canada suggests that the proposed limits be lowered. If crowdfunding works as intended, and the good ideas are in fact identified by the crowd, we expect that the good ideas would draw an adequate number of investors to meet their capital-raising goals using small investment limits. In addition, lower limits per investment could discourage concentration in one SME and may result in some diversification of crowdfunding investments by purchasing offerings from more SMEs. While crowdfunding is very risky, less concentration could have benefits for both investors and SMEs.

5.13. As noted above, FAIR Canada recommends that the individual investment limits be lowered to $500 or less per investment and $5,000 in total under the crowdfunding exemption. $5,000 is greater than 10% of the value of median savings and investments of Canadians. Even a limit of $5,000 could result in over-concentration in high-risk SME investments for the nearly 6 out of 10 respondents found to have less than $50,000 in savings.

5.14. The experience of Kickstarter shows that large fundraising goals can be met through small donations from a large number of funders.[33] The goal of the Participating Jurisdictions in proposing crowdfunding rules is to provide capital to SMEs. Investors will lose their money in many (perhaps most) cases. The Kickstarter experience suggests that fundraising goals can be met through crowd contributions in amounts only a fraction of the investment limits being proposed, without exposing individual Canadian investors to losses they cannot afford.

## 6. Enforcement of Investment Limits

6.1. FAIR Canada is concerned that adequate mechanisms have not been set out that will ensure adherence to the investor investment limits or the offering limit. The current proposal calls for (1) self-certification from investors, as well as (2) verification by the portal of the total investment through that portal. Given that numerous portals are expected to offer crowdfunding distributions, we are concerned that the proposed rules do not address the problem that investors may unintentionally (or intentionally) exceed the individual limits.

6.2. Investment limits are the main protection – and perhaps the only potentially effective protection - afforded to investors by this exemption (i.e. limiting their losses). Therefore, it is essential that regulators find a way to ensure issuers, portals and investors adhere to the limits imposed.

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[31] Statistics Canada, "Survey of Financial Security, 2012" (Date modified: 2014-02-25), available online: <http://www.statcan.gc.ca/daily-quotidien/140225/dq140225b-eng.htm>.

[32] *Ibid*.

[33] As of June 13, 2014 over 1,300 Kickstarter projects had each raised between $100,000 and $1 million, yet Kickstarter had an average pledge of just $73.60.

6.3. FAIR Canada recommends the use of a centralized database to verify aggregate investment amounts.

## 7. Advice and Suitability

7.1. FAIR Canada notes that, while suitability is a low threshold (we believe a best interest duty is necessary), investors could benefit from some form of advice with respect to crowdfunding offers. This could provide more protection than the arbitrary investment limits as proposed (or added protection if lower investment limits are adopted), by reducing the chance that any crowdfunding investments will make up a disproportionate amount of an investor's portfolio.

7.2. A survey by the NCFA found that SMEs supported the imposition of a suitability requirement for portals (62% agreed or strongly agreed), but this was noted by the NCFA in its summary of the raw results to be "…a surprising statistic and not feasible for many portal business models"[34]. FAIR Canada questions why this would be said to be infeasible, as 75% of survey respondents identified as either a planned portal or service provider.

7.3. Research conducted by the Brondesbury Group for the OSC also suggested that advice through a financial advisor was one of five strong influences on willingness to invest in crowdfunding.[35]

7.4. **We recommend that regulators examine whether a suitability element should be added to the exemption in the interests of investor protection and in light of research that supports demand for it**.

## 8. Investment Evaluation

8.1. Valuing a crowdfunding distribution by an SME, particularly a start-up, is notoriously difficult.

> For an interested investor it is a huge challenge to gain a proper assessment of the business model including all of its opportunities and risks. After all, given the only short existence of a start-up as a company there is only a small amount of valuation-relevant data available. However, for an investment decision it is precisely the communicated valuation that plays a key role as an indicator of the start-up's prospective returns and risk profile.[36]

According to the NCFA's survey of representatives of start-ups and/or SMEs, 80% of respondents agreed or strongly agreed that "Limited disclosure at the time of purchase and on an ongoing basis" was an investor risk inherent in crowdfunding.[37]

8.2. Valuation is even more difficult for unsophisticated retail investors who are inexperienced at performing such valuation and at a large information disadvantage relative to issuers. While there are significant risks inherent in investing in start-up companies, "...information asymmetry (i.e.,

[34] *Supra* note 22.
[35] *Supra* note 4 at page 3.
[36] *Supra* note 20 at page 8.
[37] *Supra* note 22.

creators have more information about risks than funders) may significantly increase the cost of these risks to investors."[38]

8.3. Technological advances have enabled quick investment decisions. According to a report by Deutsche Bank,

> a current funding record in which EUR 250,000 was raised in only 7 hours and 18 minutes shows that investment decisions in crowdinvesting are taken in an extremely short space of time. In fact, the first EUR 50,000 was collected in only 38 minutes. This raises the question of the extent to which it is at all possible to perform an appropriate valuation and calculate all the related opportunities and risks in this short timespan. Funding issues are usually fraught with complexity, risks and uncertainty. It is no doubt possible to estimate and calculate risks with a certain degree of probability following due diligence. By contrast, the black swans will remain unpredictable.[39]

We do not believe that retail investors have the capacity to complete adequate due diligence prior to investing.

8.4. The "Pebble" watch, which is one of (pre-purchase model) crowdfunding's great success stories, met its goal of raising $100,000 in two hours. It is unclear whether investors will be able to make an informed investment decision in the short amount of time often observed in crowdfunding campaigns. We question whether this would result in rational investment decision-making or something more along the lines of an 'impulse' purchase.

8.5. Further, it has been observed that "[f]unders and creators are initially overoptimistic about outcomes"[40]. Canada's own Wealthy Barber, David Chilton, tweeted to this effect on Twitter recently, saying: "Just looked at 6 start-ups' 1st-year projections and assumed 5-yr growth rates. If they hit their numbers, collectively they'll own Canada."[41]

8.6. We are not convinced that investors will make informed decisions in respect of crowdfunding. The history of securities regulation is replete with examples of speculative market bubbles and subsequent crashes, illustrative of herding behaviour. Although there are examples of the crowd monitoring and successfully identifying fraud,

> …in the context of funding, the crowd is subject to herding behavior. Much of the existing research on crowdfunding has emphasized that funders rely heavily on accumulated capital as a signal of quality… Thus, the sequential nature of investment has the potential of triggering an information cascade. This path dependence suggests that funding success will only reflect underlying project quality if early funders do a careful job screening projects.[42]

8.7. FAIR Canada questions the purported "wisdom of the crowd", as do others. As stated by Daniel Isenberg:

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[38] *Supra* note 19.
[39] *Supra* note 20 at page 11.
[40] *Supra* note 19.
[41] Chilton, David (@wealthy_barber). "Just looked at 6 start-ups' 1st-year projections and assumed 5-yr growth rates. If they hit their numbers, collectively they'll own Canada." May 21, 2014. Tweet.
[42] *Supra* note 19.

> I did my Ph.D. degree in social psychology studying the behaviour of groups, and group irrationality is well-documented – crowds are "wise" only in a very limited set of circumstances. As often as not, crowds bring us tulip crazes, subprime meltdowns, the Kitty Genovese …scandal, Salem witch trials and other tragedies. Crowdfunding advocates claim that social media will self-correct the madness of crowds, but this seems to me highly suspect.[43]

8.8. While proponents of crowdfunding tout the "wisdom of the crowd" (which is also referred to in the Notice on page D-12), **the wisdom of the crowd remains questionable**.

## 9. Lack of Exits and Minority Rights

9.1. According to the NCFA's survey of representatives of start-ups and/or SMEs, 85% of respondents agreed or strongly agreed that "May not be able to resell or redeem their investment" is an investor risk inherent in crowdfunding.[44]

9.2. FAIR Canada is concerned that many investors will not understand the liquidity constraints of crowdfunding investments. As noted below in section 16, we suggest that the required wording of the offering document be modified to make clear to investors that they would be prohibited from selling their non-reporting issuer securities indefinitely unless they can rely on another exemption. Suggesting that the securities are "difficult to sell" may be interpreted to mean that they are permitted to be sold but it could be challenging to find a buyer.

9.3. FAIR Canada is concerned that retail investors will be 'squeezed out' of any profits in the rare event that they happen to invest in a successful equity crowdfunding offering. We recommend that the Participating Jurisdictions prescribe basic mandatory protections for crowdfunding investors, including tag-along and pre-emptive rights.

9.4. We do not believe that it will be possible for the offering document to sufficiently educate retail investors about minority investor rights (or lack thereof) and the risks associated with being a minority security holder. Disclosure of what rights investors have (or do not have) is far inferior to requiring the provision of basic protections. At a minimum, we believe that the dilution statement must include a warning about potential dilution by existing securities issued by the issuer.

## 10. Fraud

10.1. According to the World Bank, "…as the [crowdfunding] market expands, there will inevitably be attempts to circumvent regulations and defraud investors.[45]

10.2. The CSA's brochure on avoiding fraud and scams notes that "[y]ou don't have to be wealthy to be scammed. One-third of fraud victims are scammed for less than $1,000. Another 28% are taken for between $1,000 and $5,000."[46]

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[43] *Supra* note 6.
[44] *Supra* note 22.
[45] The World Bank, "Crowdfunding's Potential for the Developing World" (2013), at page 10.
[46] Canadian Securities Administrators, "Protecting your money: Avoiding frauds and scams" (undated), available online: <http://www.securities-administrators.ca/uploadedFiles/General/pdfs/Protect_your_money_EWeb_2012.pdf> at page 2.

10.3. Anticipating an increase in online fraud stemming in part from passage of the JOBS Act, NASAA created a task force on Internet fraud investigations shortly after the enactment of the JOBS Act to monitor crowdfunding and other Internet offerings. The group is currently coordinating multi-jurisdictional efforts to scan various online offering platforms for fraud, and, where authorized, will coordinate investigations into online or crowdfunded capital formation fraud.[47]

10.4. In late 2012, NASAA noted a significant increase in internet domain names with "crowdfunding" in the name. A press release stated that "[m]any of these sites appear to have been formed by large credible organizations while others appear to be created by individuals that may be operating out of their basements... The pure volume suggests that the wave is about to overtake the dam." It also warned that "[i]nvestors soon can be expected to be inundated with crowdfunding pitches, legitimate or otherwise..."[48]

10.5. Crowdfunding provides opportunities for fraud. According to economic research,

> [i]nexperienced and overly optimistic investors may not only channel capital towards bad projects but also subject themselves to outright fraud. It is relatively easy to use false information to craft fraudulent pages that look like authentic fundraising campaigns. While platforms try to filter out such cases of manipulation, crowdfunding may become an appealing target for professional criminals. Furthermore, because investments are small, the risk is exacerbated by weak individual-level incentives to perform due diligence. To the extent that the cost of performing due diligence is high and the individual benefit low, the crowdfunding community may systematically underinvest in due diligence; instead, funders may free-ride on the investment decisions of others, which is feasible to do since funding information is public and funders usually cannot be excluded. Moreover, relative to platforms such as eBay and Airbnb, where sellers have an incentive to build a reputation to signal against fraud, the lack of repeated interaction over a short period of time increases the potential for fraud.[49]

10.6. As noted in the Notice, "[t]he registration requirement is also intended to serve as a safeguard against funding portals being used to facilitate fraudulent offerings of securities through the internet."[50] As noted above, we question how broadly securities regulators will be able to disseminate the message to use registered portals and whether investors will understand and follow this advice and be able to distinguish between legitimate registered portals and fraudulent ones. Permitting the use of unregistered portals exacerbates this problem.

## Crowdfunding Exemption – Issuer Requirements

### 11. Advertising/Soliciting Restrictions

11.1. It is essential to ensure that all pertinent information is provided to investors in one place. This is the rationale for having a crowdfunding portal. Advertising and solicitation through social media may have the effect of priming investors to buy, causing them to think they have been educated

[42] North American Securities Administrators Association, Press release: "NASAA Sees Sharp Spike in Crowdfunding Presence on the Internet" (December 5, 2012), available online: <http://www.nasaa.org/18951/nasaa-sees-sharp-spike-in-crowdfunding-presence-on-the-internet/>.
[48] *Ibid*.
[49] *Supra* note 19 at pages 19-20.
[50] Key Provisions of the Proposed Crowdfunding Portal Requirements, at D-30.

about the investment by the crowd, and thus causing them to disregard or scroll through the disclosure information on the portals without reading it.

11.2. It is essential that the advertising and marketing be limited to the registered portal so that regulators have some ability to provide oversight and monitoring of the advertising through the portal. Allowing advertising and solicitation via social media would present significant resource challenges to securities regulators. While we anticipate there may be significant compliance concerns relating to advertising and soliciting, we view this to be an essential investor protection element of the crowdfunding proposal.

11.3. FAIR Canada is concerned about the implications of proposed advertising and general solicitation provisions. We are also sceptical about whether issuers (and others) will comply with these rules and whether securities regulators have the ability and capacity to ensure an acceptable level of compliance.

11.4. In particular, proposed clause 18(2)(a) provides that issuers, the registered funding portal, and others involved with a distribution may "...make the [offering document and other related materials] available to potential purchasers..." In our view, **this defeats the intention of requiring that the materials be made available through the portal's website and the prohibition against advertising and soliciting. Advertising and soliciting should be limited to the portal's website and this provision completely hollows out this restriction**. In so doing, this provision essentially reduces the portal to a transactional site. We question whether in practice materials will be made available to potential purchasers without additional advertising and soliciting. FAIR Canada believes that regulators would be naïve to expect that to be the case.

11.5. If a prohibition against advertising and soliciting is to be asserted, FAIR Canada also recommends that subsection 18(1) apply to any person, not just persons involved with a distribution, or that persons involved with a distribution be broadly defined. It is unclear how far the prohibition extends, and we believe that the prohibitions against advertising and soliciting should preclude any and all advertising and solicitation outside the portal.

11.6. Further, proposed clause 18(2)(b) allows issuers, the registered funding portal, and others to "advise potential purchasers, including customers and clients of the issuer, that the issuer is proposing to distribute securities under the crowdfunding prospectus exemption and refer potential purchasers to the website of the registered funding portal..." In our view, this provision is likely to be subject to misinterpretation. The policy statement makes clear that the advice must be limited to directing attention to the portal's website, but we recommend that clause 18(2)(b) expressly provide that no other representations or solicitation is permitted.

11.7. Further, we anticipate low levels of compliance with the advertising and soliciting limits. There does not appear to be a meaningful provision to encourage compliance with the proposed rules and we question the securities regulators' capacity (and ability) to ensure compliance.

11.8. FAIR Canada is aware that comments have been made regarding the importance of advertising and soliciting on social media to successful crowdfunding campaigns. As noted above, FAIR Canada agrees with the OSC's proposals that limit this activity. If broader advertising and soliciting is considered to be necessary to a successful crowdfunding model, FAIR Canada believes that this would raise a fundamental question about the appropriateness of a crowdfunding exemption for retail investors.

## 12. Risk Warnings and the Risk Acknowledgement Form

12.1. FAIR Canada has asked various regulators for their research in respect of risk acknowledgement forms and understands that, despite their widespread use, regulators have not conducted research on investor use, investor understanding, utility or design of risk warning documents.

12.2. FAIR Canada is surprised that regulators include the risk acknowledgement form as an important investor protection safeguard in the Proposed Exemptions. Very little is known about whether investors understand the information presented and how they use such information. Behavioural sciences widely acknowledge that design and delivery of information significantly affects how it is interpreted and how it is used and understood.

12.3. We recommend that regulators **test the risk acknowledgement form with investors prior to implementing the proposed crowdfunding exemption to ensure that it serves the purpose for which it was intended**.

12.4. Additionally, we recommend that information regarding risks be provided to portal users at various stages of the crowdfunding investment process (not just in the risk acknowledgement form). Although there may be a significant amount of investor education material that builds up (both inside and outside the portals), it would be imprudent to assume that all individuals interested in crowdfunding will be aware of the risks. We expect that the most forward-thinking portals will build such information and warnings into their platform, but believe that **all portals should have minimum requirements to provide risk warnings to investors prior to the point of sale**.

12.5. Risk warnings should not be vague, such as the statement in proposed form 45-108F1 that states "[m]any start-ups and small businesses fail." FAIR Canada recommends that specific failure rates be provided (such as, the success/failure rate of small business and the success/failure rate of crowdfunded offerings). Proposed language to the effect that "some will fail, and some will succeed" is highly inappropriate and is not reflective of actual success and failure rates.

12.6. Potential investors should be provided an overview of the risks and other limitations of crowdfunding prior to viewing potential offerings. Investors should be reminded of these when they indicate interest in investing. The warnings should not be limited to the risk acknowledgement form, which we understand is to be provided at the time of the investment transaction, since that occurs after the investor makes their decision to invest. It is essential that the investor is made aware of the risks prior to their evaluation of the investment so that they can attempt to factor the risks into their decision.

12.7. We also recommend that portals be required to provide an interactive basic knowledge tutorial that investors must complete in order to view offerings.

12.8. FAIR Canada believes that the form should be modified to include information for investors regarding their two day right of withdrawal and any statutory or contractual right in the event of a misrepresentation where the form mentions the investor's legal rights. While we question the utility of these protections in practice, we believe that investor should be provided with this information where they are advised their legal rights are reduced.

12.9. FAIR Canada questions whether "...and I will find it very difficult to sell this investment" appropriately sums up resale restrictions. We suggest that more appropriate language might be "I understand that the sale of these securities is legally restricted and I may not ever be able to sell

this investment or it may be difficult to sell it. I also understand these securities are subject to an indefinite hold period and can only be resold under another prospectus exemption or under a prospectus." For a reporting issuer we suggest language that makes clear that the securities are subject to a four month hold period.

## 13. Compensation of Persons Promoting the Offering

13.1. FAIR Canada agrees it is vitally important that an issuer may not, directly or indirectly, pay a commission, finder's fee, referral fee or similar payment to any person in connection with an offering under the exemption, other than to a portal.

13.2. All information about the offering should be provided on the portal's website. The payment of compensation to salespeople for soliciting potential investors would cause great harm to retail investors. We encourage regulators to ensure compliance with this provision, as it is essential to investor protection.

## 14. Exclusion of Non-reporting Real Estate Issuers

14.1. FAIR Canada agrees with the proposed restriction that precludes real estate issuers from using the Crowdfunding Exemption. We believe that the OSC's concerns with the sale of real estate securities by non-reporting issuers in the exempt market are a valid reason for excluding these issuers from using this exemption.

## 15. Concurrent Offerings

15.1. Proposed Multilateral Instrument 45-108 would allow an eligible crowdfunding issuer to rely on other prospectus exemptions to distribute securities at the same time as conducting a crowdfunding offering. FAIR Canada is concerned that allowing issuers to rely on the crowdfunding exemption and raise money concurrently under other exemptions would cause confusion for issuers and investors. The crowdfunding model relies on the portal to deliver information to potential investors and is intended to limit advertising and solicitation. Allowing issuers (and potentially other intermediaries such as exempt market dealers ("**EMDs**") to sell securities outside of the registered portal defeats the purpose of the advertising restriction in the crowdfunding exemption.

15.2. FAIR Canada recommends that concurrent capital raising under other exemptions should be prohibited during a crowdfunding distribution period. We further recommend a cooling-off period between offerings made through different prospectus exemptions.

15.3. Similar suggestions have been made in the U.S. in response to proposed crowdfunding regulation. According to the Consumer Federation of America, provisions that allow for concurrent offerings will undermine regulatory efforts:

> [a]ll of the Commission's efforts to ensure that all crowdfunding activities occur through the intermediaries will be undermined if issuers can engage in a simultaneous offering under a different exemption. We therefore support the Commission's proposed approach to requiring transactions to be conducted through an intermediary but urge the Commission to safeguard that approach by strengthening its policy with regard to integration. As noted above, we believe the

> best approach is for the Commission to require a one- to two-month cooling off period between offerings made subject to different exemptions.[51]

15.4. The CFA Institute made similar recommendations, stating

> [w]e are concerned, however, that promotional activities of simultaneous offerings may not be clearly distinguishable and will lead to investor confusion or cross-selling by issuers or intermediaries. We therefore recommend that the Commission impose a "quiet period" between offerings relying on allowable exemptions, and suggest consideration of a three- month period.[52]

15.5. We note that in the U.S., the JOBS Act limit issuers' aggregate amount sold to all investors irrespective of the exemption(s) relied upon.[53] If the OSC rejects our recommendation to prohibit concurrent offerings and introduce a cooling off period, we suggest that the aggregate amount that can be raised by an issuer under any prospectus exemption during a crowdfunding distribution period be the crowdfunding aggregate limit (i.e. $1.5 million on a rolling 12-month basis).

## 16. Crowdfunding Offering Document

16.1. FAIR Canada is concerned that some of the language proposed for the crowdfunding offering document is unclear or may be misleading.

16.2. Specifically, we believe that the statement "[m]any start-ups and small businesses fail" does not provide sufficient information to convey to retail investors the risks inherent in SME investments, particularly the proportion that fail within a relatively short period of time (see section 4.2 above where we discuss some statistics relating to SME success and failure rates). FAIR Canada recommends that this language be updated to provide specific information relating to the large proportion of SMEs that fail.

16.3. FAIR Canada also notes above in section 9.2 that stating that securities are "difficult to sell" does not clearly convey that the sale is restricted by securities regulations. The sale is not difficult rather resale is prohibited (absent reliance on another exemption). We suggest that this language be modified to be more clear and accurate.

16.4. FAIR Canada suggests that the prescribed statement regarding dilution also include a requirement to outline any rights and characteristics of other securities already issued by the issuer that may dilute or negatively affect the rights of purchasers under the offering.

## 17. Liability for Misrepresentation

17.1. We do not believe that extending the right of action under section 130.1 of the *Securities Act* (or a comparable contractual right of action) to misrepresentations in a crowdfunding offering document would provide an adequate level of investor protection.

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[51] Consumer Federation of America, Letter Re: File Number S7-09-13 Crowdfunding (February 2, 2014).

[52] CFA Institute, Letter re: Crowdfunding (File No. S7-09-13) (3 February 2014), available online: <http://www.cfainstitute.org/Comment%20Letters/20140203.pdf>.

[53] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111-203, § 302, 124 Stat. 1376 (2010).

Right of Action Must Be Against Issuers, Management, Directors and Portals

17.2. The key provisions of the proposed crowdfunding prospectus exemption (at page D-20 of the Notice) suggest that the right of action was intended to be available against the issuer, management, directors, and portals (subject to a due diligence defence). However, this is not provided for in section 130.1, nor is it reflected in the contractual right of action addressed in section 22.

17.3. In light of the high risks faced by crowdfunding investors, and the kinds of businesses that securities regulators intend to assist in raising capital under the Crowdfunding Exemption (start-ups and SMEs), FAIR Canada believes that rights of action should be available against issuers, management, directors, and portals. In particular, a right of action against the issuer may of little to no value to investors if the issuer fails, in which case the issuer will likely have no or insufficient assets to satisfy a judgment in favour of investors (assuming that litigation can be economically pursued at all).

17.4. FAIR Canada recommends that the management, directors, and portals have responsibility for the accuracy and completeness of the issuer's information. The NCFA's survey results suggest that there is considerable support for a requirement for portals to undertake full due diligence on each issuer that seeks to raise capital (only 21% disagree and 62% agree or strongly disagree).[54] Additionally, the NCFA found that 60% of respondents agree or strongly agree that a portal should certify (and incur liability if it is wrong) that there are no misrepresentations in any document posted by an issuer on the portal's website.[55]

17.5. We suggest that if a portal does not vouch for the accuracy or completeness of the issuer's information, this be clearly explained (in specific plain language) so that the investor knows that they may not have recourse to the portal for inaccuracies or omissions.

Incorporate Marketing Materials

17.6. FAIR Canada recommends that the crowdfunding offering document incorporate by reference other marketing materials (as contemplated by section 16 of proposed Multilateral Instrument 45-108) and, for reporting issuers, their continuous disclosure. We believe that this would be consistent with the approach taken for the OM Exemption.

Limitation Period

17.7. The limitation period applicable to actions under section 130.1 is unduly limiting for crowdfunding. That limitation period is the lesser of three years from the date of the transaction and 180 days from the date of the discovery by the plaintiff of the facts underlying the claim. Crowdfunding will target less-sophisticated investors, and in our view, they should have the benefit of the same limitation period as is generally available under section 4 of the *Ontario Limitations Act*, which is two years from the date on which the claim became discoverable, subject to an ultimate limitation period of 15 years.

[54] *Supra* note 22.
[55] *Ibid*.

Practical Benefit of Right of Action for Misrepresentation

17.8. Although investors have a right to sue for a misrepresentation, the practical benefit of this is questionable given the small investment amounts and the cost of litigation. Given that, in many cases, the crowdfunding efforts will be modest and there will be modest potential damages, the economics of bringing such a claim and the adequacy of the economic incentives available to plaintiff law firms to bring suits will limit the ability to obtain a remedy.[56]

17.9. FAIR Canada notes that the language at proposed clause 22(1)(c) states that a right of action against the issuer would be subject to "the defence that the purchaser had knowledge of the misrepresentation". In our view, this clause is meant to provide a defence only where the purchaser made the purchase with knowledge that the representation was untrue or incorrect, but the proposed language is imprecise.

## 18. Reporting by Issuers

18.1. FAIR Canada also suggests that issuers who use the Crowdfunding Exemption be required to report their employment levels and innovation developments. The purpose of the crowdfunding exemption is to facilitate capital-raising for SMEs; presumably the longer-term intention is to spur economic growth, including job creation. It would be of assistance for the OSC to know whether new rules were having the intended longer-term effect.

## Proposed Crowdfunding Exemption – Portal Requirements

## 19. Funding Portal Registration

19.1. FAIR Canada fully supports the restriction that a registered funding portal will not be permitted to obtain dual registration in another registration category. Specifically, discount brokerages and EMDs should not be permitted to distribute securities in reliance on the proposed new crowdfunding prospectus exemption.

19.2. Crowdfunding portals are intended to be a specialized type of restricted dealer to facilitate only distributions of securities in reliance upon a crowdfunding prospectus exemption. The proposed regulation sets out specific requirements of crowdfunding portals, including prohibitions against making recommendations or providing advice and soliciting purchases or sales of securities offered on its platform. Portals are also prohibited from collecting know-your-client information other than that which is necessary for other purposes.

19.3. If EMDs and other registrants were permitted to register and carry on the activities of crowdfunding portals, this would result in conflicts between their EMD and restricted dealer registration requirements. EMDs have suitability obligations, while crowdfunding portals are prohibited from providing specific recommendations or advice to investors. In FAIR Canada's view, these registration obligations are at odds and could result in confusion or unintentional non-compliance. Other conflicts could arise as well. For example, EMDs could be incented to provide preferential treatment to their existing issuer clients through the portal they operate. Fees and commissions earned from these EMD clients could influence treatment on an EMD's portal, even if

[56] *Supra* note 21 at page 1759.

commissions or fees were not paid 'directly' or 'indirectly'. Given the restricted intermediary role intended to be fulfilled by crowdfunding portals, we believe it is appropriate to limit their registration to the restricted dealer category.

## 20. Portal Payment – Issuer Securities

20.1. FAIR Canada opposes the proposed rule that would allow the portal to accept securities from SMEs and start-ups as payment (even if this payment was limited to 10%). This inevitably gives rise to conflicts of interest and, given the important obligations imposed on portals, we do not believe regulators should condone such conflicts.

20.2. Crowdfunding portals are intended to act only as an intermediary in connection with a distribution of securities made in reliance on the crowdfunding prospectus exemption. If the portal receives, or is expected to receive, an ownership interest, this would cause a conflict of interest. Additionally, disclosure of an ownership interest by the portal could be construed by investors as an endorsement or recommendation.

20.3. It is important to prevent conflicts of interest to the greatest extent possible, because the portal is permitted to 'curate', highlight, or match an issuer to potential investors. The portal should be prohibited from taking an ownership interest in an issuer to prevent inappropriate or imbalanced information to investors as a result of its interest.

20.4. As an aside, FAIR Canada understands that non-equity crowdfunding portals often accept credit card payments for donations- and rewards-based funding. FAIR Canada strongly opposes the use of borrowed funds (by credit card or otherwise) to purchase securities under the crowdfunding exemption. Leverage magnifies risk, which we view to be wholly inappropriate for retail investors, particularly in inherently risky crowdfunding investments.

## 21. SRO Membership

21.1. FAIR Canada believes that SRO membership should be required for crowdfunding portals. Compliance by and oversight of portals is essential to ensuring that the investor protections built into the proposed crowdfunding exemption operate as intended. In our view, SRO oversight would ensure more frequent compliance reviews and would thus identify potential problems earlier.

## 22. Background Checks

22.1. FAIR Canada supports the proposed requirements for crowdfunding portals to complete due diligence. It is essential that portals be required to conduct background checks on issuers and their directors, executive officers, control persons and promoters. It is also essential that due diligence be conducted on the issuer's business.

22.2. It is very important that the liability for incomplete or incompetent due diligence be sufficient to ensure that this responsibility is taken seriously and completed properly and thoroughly. Regulators should ensure that investors have recourse against crowdfunding portals for inadequate background checks. A funding portal's reputation should not be the only motivating factor to ensure this responsibility is fulfilled, as this will not protect investors adequately, particularly when problems arise.

22.3. FAIR Canada understands that there are already service providers vying for business to provide background check services for crowdfunding portals. We support the policy statement provision that makes clear that the responsibility to comply with the criminal record and background check requirements remains with the portal. However, the proposed provisions in respect of criminal record and background checks requires that they be "conducted" and filed on behalf of issuers with the principal regulator. We encourage regulators to consider ensuring minimum standards are mandated in respect of these requirements and that responsibility to meet such requirements cannot be delegated to third parties. The offence of making a false statement to regulators is likely a weak deterrent to anyone who sets out to defraud investors. As a result, complete and thorough background checks are vitally important.

## 23. Proficiency

23.1. FAIR Canada supports the portal proficiency standards set out in the proposed legislation at section 30(1). However, FAIR Canada suggests than an obligation to assess the merits or expected returns of an investment to investors or the commercial viability of a proposed business or offering could assist in the funding portal's responsibility to detect and prevent fraudulent offerings. While the portal does not need to disclose merits or expected returns, business plans that are clearly not viable could be an indication of fraud and should be considered in the performance of the portal's due diligence.

## 24. Minimum Capital and Insurance Requirements

24.1. FAIR Canada suggests that the minimum capital and insurance requirements be revisited in light of our concerns regarding liability for misrepresentation. FAIR Canada recommends a review of the adequacy of EMD minimum capital and insurance requirements in order to inform whether these limits are adequate for crowdfunding portals.

## 25. Dispute Resolution

25.1. FAIR Canada recommends that funding portals have obligations with respect to investor complaints, including participation in the Ombudsman for Banking Services and Investments. Portals should be required to have a formalized process for receiving complaints and tracking them. These requirements should be overseen by an SRO or the relevant regulator.

## 26. Reporting Requirements

26.1. FAIR Canada suggests that funding portals have an obligation to report potential fraud to police and the OSC and notify investors on their portals as appropriate.

26.2. Additionally, we recommend that portals be required to be transparent about capital raised, success rates, instances of fraud, etc. We are concerned that the rare successful businesses will garner a considerable amount of attention and believe that complete information regarding failure rates and the amount of investor losses must also be reported to the relevant regulators and made publicly available.

## PROPOSED OFFERING MEMORANDUM EXEMPTION

### 27. Widespread Non-Compliance

27.1. 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**."[57] [emphasis added]

27.2. Staff Notice 45-704 also found considerable non-compliance with financial statement requirements, including non-provision of financial statements in the OM.[58] Furthermore, it identified significant investor rights issues.

27.3. *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;
- 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.[59]

27.4. *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

[57] 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.

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

[59] 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.

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")[60].

27.5. 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.

27.6. 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 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;

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

- 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."[61]

- 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.

27.7. *OSC Report on EMD Non-Compliance* - The OSC has also identified practices of concern relating to EMDs in its 2012 Annual Summary Report[62] (the "**OSC Summary Report**").

27.8. 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.[63]

27.9. 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.

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[61] CSA Staff Notice 31-334, CSA Review of Relationship Disclosure Practices, July 18, 2013 at page 9.
[62] 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>.
[63] OSC Summary Report at pages 49 – 50.

## 28. Numerous Complaints and Significant Investor Losses

28.1. Some limited information about Alberta's experience with its OM Exemption has been published. Appendix B to the CSA Notice of Public and Request for Comment: Proposed Amendments to National Instrument 45-106, published March 20, 2014 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;
- "…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"[64] and
- there have been "....numerous complaints from investors that have invested significant amounts under the OM Exemption and incurred significant losses."

28.2. While this information is helpful it is not sufficient in order to make an informed policy decision. Further information about the other jurisdictions' experience with the OM Exemption (including Alberta) that needs to be ascertained and made public includes:

- 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.

28.3. 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.[65]

28.4. FAIR Canada also recommends that the OSC gather information from other CSA members on the investor experience with risk acknowledgement forms in the exempt market, and in particular with the OM Exemption. FAIR Canada urges the OSC to publish information disclosing the effectiveness

[64] CSA March 20, 2014 Notice at Annex B, page 3.

[65] FAIR Canada has raised this issue in earlier comment letter to securities regulators. See our comment letter to the OSC 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 its comment letter to Participating Jurisdictions on Multilateral CSA Notice 45-311

of such forms in light of existing complaints, investigations and enforcement proceedings where such forms were used. In addition, investor testing should be conducted on the proposed risk acknowledgement form to see whether it would help investors make better investment decisions and help protect investors.

## 29. Concerns Voiced by OSC in 2004 Remain

29.1. The OM Exemption was introduced as a proposed prospectus exemption in 2001 in B.C. 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."[66]

29.2. While some provinces and territories joined Alberta and B.C. in implementing MI 45-103 (including Manitoba, Newfoundland and Labrador, Northwest Territories, Nova Scotia, Nunavut, PEI and Saskatchewan), Ontario did not do so. The OSC publicly stated it concerns with both the B.C. 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."[67]

29.3. In FAIR Canada's view, these concerns remain. Further, it does not appear that the introduction of the OM Exemption has been used frequently by start-ups and SMEs[68] and 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.

29.4. The justification provided by the OSC for implementing an OM Exemption now is very similar to the rationale provided by the B.C. and Alberta securities regulators when it was introduced in those provinces, namely to increase the amount of capital raised by small- and medium-sized issuers. The OSC states in its Notice: "We are proposing the OM Prospectus Exemption because we think that it may support the capital raising needs of issuers that are moving beyond the early stages of development."[69]; "We expect that the OM Prospectus Exemption will provide enhanced opportunities for exempt market dealers (EMDs) to be involved in start-up and SME financings"[70];

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

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

[68] 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."

[69] Notice, at page 6.

[70] Notice, at page 6.

and "At this time, our work has focused on the introduction of an OM Prospectus Exemption in Ontario to assist capital raising by start-ups and SMEs."[71]

29.5. The concerns cited by the OSC in 2004 when it refused to adopt the OM Exemption are just as valid today. FAIR Canada is of the view that the exempt market review undertaken by the FAIR Canada believes that the compliance deficiencies identified by CSA OM Staff Notice 45-309 should call into question the appropriateness of the OM Exemption forOntario's capital markets. We do not believe that the following is an adequate response to the investor protection issues:

> ...we need to address the following important areas as we move toward developing new and expanded prospectus exemptions that increase issuer and investor access to the exempt market:
>
> - enhancing our compliance monitoring and oversight of exempt market activity,
> - expanding our educational outreach to issuers and investors, and
> - in the event of non-compliance, assessing the regulatory tools available to us, and when and how they should be deployed.
>
> We intend to consult with the other CSA members as we further consider these issues.[72]

While all of the above are needed, this is not sufficient given the widespread non-compliance with the OM Exemption in other jurisdictions, the lack of compliance by EMDs with their regulatory obligations in related to the prospectus exemptions that are currently available in Ontario, and the lack of effective oversight and policing of the exempt market as it exists today. What is needed is a regulatory framework which deters non-compliance and encourages behaviour that is in the client's best interest at the outset.

## 30. Get it Right Now – Do not Leave Investor Protection Concerns to a Second Phase

30.1. FAIR Canada believes it would be highly inappropriate and dangerous to leave significant investor protection-related concerns to a "second phase" following implementation of the proposed exemption as is suggested numerous times in the Notice. For example:

> As a second phase of this work, assuming an OM Prospectus Exemption is implemented in Ontario, we plan to consider whether changes to the disclosure provided to investors at the point of sale would be appropriate. For example, we will consider whether disclosure tailored to specific industries, such as real estate, should be added to the current form of OM.[73]

There are many references to considering investor protection related measures at a later, second phase. FAIR Canada believes that critical investor protection concerns should be dealt with at this phase of reform and not left to a later date.

[71] Notice, at page 6.
[72] OSC Exempt Market Review, OSC Notice 45-712, "Progress Report on Review of Prospectus Exemptions to Facilitate Capital Raising", at page 22.
[73] Notice, at page 6.

30.2. FAIR Canada urges the OSC to make investor protection concerns arising from the introduction of new prospectus exemptions a top priority. We also request transparency in how the OSC plans to address the significant number of investor complaints and investor purported losses that are likely to arise from the sale of exempt market investments to retail investors in reliance on a non-vetted prospectus-like document. Such issues should not be left for later or further consideration. This will lead people to ask later, "What were the regulators thinking? Where were they?"

## 31. Failure to Identify and Address Anticipated Costs

31.1. Throughout the Notice, including in Part 8, the benefit of retail investors having the "opportunity" to invest and greater "access" to the exempt market is outlined. However, costs that are not mentioned and that will likely result from the OM Exemption include:

- decreased investor confidence in the exempt market and Canadian capital markets. Confidence in markets, including confidence that the markets are fair and that the rules are effectively enforced, is critical to capital formation.
- an increase in the cost of capital if capital raising does not lead to true capital formation[74].
- costs to retail investors that result when registrants fail to comply with their know-your-client or know-your-product suitability obligations.
- Costs to retail investors that may result through an increase in fraud or misconduct through purported reliance on an OM through non-registrants.
- costs to investors in making such investments without the seller (EMD) properly avoiding, managing or disclosing the conflicts of interest that may be present.

31.2. 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.

31.3. FAIR Canada suggests that the OSC take a cautious approach in considering the implementation of new prospectus exemptions in the absence of necessary data in order to make an informed and sound policy decision and in light of the significant investor protection concerns that have been identified. FAIR Canada strongly opposes the introduction of an OM Exemption in Ontario at the present time.

## 32. Responses to Specific Requests for Comment on the OM Prospectus Exemption

***General (Question 1):*** *We note that the existing OM Prospectus Exemption available in other CSA jurisdictions has not been frequently used by start-ups and SMEs. Have we proposed changes that will encourage start-ups and SMEs to use the OM Prospectus Exemption? What else could we do to make the OM Prospectus Exemption a useful financial tool for start-ups and SMEs?*

32.1. FAIR Canada is of the view that this raises a question of whether adequate research and analysis has been conducted regarding the barriers to accessing capital using the existing avenues that are

[74] See our earlier submission dated March 8, 2013 at page 3 and 7-9 *.

available to SMEs in Ontario and in the other CSA jurisdictions. It appears that there is little empirical evidence of the effects of regulatory constraints on the ability of SMEs to raise capital in a timely and efficient manner.[75] Should regulators put more resources into exploring ways to reduce the costs of raising capital in the regulated market? In the absence of information, it is not possible to identify *whether* it is possible or *how* it is possible to make the OM Exemption a useful financing tool for start-ups and SMEs while also ensuring that there is adequate investor protection. Given that the OM Exemption is not frequently used by start-ups and SMEs in Alberta[76], it may very well be the case that in order to make the OM Exemption a useful financial tool for start-ups and SMEs, the bar will simply be set too low.

## 33. Issuer Qualification Criteria

***Question 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?*

33.1. FAIR Canada notes that in Australia an issuer can use an offer information statement ("**OIS**") for the offer of securities instead of a prospectus if the amount of capital to be raised, when added to all amounts previously raised by the body (or a related body corporate or an entity controlled by a person who controls the body or an associate of that person) is A$10 million or less. This document must be lodged with the Australian securities regulator (ASIC) before it can be used. Other CSA jurisdictions have no limits on the size of an offering or on the number of offerings. In the Notice the OSC has stated it concern that not having a limit potentially undermines the prospectus and continuous disclosure regimes under securities law. FAIR Canada suggests that information be gathered and published on Australia's experience and that of the other CSA jurisdictions. FAIR Canada does not consider it appropriate (as is suggested in the Notice) to wait until a later phase to require disclosure in the OM of all offerings made by entities in the same corporate structure. At a minimum, such disclosure should be required immediately if the exemption is to be introduced. Such information would be not onerous to disclose and would be information that retail investors and regulators would wish to know. In addition, the OSC should consider before finalizing the proposed exemption, whether it is appropriate to require a limit on the amount of capital that may be raised through the exemption based on the Australian and other CSA jurisdictions experience.

***Question 4:*** *We have identified certain concerns with the sale of real estate securities by non-reporting issuers in the exempt market. As phase two of the Exempt Market Review, we propose to develop tailored disclosure requirements for these types of issuers. Is this timing appropriate or should we consider including tailored disclosure requirements concurrently with the introduction of the OM Prospectus Exemption in Ontario?*

33.2. It is difficult to comment given the lack of specificity as to the concerns that have been identified. We are aware through media reports, enforcement cases (such as Shire International Real Estate

[75] Cecile Carpentier and Jean-Marc Suret, "Entrepreneurial Equity Financing and Securities Regulation: an Empirical Analysis" (July 5, 2010) at page 2.
[76] No data was provided in related consultation materials on the experience of other jurisdictions with the OM Exemption.

Investments Ltd[77]) and the NASAA Enforcement Report that a number of investor losses and alleged exempt market frauds occur involving real estate investments and that many unsophisticated retail investors are under the mistaken impression that such investments are low risk because they believe they are investing in real property rather than a security.

33.3. We disagree with taking a phased approach to address identified concerns and question whether any such concerns can be addressed through disclosure alone, as disclosure is not a panacea for the more fundamental issues that exist in the exempt market.

## 34. Types of Securities

***Question 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?*

34.1. FAIR Canada agrees that novel or complex securities should not be permitted to be distributed under this exemption as they will not be easily understood by most retail investors. FAIR Canada believes that if the OM Exemption is to be introduced, a listed of permitted types of securities would be preferable to trying to define a category of "novel" or "complex" securities that would be excluded, would provide for more adequate investor protection and would be similar to what is contemplated for crowdfunding. However, to the extent that certain securities may be identified as inappropriate for distribution using an OM, FAIR Canada supports also listing them as exclusions.

***Question 6:*** *Specified derivatives and structured finance products cannot be distributed under the OM Prospectus Exemption. Should we exclude other types of securities in order to prevent complex and/or novel securities being sold without the full protections afforded by a prospectus?*

34.2. See above at paragraph 34.1 (re question 5).

## 35. Offering parameters

***Question 7:*** *We have not proposed any limits on the length of time an OM offering can remain open. This aligns with the current OM Prospectus Exemption available in other jurisdictions. Should there be a limit on the offering period? How long does an OM distribution need to stay open? Is there a risk that "stale-dated" disclosure will be provided to investors?*

35.1. FAIR Canada believes that if it is to be introduced, the offering document must disclose how long the offer will remain open and should not be permitted to remain open for more than 90 days. A 90 day limit on the length of time an offering can remain open will help to ensure that the information in the offering document does not become stale.

[77] *Shire International Real Estate Investments Ltd*., Re, 2012 ABASC 79.

## 36. Registrants

***Question 8:*** *Do you agree with our proposal to prohibit registrants that are "related" to the issuer (as defined in National Instrument 33-105 Underwriting Conflicts) from participating in an OM distribution? We have significant investor protection concerns about the activities of some EMDs that distribute securities of "related" issuers. How would this restriction affect the ability of start-ups and SMEs to raise capital?*

36.1. The Notice points out that "Staff of our Compliance and Registrant Regulation Branch, through compliance reviews, continue to identify significant compliance issues with EMDs that distribute securities of "related issuers" and "connected issuers" as those terms are defined in National Instrument 33-105 Underwriting Conflicts."[78] Similarly, the CSA found that there were significant issues with EMDs ability to address conflicts of interest with 21% of registered firms that were sampled being deficient in this area. The following deficiencies were found:

- Registered firms considered 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.

The CSA Staff Notice 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."[79] We note that this statement assumes that conflicts can be appropriately addressed by disclosure.

36.2. FAIR Canada agrees with the OSC that registrants that are related to the issuer should not be allowed to participate in an OM distribution for several reasons. Firstly, FAIR Canada supports the standard set by international securities regulators whereby market intermediaries should avoid conflicts of interest (refrain) if the conflict of interest is so great that a management mechanism is unlikely to protect the interests of the client; and should appropriately manage other conflicts of interest (through information barriers, dealing restrictions and/or disclosure).[80] An EMD who is

[78] See Notice at page A-14.
[79] CSA Staff Notice 31-334, CSA Review of Relationship Disclosure Practices, July 18, 2013 at page 9.
[80] International Organization of Securities Commissions, Market Intermediary Management of Conflicts that Arise in Securities Offerings – Final Report (November 2007), online: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD257.pdf> at page

related to the issuer will simply have too great a level of conflict which will prevent it from properly discharging its regulatory obligations – the interests of its clients will not be given paramount status above those of its own.

36.3. Secondly, a considerable amount of research has been conducted regarding the effects of disclosure, both within the financial services context and more broadly. These behavioural studies have proven the perverse effects of disclosing conflicts of interest. As summed up in the abstract to "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest":

> Conflicts of interest can lead experts to give biased and corrupt advice. Although disclosure is often proposed as a potential solution to these problems, we show that it can have perverse effects. First, people generally do not discount advice from biased advisors as much as they should, even when advisors' conflicts of interest are disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. As a result, disclosure may fail to solve the problems created by conflicts of interest and may sometimes even make matters worse.[81]

36.4. Additional research has shown that disclosing a conflict of interest can lead to the perverse result that the client will trust the advice less but will be feel more pressure to follow the advice.[82] Again, another perverse effect of disclosure that demonstrates it is not a panacea.

36.5. Thirdly, research suggests that disclosure would be more effective when recipients of advice have expertise or experience to help them assess the potential effects of the disclosed conflicts of interest.83 This is telling about the usefulness of such disclosure to unsophisticated recipients, such as individual retail investors, who are in the greatest need of protection. "For disclosure to be effective, the recipient of advice must understand how the conflict of interest has influenced the advisor and must be able to correct for that biasing influence."84 In our view, most investors do not have the requisite knowledge and experience to sufficiently adjust for the conflict of interest that is disclosed.8586

36.6. FAIR Canada agrees with the Notice that the best way to avoid the conflicts of interest presented by a registrant being a related party to the issuer, is to prohibit the related- registrant from

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10. According to IOSCO's Objectives and Principles of Securities Regulation (May 2003), online: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf> "A firm should try to avoid any conflict of interest arising but, where the potential for conflicts arise, should ensure fair treatment of all its customers by proper disclosure, internal rules of confidentiality or declining to act where conflict cannot be avoided. **A firm should not place its interests above those of its customers."** *emphasis added+

[81] Daylian M. Cain, George Loewenstein, and Don A. Moore, "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest" (2005) 34(1) J. Legal Stud. 1.

[82] Sanita Sah, George Lowenstein and Daylian Cain, "The Burden of Disclosure: Increased Compliance with Distrusted Advice", The Journal of Personality and Social Psychology, 20013, Vol. 104, No. 2, p298-304.

[83] Daylian M. Cain, George Loewenstein, and Don A. Moore, "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest" (2005) 34(1) J. Legal Stud. 1 at page 20.

[84] Cain, at page 3.

[85] This is as a result of the combination of (1) a lack of awareness of conflicts of interest and (2) the low overall investment knowledge of Canadians. The CSA 2012 Investor Index (see supra note 27) found a low awareness of how Canadians' financial advisors are compensated and that "…overall investment knowledge of Canadians is low, with 40 percent of Canadians failing a general investment knowledge test." Another example is CSA Investor testing of Fund Facts revealed that retail investors had difficulty understanding the reference to "conflicts of interest" and it caused confusion.

[86] CSA Implementation of Stage 2 of Point of Sale Disclosure for Mutual Funds – Delivery of Fund Facts June 13, 2013 36 OSCB 6028. .

participating in the distribution of that issuer. This will increase the likelihood that the registrant will comply with its suitability obligations, and only recommend products that are suitable for the particular retail investor, if such conflicts are avoided. This approach would also help improve market confidence.

36.7. FAIR Canada recommends that registrants connected to the issuer should not be allowed to participate in the OM distribution, for the same reason. Issuers will still have many non-conflicted EMDs through which to distribute their exempt product. We disagree that the OSC should simply "monitor the use of the exemption" and possibly "propose further amendments at a later date." It would be imprudent to wait until later to tighten up the rules. If the OM Exemption is to be introduced, it must be done cautiously with investor protection-related provisions being implemented immediately. Further we recommend that, if introduced (which we do not recommend) a statutory review of the OM be conducted two years after it is implemented..

***Question 9:*** *Concerns have been raised about the role of unregistered finders in identifying investors of securities. Should we prohibit the payment of a commission or finder's fee to any person, other than a registered dealer, in connection with a distribution, as certain other jurisdictions have done? What role do finders play in the exempt market? What purposes do these commissions or fees serve and what are the risks associated with permitting them? If we restrict these commissions or fees, what impact would that have on capital raising?*

36.8. FAIR Canada is concerned that investors may not be adequately protected if finder's fees are paid to non-registered individuals who are not subject to any competency standards or obligations to investors. This could also impact investor confidence in our markets. FAIR Canada recommends that the OSC obtain information from the other jurisdictions that have this prohibition (namely, the Northwest Territories, Saskatchewan and Yukon) and compare the level of investor protection and ability to raise capital with the experience of jurisdictions where finder's fees are permitted. This information should be ascertained and publicly disclosed before permitting finder's fees in Ontario in order to ensure that there is adequate investor protection at the time the rule is introduced.

## 37. Investor qualifications – definition of eligible investor

***Question 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?*

37.1. Firstly, 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.

37.2. Secondly, FAIR Canada agrees that the net asset test should not include the equity in a person's primary residence given that a person's home is an illiquid asset and because it is 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.

37.3. Thirdly, FAIR Canada disagrees that if one rightly excludes the equity in one's principal residence from the calculation of net assets, then the threshold should be reduced to $250,000. To do this would be to obviate most if not all of the benefit of excluding the principal residence in the first place.

37.4. Finally, FAIR Canada recommends that in addition to ensuring pension and education savings assets of a retail investor are not included in the calculation of net assets, 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 they can afford to place at risk, and from which they might better be able to bear a loss.

***Question 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?*

37.5. 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 interest. In addition, to qualify, the registrant must have recommended that the proposed exempt investment be in the best interest of the retail investor ("eligible investor"). Finally, the OSC should monitor the use of this qualifying criterion through requiring the provision of information to the OSC on the use of this qualifying criterion including the name of the registrant who provided the investment advice.

37.6. FAIR Canada recommends that the registrant be required to be an IIROC member to provide investors with the additional protections associated with SRO membership. FAIR Canada does not agree that the category of registrants qualified to act as an eligibility advisor be expanded 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 was 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.

37.7. 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.

## 38. Investment Limits

***Question 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?*

38.1. FAIR Canada notes that the OSC's approach in the Concept Proposal (OSC Staff Consultation Paper 45-710) to use the terms and conditions of the crowdfunding exemption, including the investment limits, and apply them to the OM Exemption has been abandoned..[87] The previous proposed limits (in OSC Staff Consultation Paper 45-710) were as follows: a limit on a purchaser's investment in a particular distribution of $2,500 under this exemption and a limit of $10,000 in total under this exemption in any calendar year if not an accredited investor. FAIR Canada notes that the new investment limits on a purchaser's investment in a particular distribution is $10,000 if not an "eligible investor", $30,000 if an "eligible investor, and no limit if an accredited investor in a 12-month period.

38.2. The Multilateral CSA Notice and Request for Comment on Proposed Amendments to National Instrument 45-106 relating to the OM Exemption dated March 20, 2014, advises that the Participating Jurisdictions (namely Alberta, Saskatchewan, and New Brunswick) are proposing the same purchaser limits as proposed by Ontario. The CSA Notice indicates that these limits are being proposed because the former $10,000 limit per distribution for non-eligible investors may have been circumvented by investors investing 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. The OSC has harmonized to these same limits.

38.3. 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 limit.

(iii) The size of the investment bears no relationship to the size of their existing portfolio of investments and will likely lead to a risk of overconcentration and lack of diversification by some investors.

(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).[88] The average contribution was approximately $6,000.[89] The average contribution less average withdrawal per tax free savings account ("TFSA") was $2,741 in 2011. Is it

[87] OSC Staff Notice 45-712 Progress Report on Review of Prospectus Exemptions to Facilitate Capital Raising, at page 6.
[88] See Statistics Canada, Registered retirement savings plan contributions, 2012 released March 25, 2014.
[89] http://www.statcan.gc.ca/daily-quotidien/140325/t140325b001-eng.htm

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.[90] Almost 6 out of 10 respondents were found to have less than $50,000 in savings and investments.[91] 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."[92] 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..."[93].

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.

## 39. Ensuring Adherence to the Investment Limits

39.1. 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 to ensure compliance with the investment limits on registrants, this will not result in the limits not being exceeded due to the following: (i) the misaligned incentives (that is, the frequency of conflicts of interest between that of the seller and the retail investor); (ii) the fact that such requirements are not in the rules but in the proposed amendments to the Companion Policy; (iii) the low level of compliance by EMDs with the requirements in other jurisdictions where the exemption is currently in use; (iv) the practical difficulties in monitoring what is being proposed: (for example it will be difficult to monitoring compliance; and (v) lack of any real repercussions to the EMD or issuer should the limit be exceeded.

39.2. Securities regulators should also not rely on self-certification through the 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 formalities.

39.3. FAIR Canada recommends that there be a registry or database maintained by the OSC or 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.

[90] Brondesbury exempt market survey at page 9.
[91] Brondesbury exempt market at page 9.
[92] http://www.statcan.gc.ca/daily-quotidien/140225/dq140225b-eng.htm
[93] http://www.statcan.gc.ca/daily-quotidien/140225/dq140225b-eng.htm

## 40. Point of Sale Disclosure

***Question 13:*** *Current OM disclosure requirements do not contain specific requirements for blind pool issuers. Would blind pool issuers use the OM Prospectus Exemption? Would disclosure specific to a blind pool offering be useful to investors?*

40.1. Rather than asking whether specific disclosure would be useful, the OSC should question whether the OM Exemption ought to be available at all for blind pool issuers who have no specific business plan. Blind pool issuers are excluded from the proposed crowdfunding exemption and should be excluded here also. Additionally, FAIR Canada disagrees that the disclosure issue should be put off to be considered during phase two work".[94]

***Question 14:*** *We are not considering any significant changes to the OM form at this time. However, we are aware that many OMs are lengthy, prospectus-like documents. Are there other tools we could use at this time (short of redesigning the form) to encourage OMs to be drafted in a manner that is clear and concise?*

40.2. 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.

40.3. If it is to be introduced, FAIR Canada recommends that the OSC require the OM to be filed before it is used to solicit investments and that the OSC not allow it to be used until it has been reviewed by the OSC. Australia's security regulator (ASIC) requires the OIS to be lodged before it can be used. Alternatively, the OSC should require the OM to be filed, with a certain percentage of those filed being subject to review by the OSC before they are permitted to be used to solicit purchases. This would increase the number of compliant OMs.

40.4. FAIR Canada again disagrees with the approach the OSC is taking to put off investor protection measures to a later phase. The OSC recognizes that many retail investors will have difficulty understanding the OM and that its disclosure will not lead to an informed decision but is proposing to put off, considering how the OM forms could provide improved disclosure to investors.[95] We urge the OSC to defer implemention of any new prospectus exemption, including the OM, until measures are in place that will ensure adequate investor protection.

[94] See the Notice, at page A-4.
[95] See the Notice, at A-23 and A-24.

## 41. Marketing Materials

***Question 15:*** *In our view any marketing materials used by issuers relying on the OM Exemption should be consistent with the disclosure in the OM. We have proposed requiring that marketing materials be incorporated by reference into the OM (with the result that liability would attach to the marketing materials). Do you agree with this requirement?*

41.1. Yes, incorporation of marketing materials 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 it will not. For example, the regulator should not allow marketing to misuse hypothetical data, provide 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.

## 42. Ongoing Information Available to Investors

***Question 16:*** *Do you support requiring some form on ongoing disclosure for issuers that have used the OM Prospectus Exemption, such as the proposed requirement for annual financial statements? In our view, this type of disclosure will provide a level of accountability. Should the annual financial statements be audited over a certain threshold amount? If the aggregate amount raised is $500,000 or less, is a review of financial statements adequate?*

42.1. The CSA Notice dated March 20, 2014 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.

42.2. Accordingly, the OSC and the Participating Jurisdictions in the related CSA Notice 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.

42.3. 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.

42.4. 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.

42.5. We would also refer the OSC to our letter dated February 20, 2013 (in response to Multilateral CSA Notice 45-311), which sets out our position on financial statements.[96] 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[97], it is essential that this be required under the OM Exemption prior to an individual investing.

42.6. We do not support the OSC's proposed alternative approach "....to require that the issuer provide disclosure on the type and amount of continuous disclosure that it proposes to provide on an ongoing basis to investors" as this will likely result in very little continuous disclosure being available. Disclosure of what rights investors have (or do not have) is far inferior to requiring the provision of basic protections.

***Question 17**: We have proposed that non-reporting issuers that use the OM Prospectus Exemption must notify security holders of certain specified events, within 10 days of the occurrence of the event. We consider these events to be significant matters that security holders should be notified of. Do you agree with the list of events?*

42.7. Yes. We support the requirement to provide a notice to the investor of material changes within 10 days. However, we question whether there will be compliance with such requirements.

***Question 18:** Is there other disclosure that would also be useful to investors on an ongoing basis?*

42.8. The issuer should have to disclose if any of its principals have invested their own money in the issuer, at a minimum, and whether they continue to have a financial stake in their issuer as part of their ongoing disclosure. Furthermore, the OSC should consider requiring that the principals have some skin in the game as it should not simply by the retail investor whose money is at risk.

***Question 19:** We propose requiring that non-reporting issuers that use the OM Prospectus Exemption must continue to provide the specified ongoing disclosure to investors until the issuer*

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

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

*either becomes a reporting issuer or the issuer ceases to carry on business. Do you agree that a non-reporting issuer should continue to provide ongoing disclosure until either of these events occurs? Are there other events that would warrant expiration of the disclosure requirements?*

42.9. We agree with the requirement to provide ongoing disclosure as proposed.

## 43. Reporting of distribution

***Question 20:*** *We believe that it is important to obtain additional information to assist in monitoring compliance with and use of the OM Prospectus Exemption. Form 45-106F11 would require disclosure of the category of "eligible investor" that each investor falls under. This additional information is provided in a confidential schedule to Form 45-106F11 and would not appear on the public record. Do you agree that collecting this information would be useful and appropriate?*

43.1. We have noted in this and in previous submissions on the exempt market that important policies are being determined regarding proposed prospectus exemptions or the reform of existing prospectus exemptions without sufficient data. That 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 in future. 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.

43.2. 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.

## FAMILY, FRIENDS AND BUSINESS ASSOCIATES PROSPECTUS EXEMPTION (FFBA EXEMPTION)

### 44. Lack of Data Regarding Use of Exemption

44.1. The OSC Progress Report indicates that start-ups and early-stage companies could benefit from greater access to capital from their network of family, friends and business associates than is currently permitted under Ontario Securities law.

44.2. No data is provided in either the OSC Progress Report or in the Notice about the degree of reliance on the FFBA Exemption by issuers, including by stage of business development (start-up versus established business) or by size of issuer (SME versus large issuers). Given that the overwhelming majority of the amount invested in the exempt market is by accredited investors (90% of the total amount invested in 2011), we wonder how often this exemption is relied upon in the jurisdictions which have this exemption and how much money is raised. We believe that a small percentage of the total amount raised in the exempt market in other jurisdictions is through this exemption (less than 3%).[98]

### 45. Existing Ontario Family Member Exemptions Sufficient

45.1. Ontario currently has two exemptions in NI 45-106 which allow Ontario start-ups and early stage companies to raise capital from family members without a prospectus: the private issuer exemption (section 2.4 of NI 45-106) and the founder, control person and family exemption (section 2.7 of NI 45-106).

45.2. The private issuer exemption allows a non-reporting issuer to distribute its securities to a maximum of 50 people who have certain specified relationships with the issuer, including specified family members of its executive officers, directors or founder. This exemption is available in the other CSA jurisdictions. The historical rationale for the exemption is that this is the number of individuals who would fall within the requisite categories and have some relationship with the issuer allowing them to (a) gauge the issuer's principals' capabilities and trustworthiness, and (b) extract sufficient material information to avoid a large level of informational asymmetry.[99] The fact of the relationship was also seen to reduce the likelihood of fraud since they would know the principals of the issuer.

45.3. The founder, control person and family exemption (section 2.7 of NI 45-106) allows an issuer to distribute its securities to specified family members of its executive officers, directors or founders and to control persons of the issuer.[100] These persons were included in the definition of

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[98] Our view is based on data which shows that over 90% of the total amount invested in the exempt market in 2011 was through the Accredited Investor Exemption and the Minimum Amount ("MA") Exemption raises the second most highest amount of capital at 3.7% of the total amount invested in the exempt market as noted in the Consultation Note published on February 27, 2014 regarding the Accredited Investor and MA Exemptions.

[99] For example, the OSC Staff Consultation Paper 45-710 states that "These types of investors are generally thought to have a relationship to the issuer that allows them to, at least partially, mitigate the risks of the investment because of the closeness of the relationship or the fact that they have access to information from the issuer (at page 9).

[100] Section 2.7 of NI 45-106 provides that "In Ontario, the prospectus requirement does not apply to a distribution to a person who purchases the security as principal and is

a) The founder of the issuer,
b) An affiliate of a founder of the issuer,
c) A spouse, parent, brother, sister, grandparent, grandchild or child of an executive officer, director or founder of the issuer, or

"accredited investor" in the former Ontario Rule 45-501. When NI 45-106 was implemented, this exemption was seen to be necessary to maintain the status quo in Ontario because Ontario was not a part of the broader FFBA Exemption in section 2.5 of NI 45-106.[101]

45.4. FAIR Canada is of the view that **the above-noted exemptions are sufficient to capture all individuals who would perhaps have the requisite nexus to a start-up or SME** so as to potentially mitigate the risks of the investment through the knowledge of the issuer's principals (and their capabilities and level of trustworthiness) as well as those individuals who possibly have access to information about the issuer in order to make an informed decision. We do not believe there is a valid rationale for introducing the FFBA Exemption which includes a much broader list of more remote family members as well as close personal friends or close business associates.[102] Harmonization of the FFBA Exemption is not justifiable.

45.5. The reason that Ontario did not adopt the FFBA Exemption in 2004 remains valid today: "Ontario is not adopting the family, friends and business associates exemption as we do not believe that an exemption that allows securities to be issued to an unlimited group of non-accredited investors is appropriate for the Ontario market."[103]

45.6. As noted in the Progress Report, the FFBA Exemption allows access to more types of family members as well as close personal friends and close business associates. The OSC has previously been concerned that this exemption allows securities to be issued to an unlimited number of undefined "close personal friends" and "close business associates".[104]

## 46. Abuse of FFBA Exemption

46.1. We suspect that there are many abuses of the FFBA Exemption in the exempt market and that how issuers and/or registrants determine who is a "close personal friend" or "close business associate" is extremely difficult to police and is widely abused. The inability to contain who constitutes a "close personal friend" or "close business associate" makes oversight of this exemption unworkable.

46.2. David Baines of the Vancouver Sun has reported on various exempt market abuses, including abuse of the FFBA Exemption. For example, he reported on the IAC-Independent Academies Inc. case wherein the British Columbia Securities Commission (BCSC) alleges that from August 2002 to July 2011, Theodore Robert Everett, Leonard George Ralph and Robert H. Duke sold $5.7 million worth of securities to 183 investors in reliance on exemptions including the FFBA Exemption when only 15 investors (accounting for $1.94 million of the money) qualified for this exemption. In July 2011, after learning most of the investors did not qualify as friends, family or business associates,

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d) A person that is a control person of the issuer.

[101] See OSC Supplement, 2004 at section 4(a) at page *.

[102] Section 2.5(1) of the NI-45-106 includes the following individuals to whom the prospectus requirement does not apply:
…(c) a parent, grandparent, sister, child or grandchild of the spouse of a director, executive officer or control person of the issuer or of an affiliate of the issuer,
(d) A close personal friend of a director, executive officer or control person of the issuer, or of an affiliate of the issuer,
(e) A close business associate of a director, executive officer or control person of the issuer, or of an affiliate of the issuer,
…
(g) A parent, grandparent, brother sister, child or grandchild of a spouse of a founder of the issuer…

[103] See OSC Supplement, 2004, at section 4(a) at page *.

[104] Progress Report, at page 5.

the BCSC issued a cease trade order.[105] Another case reported by David Baines involves a time share firm Aviawest Resorts Inc. and its former directors who were accused of illegally selling promissory notes to 214 investors, of which 173 were allegedly sold the investment based on the fact they were business associates. Many of the affidavits failed to establish their relationship was sufficient to qualify them as close business associates.[106]

46.3. In our comments on OSC Staff Consultation Paper 45-710, FAIR Canada requested that data on the experience of other CSA jurisdictions with respect to the FFBA Exemption be made public before considering the adoption of it in Ontario. FAIR Canada respectfully requests that such information be published so that it can be considered and commented upon by stakeholders before the OSC makes a policy determination as to whether to introduce this exemption into Ontario at this time.

46.4. FAIR Canada does not believe that the modifications to the FFBA Exemption proposed by the OSC (such as prohibiting advertising, the prohibition of any finder's fees or commissions, the use of a risk acknowledgement form and additional guidance on the scope of "close personal friends" and "close business associates") will be sufficient to protect investors in light of the abuses of this exemption, and the practical difficulties in ensuring compliance (including the need for staff at the OSC to track compliance).

46.5. Many investment frauds involve an element of affinity fraud, whereby fraudsters focus on a group or groups with whom they share an affiliation such as family, friends and social organizations. Marketing a fraudulent investment scheme to members of an identifiable group or organization continues to be a successful practice for Ponzi scheme operators and other fraudsters. Many victims, particularly of Ponzi schemes, are discovered to be close to the perpetrator, including immediate family members, close friends and business associates. As we note above, securities regulators should determine and publish how prevalent fraud is under the FFBA Exemption.

46.6. Given that a FFBA Exemption is premised on the theory that those close to the promoter can gauge that person's trustworthiness, if many cases that involve serious investor harm also involve perpetrators who target friends and family, the rationale for this exemption merits closer review and it should not be introducing until such a review has been completed and published and stakeholder feedback solicited on it.

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[105] January 15, 2013, "David Baines: BCSC accuses trio of defrauding investors in Comox Valley development scheme: Proposed $4-billion Sage Hills sports and educational mecca turns into bust for financiers, available online at: http://www.vancouversun.com/business/David+Baines+BCSC+accuses+trio+defrauding+investors+Comox+Valley+development+scheme/7824621/story.html; BCSC decisions found at 2013 BCSECCOM 1 (January 15, 2013) and 2014 BCSECCOM 93 (March 13, 2014).

[106] December 12, 2012, David Baines: Victoria time-share company under regulatory microscope as investors lick wounds", available online at http://www.vancouversun.com/business/David+Baines+Victoria+time+share+company+under+regulatory+microscope+investors+lick+wounds/7690525/story.html. See also BCSC Decision 2013 BCSECCOM 319.

## PROPOSED EXISTING SECURITY HOLDER PROSPECTUS EXEMPTION

### 47. FAIR Canada Supports Proposed Existing Security Holder Prospectus Exemption

47.1. FAIR Canada supports allowing listed issuers the ability to raise money by distributing securities to their existing security holders provided shareholders are given adequate notice and disclosure, time to consider the offering and ability to participate in the offering. Further the rules should include protections to avoid abuse including making offers on a pro-rata basis consistent with investors' existing shareholdings.

47.2. We note that the OSC proposed existing security holder exemption is largely based on that adopted by certain other CSA jurisdictions on March 13, 2014 as noted in Multilateral CSA Notice 45-313 with some modifications made to address some concerns noted by the OSC.

### 48. Additional Protections Needed

48.1. FAIR Canada previously provided comments by letter dated January 20, 2014[107] on Multi-lateral CSA Notice 45-312 Proposed Prospectus Exemption for Distributions to Existing Security Holders[108]. FAIR Canada continues to believe that the model requires the following additional key components in order to prevent abuse by market players at the expense of investors and thus provide adequate investor protection:

- The investor should have the ability to purchase additional shares consistent with their existing shareholdings. (For example, if an investor holds 10,000 shares, they can purchase up to an additional 10,000 (instead of an arbitrary $15,000 limit absent advice regarding the suitability of the investment or no limit if advice as to suitability is provided). The limit should be based on a shareholder's holdings on the "record date".
- The "record date" should be 30 days prior to the date of the announcement to prevent potential abuse by market participants.
- The private placement rules of the TSXV should be made an integral part of the proposed exemption so as to be enforceable by the regulators.
- There should be an aggregate limit on the amount raised to no more than 25% of the number of the existing outstanding securities of the class to be issued in any twelve month period (similar to a rights offering exemption).
- The announcement should disclose the holdings of insiders and whether the insiders intend to subscribe for the offering in full or in part. Insiders should not be permitted to subscribe for the offering unless they have disclosed an intention to subscribe in the announcement.

[107] FAIR Canada submission dated January 20, 2014, available online at: http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-comments-re-Proposed-Exemption-for-Distributions-to-Existing-Security-Holders.pdf.
[108] CSA Notice 45-312, available online at http://www.msc.gov.mb.ca/legal_docs/legislation/notices/45_312_notice_package.pdf.

## 49. Issuer Qualification Criteria

49.1. FAIR Canada believes that the proposed exemption should be limited initially to those issuers listed on the TSX-V as it is small and medium sized issuers that have been identified as having the greatest need to access capital and the greatest difficulty raising it. In addition, given that the proposed exemption is new and experimental, it makes sense to introduce it on a more limited basis to start, to see its usefulness to issuers, its take up by investors and whether it provides adequate investor protection and adequate controls to prevent abuses before broadening its scope. FAIR Canada notes that the other CSA Jurisdictions that adopted it on March 13, 2014 did not limit it to TSXV issuers, however.

## 50. Offering Parameters

50.1. FAIR Canada supports the OSC's proposal of requiring the issuer to allocate the offering to existing security holders on a pro rata basis. FAIR Canada recommends that the amount to be invested through the proposed exemption should be based on the current holdings and on a pro-rata basis rather than an arbitrary amount (proposed at $15,000). This would help ensure that the investor has the wherewithal to make the investment and, more importantly, protect investors from potential manipulation by less scrupulous actors. Opportunity for manipulation will be reduced through basing the maximum number of shares that may be subscribed for on the holdings of the security holder on the record date and through requiring a pro-rata take up.

50.2. FAIR Canada recommends that investors be warned that increasing their shareholdings results in increasing their exposure to high-risk investments and that they should consider whether, in light of their portfolio of holdings, it is appropriate to do so or not.

50.3. FAIR Canada's understanding is that most shareholders of TSXV issuers are at least aware that such investments are high risk or they may be sophisticated investors. However, it may also be the case that some retail investors purchase the securities of TSXV-listed issuers anticipating large investments returns, without being fully aware of the risks of doing so. Therefore, being a current security holder of an issuer may mean that the investor will have made an informed decision by considering available information about the issuer or have engaged an investment adviser to do so but it certainly is no guarantee that this is the case.

50.4. Thus, it is particularly important for venture issuers that their continuous disclosure obligations be met so that retail investors have as much information as possible in order to make a more informed investment decision, for the announcement of the offering to include the most up-to-date information and for the notice to investors to clearly state that such investments are speculative and high risk and the investor should consider whether purchasing additional holdings in the TSXV-listed issuer would be appropriate for them, given their portfolio of investments (as some investors will have purchased the securities through a discount brokerage rather than through an investment dealer with "know-your-product" and "know-your-client" obligations).

50.5. Further, FAIR Canada recommends that a 25% limit on the amount of outstanding securities of the class to be issued in any 12 month period be required so as to limit significant dilution concerns.

## 51. Record Date

51.1. FAIR Canada recommends that the record date be thirty days rather than one day prior to the announcement of the offering so as to prevent any gaming of the system, in particular by persons close to the issuer why may have access to information about the proposed offering.

## 52. Resale Restrictions

52.1. FAIR Canada agrees that a four month hold period is appropriate for this exemption as it will be helpful to ensure that investors are purchasing as principal. In any event, investors who are existing shareholders would be free to trade their existing securities of the issuer held on the record date during the four month hold period for the newly issued securities.

## 53. Reporting of Distribution

53.1. FAIR Canada supports the provision of a report of exempt distribution when a distribution is made relying on this exemption so as to gather information on the use of the exemption and to monitor compliance with it.

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), Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca) or Lindsay Speed at 416-214-3442 (lindsay.speed@faircanada.ca).

Sincerely,

Canadian Foundation for Advancement of Investor Rights