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Fondation canadienne *pour* l'avancement *des* droits *des* investisseurs

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British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
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Autorité des marchés financiers
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
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RE: CSA Consultation Paper 51-404 – Considerations for Reducing Regulatory Burden for Non-Investment Fund Reporting Issuers

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We are writing with regards to CSA Consultation Paper 51-404 – *Considerations for Reducing Regulatory Burden for Non-Investment Fund Reporting Issuers* ("Consultation Paper").[1] Our concerns relate to what

[1] CSA Consultation Paper 51-404 – Considerations for Reducing Regulatory Burden for Non-Investment Fund Reporting Issuers (6 April 2017) ["*Consultation Paper*"].

the term "regulatory burden" means for investors. In particular, reducing regulations may not be in investors' interests at all. This should be of concern to a regulatory body charged with protecting investors interests under securities law.

FAIR Canada is a national, charitable organization dedicated to putting investors first. As a voice for Canadian investors, FAIR Canada is committed to advocating for stronger investor protection in securities regulation. Visit www.faircanada.ca for more information.

1. Overview of Consultation Paper

1.1. The stated purpose of the Consultation Paper is "to identify and consider areas of securities legislation applicable to non-investment fund reporting issuers that could benefit from a reduction of undue regulatory burden, without compromising investor protection or the efficiency of the capital market."[2] According to the CSA, regulations must reflect the need of Canadian businesses to remain competitive.

1.2. The Consultation Paper sets out five potential changes which may reduce regulatory burdens for reporting issuers, namely (1) extending the application of streamlined rules to smaller reporting issuers; (2) reducing the regulatory burdens associated with the prospectus rules and offering process; (3) reducing ongoing disclosure requirements; (4) eliminating overlap in regulatory requirements; and (5) enhancing electronic delivery of documents.[3] These proposals focus on alleviating the regulatory burdens related to raising capital in the public markets, and the ongoing costs of continuous regulatory requirements, such as continuous disclosure.

2. What Does "Reducing the Regulatory Burden" Mean?

2.1. It is not clear from the Consultation Paper what precise goals will be achieved by the proposed initiatives. Specifically, what does reducing "regulatory burden" mean? Is the goal to increase efficiency for issuers (i.e. given that "efficiency" is a term appearing in the mandate of securities regulators)? Is it to consolidate financial information for investors? Is it to decrease disclosure obligations? More clarity regarding this ambiguous term is warranted.

2.2. Assuming that efficiency is the goal, it is still unclear what type of efficiency is sought. There are various conceptions of efficiency, including: informational efficiency; allocational efficiency; and, "Pareto optimality" or "Kaldor-Hicks" efficiency.[4] Informational efficiency refers to whether the market price of a security reflects all information relevant to its pricing and is thus increased with more disclosure requirements.[5] On the other hand, allocational efficiency, which refers to the

[2] *Ibid* at 2.
[3] *Ibid* at 3.
[4] Anita Anand, *Towards Effective Balance Between Investors and Issuers in Securities Regulation*, in Canada Steps Up (2006) at 18 [*Anand*].
[5] *Ibid at 29.* Also see Eugene Fama, "Random Walks in Stock Market Prices" (1995) 51 Financial Analysts Journal 75. According to Eugene Fama, "in an efficient market, at any point in time the actual price of a security will be a good estimate of its intrinsic value". Under this conception, some of the measures discussed in the Consultation Paper, specifically reduce disclosure requirements and would reduce informational efficiency.

"effectiveness with which a market channels capital to its highest, most productive uses"[6] may be increased by reduced disclosure requirements.[7] Pareto optimality introduces alternative considerations and considers whether a particular initiative will make citizens better off without making any one person worse off.[8] A variation of this concept, Kaldor-Hicks efficiency, considers whether citizens who benefit under a particular change can adequately compensate those who do not benefit from it.[9]

2.3. To assess whether regulatory initiatives result in a "better off" or "worse off" outcome, the costs and benefits of the initiatives should be weighed. It is unclear whether the proposed initiatives set out in the Consultation Paper would be Pareto optimal or Kaldor-Hicks efficient. Although it is not always easy or possible to predict the costs and benefits of a proposed initiative, the CSA should attempt to conduct a cost-benefit analysis to determine whether the proposed initiatives would result in an overall "better off" outcome for the capital markets as a whole (i.e. not just the issuer community).

2.4. These differing conceptions of efficiency show that "reducing regulatory burden" is ambiguous. Even if the purpose is to increase efficiency, further elaboration regarding "reducing regulatory burden" is needed.

2.5. The OSC recently echoed concerns for "regulatory burden" similar to that of the CSA. The OSC's latest Statement of Priorities outlined that "the global interconnectedness of markets and mobility of capital create a strong need for harmonization and coordination of regulation. However, the potential for increased protectionism and deregulation could inhibit global harmonization and create opportunities for regulatory arbitrage. In light of such developments, the OSC may face pressure from certain stakeholders to scale back areas of regulation making it increasingly important for the OSC to address concerns of regulatory burden."[10] This statement is not only vague, but fails to consider that reducing regulatory burden may well undermine investors' interests and the OSC's own mandate. In addition, the statement indicates that regulators may not appreciate that following possible deregulatory efforts south of the border could (i) undermine achievements made to improve our regulatory framework in light of the global financial crisis; (ii) be short lived and costly to deregulate and then re-regulate; and (iii) undermine confidence in our capital markets.[11]

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[6] *Anand, supra* note 4 at 31.

[7] In general, regulations reduce the ability of the market to allocate capital at low costs. Allocational efficiency is consistent with investor interests in the sense that investors will receive higher "market wide" returns when efficient capital allocation is operating properly. See *Anand, supra* note 4 at 31. According to Wallison and Smith, by reducing obstacles to capital flows, allocational efficiency promotes the country's economic growth. See Peter Wallison & Cameron Smith, "The Responsibility of the Securities and Exchange Commission for Efficiency, Competition and Capital Formation: Reforms for the First 1000 Days" (Paper presented to the Financial Services Roundtable, October 2005) [unpublished].

[8] *Anand, supra* note 4 at 32.

[9] Michael Trebilcock, *The Limits of Freedom of Contract* (Cambridge: Harvard University Press, 1993).

[10] OSC Notice 11-777 - Notice of Statement of Priorities for Financial Year to End March 31, 2018 (29 June 2017).

[11] See, for example Ben Protess and Julie Hirschfeld Davis, "Trump moves to Roll Back Obama-Era Financial Regulations", *New York Times* (February 3 2017), online: <https://www.nytimes.com/2017/02/03/business/dealbook/trump-congress-financial-regulations.html>. Many of the rules that the Trump administration is considering for change or deregulation are designed explicitly to protect investors and promote long term stability in the capital markets. If regulators like the OSC blindly follow the path of American deregulation, they will largely be removing rules designed explicitly to protect investors. Moreover, there is little bi-partisan consensus on these regulations, meaning that that re-regulation is likely once a change in leadership occurs.

2.6. The CSA has launched a related initiative to examine the investment fund disclosure regime in its Rationalization of Investment Fund Disclosure ("Project RID") initiative. Project RID "will review the existing disclosure requirements to identify potentially redundant or obsolete disclosures that should be reconsidered by the CSA."[12] This review will take place in 2017, with mid-2018 targeted for publication of proposed rule amendments. As the CSA engages in a review of investment fund disclosure, concerns set out in this comment letter will also be relevant. The CSA should keep these comments in mind – and in particular the need to ensure that investors are not disadvantaged with reforms aimed at reducing the regulatory burden – as it sets out any proposed changes.

2.7. We wish to note that the CSA has already implemented steps to reduce the burden on reporting issuers through recent reform initiatives. Specifically, the CSA has implemented new prospectus exemptions, modified existing exemptions and tailored disclosure requirements to alleviate regulatory burden for venture issuers.[13] These changes have reduced the regulatory burden imposed on reporting issuers. Before moving forward with any further reforms, we believe that the regulators should demonstrate with empirical evidence that these and further steps are beneficial for the capital markets - this includes investors as key stakeholders in the capital markets.

3. Why Should Smaller Firms be Subject to Less Regulation?

3.1. Advocates of reduced regulation suggest that undue regulatory burden is placed on small companies that bear proportionally higher regulatory costs because of economies of scale. Despite the common argument that a reduction in reporting requirements will make it easier for small companies to raise capital, there is limited empirical data establishing the benefits of this so-called "proportionate regulation". In fact, a 2016 study of TSX Venture Exchange firms suggests that the arguments made in favour of proportionate regulation are not relevant given the voluntary adoption of corporate governance mechanisms among small firms.[14] The study found that despite the exemption of venture issuers from the requirement that audit committees be financially literate and independent,[15] 88 percent of the audit committees examined

Canadian securities regulators should be leaders, not followers, when it comes to investor protection and ensuring capital market stability.

[12] OSC Bulletin Issue 40/26 (29 June 2017).

[13] CSA Staff Notice 45-314 – Updated List of Current Exempt Market Initiatives (28 January 2016) summarizes prospectus exemption initiatives and amendments from 2014 to 2016, including the existing security holder exemption (ESH Exemption), the rights offering prospectus exemption (Rights Offering Exemption), the investment dealer exemption (Investment Dealer Exemption), the crowdfunding exemption (Crowdfunding Exemption), the offering memorandum exemption (OM Exemption), and the friends, family and business associates exemption (FFBA Exemption); CSA Notice of Amendments to NI 51-102 Continuous Disclosure Obligations, NI 41-101 General Prospectus Requirements and NI 52-110 Audit Committees (9 April 2015) outlines the amendments made in 2015 to focus disclosure by venture issuers. It includes the implementation of the option of providing quarterly highlights, the use of a new tailored form of executive compensation disclosure and a reduction of historical financial data required in venture IPO prospectuses to two years.

[14] Anita I. Anand, Wayne Charles & Lynnette D. Purda, "Voluntary Corporate Governance, Proportionate Regulation and Small Firms: Evidence from Venture Issuers" (December 2016) Forthcoming December 2017 in Canadian Business Law Journal, online: <https://ssrn.com/abstract=2938690> [*Anand, Charles & Purda*].

[15] *Audit Committees*, OSC NI 52-110, 27 OSCB 3252 (March 26 2004).

maintained a majority of independent members and 85 percent maintained a majority of members who are financially literate. This study has limitations: it is based on a limited number of firms in the sample and generally the disclosure of firms on the Venture Exchange is more sparse than firms on the TSX.[16] Furthermore, if firms chose to comply because they viewed compliance as beneficial, this says nothing about the extent to which investors are protected – there is no guarantee that firms will continue to comply voluntarily.

3.2. A sized-based distinction, as is in place in the United States, should not be implemented in Canada. The Canadian market is substantially different from that of the U.S., primarily in terms of the number of small to medium size companies that go public and remain publicly listed. Implementing a size-based distinction would have an overall negative impact on Canadian capital markets as it will likely encourage practices to intentionally reduce a firm's size, its assets or market capitalization, which can be detrimental to both the firm and its shareholders.

3.3. The SEC's Division of Economic and Risk Analysis conducted a study on the SEC's proposed expansion of the definition of a "smaller reporting company"[17] and found that scaled disclosures are likely to have a negative effect on institutional ownership.[18] For sophisticated institutional investors who utilize the data in making investment decisions, the scaled disclosure requirements for smaller companies may make them less attractive and in turn, reduce the institutional investor demand for smaller companies.

4. Ongoing Disclosure Requirements Should not be Reduced

4.1. Venture issuers currently require only two years of financial statements and related analysis for a venture issuer IPO prospectus. It would be inappropriate to extend the two-year eligibility criteria for issuers that intend to become non-venture issuers. Even for small firms with pre-IPO revenues under a certain threshold, the historical data provided by additional years of disclosure are necessary and fundamental to provide an accurate and fair representation of the company. Investors should not be restrained from having a better understanding of their investment options.

4.2. Disclosure is an essential accountability mechanism to ensure that issuers are held responsible and stakeholders are well-informed. As such, we oppose the reduced disclosure requirements mentioned in part 2.3 of the Consultation Paper. Reducing disclosure requirements would undermine the interests of investors and may allow the more egregious of companies to avoid

[16] *Anand, Charles & Purda, supra* note 14 at 22.
[17] As part of the SEC's Disclosure Effectiveness Initiative, on June 27, 2016, the SEC proposed redefining "smaller reporting company" in Item 10(f) of Regulation S-K and other Commission rules in order to expand the number of registrants that would fall under it. See Amendments to Smaller Reporting Company Definition, Release No. 33-10107 (27 June 2016), online: <https://www.sec.gov/rules/proposed/2016/33-10107.pdf>; The SEC's Disclosure Effectiveness Initiative was mandated by the Fixing America's Surface Transportation Act (the "FAST Act") which was passed in December 2015. Section 72002 of the FAST Act directed the SEC to "further scale or eliminate requirements . . . to reduce the burden on emerging growth companies, accelerated filers, smaller reporting companies, and other smaller issuers, while still providing all material information to investors."
[18] Securities Act Release No. 10107, 81 Fed. Reg. 43130 (July 1, 2016) at 43144, online: <https://www.gpo.gov/fdsys/pkg/FR-2016-07-01/pdf/2016-15674.pdf>.

regulatory oversight. The CSA states three objectives of securities regulation: investor protection, promoting fair, efficient and transparent markets, and reducing systemic risk.[19] Disclosure keeps investors adequately informed about their investments, and prevents inaccurate financial reporting through transparency requirements. Disclosure is critical to the maintenance of public accountability.

4.3. The CSA should also not change its current quarterly reporting requirement to semi-annual. Semi-annual reporting has been previously considered and rightfully abandoned by the CSA.[20] Quarterly reporting provides greater transparency about the reporting issuers and any changes to its operations. Advocates of semi-annual reporting suggest that it eliminates "quarterly earnings hysteria" and allows companies to focus on long-term value instead of the short-term.[21] These arguments fail to note that investors range from short-term to long-term and have different information needs. While semi-annual highlights may be sufficient for some investors, it will be insufficient and disadvantageous for others. Quarterly reports better protect investor interests by addressing the information needs of a range of investors.

4.4. In short, the current regulatory and disclosure requirements play an important role in adequately informing the market. While we do not favour reducing regulation generally, consolidating financial information, such as MD&A, financial statements and AIF, is a useful recommendation and would benefit investors. Consolidation should occur to the extent that only overlap in the disclosure requirements is eliminated or reduced. In so doing, issuers would benefit from the reduction of redundant document production, while investors would still be provided with the same disclosure information. Changes such as the modification of the MD&A and the AIF, which both discuss the risks associated with the reporting issuer, would be reasonable and advantageous.

4.5. In addition, improving the effectiveness of existing disclosure by making more salient existing information – for example, by requiring issuers to identify their key 3 to 5 risks upfront, while disclosing all material risks as required, may benefit investors. Retail investors generally lack the ability to shift through technical and complicated documents.[22] Moreover, the poorest Canadians are the ones who typically possess the least financial knowledge.[23] Rather than reducing the amount of disclosure given to investors, regulators should be improving the quality and accessibility of these documents to ensure that all Canadians can meaningfully engage with the material. Failing to do so will leave the most vulnerable investors at risk.

<u>Electronic Delivery:</u>

[19] Canadian Securities Administrators, "Our Mission", (2009) online: <https://www.securities-administrators.ca/our-mission.aspx>.
[20] The implementation of semi-annual reporting to quarterly reporting was proposed in NI 51-103, but the CSA ultimately chose not to implement the change in reporting requirement amidst numerous concerns raised by commenters.
[21] Paul Amirault, Thierry Dorval et al, "It's time to end quarterly reporting" (April 2017), Norton Rose Fullbright, online: <http://www.nortonrosefulbright.com/knowledge/publications/148630/its-time-to-end-quarterly-reporting>.
[22] Canada, The Task Force to Modernize Securities Legislation in Canada, *Canada Step Up*, Vol 1 (Toronto: October 2006) at 56.
[23] Innovation Research Group, Inc. "2012 CSA Investor Index", (16 October 2012), *Canadian Securities Administrators,* online: <www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL_EN.pdf>.

4.6. We do not think that it is appropriate to satisfy delivery requirements by making documents available electronically without prior notice or consent. At this time, FAIR Canada does not agree that access should equal delivery. If an electronic notice is sent to investors, a specific link to the relevant documents should be provided because simply making a document available on SEDAR is not sufficient. Investors will find it difficult to locate documents on SEDAR, and from behavioral economics, we know that fewer investors will review a document, if it is not delivered to them (either physically or electronically through a pdf or link).[24]

4.7. More broadly, in response to consultation question 33, FAIR Canada finds that some regulatory documents that are required to be delivered, such as Fund Facts and Plan Summaries for Group Scholarship Plans, are difficult to find on the fund manufacturer or group scholarship plan dealer's website. Mandating where these documents are required to be found on a provider's website would improve investor protection.

4.8. The Fund Facts document has also been permitted to be delivered by linking to a document containing numerous fund fact documents of the manufacturer – but it is extremely difficult for the individual retail investor to determine which fund facts document is relevant to their proposed purchase or existing holding. Therefore, the effectiveness of disclosure (electronic or otherwise) may be increased by introducing additional requirements rather than lessening them.

5. More Empirical Study Needed

5.1. In light of the CSA's acknowledgement that investor protection should not be compromised in implementing the proposed changes set out in the Consultation Paper,[25] we advocate further study on the impacts of any proposed deregulation on investors. As noted, limited empirical work currently exists. More research should be undertaken to determine whether any proposed initiatives would impact stakeholders including investors.

5.2. In the U.S., a similar initiative to reduce regulatory burden was commenced by the SEC's Disclosure Effectiveness Initiative.[26] The Office of the Investor Advocate ("OIA") has raised concerns that many of the proposed changes "appear to pit the informational needs of investors against the costs and burdens to the companies who provide the disclosure".[27] The OIA stressed

[24] Canadian Foundation for Advancement of Investor Rights, "Re: CSA Notice and Request for Comments regarding Proposed Streamlined Prospectus Exemption for Rights Offering (the "Notice")" (February 25 2015), *FAIR Canada*, online: <faircanada.ca/wp-content/uploads/2011/01/150225-final-FAIR-Canada-Comments-re-Rights-offerings.pdf> at 5.
[25] *Consultation Paper, supra* note 1 at 2.
[26] Following a study of disclosure requirements under Regulation S-K which was mandated by the JOBS Act, the SEC undertook a Disclosure Effectiveness initiative to review and modernize public company reporting requirements, specifically in regards to Regulation S-K (which outlines reporting requirements for SEC filings for public companies) and Regulation S-X (which outlines form and content requirements for financial statements). This initiative is ongoing and considers whether "existing disclosure requirements should be modified or eliminated, whether new disclosure requirements should be created, and whether disclosures could be presented and provided more effectively". See SEC, *Report on Modernization and Simplification of Regulation S-K* (23 November 2016) at 1, online: SEC <https://www.sec.gov/files/sec-fast-act-report-2016.pdf >.
[27] Office of the Investor Advocate, *Report on Activities Fiscal Year 2016* at 11, online: <https://www.sec.gov/advocate/reportspubs/annual-reports/sec-investor-advocate-report-on-activities-2016.pdf>.

the importance of maintaining investor protection if regulatory burden is to be reduced.[28] It noted that in regards to proposed deregulation in the U.S., Congress should "resist the temptation to mandate or pressure the SEC to adopt reforms where the available evidence is inconclusive."[29]

5.3. Similarly, in Canada, until further study is conducted regarding the impact of deregulation on investors, the CSA should not move forward with the proposed initiatives. Investors benefit from transparency and accountability, so it would be counterintuitive to assume that reduced disclosure will not harm them to some degree. In a speech on November 9, 2016, Investor Advocate Rick Fleming stated that as the SEC's Disclosure Effectiveness initiative "moves forward, the Commission should focus, first and foremost, on meeting the informational needs of investors."[30] We suggest that a similar focus is needed here.

6. Conclusion

6.1. The very purpose of securities regulation is to ensure investor protection and market efficiency. Loosening regulations in the manner proposed may undermine these objectives. As recognized in the Consultation Paper, the burden of compliance must be balanced against "the significance of the regulatory objectives sought to be realized and the value provided by such regulatory requirements to investors and other stakeholders."[31] Before the CSA moves forward with any initiatives to reduce regulatory burden, empirical evidence that investors will not be negatively impacted is necessary. At present, the Consultation Paper is equivocal about whether suggested reforms to reduce the regulatory burden will negatively impact investor protection.

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 Anita Anand at anita.anand@utoronto.ca or Marian Passmore at 416-214-3441/marian.passsmore@faircanada.ca.

Yours Truly,

Anita Anand on behalf of FAIR Canada

[28] Office of the Investor Advocate, *Report on Objectives Fiscal Year 2018* (21 April 2017) at 7, online: <https://www.sec.gov/advocate/reportspubs/annual-reports/sec-office-investor-advocate-report-on-objectives-fy2017.pdf>.
[29] *Ibid* at 2.
[30] Rick A. Fleming, SEC Investor Advocate, Speech at NASAA Corporation Finance Training: Moving Forward with the Commission's Disclosure Effectiveness Initiative (19 November 2016), online: <https://www.sec.gov/news/speech/moving-forward-with-the-disclosure-effectiveness-initiative.html#_edn3>.
[31] *Consultation Paper, supra* note 1 at 2.