The Law Page

REGULATION

Growing 'exempt market' draws scrutiny

Sector that makes it easier for startups to raise capital from sophisticated investors has also been used by fraudsters

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As Canada's securities watchdogs review the rules that govern what's known as the "exempt market," the industry is pushing for softer regulations despite concerns the sector is responsible for more than its fair share of fraud.

The exempt market is supposed to allow certain sophisticated investors with large amounts of money and a high tolerance for risk to invest without the benefit of a prospectus, the information document investors are normally required by law to receive.

Both supporters and critics of the exempt market say it is an important way for small businesses and startups to secure access to capital without the expense of a formal listing on a stock exchange or a full prospectus.

But the exempt market also suffers from abuse, with fraudsters twisting its rules to sell dodgy or unsuitable investments to regular people – "retail investors" – with little investment experience.

"There doesn't seem to be a culture of compliance regarding these particular rules, and that's something that really needs to be changed," said Ilana Singer, a lawyer and deputy director of the Canadian Foundation for Advancement of Investor Rights (FAIR Canada), which has called for tightening the current rules.

The exempt market has grown enormously, with $86.5-billion raised in Ontario alone in 2011, up from $78.6-billion the year before, with observers blaming the tightening of the credit markets for pushing small companies to seek other sources of funding.

In June, the Ontario Securities Commission announced a review to determine whether it should try to broaden investor participation in the exempt market.

The move came following another review launched by the Canadian Securities Administrators, the umbrella group for Canada's market watchdogs, on two key exempt-market rules that determine who is eligible to purchase securities without a prospectus.

One rule allows investors who can put up a minimum of $150,000 to invest in exempt securities. The other opens exempt securities to "accredited investors," as defined by their total assets and income. For example, investors who have at least $1-million in assets, not including their home, or have a net income of at least $200,000, would qualify.

Ms. Singer said it does not necessarily follow that an investor with $150,000 is "sophisticated," or could handle a catastrophic loss. The amount has not been changed since 1987. She said she would prefer to see this category scrapped altogether, or at least indexed to inflation and limited to no more than 5 per cent of an investor's portfolio.

FAIR would also like to see the accredited investor rules rewritten, applying criteria meant to determine if the investor has enough experience in the markets to handle the risk.

In its submission to the OSC, FAIR lists a series of recent cases involving the exempt market. In several, the OSC found that investors who did not qualify (including, in one case, unemployed investors) were sold exempt securities anyway. In one case, investors who were not eligible were told the declarations they were signing to the contrary were "for decoration" or a "formality."

Those who sell exempt securities for a living say they agree that regulators need to catch fraudsters, but argue the rules should be loosened to boost investment and help the economy.

Ontario's regime is already more restrictive than those in the other provinces, where certain investors can put up to $10,000 into exempt securities provided they see an "offering memorandum."

Craig Skauge, a Calgary-based consultant who heads the Western Exempt Market Association, has launched a campaign to have this exemption adopted in Ontario. He argues that the exempt market is the only way some entrepreneurs can raise capital.

"The fact is, brokers won't talk to you unless you want to raise $25-million," he said.

Brian Koscak, a lawyer with Cassels Brock & Blackwell LLP in Toronto and chairman of the Exempt Market Dealers Association of Canada, said the U.S. Jumpstart Our Business Startups (JOBS) Act, makes it easier for U.S. startups to raise capital and even allows for online "crowd funding."

Canadian regulators need to keep up, he argues, while striking a balance between fighting fraud and encouraging investment.

"There's only so many things [regulators] can do to protect investors," Mr. Koscak said. "At the end, investors need to protect themselves."

FAIR Canada's Ilana Singer says the market lacks a 'culture of compliance.' JENNIFER ROBERTS FOR THE GLOBE AND MAIL

LEXPERT

In the wake of rapid economic and social reforms in Myanmar – including this spring's parliamentary election of opposition figure Aung San Suu Kyi – Ottawa is preparing to open its first embassy in the developing country, and send a trade mission there next month.

In addition, Myanmar has retained Heenan Blaikie LLP's former chair of international business law, Douglas Robertson, to help write two pieces of reform legislation: a competition law and a consumer-protection law.

Lexpert contributor Sandra Rubin reports on international business law at www.lexpert.ca.