



Canadian Foundation *for*  
Advancement of Investor Rights

June 3, 2013

The Secretary  
Ontario Securities Commission  
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Sent via e-mail to: [comments@osc.gov.on.ca](mailto:comments@osc.gov.on.ca)

**RE: Ontario Securities Commission Notice 11-768 - Statement of Priorities**

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FAIR Canada is pleased to offer comments on the Ontario Securities Commission (“**OSC**”) Notice 11-768 – Statement of Priorities for Financial Year to End March 31, 2014 (dated April 4, 2013) (the “**Draft Statement**”).

FAIR Canada is a national, non-profit 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](http://www.faircanada.ca) for more information.

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**EXECUTIVE SUMMARY:**

1. FAIR Canada is very supportive of the overall direction of the OSC’s Draft Statement. We are encouraged by the focus on investor protection, the OSC’s dedication to keeping pace with national and international market developments, and its willingness to evolve in order to be an efficient and effective regulator.
2. We commend the OSC for its creation of the Office of the Investor and we encourage the OSC to continue its efforts to reach out to investors.
3. We are also very supportive of the commitment by the Canadian Securities Administrators (“**CSA**”), including the OSC, to support independent dispute resolution for investment complaints. We believe that fair dispute resolution is an integral part of investor protection, and we applaud the CSA for its commitment to ensuring that Canadian financial consumers have access to an independent ombudservice.

**SUMMARY OF RECOMMENDATIONS:**

1. FAIR Canada suggests that the OSC provide more concrete success measures for several of its priorities. We do not believe that vague, subjective success measures will serve the OSC in its efforts to be transparent and accountable.
2. We urge the OSC to focus on the quality of capital formation rather than the amount of capital raised and increased accessibility. New potential prospectus exemptions must be measured against the fundamental objectives of securities regulation, the first of which is investor protection.
3. We encourage the OSC to publish the results of any research undertaken with respect to capital raising by SMEs or to give priority to such research if it has not sufficiently progressed to allow for more informed policy-making. We caution against the introduction of any new exemptions absent adequate data regarding the exempt market in Canada.
4. FAIR Canada urges the OSC to provide a regulatory framework for the exempt market that provides for strong investor protection and efficient markets.
5. FAIR Canada strongly recommends that the OSC not introduce an equity crowdfunding exemption nor an offering memorandum exemption, as neither have been demonstrated to meet an investor need, and we believe both would reduce investor protection and undermine investor confidence in the Ontario capital markets.
6. FAIR Canada recommends that the OSC add as a strategic priority the reform of the regulatory framework for EMDs. We recommend that the OSC consider a framework where EMDs that are performing investment dealer-like activities should be required to join IIROC and not be permitted to avoid SRO-level oversight.
7. FAIR Canada recommends a balanced approach to cost-benefit analysis in OSC rule proposals. We caution against a strict approach, and encourage regulators to consider the distribution of the costs and benefits of any regulatory proposal. We recommend that, where practical, the OSC seek to measure the costs and benefits of regulatory proposals and to report the results of analyses to the public, without being specifically bound by the conclusions of those analyses.
8. FAIR Canada suggests that during the OSC's "mystery shop" research sweep of advisors the OSC also consider whether advice that is considered to be "suitable" meets investing consumers' expectations of advice<sup>1</sup> and whether it instils investor confidence in the capital markets.

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<sup>1</sup> There is strong evidence of an expectation of advice that is in the client's best interest. See, for example, The Brondesbury Group, *Investor behaviour and beliefs: Advisor relationships and investor decision-making study*, a report prepared for the Investor Education Fund, 2012, at p.16, available at: <http://www.getsmarteraboutmoney.ca/en/research/Our-research/Documents/2012%20IEF%20Adviser%20relationships%20and%20investor%20decision-making%20study%20FINAL.pdf>

9. We recommend that in addition to publishing an initial assessment of the application of a best interest standard for advisers and dealers, the OSC publicize concrete steps it plans to take to move forward with this initiative, given the significant length of time it takes to make real, meaningful regulatory change.
10. FAIR Canada urges the OSC, together with the CSA, to do more than “advance the discussion of mutual fund fees”. Following the mutual fund fees roundtable, we would like to see the CSA, lead by the OSC, identify options and issue recommendations in order to make progress in this area.
11. FAIR Canada recommends that the existing and proposed prospectus exemptions need to be reviewed in light of the findings of the OSC’s compliance report on Exempt Market Dealers (“EMDs”) and Portfolio Managers (“PMs”)<sup>2</sup>. Moreover, we suggest a review of the lighter touch approach to the regulation of PMs and EMDs in order to adequately protect investors. We urge the OSC to initiate a consultation on reform of the regulatory framework for EMDs and PMs.
12. We recommend that the OSC consider the capacity of its compliance and enforcement departments prior to any consideration of broadening available prospectus exemptions.
13. FAIR Canada urges the OSC to give priority to a whistleblower program so that it can gain valuable information that it may not otherwise obtain and in order to aid in carrying out its mandate to protect investors and foster confidence in our capital markets.
14. We also recommend that regulators consider introducing rules that require all registrants to report potential serious misconduct by other registrants.
15. FAIR Canada urges the OSC to give priority to initiatives aimed at preventing misleading advertising that encourages advisors to recommend and consumers to invest in products that will not deliver what is promised. In particular, advertising that promotes products as “tax efficient” and return of capital income funds that are not clear that the stated rates are not earnings but rather are distribution rates require regulatory intervention.
16. FAIR Canada also reiterates several comments we made on previous OSC draft Statement of Priorities, including:
  - a. a recommendation for mandatory compensation fund coverage, including issuance of a policy paper on the compensation fund gap;
  - b. the need for the appointment of Commissioners specifically responsible for representing the interests of retail investors;

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<sup>2</sup> OSC Staff Notice 33-740 – Report on the results of the 2012 targeted review of portfolio managers and exempt market dealers to assess compliance with the know-your-client, know-your-product and suitability obligations, available online at [http://www.osc.gov.on.ca/en/NewsEvents\\_nr\\_20130531\\_osc-33-740.htm](http://www.osc.gov.on.ca/en/NewsEvents_nr_20130531_osc-33-740.htm).

- c. a recommendation that the OSC commit to publishing a comprehensive response that addresses all of the recommendations made in the report by the Standing Committee on Government Agencies (“**SCOGA**”);<sup>3</sup>
- d. the need for the OSC to address inappropriate recommendations to borrow to invest (leverage), including improper relationships between dealer firms and financing companies. We recommend that CSA members, including the OSC, immediately preclude advisers and dealers from charging asset-based fees on monies that are borrowed for investment purposes and prohibit the acceptance of trailing commissions in respect of amounts invested using borrowed funds;
- e. a recommendation that the OSC closely review the propriety of continuing to permit group scholarship plans to be sold to Canadian consumers and consider introducing substantive regulation to address current abuses;
- f. extend fund facts to other investment products so that consumers have a summary document prior to sale;
- g. address within the final 2013-2014 Statement of Priorities the perception that the TSX falls below international standards with respect to the separation of its regulatory and commercial activities and make it a priority to ensure that the TSX implements adequate safeguards; and
- h. there is a real need for a single, comprehensive tool that would allow investors to check the securities regulatory background of a potential advisor or investment firm. FAIR Canada calls on the OSC, as a member of the CSA, to push for a user-friendly, one-stop tool where investors can access registration, disciplinary and background information (including proficiency and SRO membership) regarding advisers, dealers and their respective registered persons.

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## 1. **General Comments**

- 1.1. FAIR Canada is very supportive of the overall direction of the OSC’s Draft Statement. We are encouraged by the focus on investor protection, the OSC’s dedication to keeping pace with national and international market developments, and its willingness to evolve in order to be an efficient and effective regulator.
- 1.2. We commend the OSC for its creation of the Office of the Investor and we encourage the OSC to continue its efforts to reach out to investors.
- 1.3. We are also very support of the commitment by the CSA, including the OSC, to support independent dispute resolution for investment complaints. We believe that fair dispute

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<sup>3</sup> Standing Committee on Government Agencies, “Report on Agencies, Boards and Commissions: Ontario Securities Commission” (March 2010), online: <[http://www.ontla.on.ca/committee-proceedings/committee-reports/files\\_pdf/OSC%20Report%20English.pdf](http://www.ontla.on.ca/committee-proceedings/committee-reports/files_pdf/OSC%20Report%20English.pdf)>.

resolution is an integral part of investor protection, and we applaud the CSA for its commitment to ensuring that Canadian financial consumers have access to an independent, national ombudservice for investment complaints.

- 1.4. FAIR Canada is supportive of the OSC's intention to "demonstrate improved accountability through more detailed... performance reporting against its priorities." We believe that the OSC is striving to improve its accountability and we look forward to its imminent publication of a report on its progress against its 2012-2013 priorities.
- 1.5. We note our concern regarding some ambiguity in the success measures provided in the Draft Statement. For example, how will the OSC measure whether proposals "reflect a better understanding" of investor issues? Compared to what? This appears to be a subjective measurement. Similarly, measures of proposals being "advanced" or moved forward and measures that the OSC "better understand the risks" are vague. We suggest that the OSC provide more concrete success measures for several of its priorities.

## 2. **OSC Proposed Issue/Priority 5 - Capital Markets Accessibility**

- 2.1. FAIR Canada believes that the OSC should focus on the **quality of capital formation** given its mandate "to foster fair and efficient capital markets and confidence in capital markets" and must assess the quality or efficiency of the market (including the exempt market) rather than the amount of capital raised or increased accessibility.

### **Focus on Objectives and Principles of Securities Regulation When Regulating the Exempt Market**

- 2.2. The three Objectives of securities regulation as set out by the International Organization of Securities Commissions in its June 2010 "Objectives and Principles of Securities Regulation" are:
  - protecting investors;
  - ensuring that markets are fair, efficient and transparent; and
  - reducing systemic risk.
- 2.3. Similarly, the *Securities Act* (Ontario) provides: "The purposes of this Act are, (a) to provide protection to investors from unfair, improper or fraudulent practices; and (b) to foster fair and efficient capital markets and confidence in capital markets."<sup>4</sup>
- 2.4. Any new potential exemption, such as crowdfunding and the Offering Memorandum ("OM") exemption, should be assessed against these fundamental objectives. We do not believe that a fundamental objective of securities regulation includes increasing access to investment opportunities for investors. **What should concern securities regulators is not whether something is "accessible" to everyone or "democratic" but whether it is designed so that the market is efficient and investors are adequately protected.**

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<sup>4</sup> R.S.O. 1990, c. S.5, s. 1.1.

**Make Informed Policy-Making Decisions Through Research and Empirical Data**

- 2.5. The OSC has not cited any information on the costs for small and medium enterprises (“SMEs”) to access capital through the existing avenues that are available to them (such as a traditional IPO, debt financing, traditional bank loans, angel investors or otherwise) in OSC Staff Consultation Paper 45-710 – Considerations for New Capital Raising Prospectus Exemptions (the “**Exempt Market Review**”). **There is a lack of empirical data of the effects of regulatory constraints on the ability of SMEs to raise capital in a timely and efficient manner.** This impedes the quality of the policy-making process.
- 2.6. The OSC’s previous Statement of Priorities for the Year ended March 2013 stated that the OSC would “[u]ndertake comparative research on capital raising regimes in other jurisdictions, including gathering economic data focussing specifically on approaches to raising capital for start-up and small businesses. This work will include consultation with issuers, investors, dealers, academics and others” and would “[e]xpand its research and data analysis capabilities to adopt a data-based approach to identifying issues, decision making and policy development.”
- 2.7. **We urge the OSC to publish the results of any research undertaken with respect to capital raising by SMEs or to give priority to such research if it has not sufficiently progressed to allow for more informed policy-making.** The publication of such information would be consistent with the OSC’s Strategy 1 in its 2012-2015 Strategic Plan which set out that there would be an increased focus on data to support OSC policy initiatives. It would also be consistent with its goal to be a modern, accountable and efficient organization by increasing its reliance on data and analysis in undertaking its work (Priority 11 of the Draft Statement).
- 2.8. The only comparative information provided in the Exempt Market Review was a comparison of the JOBS Act crowdfunding rule with the OSC concept proposal for crowdfunding. The JOBS Act is the product of political pressure to find ways to deal with a struggling U.S. economy. The U.S. Securities and Exchange Commission (“**SEC**”) is now left with the enormously difficult task of drafting rules that will adequately protect investors (if this is in fact possible) while allowing equity crowdfunding to proceed. FAIR Canada believes that the OSC’s proposed crowdfunding concept results in too large a degree of informational asymmetry, too great a risk of fraud and investor harm and, therefore, will not result in efficient markets nor the desired benefits that its proponents argue it will achieve. We expect that, instead, it will undermine investor confidence in the Canadian capital markets.
- 2.9. **We do not believe that Canadian securities regulators have adequate data regarding the exempt market in Canada from which to make informed decisions on new exemptions, including crowdfunding.** While the total size of the exempt market (\$87 billion) is mentioned frequently in any discussion of the exempt market, what is not known is how much of the exempt market involves the individual accredited or retail investor, let alone how they have fared. Whilst \$28 billion of the capital raised in Ontario was channelled to non-reporting, non-investment fund, private companies, it is not

known how much of the \$28 billion was raised by SMEs nor how much of that raised by non-reporting issuers was from individual accredited investors as opposed to institutional investors and permitted clients. How much of the capital raised from accredited individual investors was misappropriated through fraud or other wrongdoing?

- 2.10. Priority 11 of the Draft Statement (greater reliance on data and analysis to support the OSC's work) has, as a measurement of success, the visible use of data to support regulatory changes to the exempt market. We support the generation of the much needed data, mentioned above, to inform the policy-making process. The data should be utilized to determine whether regulatory changes to the exempt market are desirable rather than support policy-decisions that have already been arrived at but need some empirical justification. We are concerned about the OSC's success measure 2 under Priority 11 "[v]isible use of data to support regulatory changes to the exempt market", which presupposes that changes are needed. We have not seen any persuasive evidence that regulatory changes are warranted at this time.
- 2.11. As Ontario's securities regulator, the OSC has a responsibility to collect information that is needed in order to make more informed policy-making decisions. Much information exists but is not publically available or may only be purchased at substantial prices. This disadvantages financial consumers and consumer advocates who do not have the financial resources to obtain the information. We encourage governments and regulators to collect information and make it publically available so that knowledge is increased and more informed policy-making can result.
- 2.12. We are aware that an empirical study of 1,500 investors has been conducted to obtain their views regarding crowdfunding. We look forward with interest to reviewing the results of that study.
- 2.13. FAIR Canada has referenced several academic studies and bodies of research in its submission on the Exempt Market Review, which we believe should help inform the policy-making process. The studies referenced do not support the further relaxation of securities regulations to allow more financing of unregulated SMEs by retail investors given their inability to accurately appraise the correct price of the securities offered, deal with the high level of information asymmetry in the market, and their tendency to exhibit a preference for positive skewness when investing in SMEs, where they seek outsized returns or lottery-style earnings.
- 2.14. FAIR Canada urges the OSC to provide a regulatory framework for the exempt market which provides for strong investor protection and efficient markets. Such a regulatory framework will facilitate true (i.e. quality) capital formation, resulting in a lower cost of capital and increased confidence in our markets.
- 2.15. FAIR Canada strongly recommends that the OSC not introduce an equity crowdfunding exemption nor an offering memorandum exemption, as neither have been demonstrated to meet an investor need, and we believe both would reduce investor protection and undermine investor confidence in the Ontario capital markets.

### 3. OSC Proposed Issue/Priority 11 – Improved Cost-benefit Analysis in OSC Rule Proposals

- 3.1. FAIR Canada appreciates the OSC's desire to increase its reliance on data and analysis in undertaking its work. We believe that the more information the OSC has the better able it will be to make informed, responsive policy and to fulfill its purposes to protect investors and foster fair and efficient markets.<sup>5</sup>
- 3.2. **FAIR Canada suggests that a full cost-benefit analysis may not be appropriate in the circumstances of some regulatory proposals. Extensive cost-benefit testing is time-consuming, imprecise, and “[i]t is very common in [regulatory impact analysis] to find that important benefits and costs cannot be quantified.”**<sup>6</sup> In short, costs and benefits are difficult to measure, data is scarce (and often not available to consumers) and studies are open to critique as a result of them being commissioned by industry lobby groups. While the Organisation for Economic Co-operation and Development's (“OECD”) handbook suggests that “partial” cost-benefit analysis in these circumstances can narrow “the range of issues that must be dealt with through more subjective, qualitative analysis”<sup>7</sup> we emphasize that a cost-benefit analysis is not a panacea for the evaluation OSC rule proposals. FAIR Canada is concerned that cost-benefit analyses may stall regulatory proposals where a timely regulatory response is necessary to protect investors. In our view, reform already takes far too long to be adopted and implemented. As it stands, investor-focused initiatives that would be of real benefit to investors often elicit delay tactics by some members of industry to hinder progress given that the initiatives may affect their profitability. The point of sale initiative is an example of how industry can successfully delay implementation of an investor-focused initiative, with delivery of the Fund Facts document still not yet in investors' hands prior to the sale of a mutual fund.
- 3.3. We also note that, according to the OECD, “it may be appropriate to proceed with regulation even though the costs appear to be greater than the benefits – this may occur if most benefits are gained by the target group.”<sup>8</sup> We note that much of the intended benefit of securities regulation will accrue to less-sophisticated, vulnerable consumers while many of the costs will primarily affect members of the investment industry (although some of these costs may be passed on to consumers), and, therefore, it is important not to simply determine whether the benefits outweigh the costs. **Consideration must be given to the distribution of the costs and benefits of any regulatory proposal.**
- 3.4. The final of the six principles the OSC is to consider in pursuing the principles of the *Securities Act* (Ontario) is “[b]usiness and regulatory costs and other restrictions on the

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<sup>5</sup> Securities Act, R.S.O. 1990, c. S.5 at s. 1.1.

<sup>6</sup> Organisation for Economic Co-operation and Development, “Introductory Handbook for Undertaking Regulatory Impact Analysis (RIA)” (Version 1 – October 2008), online: <<http://www.oecd.org/gov/regulatory-policy/44789472.pdf>> at page 10.

<sup>7</sup> *Ibid.*

<sup>8</sup> *Supra* note 6 at page 7.



business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought to be realized.”<sup>9</sup> This does not dictate that benefits must outweigh costs; it simply requires that they be proportionate.

- 3.5. **Given that the costs of securities regulation are much more readily quantifiable than the benefits, there is a real risk that a strict approach to attempting to ensure that regulation is only made when the benefits of the regulation are larger than the costs it imposes may result in policy that does not provide an adequate level of investor protection. Given that the OSC’s *primary purpose* is to protect investors and to foster fair and efficient markets, and that the principle the OSC is to *consider* is that the costs should be proportionate to (not necessarily outweighed by) the regulatory objectives sought, we recommend a balanced approach to cost-benefit analysis in OSC rule proposals.**
- 3.6. We recommend that, where practical, the OSC seek to measure the costs and benefits of regulatory proposals and to report the results of analyses to the public, without being specifically bound by the conclusions of those analyses.

#### **4. A Best Interest Standard and Mutual Fund Fees**

- 4.1. FAIR Canada believes that the OSC and the CSA must commit to moving the best interest standard and mutual fund fees initiatives forward promptly for the benefit of Canadian financial consumers. The Canadian public has waited too long already for meaningful investor protection in these areas. In order to be an effective and responsive regulator, the OSC must push for real and timely progress on these initiatives. We believe that delay could be fatal to either of these initiatives.

##### **“Mystery Shop”**

- 4.2. FAIR Canada fully supports the OSC’s proposed action to conduct a “mystery shop” research sweep of advisors to gauge the suitability of advice currently being provided and identify areas of concern and assist in targeting future OSC suitability sweeps.
- 4.3. We suggest that during this research, the OSC also consider whether advice that is considered to be “suitable” meets investing consumers’ expectations of advice<sup>10</sup> and whether it instils investor confidence in the capital markets.

##### **Best Interest Standard**

- 4.4. FAIR Canada supports the OSC’s proposed action to “publish an initial assessment of the application of a best interest standard for advisers and dealers (including a regulatory impact analysis)”. FAIR Canada encourages the OSC to go further and make real progress on this investor-focused initiative. We recommend that in addition to an initial assessment, the OSC publicize concrete steps it plans to take to move forward with this

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<sup>9</sup> R.S.O. 1990, c. S.5 at s. 2.1.

<sup>10</sup> *Supra* note 1.

initiative, given the significant length of time it takes to make real, meaningful regulatory change.

- 4.5. FAIR Canada is concerned about language in the Draft Statement, in reference to the statutory best interest standard, that states “[t]his is a complex issue that requires careful consideration in order to protect investors while recognizing challenges to the current business models of market participants.” Nowhere in the OSC’s vision, mandate or organizational goals is there any reference to accommodation of the current business models of market participants. The question posed is whether or not there is a need for a best interest duty, and we believe that the investor research undertaken to date resoundingly supports the introduction of such a standard. **Investor protection should not be sacrificed to protect entrenched, outdated business models that do not serve the interests of Canadian consumers.**
- 4.6. We suggested that concrete steps, or at least recommendations, be included as a success measure for Priority 2 Issue (Expectation Gap).

#### **Mutual Fund Fees**

- 4.7. FAIR Canada is supportive of regulatory change in respect of mutual fund fees. We urge the OSC, together with the CSA, to do more than “advance the discussion of mutual fund fees”. We are pleased that the mutual fund fee roundtable has been scheduled, and believe that this will advance the discussion. Following the roundtable, we would like to see the CSA, lead by the OSC, identify options and issue recommendations in order to make progress in this area. Before issuing a progress update, we encourage the OSC, together with the CSA, to make real progress on this initiative in the interests of investor protection.

### **5. Deliver Effective Compliance and Enforcement**

- 5.1. FAIR Canada supports the OSC’s desire to “continue to focus on the need to promote improved, proactive compliance and credible deterrence, and to take effective enforcement action where warranted. The OSC will protect the interests of investors by taking action against firms and individuals who do not comply with Ontario securities law and/or act in a manner contrary to the public interest.”

#### **Widespread Non-Compliance in the Exempt Market**

- 5.2. **Widespread non-compliance with the rules in the exempt market and a perception of weak oversight harm investors and weaken confidence in the capital markets.** Numerous CSA-member notices and reviews indicate a high level of non-compliance with the OM exemption in the participating jurisdictions.<sup>11</sup> In addition, significant non-

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<sup>11</sup> For example, Saskatchewan’s Financial Services Commission Securities Division’s (now the Financial and Consumer Affairs Authority, the “Saskatchewan Authority”) 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**.” [emphasis added]. Saskatchewan Financial Services

compliance by EMDs has been noted by regulators. The OSC's review of EMDs uncovered a number of serious deficiencies and led to a sweep of over 85 EMDs and PMs. The compliance sweep has found significant deficiencies of EMDs including:

- non-compliance with the accredited investor exemption (18% of EMDs reviewed sold securities to clients who were non-accredited investors);
- inadequate suitability assessments due to inadequate documentation on how suitability determination made (22% of EMDs);
- encouraging non-accredited investors to invest in a single product in reliance of the \$150,000 minimum amount prospectus exemption resulting in over-concentration of clients' assets in a single exempt product (15% of EMDs reviewed);
- misuse of a client-directed trade instruction (2%);
- inadequate relationship disclosure information (45%);
- no or inadequate policies and procedures (45%); and
- inadequate processes for the collection, documentation and maintenance of KYC information (75%).

The compliance report also found the following significant deficiencies of PMs including:

- inadequate suitability assessments (5%);
- inadequate relationship disclosure information (45%); and
- inadequate processes for the collection, documentation and maintenance of KYC information (70% of PMs reviewed).<sup>12</sup>

5.3. The OSC's compliance report indicates that 3% of the firms reviewed discontinued their operations as a result of the review, 2% are subject to further regulatory action, 62% were issued deficiency reports where more than 30% of the identified deficiencies were considered "significant deficiencies" and all require enhanced compliance.<sup>13</sup>

5.4. FAIR Canada recommends that the existing and proposed prospectus exemptions need to be reviewed in light of the findings of the OSC's compliance report. Moreover, we suggest a review of the lighter touch approach to the regulation of PMs and EMDs (discussed below at 5.10) in order to adequately protect investors.

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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. See also 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.

<sup>12</sup> OSC Staff Notice 33-740 – Report on the results of the 2012 targeted review of portfolio managers and exempt market dealers to assess compliance with the know-your-client, know-your-product and suitability obligations, May 30, 2013, available online at [http://www.osc.gov.on.ca/en/NewsEvents\\_nr\\_20130531\\_osc-33-740.htm](http://www.osc.gov.on.ca/en/NewsEvents_nr_20130531_osc-33-740.htm).

<sup>13</sup> OSC Staff Notice 33-740 at page 8.

- 5.5. FAIR Canada urges the OSC to take a multi-faceted approach utilizing compliance and enforcement tools along with regulatory reform of EMDs and PMs in order to ensure adequate investor protection.
- 5.6. **When designing any new exemptions, there must be adequate assurance that the rules will be adhered to and regulators must have the resources to supervise and police compliance. Otherwise, regulatory requirements simply provide the illusion of investor protection.**

**Inadequate Resources for Effective Oversight and Enforcement of Expanded Exempt Market**

- 5.7. **Given the low levels of compliance by registrants and issuers in the exempt market, and given the limited resources available at the OSC, FAIR Canada questions the OSC's ability to ensure adequate compliance with the rules should it broaden the available exemptions.** The current risk-based approach to compliance oversight will result in the new "high risk" firms being reviewed while those that would previously have been high risk may no longer be captured in this category. With the same level of resources but a greater number of exemptions and greater number of financial consumers to whom to market and sell exempt products, the risk of mis-selling increases as does the potential for investor harm.
- 5.8. Regulators must ensure adequate compliance and effective enforcement against those who do not comply; otherwise, the rules simply create the illusion that regulators have protected investors and confidence in our markets will decrease.

**2013 Ontario Budget – Increasing the Scope of OSC Compliance Reviews**

- 5.9. We note that the Ontario government's 2013 Ontario Budget states that the government plans to propose further changes to update the *Securities Act* (Ontario) by enhancing the OSC's toolkit for regulating Ontario's capital markets through increasing the scope of OSC compliance reviews. We look forward to learning further details related to this item.

**Regulatory Framework for EMDs and PMs Needs Reform**

- 5.10. FAIR Canada recommends that the OSC add as a strategic priority the reform of the regulatory framework for EMDs and PMs, as the current framework is not providing adequate investor protection. Currently EMDs and PMs are subject to lighter regulation, less oversight and do not form a scheme that provides compensation to investors in the event of insolvency. The OSC's compliance report documents widespread non-compliance with fundamental obligations owed by registrants to their clients. **We recommend that the OSC consider a framework where EMDs that are performing investment dealer-like activities should be required to join IIROC and not be permitted to avoid SRO-level oversight. We believe that this would result in better protection for investors, through closer supervision and heightened compliance requirements, as well as insolvency coverage through the Canadian Investor Protection Fund. We urge**

**the OSC to initiate a consultation on reform of the regulatory framework for EMDs and PMs.**

- 5.11. In order to adequately protect investors, reforming the regulatory framework for EMDs should take priority over broadening the exemptions that can be relied upon by issuers and EMDs. FAIR Canada believes that there will be a much greater risk of investor harm if exemptions are broadened without first ensuring a high rate of compliance with the rules.

**Early Detection of Illegal Securities-Related Activity**

- 5.12. FAIR Canada supports the goal of increasing the effectiveness of the OSC's enforcement processes, and in pursuing strategies that will increase the early detection of illegal securities-related activity. Early detection of illegal activity will reduce the amount of investor harm.
- 5.13. FAIR Canada provided comments in response to an OSC request for comments regarding proposed enforcement initiatives in December 2011 (the "**Enforcement Consultation**").<sup>14</sup> While FAIR Canada supported the OSC's goal of increasing its effectiveness in protecting the public interest, we expressed concerns about particular initiatives the OSC had proposed, particularly no-contest settlements.
- 5.14. The Enforcement Consultation indicated that staff had been examining the prospect of introducing a new whistleblower program and that staff would issue a separate staff notice inviting comment in the near future. **FAIR Canada urges the OSC to give priority to a whistleblower program** so that it can gain valuable information that it may not otherwise obtain and in order to aid in carrying out its mandate to protect investors and foster confidence in our capital markets. Such a program would also lead to more timely detection of wrongdoing and fraud. **We also recommend that regulators consider introducing rules that require all registrants to report potential serious misconduct by other registrants.**

**Restitution for Investors**

- 5.15. The OSC's 2011 – 2012 Statement of Priorities had as a priority "Work with the Ontario Government to explore a mechanism by which the OSC could award compensation to Ontario investors who suffer losses because of violations of the *Securities Act* (Ontario)"<sup>15</sup>. The OSC's Report on the Statement of Priorities for fiscal 2011-12 indicates that "[s]taff continue to work on methods to allocate funds to victims of securities violations in appropriate circumstances", however, there are no details provided as to what are the difficulties in obtaining the power to make restitution orders when there is

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<sup>14</sup> (2011) 34 OSCB 10720, Request for Comments on Proposed Enforcement Initiatives (October 21, 2011).

<sup>15</sup> Ontario Securities Commission, 2011 – 12 Statement of Priorities, online: <[http://www.osc.gov.on.ca/documents/en/Publications/sop\\_fiscal-2011-2012.pdf](http://www.osc.gov.on.ca/documents/en/Publications/sop_fiscal-2011-2012.pdf)>.

a violation of securities laws as recommended by the Standing Committee on Government Agencies' Report on the OSC<sup>16</sup> (the "SCOGA Report")<sup>17</sup>.

## 6. Market Environment and Risks to Investors

- 6.1. The market environment also poses concern for investors. As noted in the Draft Statement under "The Environment – Risks and Challenges", given the low interest rate environment, investors are searching for better returns: "The demand for yield may increase the potential for mis-selling, as investors may be drawn to securities that have a risk profile that may not be consistent with their investment goals, investment horizon or tolerance for risk and may prove to be unsuitable in a changing economic climate." Many financial consumers have also been found to have unrealistic return expectations.<sup>18</sup> The lack of compliance with suitability requirements by EMDs that has been documented coupled with the market environment in which many consumers may be tempted by the purported higher return and low levels of financial literacy, provides the conditions for unacceptable levels of investor harm.
- 6.2. FAIR Canada urges the OSC to give priority to initiatives aimed at preventing misleading advertising that encourages advisors to recommend and consumers to invest in products that will not deliver what is promised. In particular, advertising that promotes products as "tax efficient" and return of capital income funds that are not clear that the stated rates are not earnings but rather are distribution rates require regulatory intervention. A fine print "explanation" of misleading advertising is insufficient, in our view, to prevent investor harm. As stated in the April 2012 Investment Fund Practitioner: "...to the extent that investors may be assessing a fund's performance based on its distribution rates or yield, they may reach incorrect conclusions about their returns on these funds. The fund's distribution rate or yield is based on its distributions, rather than its earnings or performance."<sup>19</sup>
- 6.3. OSC Staff Notice 81-718, the 2012 Summary Report for Investment Fund Issuers<sup>20</sup> noted that reviews by OSC staff of marketing and advertising materials have resulted in investment fund managers:
- Removing certain ads that were brought to their attention
  - Materially changing their sales communications
  - Reviewing and revising their policies and procedures

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<sup>16</sup> *Supra* note 3 at page 22.

<sup>17</sup> *Ibid.* at page 24.

<sup>18</sup> Innovative Research Group, Inc., "2012 CSA Investor Index" (October 16, 2012), online: <[http://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL\\_EN.pdf](http://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL_EN.pdf)> at page 64.

<sup>19</sup> See <[http://www.osc.gov.on.ca/en/InvestmentFunds/ifunds\\_20120413\\_practitioner.htm](http://www.osc.gov.on.ca/en/InvestmentFunds/ifunds_20120413_practitioner.htm)>.

<sup>20</sup> OSC Staff Notice 81-718, 2012 Summary Report for Investment Fund Issuers, available online at [http://www.osc.gov.on.ca/documents/en/Securities-Category8/sn\\_20130124\\_81-718\\_summary-rpt-if-issuers-2012.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category8/sn_20130124_81-718_summary-rpt-if-issuers-2012.pdf).

- Re-training their staff involved in producing and approving their marketing materials.<sup>21</sup>

FAIR Canada is not aware of any disciplinary action being taken as a result of a misleading advertisement or marketing material but believes such action would deter misleading advertising from occurring. Merely requiring changes to materials does not serve as a deterrent against misleading marketing and advertising. Guidance makes expectations clear but is not sufficient, in our view

## **7. FAIR Canada suggests additional issues for consideration.**

- 7.1. In addition to the priorities included in the Draft Statement, FAIR Canada would suggest that the OSC consider the following issues before it finalizes its Statement of Priorities for 2013-2014:
- 7.2. **SRO Oversight and Compensation Fund Coverage** – In its submission to the OSC on its 2011-2012 draft Statement of Priorities, FAIR Canada recommended that the OSC publish a policy paper by the end of 2011 which would propose a requirement that all registrants be backed by a compensation fund, either through mandatory SRO membership or the creation of a new fund, in order to protect investors in the event of insolvency of a registrant. In FAIR Canada's view, non-SRO member registrants pose greater risks to investors than SRO member registrants, and require closer oversight than is currently provided.
- 7.3. FAIR Canada and the MFDA have each issued reports (A Decade of Financial Scandals<sup>22</sup> and Regulatory Gap in Canada – Part II<sup>23</sup>, respectively) which identify a serious gap in coverage for investors in the event of the insolvency of a registrant. This is a serious defect in our system. FAIR Canada recommends that the OSC undertake its own analysis of the compensation fund gap and issue a policy paper by March 31, 2014 which will propose a system through which all registrants will be backed by a compensation fund.
- 7.4. **Investor-Representative Commissioners** – The SCOGA Report called for the appointment of one or more Commissioners specifically responsible for representing the interests of retail investors.<sup>24</sup> FAIR Canada urges the OSC to make this one of its commitments for 2013-2014. FAIR Canada also recommends that the OSC include a commitment that, in 2013-2014, it will publish a comprehensive response addressing all recommendations made in the SCOGA Report.
- 7.5. FAIR Canada has great respect for all Members of the OSC and recognizes that Members currently take the retail investor perspective into consideration in the course of their

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<sup>21</sup> OSC Staff Notice 81-718, at page 21.

<sup>22</sup> FAIR Canada, "A Decade of Financial Scandals" (February 2011), online: <[http://faircanada.ca/wp-content/uploads/2011/01/Financial-scandals-paper-SW-711-pm\\_Final-0222.pdf](http://faircanada.ca/wp-content/uploads/2011/01/Financial-scandals-paper-SW-711-pm_Final-0222.pdf)>.

<sup>23</sup> Mutual Fund Dealers Association, "Regulatory Gap in Canada – Part II - Fund Managers: The Need for a Compensation Fund" (November 20, 2008), online: <<http://www.mfda.ca/regulation/bulletins11/Bulletin0469-P.pdf>>.

<sup>24</sup> *Supra* note 3 at page 26.

duties. This recommendation is not intended as a criticism of any of the current Members. However, current Members of the OSC are persons with considerable experience representing and working with stakeholders other than retail investors. Based on our review of Member biographies, no Member of the OSC has extensive experience in primarily representing the interests of retail investors.

- 7.6. **Leverage** – FAIR Canada is concerned that many investors are being inappropriately encouraged to borrow to invest and that there are inappropriate contractual relationships between dealer firms and financing companies to provide preferential rates on investment loans to investors. Specifically, FAIR Canada is concerned that leverage is commonly being recommended to be used to invest in mutual funds, which we view to be inappropriate in most cases. The OSC released an investor warning regarding the risks of leveraged investing in January 2012.<sup>25</sup> FAIR Canada recommends that the OSC add an initiative to examine the prevalence of this problem, particularly focusing on mutual and other investment funds, under its first goal (“Deliver Responsive Regulation”). In our view, there should be a presumption that leveraged investing is unsuitable for retail investors, and it should be up to registrants who encourage this practice to prove that such an investment strategy is suitable for that particular investor. FAIR Canada has written to the CSA to raise this issue, stating that current suitability requirements do not provide adequate investor protection with respect to leveraged investing.
- 7.7. FAIR Canada recommends that the CSA immediately address the risks of providing unsuitable recommendations to borrow to invest by precluding advisers and dealers from charging asset-based fees on monies that are borrowed for investment purposes and prohibiting the acceptance of a trailing commission in respect of amounts invested using borrowed funds. This reform has been adopted by the Australian Securities and Investments Commission.
- 7.8. **Group Scholarship Plans** – FAIR Canada believes that, given many features common to group scholarship plans, improved disclosure is inadequate to provide an acceptable level of protection for the vulnerable consumers such plans frequently target. We believe that disclosure alone will only create the illusion of consumer protection and cannot be an end in itself given the problems with the design of group scholarship plans, the aggressive manner in which they are marketed and advertised, and the misalignment of incentives between the salespersons and consumers. Many purchasers of these plans are modest or lower income Canadians who often have low financial literacy and who are urged to invest in these plans in order to take advantage of the government grants associated with them. FAIR Canada is of the view that group scholarship plans are generally poor savings vehicles with little or no benefits to consumers.

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<sup>25</sup> Ontario Securities Commission, “Important information about the risks of leveraged investing and costs of investing” (January 23, 2012), online: <[http://www.osc.gov.on.ca/en/Investors\\_inv\\_news\\_20120123\\_cost-investing.htm](http://www.osc.gov.on.ca/en/Investors_inv_news_20120123_cost-investing.htm)>.



- 7.9. As noted by the CFA CAC, “[o]ne might question whether scholarship plans, something deemed suitable for retail investors but sold by commissioned sales agents with minimal licensing standards, fits within an enhanced investor protection model and would be permitted by the CSA if it was a new product.”<sup>26</sup> FAIR Canada agrees with this statement and recommends that the OSC closely review the propriety of continuing to permit such products to be sold to Canadian consumers.
- 7.10. FAIR Canada also encourages CSA members to consider introducing substantive regulation to address current abuses including not permitting GSPs to further restrict the programs and schools that are eligible for grants and investment earnings beyond the criteria set by the government; capping upfront fees (so as to reduce incentives to place individuals in these plans when they are unlikely to be able to meet the contribution requirements and are thereby likely to default and lose their money); and improving corporate governance. The CSA has responded that such suggestions “will be considered in the context of future policy developments concerning scholarship plans.” We hope that other phases of the Modernization Project (Phases 2 and 3), which were to encompass issues such as corporate governance of group scholarship trusts, membership in a self-regulatory organization and sales communications and calculation and disclosure of performance data, will move forward quickly.
- 7.11. **Extend Fund Facts to Other Investment Products** – FAIR Canada supports the OSC’s proposed action to develop a summary document for ETFs and consider mechanisms for delivery (Priority 3). We encourage extending fund facts to other documents such as structured products, hedge funds and other complex investment products. Ideally, all investment products sold to investors should have a summary document that is provided to investors prior to sale.
- 7.12. **Exchange Conflicts of Interest** – In July 2009, FAIR Canada released an expert report<sup>27</sup> (the “**TSX Report**”) that identified conflicts of interest that exist between the TSX’s self-regulatory responsibilities and its business activities. The TSX Report outlined how similar conflicts have been addressed in several important developed markets, including the US (both NYSE and NASDAQ), the UK, Australia and Hong Kong. The TSX Report found that all of the other seven major exchanges reviewed have addressed their conflicts of interest by implementing one of three specific and sound approaches to conflict of interest management. The TSX was the only exchange among this group that has not implemented specific measures to manage its conflict of interest in regulating listed companies. The TSX Report stated that the TSX should implement safeguards to minimize the risk that conflicts will affect the administration of listings regulation, as well as to address the perception that they could do so.

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<sup>26</sup> The Canadian Advocacy Council for Canadian CFA Institute Societies, Letter Re: Scholarship Plan Prospectus Form (January 16, 2012), online: <[http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/com\\_20120116\\_41-101\\_summersk.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/com_20120116_41-101_summersk.pdf)>.

<sup>27</sup> Carson, John W., “Managing Conflicts of Interest in TSX Listed Company Regulation” (July 23, 2010), online: <<http://faircanada.ca/wp-content/uploads/2008/12/TSX-Listings-Conflicts-final-report-23-Jul1.pdf>>.

- 7.13. In a March 2010 report, the Standing Committee on Government Agencies recommended “that the [OSC] review the potential for conflict of interest between the regulatory and commercial functions of the Toronto Stock Exchange and that it take the steps necessary to address any problems identified.”<sup>28</sup>
- 7.14. FAIR Canada recommends that the OSC address within its Draft Statement “the perception that the TSX falls below international standards with respect to the separation of its regulatory and commercial activities”<sup>29</sup> and make it a priority to ensure that the TSX implements adequate safeguards.
- 7.15. **Comprehensive Background Check** - FAIR Canada believes that there is a real need for a single, comprehensive tool that would allow investors to check the securities regulatory background of a potential advisor or investment firm. The current process of verifying that a potential advisor is registered is unnecessarily complex and confusing for retail investors. Even when consumers are aware that they should “check” the registration information of a firm or individual, the complexity of the regulatory regime and the fact that multiple sources must be consulted can make background checks, or even determining whether someone is registered or not, a difficult and confusing exercise for a retail investor. It is not practical to ask the average retail investor to navigate through the complexities of the current system to locate the basic information they need.
- 7.16. FAIR Canada recommends that Canadian securities regulators provide an informative, comprehensive, “one-stop” national system for investors to check registration and background information (including proficiency and disciplinary history) and SRO membership for all firms registered with securities regulators and members of SROs, and to identify non-securities licenses for individuals licensed under different regimes with different sponsoring firms. This system should include plain language explanations of the information provided and be searchable under business names as well as proper legal names. Additionally, we recommend that the system provide assistance to investors who do not have access to the internet and those who are not computer-savvy. One phone number where a consumer can call to have the relevant information explained would be an important element of such a system.

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<sup>28</sup> *Supra* note 3 at page 35.

<sup>29</sup> *Ibid.*

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 Ermanno Pascutto at 416-214-3443 (ermanno.pascutto@faircanada.ca) or Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca).

Sincerely,

A handwritten signature in blue ink, appearing to read "Ermanno Pascutto".

Canadian Foundation for Advancement of Investor Rights