

June 18, 2014

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
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

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 letter¹, 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.

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.

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