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RE: Proposed Prospectus Exemption for Certain Distributions through an Investment Dealer: Multilateral CSA Notice 45-315

FAIR Canada is pleased to offer comments on the proposed prospectus exemption that would allow issuers listed on a Canadian exchange to raise money by distributing securities to investors who have obtained advice about the suitability of the investment from an investment dealer (the “Proposed Exemption”) that is proposed by the securities regulatory authorities in British Columbia, New Brunswick and Saskatchewan (the “Participating Jurisdictions”).

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. **The Proposed Exemption**

1.1. The Participating Jurisdictions are proposing a new prospectus exemption that would allow issuers listed on a Canadian exchange to raise money by distributing securities to investors who have obtained advice about the suitability of the investment from an investment dealer.

1.2. The key conditions for the proposed exemption are:

- The issuer must be a reporting issuer in a least one jurisdiction of Canada and have a class of equity securities listed on a Canadian exchange;
- The issuer must be in compliance with its continuous disclosure requirements;
- The offer can consist only of a listed security, a unit consisting of a listed security and a warrant to acquire another listed security, or another security convertible into a listed security at the security holder’s sole discretion;

- The news release announcing the offering must contain certain information including disclosing the distribution and the use of proceeds and that there is no material fact or material change about the issuer that has not been generally disclosed; and
 - The investor must obtain advice regarding the suitability of the investment from an investment dealer and the consultation asks in one of its three questions posed to stakeholders whether the exemption should be expanded to exempt market dealers.
- 1.3. The consultation document frames the Proposed Exemption as providing retail investors with the “opportunity” to invest directly in issuers and states that “retail investors do not have an opportunity to participate in the more favourable terms generally offered through private placements, such as a discount to the current market price allowed under exchange policies.”

2. Suitability Advice Not Sufficient

- 2.1. FAIR Canada is of the view that, in practice, the only investment dealers who will be able to provide advice regarding whether the investment is suitable or not are dealers participating in its underwriting, since only those dealers are likely to have sufficient information about the issue to comply with the Know-Your-Product rule. As a consequence, suitability advice will not be provided by an unbiased investment dealer free of conflicts of interest. Instead, the investment advice will come from a dealer that has an inherent conflict of interest.
- 2.2. FAIR Canada believes that the suitability advice will not be objective as a result of the conflict of interest, and disclosure of the conflict will not adequately protect investors. Retail investors expect that advice that is provided by their investment advisor will be in their best interest regardless of any conflicts that exist.¹
- 2.3. FAIR Canada believes that the exemption would only be acceptable if it were subject to a statutory best interest duty. The recommendation that the retail investor purchase the security must be as a result of it being in the best interests of the investor, not simply that it is suitable for the investor.
- 2.4. Numerous surveys of Canadian financial consumers demonstrate that they have a blind trust in financial advisors and a near-complete disregard for any effect that a conflict of interest may have on the advice provided. Further, the research suggests that disclosure would be more effective when recipients of advice have expertise or experience to help them assess the potential effects of the disclosed conflicts of interest.² This is telling about the usefulness of such disclosure to unsophisticated recipients, such as individual retail investors, who are in the greatest need of protection.

¹ Investor Education Fund, “Investor behavior and beliefs: Advisor relationships and investor decision-making study”, written by The Brondesbury Group, 2012 at page 28, available online at: <http://www.getsmarteraboutmoney.ca/en/research/Our-research/Documents/2012%20IEF%20Adviser%20relationships%20and%20investor%20decision-making%20study%20FINAL.pdf>.

² Daylian M. Cain, George Loewenstein, and Don A. Moore, “The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest” (2005) 34(1) J. Legal Stud. 1. at page 20.

- 2.5. “For disclosure to be effective, the recipient of advice must understand how the conflict of interest has influenced the advisor and must be able to correct for that biasing influence.”³ In our view, most investors do not have the requisite knowledge and experience to sufficiently adjust for the conflict of interest that is disclosed.⁴
- 2.6. Therefore, FAIR Canada is of the view that suitability is too low a standard on which to base this new prospectus exemption that will target retail investors.

3. Will Retail Investors Have Good Outcomes Through Such Opportunities to Invest?

- 3.1. FAIR Canada notes that the consultation document does not cite any empirical evidence behind its notion that retail investors will benefit from being able to invest directly in issuers that offer un-listed securities.
- 3.2. One academic paper indicates that private offerings are chosen by an issuer over a public offering given the higher cost of the former over the latter and that, given the cost savings, issuers may be able to offer investors better terms for private issuances by theoretically passing on the savings from avoiding those securities registration costs.⁵ However, the theoretical saving is not necessarily borne out in practice, and no empirical evidence of it was included.
- 3.3. Other academic research does not support the hypothesis that investors will benefit through the purchase of private placements from listed issuers. In a study on the return on private investment in small public entities, Professors Cecile Carpentier, Jean-Francois L’Her and Jean-Marc Suret found that private placement issuers offer, on average, poor returns.⁶ Another study examining returns from private placements issued by firms listed on the Toronto Stock Exchange also found that the private placements of equity underperformed.⁷ The results they obtain suggest that investors in small public issuers can be overly optimistic: they tend to neither question unrealistically high valuations nor believe the issuer will have poor returns (and these investors were “accredited”).
- 3.4. In the absence of better empirical support for the notion that such investments would be of benefit to retail investors, and given the conflicts of interest that will be present in a determination of whether the investment is suitable for the retail investor (without it

³ *Ibid* at page 3.

⁴ This is as a result of the combination of (1) a lack of awareness of conflicts of interest and (2) the low overall investment knowledge of Canadians. The *CSA 2012 Investor Index* found a low awareness of how Canadians’ financial advisors are compensated and that “...overall investment knowledge of Canadians is low, with 40 percent of Canadians failing a general investment knowledge test.” Innovative Research Group, “2012 CSA Investor Index” (October 16, 2012), available online at: http://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL_EN.pdf at page 45.

⁵ So-Yeon Lee “Why the “Accredited Investor” Standard Fails the Average Investor” 31 *BU Rev Banking & Fin Law* 987 at 1016 available online at: <http://www.bu.edu/rbfl/files/2013/09/AccreditedInvestorStandardFails.pdf>

⁶ Cecile Carpenter, Jean-Francois L’Her and Jean “The return on private investment in small public entities” May 4, 2011 available online at: <http://ssrn.com/abstract=1712481>.

⁷ Maher Kooli, “Does Earnings Management Explain the Performance of Canadian Private Placements of Equity” *J Private Equity* (Spring 2009) at 86-94, available online at: <http://www.ijournals.com/doi/full/10.3905/JPE.2009.12.2.086>.

actually being in the investor's best interest to purchase it), FAIR Canada does not support the introduction of the Proposed Exemption.

- 3.5. FAIR Canada recommends that if the Participating Jurisdictions nonetheless, proceed to introduce the Proposed Exemption, they should not expand its availability to exempt market dealers ("EMDs") given the unacceptable level of non-compliance by EMDs with relationship disclosure and suitability obligations.⁸
- 3.6. Moreover, if the Participating Jurisdictions nonetheless introduce the Proposed Exemption based on receiving suitability advice, it should also be made explicitly clear that that the investment dealer has recommended to the individual that the proposed investment is a suitable investment and not simply require that a consultation regarding suitability occurred.

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 or Marian Passmore at 416-214-3441/marian.passmore@faircanada.ca.

Sincerely,



Canadian Foundation for Advancement of Investor Rights

⁸ See CSA Staff Notice 31-334 CSA Review of Relationship Disclosure Practices dated July 18, 2013, available online at http://www.osc.gov.on.ca/documents/en/Securities-Category3/csa_20130718_31-334_review-disclosure-practices.pdf, and OSC's 2012 Annual Report for Dealers, Advisers and Investments Fund Managers, available online at http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20121122_33-738_annual-rpt-dealers.htm.