

FAIR

Canadian Foundation *for*
Advancement of Investor Rights

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RE: Proposed Multilateral Instrument 45-109 Prospectus Exemption for Start-up Businesses

FAIR Canada is pleased to offer comments on Multilateral CSA Notice of Publication and Request for Comment on Draft Regulation 45-109 respecting a prospectus exemption for start-up businesses (the “**Notice**”) dated October 19, 2015 (the “Start-Up Business Exemption”).

Since this Notice was published for comment, Multilateral Instrument 45-108, Crowdfunding has been published in final form and will come into effect in January 2016 in the provinces of Manitoba, Nova Scotia, New Brunswick, Ontario, and Quebec (with Saskatchewan republishing for a further 60 day comment period). In addition, the jurisdictions of Alberta, New Brunswick, Nova Scotia, Ontario, Quebec and Saskatchewan have published Multilateral Notice of Amendments to National Instrument 45-106 Prospectus Exemptions relating to the Offering Memorandum Exemption, which also will come into effect in January 2016 (April 2016 in Saskatchewan). As noted in the Notice, some members of the CSA (namely, British Columbia, Manitoba, Nova Scotia, New Brunswick, Quebec and Saskatchewan) have, prior to the publishing of this Notice, adopted Multilateral Instrument 45-109, Start-up Crowdfunding Exemption.

To date, Alberta has neither proposed nor adopted a prospectus exemption specifically tailored to crowdfunding. However, the Notice contemplates that the Start-up Business Exemption will be used to conduct online crowdfunding through a registered portal or through traditional distribution methods.

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

1. Executive Summary

- 1.1. **In light of the serious investor protection concerns that have been identified with the Offering Memorandum Exemption¹, FAIR Canada urges the Alberta Securities Commission (“ASC”) not to move forward with the Start-Up Business Exemption. Given that the ASC (and some other participating jurisdictions) saw fit to amend the OM Exemption in light of its experience, by adopting certain measures that regulators believe would improve investor protection², it should not now undermine those efforts by introducing a new exemption that allows those investor protection measures to be avoided.**
- 1.2. **FAIR Canada believes that securities regulators should be undertaking fundamental reform of the exempt market in order to adequately protect investors and foster fair and efficient capital markets and confidence in those markets.** We urge securities regulators to work together to implement proper reforms to the accredited investor exemption and other prospectus exemptions so that the various jurisdictions in Canada have a regulatory regime in which businesses are able to raise sufficient capital while investors are adequately protected.
- 1.3. FAIR Canada urges regulators and governments to approach the harmonization of rules regarding investments with the goal of furthering the key mandate of investor protection; and to not engage in a harmonization process at the expense of adequate investor protection.
- 1.4. Reforms are needed in light of widespread deficiencies with disclosure requirements in the exempt market (for example, regarding the Offering Memorandum), a lack of compliance by exempt market dealers (“EMDs”) with their regulatory obligations (including know-your-client and know-your product suitability obligations), and serious conflicts of interest not being avoided, managed or disclosed by the seller.
- 1.5. FAIR Canada has noted in its recent Fraud Report that there is a lack of empirical data to determine the incidence of fraud, misrepresentation and resulting losses suffered by investors whose purchases are made through prospectus exemptions.³ Nonetheless, based on media

¹ See FAIR Canada’s letter to the CSA regarding CSA Notice of Publication and Request for Comment on Proposed Amendments to NI 45-106, (June 18, 2014), available online at: <http://faircanada.ca/wp-content/uploads/2011/01/140618-final-comments-to-CSA-re-OM-exemption-2.pdf>

² The participating jurisdictions amended the Offering Memorandum exemption “...in light of the particular risks associated with the OM exemption and based on the experience of certain participating jurisdictions” to include the following that they “believe that it is appropriate to introduce ...new investor protection measures...These include:

- Requiring that non-reporting issuers provide to investors:
 - Audited annual financial statements,
 - An annual notice on how the proceeds raised under the OM exemption have been used, and
 - In New Brunswick, Nova Scotia and Ontario, notice in the event of a discontinuation of the issuer’s business, a change in the issuer’s industry or a change of control of the issuer;
- Requiring that marketing materials be incorporated by reference into the offering memorandum to provide investors with the same rights of action in respect of all disclosure made under the OM exemption in the event of a misrepresentation; and
- Imposing additional investment limits in respect of both eligible (i.e., investor who meet certain income or asset thresholds) and non-eligible investors that are individuals to limit the risks associated with an investment in securities acquired under the OM exemption.”

³ August 2014, A Report on A Canadian Strategy to Combat Investment Fraud, available online at <http://faircanada.ca/wp-content/uploads/2014/08/FINAL-A-Canadian-Strategy-to-Combat-Investment-Fraud-August-2014-0810.pdf>.

reports⁴, reported cases⁵ and notices from securities regulators,⁶ there appears to be serious and widespread fraud and financial loss linked to investments made through prospectus exemptions.

- 1.6. We recommend that securities regulators consider gathering more data on the exempt market and on investment fraud perpetrated in Canada. We also recommend that regulators make such data public in order to determine the relationship between prospectus exemptions and investment fraud with a view to developing better investor protection. It is essential to ask how investors can differentiate between legitimate prospectus-exempt investments and fraudulent investments. If this is not possible, tools to better protect investors should be developed, including clearer warnings about the correlation of fraud and exempt market investing.
- 1.7. Exemptions should only be permitted if there is adequate investor protection; otherwise real capital formation – where monies are invested in productive assets (leading to increased jobs and economic growth) – will not occur. Investor protection mechanisms are not an impediment to efforts to raise capital, but rather an essential feature of an efficient and effective market in which investors have confidence. Ignoring the need for investor protection will only make the exempt market more inefficient and further reduce investor confidence in our capital markets, thereby further hurting economic growth.
- 1.8. FAIR Canada has voiced, on behalf of retail investors, its opposition to the following initiatives:
 - (i) the Crowdfunding Exemption (45-108)⁷;
 - (ii) the Start-up Crowdfunding Exemption (MI 45-316)⁸; and
 - (iii) the Offering Memorandum Exemption (45-106).⁹
- 1.9. **In our comments on those proposed exemptions (or amendments to existing prospectus exemptions with respect to the Offering Memorandum (except for in Ontario)), we have**

⁴ FAIR Canada highlighted media reports on exempt market related frauds in a 2013 FAIR Canada Newsletter, available online here: <http://archive.constantcontact.com/fs123/1102284477892/archive/1114331931909.html>.

⁵ FAIR Canada “A Canadian Strategy to Combat Investment Fraud”, (August 2014), available online at: http://faircanada.ca/wp-content/uploads/2014/08/FINAL-A-Canadian-Strategy-to-Combat-Investment-Fraud-August-2014-0810.pdf?utm_source=August+Newsflash+2014&utm_campaign=August+Newsflash&utm_medium=email

⁶ Alberta’s Securities Commission states that there have been “...numerous complaints from investors that have invested significant amounts under the OM Exemption and incurred significant losses.” Multilateral CSA Notice of Publication and Request for Comment Proposed Amendments to National Instrument 45-106 Prospectus and Registration Exemptions Relating to the Offering Memorandum Exemption, published March 20, 2014, at Annex B; available online at Annex B; available online at <http://www.lautorite.qc.ca/files//pdf/reglementation/valeurs-mobilieres/45-106/2014-03-20/2014mars20-45-106-avis-cons-om-en.pdf>.

⁷ FAIR Canada’s letter to the CSA regarding Regulation 45-108 Respecting Crowdfunding, (June 18, 2015), available online at: <http://faircanada.ca/submissions/csa-crowdfunding-and-start-up-exemptions/>

⁸ FAIR Canada’s letter to the BCSC regarding BC Notice 2014/03 – Notice and Request for Comment on Start-Up Crowdfunding, (June 18, 2014), available online at: <http://faircanada.ca/submissions/bcsc-start-up-crowdfunding/>

⁹ FAIR Canada’s letter to the CSA regarding NI 45-106, and FAIR Canada’s letter to the OSC regarding OSC Notice and Request for Comments on the Introduction of Proposed Prospectus Exemptions and Proposed Reports of Exempt Distribution in Ontario, (June 18, 2014), available online at: <http://faircanada.ca/submissions/osc-proposed-prospectus-exemptions/>.

made numerous recommendations so that investors will be better protected, capital markets will be more efficient, and investors will have more confidence in those markets. We urge you to give serious consideration to our recommendations if intent on proceeding with the Start-up Business Exemption. We urge that implementation of any new exemption for start-ups and early stage businesses be done 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.

- 1.10. Accordingly, if Alberta decides to move forward with the exemption, we set out below comments on the proposed Start-up Business Exemption to the extent it materially differs from Crowdfunding, NI 45-108 and/or the Offering Memorandum, NI 45-106, as recently amended. Otherwise, we refer you to our June 18, 2014 submissions¹⁰ for our recommendations.

2. Specific Comments

- 2.1. The Start-Up Business Exemption affords less adequate protection for retail investors than the Offering Memorandum exemption given the following: the lack of any requirement for financial statements; the lack of any annual investment limits for investors (as opposed to limits per issuer); no ongoing disclosure requirements; and no incorporation by reference into the offering document of any marketing materials so as to give investors the same rights to sue for misrepresentation in respect of all disclosure made in the course of promotion pursuant to the Start-Up Business Exemption.
- 2.2. The Notice remarks that "...the costs of using the OM Exemption, whether in conjunction with the use of a portal or otherwise, can be very high relative to the limited funds required." FAIR Canada questions assertions by early stage businesses and SMEs that the cost of preparing an Offering Memorandum is prohibitively expensive for capital raising. The Notice does not provide any dollar figures with respect to the average or mean cost of preparing an Offering Memorandum including the preparing of audited financial statements or other financial information for early stage businesses and SMEs (whether as required by corporate laws or otherwise), nor does it compare this with what it proposes for a fully compliant Start-Up Business distribution. We question whether sufficient empirical work has been conducted on these costs. If empirical data has been gathered, we urge regulators to make such information public.

Lack of Financial Statement Requirement

- 2.3. FAIR Canada has serious concerns about the lack of any requirement for financial statement disclosure. Investors use audited financial statement disclosure to decide whether or not to invest in particular securities. Financial statement disclosure is intended to encourage more efficient management and to discourage fraud. Auditors, as gatekeepers, serve a fundamental purpose and fill an important role in promoting confidence and trust in certain financial information in financial statements. Auditors are intended to ensure independence,

¹⁰ See FAIR Canada's letter to the CSA regarding NI 45-106 (June 18, 2014), and FAIR Canada's letter to the CSA regarding Regulation 45-108 (June 18, 2014).

impartiality and expertise; and audits enable shareholders to oversee management. We refer you to our letter to the ASC dated February 20, 2013 (in response to Multilateral CSA Notice 45-311), which sets out our position on financial statements.¹¹

- 2.4. At a bare minimum, the requirement for financial statement disclosure should be harmonized with that of 45-108, Crowdfunding or the Offering Memorandum Prospectus Exemption.

Ongoing Disclosure

- 2.5. FAIR Canada believes that ongoing disclosure to investors should occur in order to hold issuers accountable for their use of proceeds and in order to reduce incentives for using a non-corporate structure to avoid reporting obligations.¹²
- 2.6. We believe that audited financial statements, notice of use of proceeds, notice of a change in control of the issuer, notice of a change in the issuer's industry and notice of any discontinuation of the issuer's business be required, at a minimum, in harmonization with the Offering Memorandum Exemption requirements as adopted by New Brunswick, Nova Scotia and Ontario. That said, however, we question whether there will be compliance with those requirements and whether there will be sufficient accountability to retail investors who become the issuer's security-holders.

Incorporate Marketing Materials

- 2.7. FAIR Canada recommends that the offering document incorporate by reference any marketing materials. This will result in the marketing materials being subject to the same liability as the disclosure provided in the offering document in the event of a misrepresentation. We believe that this would be consistent with the approach taken for the OM Exemption. We refer you to our letter dated June 18, 2014 for further details on marketing materials and liability for same.

Investment Limits

- 2.8. **While investment limits don't reduce the risk of fraud¹³, FAIR Canada believes limits are necessary under a Start-Up Business Exemption in order to reduce the extent of losses, even for legitimate offerings.**
- 2.9. The underlying premise of crowdfunding exemptions is that small and very early-stage businesses can meet their capital-raising needs by sourcing a small amount of money from a large number of people. We recommend that the individual investor limits be decreased to \$500 or less per offering. We also recommend that a limit be placed on the total amount that

¹¹ FAIR Canada's letter to the CSA regarding CSA Notice 45-311, (February 20, 2013), available online at: <http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-comments-re-Certain-OM-Exemptions.pdf>.

¹² Requirements under provincial and federal business corporations acts and provincial securities acts require corporations to appoint an auditor to hold office, impose duties upon such auditors, and require the preparation of annual financial statements. If not required to do so under securities laws, issuers may choose to use a non-corporate structure to avoid financial statement and other disclosure obligations. We have been informed that a non-corporate structure is quite commonly used for those who utilize the OM Exemption in Alberta

¹³ See our letter dated June 18, 2014 to participating CSA jurisdictions regarding NI 45-108 at paragraph 5.1; available online at <http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-CSA-Crowdfunding-and-Start-Up-Exemption-Comments.pdf>.

can be invested by investors in any start-up or early stage business through the various exemptions in a given calendar year, including in the Start-Up Business Exemption, in the amount of \$5,000. The current proposed limits are not small amounts for most retail investors and there is no investment limit with respect to the total that individuals can invest in start-ups or early stage businesses made in reliance on various prospectus exemptions (whether crowdfunded or otherwise) in a calendar year.¹⁴ As a bare minimum, the annual investment limits imposed under 45-108, Crowdfunding (by the Ontario Securities Commission (“OSC”)) should be adopted

2.10. **We are of the view that crowdfunding and other prospectus exemptions aimed at individual investors should not be introduced until such time as regulators have a reasonable prospect of enforcing those investment limits.** FAIR Canada notes that the Start-Up Business Exemption has a \$1,000,000 lifetime limit on the amount that an issuer can raise under the Start-up Business Exemption or any corresponding exemption (for example, the Start-Up Crowdfunding Exemption, 45-316). Adequate mechanisms have not been set out to ensure compliance with the investor investment limits per issuer or the offering limit. FAIR Canada recommends the use of a centralized database to verify aggregate investment amounts rather than reliance upon self-certification.¹⁵

2.11. FAIR Canada also is concerned that the investment limits for individual investors will become the *de facto* minimum amount that can be invested in light of the following: (i) the proposed **Guidance at section 5.8 of Form 45-109F1 that gives the issuer an option to set a minimum investment amount per investor (which can be up to \$1500 if no dealer is involved and can be a minimum of \$5,000 if a dealer is involved)**; (ii) the possible desire (expressly recognized by the securities regulator in the Notice) to set a higher investment limit so as to “raise more capital from a smaller number of investors, potentially reducing the costs associated with having a large number of investors”¹⁶, and (iii) the lack of compliance by exempt market dealers with their KYC, KYP and suitability obligations.¹⁷

¹⁴ For further details on FAIR Canada’s views on investment limits, we refer you to our letter to the OSC regarding Proposed Prospectus Exemptions (June 18, 2014), at section 5 and 6, pages 12-15.

¹⁵ See our letter dated June 18, 2014 to participating CSA jurisdictions regarding NI 45-108 respecting crowdfunding, at page 2 and 13.

¹⁶ Notice at page 3.

¹⁷ Compliance reviews by CSA members have found significant deficiencies in how EMDs address conflicts of interest with 21% of registered firms that were sampled being deficient in how they address conflicts of interest including:

- Registered firms considered themselves to operate independently, and assumed that they did not have relationships that could potentially present a conflict of interest requiring disclosure, but this was not the case.
- Registered firms indicated that their policies and procedures manual or other internal policies described their conflicts, but acknowledged that they did not disclose these conflicts to clients.
- EMDs indicated that the issuer’s offering documents adequately described the conflicts of interest, but this was not the case.
- Registered firms disclosed that they had conflicts, but they did not describe the conflicts or explain how they were addressing them.
- Registered firms provided an insufficient or unclear explanation about their conflicts and did not discuss the potential impact on clients.
- Registered firms disclosed the conflicts of interest at the individual dealing or advising level, but did not consider and disclose conflicts of interest at the firm level.

In addition, EMDs have a low level of compliance with existing know-your-client and know-your-product obligations, as found in compliance sweeps by regulators. There is no published report which indicates from the securities regulators that

Investors Limited Financial Literacy

- 2.12. We are concerned that, currently, many retail investors do not understand the risks associated with crowdfunding. The OSC's Exempt Market Study on Crowdfunding found that "[w]hile it is clear that investing via crowdfunding is more likely as risk tolerance increases, we are concerned with the high proportion of low risk people who might potentially invest via crowdfunding. In our view, the survey made the risks quite visible and explicit leaving us to wonder how they concluded that crowdfunding was appropriate for them."¹⁸ We question whether investor education efforts (on portals or elsewhere) could effectively address this concern. We are not optimistic that they can or will.
- 2.13. The 2012 CSA Investor Index also found that 58% of Canadians do not understand the fundamental principle of risk-reward tradeoff and found that only 12% of Canadians have realistic expectations of market returns. Only 9% of low knowledge investors were found to have realistic market expectations.¹⁹

High Risk Tolerance Investors Who Can Afford To Lose it All

- 2.14. It is widely accepted that many investors (possibly most) will lose money by investing in start-up and early stage businesses, given those enterprises' failure rates.²⁰ The Notice remarks that a start-up business investment is not necessarily suitable for all investors if \$5,000 is invested and that "these investments will generally only be suitable for investors with both (i) an appreciation of the risks and a very high risk tolerance and (ii) the financial ability to withstand the loss of their investment." Later in the Notice it states that "suitability requirements ...will help ensure that investors that have *low risk tolerance* or lack the ability to withstand the loss of an investment do not make investments that are not suitable for them." (our emphasis) FAIR Canada recommends that it be expressly set out in the rule or guidance that investing under this prospectus exemption is only available to those who have a high risk tolerance and ability to withstand the loss of their entire investment.

Investors Who Obtain Advice Need Objective, Independent Advice in their Best Interests

- 2.15. If a higher investment limit is to be permitted for those who obtain suitability advice, FAIR Canada recommends that the advice must come from a registrant who has an obligation (either statutorily or contractually) to act in the client's best interests. In addition, to qualify, the proposed exempt investment should actually be recommended by the registrant as an investment that is in the best interest of the retail investor. This requirement should be monitored by requiring that information on the use of the qualifying criteria, including the name of the registrant who provided the advice, be provided to the ASC.

the above-noted problems have been adequately addressed; and EMDs are not members of an SRO, which would provide some level of protection to investors.

¹⁸ The Brondesbury Group, "Exempt Market Study on Crowdfunding" (May 28, 2013) at page 34.

¹⁹ Innovative Research Group, "2012 CSA Investor Index" (October 16, 2012), available online: <https://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL_EN.pdf>.

²⁰ FAIR Canada's letter to the CSA regarding Regulation 45-108 (June 18, 2014), at paragraph 4.2.

Risk Warnings and the Risk Acknowledgement Form

- 2.16. FAIR Canada is very concerned with the lack of any investor testing of the risk acknowledgement to determine whether it serves the purpose for which it is intended. Behavioural sciences widely acknowledge that design and delivery of information significantly affects how it is interpreted and how it is used and understood.
- 2.17. FAIR Canada refers you to our comments on risk warnings and risk acknowledgement forms at section 12 of our letter to the OSC dated June 18, 2014.²¹

Reports of Exempt Distribution

- 2.18. FAIR Canada urges regulators to ensure that adequate information is collected through the reports of exempt distribution so that the information needed to understand this area of our capital markets and to regulate effectively with sufficient data for sound policy decisions is collected. We refer you to our submission dated October 15, 2015.²²

Sun-Set Clause

- 2.19. Given the experimental nature of start-up and crowdfunding regulation, if the ASC proceeds with the introduction of this exemption, we strongly urge that a sunset clause of two years be included.

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

²¹ FAIR Canada's letter to the OSC regarding Proposed Prospectus Exemptions (June 18, 2014) at page 20-21.

²² FAIR Canada's letter to the CSA regarding CSA Notice and request for comment on Proposed Amendments relating to Reports of Exempt Distribution, (October 15, 2015), available online at: <http://faircanada.ca/wp-content/uploads/2015/10/151015-CSA-Re-Proposed-Exempt-Distribution-Reports-final-signed.pdf>