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Re: OSC Staff Consultation Paper 45-710, *Considerations for New Capital-Raising Prospectus Exemptions*

The Investment industry Association of Canada (“the IIAC” or “the Association”) appreciates the opportunity to provide comments on the OSC Staff Consultation Paper: 45-710, *Considerations for New Capital-Raising Prospectus Exemptions* (the “Consultation Paper”).¹ Before addressing the specific requests for input, the IIAC believes four fundamental questions that the Consultation Paper raises should be considered:

1. What is the extent and nature of the capital-raising problem that the Consultation Paper seeks to address?
2. To what extent would changes recommended in response to Canadian Securities Administrators (CSA) Staff Consultation Note 45-401, *Review of Minimum Amount and Accredited Investor Exemptions*, address any identified problem?
3. What consequences might the new capital-raising mechanisms have on less sophisticated and retail investors?
4. Is divergence between the outcomes that may arise from this Consultation Paper and offering memorandum exemptions in B.C. and Alberta consistent with a national securities regulator or at least close harmonization?

These questions are addressed in more detail below and our comments on specific matters raised in the Consultation Paper follow.

A. Conceptual Issues

1. What is the extent and nature of the capital-raising problem that the Consultation Paper seeks to address?

The Consultation Paper does not specifically quantify an access-to-capital problem for small- and medium-sized enterprises (SMEs), nor show it to be attributable to securities regulation as distinct from market conditions generally. To the extent that there has been a problem that could have been quantified, it is uncertain what effect the federal 2012-13 budget's \$400 million in venture capital funding and Ontario's 2012 budget promise of a new strategic direction in business support programs will have (the Ontario budget noted that the province supplies \$2 billion in annual support to businesses, including targeted tax expenditures, through more than 40 different programs across at least seven ministries). Reportedly, data for 2012 show a rebound in venture capital investment to 2002 highs.

To the extent that there is a capital-raising problem, and it relates to securities regulation, the IIAC has heard and shared concerns regarding regulatory costs. One non-IIROC dealer respondent to the Consultation Paper remarked: "We need to focus on how to provide the information to investors without bankrupting the issuer!" ***The IIAC believes further study is required to quantify the nature of the capital-raising problem; whether and how regulation contributes to the problem; and if regulation can and should be modified to assist in capital-raising.***

2. To what extent would changes recommended in response to CSA Staff Consultation Note 45-401, *Review of Minimum Amount and Accredited Investor Exemptions* ("Consultation Note 45-401"), address the problem?

The Consultation Paper references comments received in response to Consultation Note 45-401 regarding the minimum amount and accredited investor exemptions that enable retail investors to participate in the exempt market and provide issuers with an important means of raising capital from investors with the means and desire to invest in such securities. In a February 29, 2012 response to Consultation Note 45-401, the IIAC supported retention of the accredited investor prospectus exemption, which offers an important way for issuers to raise capital without the significant, time-consuming and expensive requirements associated with undertaking a prospectus offering. The IIAC believes the existing income and asset criteria provide a perhaps imperfect, but nevertheless objective test with a reasonable link to sophistication and the investors' ability to withstand loss. However, the IIAC agrees that the current \$150,000 minimum amount prospectus exemption should be removed, as it has resulted sometimes in investors' portfolios being overly concentrated and would, for example, bring new investors into the SME market if the prospectus exemption based on registrant advice were introduced.

To balance the need for an efficient capital-raising mechanism with the need to protect vulnerable investors from the reduced disclosure and liability protections associated with the use of the exemption, the IIAC believes that:

1. All parties selling securities issued under the exemptions should be registrants subject to equivalent client suitability, know your client (KYC) and know your product (KYP) requirements.
2. There should be appropriate reporting and monitoring of different types of registrants to ensure investors obtain the same level of protection.

The IIAC recommends equivalent investor protection, reporting and monitoring requirements to avoid the confusion that can arise when different retail investors face different risks when purchasing the same security – one from a regulated dealer and the other from an unregulated party.

3. What consequences might the new capital-raising mechanisms have on less sophisticated and retail investors?

To the extent that the new capital-raising measures would extend access of issuers to non-accredited or so-called small retail investors, the IIAC believes that further review is warranted.

1. *The Consultation Paper does not fully examine the impact of a further potential expansion in the exempt market on retail investors in light of the following CSA or OSC findings:*

- a. The CSA's 2012 *Investor Index* shows that the overall investment knowledge of Canadians remains low. Financial literacy has been identified as a problem by federal and provincial governments. This has led to an extensive and increasing level of IROC dealer regulation and oversight that has been explained by the OSC's responsibility to "provide protection to investors from unfair, improper or fraudulent practices." A review of OSC and CSA enforcement reports shows that a substantial percent and dollar value of enforcement actions relate to non-registrants, in particular, illegal distributions leading to significant losses.
- b. OSC Staff Notice 33-738, *2012 OSC Annual Summary Report for Dealers, Advisers and Investment Fund Managers*, lists concerns including: inadequate collection and documentation of KYC information for clients, inadequate assessment of suitability of investments for clients, and insufficient KYP due diligence; trades with clients that are not accredited investors; inadequate supervision of dealing representatives; trading in securities without registration; and poor marketing and client disclosure concerns. Exempt market dealers defined as having higher risk were also identified as having: made inappropriate use of investor monies; not disclosed material outside business activities; and maintained inadequate

working capital and insurance. While these issues are not avoided in the case of IIROC dealers, there is monitoring and supervision, and an easy-to-access redress mechanism that can be quicker than going through the OSC/CSA or the court system.

It is therefore not clear why providing more access by non-accredited investors to investments with minimal disclosure documents, potentially presented by parties who are not subject to the proficiency, oversight, conflict of interest, KYC and KYP requirements, and who do not provide (at least not currently) for free and easy access to redress mechanisms, is a good idea.

2. *The analysis does not consider the potential impact on accessibility of investments and other services to retail investors.*

The IIAC believes that the OSC has recognized in the past the downside to not allowing retail investors to access underwritings. The preponderance of issuances continues to move towards the exempt market (there was \$41 billion in common equity issued nationwide in 2011, compared to \$87 billion in exempt purchases in Ontario alone that same year) possibly due to increasing costs in the more regulated market. Less in the way of public and advised private issuance, combined with the costs of additional regulation and flat markets, make it difficult for at least smaller IIROC dealers to compete, leading to some firms closing and consolidation of others. Additional costs of regulation divided by fewer advised clients suggests that the average cost per client will rise, which could aggravate a move to higher minimum balance requirements. Whether the availability of advised services to retail clients is important is a matter for public policy discussion.

To the extent that securities regulation can be shown to be a material impediment to capital-raising, and that reduced regulation could be the solution to a quantified lack of capital, the IIAC believes that any next step in the pursuit of options extending access to financial assets of non-accredited investors should clearly enunciate:

- ***Some quantification of the expected benefits***
- ***Possible accessibility effects on retail investors***
- ***Estimated costs of handling the questions and complaints that would arise***
- ***How these costs would be recovered, on the assumption that they should not be borne by the investors who use the more regulated channel, nor by issuers that do not use the exempt channel.***

4. Is divergence between the outcomes that may arise from this Consultation Paper and offering memorandum exemptions in B.C. and Alberta consistent with a national securities regulator or at least close harmonization?

The publication of the Consultation Paper was followed quickly by the release for comment of *Multilateral CSA Staff Notice 45-311, Exemptions from Certain Financial Statement-Related Requirements in the Offering Memorandum Exemption to Facilitate*

Access to Capital by Small Businesses and, later, the B.C. Securities Commissions' *Notice and Request for Comment: National Instrument 45-106 Prospectus and Registration Exemptions --Proposed Prospectus Exemption to Assist Capital Raising by Small Businesses*. The IIAC strongly believes that investor protection demands that Canadians' interests be best provided for through the use of a common standard for accredited or small investors wherever they live in the country.

The IIAC believes that CSA members should agree on national exemptions that apply across the country and that, until that time, any new OSC exemptions should be patterned on existing ones. In this regard, the Alberta exemption offers a good model.

Below the IIAC addresses those questions posed in the Consultation Paper for which the IIAC believes it has sufficient data to answer.

B. Detailed Comments

The IIAC agrees that securities regulation is a fine balance; the Association believes that regulation should aim to optimize the all-in risk-adjusted cost to issuers and investors, and appreciates the summaries of approaches to raising capital adopted in other countries. As the Consultation Paper and answers to questions at the consultation session attended did not provide the evidence we believe the OSC is seeking as to whether the Australian or U.K. models have facilitated additional capital-raising in and of themselves, or whether there have been any better or worse outcomes for retail investors in these countries, the IIAC believes that research into these key factors should be undertaken and reported to stakeholders before crowd-funding changes proceed.

2.2 Current regulatory approaches – Prospectus exemptions based on relationship with the issuer

- 1. Is the 50 security holder limit under the private issuer exemption too restrictive? If so, what limit would be appropriate? Please explain.*** In light of the number of people by which the friends and family exemption can expand the number of investors, the IIAC does not think there is a need for an increase from 50 in the limit on the number of security shareholders under the private issuer exemption. The IIAC understands that it is extremely rare since the exemption was introduced in 1978 that 50 has proven to be a restrictive limit.
- 2. Should the OSC consider re-introducing the closely-held issuer exemption in addition, or as an alternative, to the private issuer exemption? If yes, should the conditions be changed?*** The IIAC is not aware of any public policy reason for re-introducing the closely-held exemption in addition or as an alternative to the private issuer exemption. This would further contribute to the challenges of different approaches to capital-raising regulation in different provinces.

3. ***Should the OSC consider adopting a family exemption that allows for securities to be issued to an unlimited number of family members of the directors, executive officers or control persons of the issuer or its affiliates? Please explain.*** As noted in 1. above, the IIAC is not aware of an issue that would be resolved by a change or expansion in the family exemption.
4. ***Are there other changes that should be made to the current Ontario exemptions referred to above?*** For greater clarity, and greater certainty that the family exemption is, in fact, used by family members of the directors, executive officers or control persons of the issuer or its affiliates, the IIAC recommends that no compensation – for example, no finders' fees – be permitted to be paid and that issuers be required to certify that no such compensation has been paid. As well, the IIAC reiterates the importance of harmonizing all provincial exemptions to reduce the expense of inefficiencies and inconsistencies in securities regulation.

5.2 Exploration of Crowd-funding – General questions

The IIAC appreciates the insights provided in the paper regarding crowd-funding or crowd-funding-type regimes in other countries and notes that most are relatively new. The U.S. model, under the *Jumpstart Our Business Startups (JOBS) Act* passed in April 2012, is awaiting regulations. It was expected that the Securities and Exchange Commission would move quickly on the necessary regulations, however, it is understood that this may now take more time. Some securities regulators, as well as consumer and investor advocates, including the American Association of Retired Persons, Consumer Federation of America and Council of Institutional Investors, levied criticisms against earlier versions of the bill with denunciations ranging from:

- "gutting regulations designed to safeguard investors"
- "legalizing boiler room operations"
- "a terrible package of bills that would undo essential investor protections, reduce market transparency and distort the efficient allocation of capital"
- driven by "the dangerous and discredited notion that the way to create jobs is to weaken regulatory protections"
- going to lead to a "regulatory race to the bottom".

While the above clearly includes hyperbole, it is nevertheless true that loosening investment protections could expose small and inexperienced investors to more fraud. The IIAC thinks that there is insufficient information to conclude crowd-funding would be useful in the long-run, or whether crowd-funding would be a better way to raise capital, with no greater risk to the investor, than other initiatives currently under consideration at the federal and provincial level. The IIAC believes, therefore, that it is premature to conclude that crowd-funding should be pursued before the additional research outlined in sections A.1 and A.2 above and section 7.3 below is complete. Without this information, the IIAC does not believe there is enough data to answer most

of the questions in the Notice in a reasoned way and therefore the IIAC presents the following general views only:

- 1. Financial literacy:** As recommended above, the IIAC believe that all parties selling securities issued under the crowd-funding and other exemptions under consideration should be registrants subject to equivalent client suitability, KYC and KYP requirements and that reporting and monitoring should be implemented to ensure that investors obtain the same level of protection in the case of such registrants. This stems from financial literacy concerns, compounded if there is an absence of suitability, KYC and KYP requirements, as well as reduced disclosure and liability, and at least currently a lack of easy-to-access redress mechanisms, especially in light of the potential for fraud. Two areas particularly relevant for retail investors in terms of financial literacy that did not appear to be addressed are:

 - a. Illiquidity:** What makes illiquidity a particular challenge is that if a retail investor does not understand the concept and expects a return of his or money in a relatively short time, he or she may instead need to borrow to make general household payments, compounding what may be a challenging financial situation. Consumer debt is a public policy concern.
 - b. Tax-effective investments:** It is unlikely that most crowd-funded securities will qualify for registered retirement savings plans or tax-free savings accounts. Finance Canada estimates an after-tax yield improvement of about 1.5% on assets held in registered form as compared to when the same assets are held in non-registered form. It is not certain that non-IIROC dealers selling to investors have sufficient information or the inclination to take into consideration effective tax-planning.
- 2. Portal:** Following the additional data collection and analysis referenced in sections A.1 and A.2, the IIAC believes that some of the fundamental costs of crowd-funding – the portal – should be considered. Given the potentially very disparate users of the portal that is the basis for connecting people with money with those with business ideas, we agree that it is reasonable for there to be a degree of regulatory oversight to verify the critical information on which investors will base their decisions.

 - a. Based on knowledge of the development and ongoing costs of capital markets infrastructure subject to OSC/CSA oversight, the IIAC suspects that the costs to build and maintain the portal infrastructure could be significant given the number of possible investors and issuers, and the limited dollar-value per transaction.
 - b. Whether and how the portal would interact with the electronic holding, clearing and settlement system that connects sources and users of capital through, for example, CDS Clearing and Depository Services Inc. (CDS) and provides the

certainty of the security-for-payment process Canadians have come to expect, should also be evaluated. While use of CDS is not a requirement, and alternate payment options are available, the OSC should consider if a return to paper evidences of ownership of high-volume, low-value amounts is advisable or what alternatives there may be. Certainty of ownership is a high priority for investors and will lead to some additional costs.

3. Financial Statements: The Consultation Paper recognizes that the cost of an audit can be an impediment for start-ups and SMEs using the OM exemption. Other Canadian jurisdictions considering amendments to the OM exemption have pointed to the high costs of preparing IFRS- and Canadian-GAAP-compliant audited financial statements as possibly dissuading start-ups and early-stage entities from seeking financing for certain ventures. We believe that rather than relying only on management-certified financial statements as is under consideration, it would be preferable to require complementary documents that offer additional evidence of professional management. These could be filed with the regulatory authorities and provided to investors and relevant brokers. Typically available or easily obtainable at low cost, these additional items include:

- Income tax returns filed by the issuer for the most recently completed year (if any) (part of the U.S. *Jumpstart Our Business Start-ups (JOBS) Act*) and
- Bank confirmation(s), using the standard Canadian Bankers Association (CBA) and Canadian Institute of Chartered Accountants (CICA) form.

The IIAC believes that the OSC should elaborate on the views of the accounting community on whether any additional minimum provisions are warranted for financial statement review in the case of low-dollar-value crowd-funding financing (and the offering memorandum prospectus exemption – see 5.3 below). The association may have additional views once this is done.

5.3 Exploration of an OM prospectus exemption

The IIAC is generally supportive of an OM exemption being adopted in Ontario under the following conditions:

1. It must be limited to private companies or, if extended to public companies, it must be through an IIROC registered dealer.
2. It should be subject to appropriate reporting and monitoring.
3. It should prohibit commissions or other compensation from being paid to agents or finders that do not have IIROC-dealer equivalent suitability, KYC and KYP responsibilities.

4. Should the OSC proceed with such an exemption, it should work with other jurisdictions to ensure that there is one consistent OM exemption, rather than adding to the range of OM exemptions that complicate and increase the costs of inter-jurisdictional capital-raising.

See also comments regarding financial statements in section 5.2.3

6.2 Exploration of a prospectus exemption based on investment knowledge

The IIAC believes that this proposed exemption is problematic on a number of levels. Although the IIAC acknowledges that income and asset criteria may not provide a consistently accurate proxy for sophistication, investment knowledge and experience can be subjective, resulting in regulatory uncertainty, inconsistent application and regulatory risk for those purchasing and selling securities in reliance on the exemption. The proposed test does not adequately capture those who may have sufficient investment knowledge, as a requirement for one year in the industry certainly does not bestow on an individual sufficient knowledge to be considered sophisticated. Education is not necessarily an appropriate proxy either because, as with other professions (e.g., interning for doctors; articling for lawyers), some real-life experience is required. If there is an appropriate test, it may be appropriate to increase and emphasize industry experience over education. However, the IIAC expects that the criteria, if properly targeted, will result in mainly the same individuals as those eligible under the accredited investor exemption, especially to the extent that the registrant advice exemption is adopted.

6.3 Exploration of a prospectus exemption based on registrant advice

1. ***New prospectus exemption based on advice provided by a registrant:*** With the implementation of successive investment protection measures and, in particular, the client relationship model (CRM) with its new enhanced suitability, conflict of interest and relationship disclosure requirements, the IIAC believes that it makes sense to allow this further prospectus exemption. This is because there has been extensive public policy debate on the need for investor protection, leading to IIROC, OSC/CSA rules and oversight of dealer financial operations, staff supervision, product due diligence and trading activity, as well as the proficiency and ethical business and financial conduct of registered employees, including requirements to have supervisory compliance staff in place to test the firms' policies and procedures. The IIAC believes that this exemption has the potential to help SMEs to quickly, more broadly access capital than, say, an expansion or change in the other exemptions under consideration.
2. ***Fiduciary duty:*** The IIAC has responded to CSA Consultation Paper 33-403, *The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients*. The Association believes that a fiduciary duty could have serious

implications for issuers and investors. These include: potentially reduced choice among business models, reduced access by investors to financial products, decreased affordability of financial advice, greater uncertainty regarding obligations in the client-advisor relationship, onerous compliance requirements and increased exposure to risk and liability for advisors. Furthermore, the CSA has not provided evidence of investor harm under the current regulatory and legal regime, especially given the recent improvement to the regime under CRM, which can respond to any investor protection concerns raised by the regulators.

- 3. Requirement for ongoing relationship with the client:** The IIAC would support the exemption mandating an ongoing relationship with the client, as it is key to ensuring that the registrant can appropriately manage suitability and KYC requirements and, therefore, is fundamental to retail investor protection.

7.2 Electronic filing

With respect to possible concerns with mandating use of the E-form, the IIAC agrees with electronic filing and believes it should be implemented as soon as possible. In the case of any electronic filing, the IIAC believes that those filing may want to automate as much as possible and therefore the filing mechanism should accommodate this, for example, through downloadable spreadsheets or other CSV filing options.

7.3 Additional information required

As only specified prospectus exemptions trigger a requirement to file a report, it is not clear whether available data capture all exempt market activity. The IIAC has examined the exempt market data provided in the Consultation Paper against data the IIAC obtains from a variety of sources and appreciated the opportunity to follow up with OSC staff on this point to try to reconcile the discrepancy. As noted above, the IIAC believes that a complete snapshot of public and private capital-raising over time is necessary to support good decision-making.

- **Concerns with requiring additional information in the report:** Some of the information referenced in this section will be highly confidential and should only be available to the regulators, while other data should be aggregated and available publicly. This requires additional care in the collection, scrubbing and use of the data.

There is some data required that will be more difficult to collect and update, and this information is much more appropriate for a periodic survey (e.g., investor age range and work status).

- **Other types of information that should be required in the report:**

- It would be useful for directors and executive officers to provide information about previous positions and involvement with exempt or non-exempt issuances.
- The IIAC recommends the OSC and other CSA representatives convene a small working group with registrants to discuss in more detail what reporting is reasonable, in what format, what implementation period is workable, etc.
- The IIAC also believes that the reports, if the recommended prohibition on the payment of commissions or other compensation to finders is not adopted, should also be required to include the names of external agents and their relationship to the company or its management.

8.2 Need for investor research to support review

The IIAC agrees with the need for investor research to support concept reviews and rulemaking, and recognizes the challenge in obtaining information about the investment knowledge, objectives and behaviour of individual investors. While the Consultation Paper suggests that the feedback the OSC received during consultations was principally from the investment industry, it would be helpful to have summarized feedback by respondent segment.

To the extent there is a need for research, the IIAC believes that the credibility of research results can be enhanced by discussion of the research approach and questions with the various stakeholders (investors, issuers, industry) before data-gathering starts or, in this case, completes.

The IIAC would be pleased to elaborate on our views and meet with you at your convenience.

Yours sincerely,



ⁱ All IIAC members were encouraged to participate on the IIAC Working Group formed to respond to the Consultation Paper and it represents a cross-section of firms of various sizes and locations, representing retail, institutional and issuer clients.