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August 7, 2018

Ministers Responsible for Securities Regulation in the Provinces and Territory Participating  
in the Cooperative Capital Markets Regulatory System

Capital Markets Authority Implementation Organization

(via email to: [comment@ccmr-ocrmc.ca](mailto:comment@ccmr-ocrmc.ca))

**RE: Comments on Draft Prospectus and Related Registration Exemptions for the Cooperative  
Capital Markets Regulatory System**

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FAIR Canada is pleased to offer comments on the Draft Prospectus and Related Registration Exemptions for the Cooperative Capital Markets Regulatory System published on May 8, 2018 (the “**CCMR Prospectus Exemptions**”), which will harmonize the prospectus exemptions and related registration exemptions in British Columbia, New Brunswick, Ontario, Prince Edward Island, Saskatchewan and the Yukon (collectively, the “**CMR Jurisdictions**”).

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 protection in securities regulation. Visit [www.faircanada.ca](http://www.faircanada.ca) for more information.

**1. General Comments**

- 1.1. While harmonization of prospectus and registration exemption requirements represents a potential benefit of the Cooperative Capital Markets Regulatory System (the “**CCMR**”), FAIR Canada believes that strengthened investor protection and more effective regulatory oversight, including compliance and enforcement, by the Capital Markets Regulatory Authority (the “**CMRA**”) of the exempt market must also be included as a critical element of this overall process. As FAIR Canada has commented in its [White Paper on the Proposed Cooperative Capital Markets Regulator - "What About the Investors?"](#), we have investor-related concerns about the CCMR in terms of both its governance structure and substance. We also have general and specific concerns about some of the proposed changes in the CCMR Prospectus Exemptions. We discuss these changes in detail below.
- 1.2. FAIR Canada believes it will be incumbent on the CMRA to devote more resources to compliance and enforcement in the exempt market than has been the general practice in the CMR Jurisdictions in the past. Currently, it is clear that non-compliance in the

exempt market is widespread. As the Ontario Securities Commission and Alberta Securities Commission observed in separate 2017 reports,<sup>1</sup> exempt market participants are frequently failing to comply with book and recordkeeping requirements, KYC and suitability obligations, marketing and disclosure requirements, and prescribed trading limitations, among other things. These breaches undermine investors' ability to receive full, true and plain disclosure of material information about investment opportunities and expose them to serious risk of substantial harm.

- 1.3. The CCMR Prospectus Exemptions introduce new risk acknowledgement forms in some of the CMR Jurisdictions and carry forward existing forms in others.<sup>2</sup> Currently, there is a dearth of evidence on the effectiveness of these forms. We strongly recommend that the CMRA conduct research on the efficacy of risk acknowledgement practices, particularly taking into account behavioural insights on decision-making biases. It is important that the CMRA understand how these forms—including their design, content and the timing of when they must be completed—affect their usefulness as investor protection tools. We would urge the CMRA to publish the results of its research, and to reform existing risk acknowledgment requirements if the evidence warrants it.
- 1.4. FAIR Canada supports the decision to not incorporate the so-called Northwest exemption into the CCMR Prospectus Exemptions. This exemption—which is currently in effect in certain jurisdictions—exempts dealers from the registration requirement when selling private placement securities under various capital raising exemptions. Research conducted by the B.C. Securities Commission highlighted issues of significant non-compliance with the exemption and heightened investor exposure to high-risk investments.<sup>3</sup>

## **2. Specific Comments**

### **Multilateral Instrument 45-108**

#### ***Crowdfunding prospectus exemption***

- 2.1. As FAIR Canada has noted in previous submissions,<sup>4</sup> we do not support the existence of a crowdfunding exemption. Among other things, we are concerned that many investors do not understand the liquidity constraints of crowdfunding investments in small and medium enterprises (“SMEs”); that there are inadequate mechanisms to ensure adherence to the investor investment and offering limits; and that investors have

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<sup>1</sup> ASC Notice 33-705 – Exempt Market Dealer Sweep, May 10, 2017; OSC Staff Notice 33-748 2017 Annual Summary Report for Dealers, Advisers and Investment Fund Managers (July 11, 2017) (“OSC Notice 33-748”).

<sup>2</sup> See changes to the Family, Friends and Business Associates exemption and Offering Memorandum exemption.

<sup>3</sup> BC Notice and Request for Comment – Proposed Revocation of BC Instrument 32-513 Registration Exemption for Trades in Connection with Certain Prospectus-Exempt Distributions (January 3, 2013).

<sup>4</sup> FAIR Canada Comment Letter RE: Draft Regulation 45-108 respecting Crowdfunding (June 18, 2015).

inadequate recourse in the event of harm. It is incumbent on the CMRA to ensure investors are afforded the highest level of investor protection possible under this exemption and we propose recommendations below which we believe would assist in achieving this goal.

- 2.2. We recommend that the CMRA decrease the individual investor limits under s. 5(1)(c)(i) from \$2,500 to \$500, and from \$10,000 to \$5,000 in total for all distributions under the crowdfunding exemption in a year. The current proposed limits are not small amounts for most retail investors. If the underlying premise of the crowdfunding exemption is that SMEs can meet their capital-raising needs by sourcing a small amount of money from a large number of people, the lower investment limits should not materially impair SMEs' ability to raise funds.
- 2.3. We oppose enabling issuers to achieve their "aggregate minimum proceeds" threshold through concurrent exempt distributions, as is currently permitted under s. 6(b). As discussed below, investors should be notified if an issuer fails to raise the aggregate minimum proceeds through the exemption under which the investor subscribed, and should have the option of cancelling their subscription.
- 2.4. We recommend that a centralized database on which issuers must file and verify aggregate investment and offering amounts be established. A regulator-operated database is more likely to ensure adherence to the prescribed investment and offering limits than the current process of self-certification.
- 2.5. Investors should be informed about crowdfunding opportunities and their risks prior to making investments. We support the imposition of a suitability requirement on funding portals under s. 21(b)(ii)(H), and would additionally recommend that portals be required to ensure that all persons who enter their portals complete an interactive knowledge tutorial before being able to view offerings.
- 2.6. We also recommend that, under s. 35, funding portals be required to provide prominent online disclosure of the amount of capital sought and raised on their sites, issuers' success rates, instances of fraud, etc. Such disclosure would further enhance investors' knowledge of the risks of crowdfunding investments.
- 2.7. We are concerned about the risk of investors being "squeezed out" of any gains or other entitlements in the rare event that they do invest in a successful crowdfunding offering. We recommend that the CMRA prescribe basic mandatory protections for crowdfunding investors, including tag-along and pre-emptive rights.
- 2.8. We are concerned about the carve-out to the general prohibition on direct or indirect advertising and solicitation under s. 11(2). In our view, it must be clear that enabling issuers to "inform" purchasers about their proposed crowdfunding distribution is

limited solely to referring purchasers to the relevant funding portal, so that issuers shall not be able to engage indirectly in advertising and solicitation tactics. It is essential that advertising and marketing be limited to the registered portal so that the CMRA can monitor all communications made regarding crowdfunding distributions.

- 2.9. We recommend 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; to report potential fraud to police and securities regulators; and to notify investors on their portals as appropriate.
- 2.10. As discussed below, FAIR Canada opposes the adoption of the start-up crowdfunding exemption in the CMR Jurisdictions. We therefore oppose the change to s. 41(b), and the addition of s. 41(d), under MI 45-108, which will permit restricted dealer funding portals and registered individuals of these portals to act as intermediaries in start-up crowdfunding exemptions in all of the CMR Jurisdictions.

### **CMRA Regulation 45-501**

#### ***Start-up crowdfunding exemption***

- 2.11. FAIR Canada strongly opposes the adoption of a start-up crowdfunding exemption in the CMR Jurisdictions.<sup>5</sup> There is inadequate evidence supporting the need for such an exemption, particularly given the existence of the general crowdfunding exemption under MI 45-108. Moreover, it seems likely that the existence of these two similar exemptions will create a perverse incentive for issuers to favour the start-up exemption simply because it imposes fewer regulatory requirements on them while enabling them to raise still-sizeable funding amounts. Meanwhile, the waiver of the registration requirement for funding portals under the start-up exemption (and corresponding relaxation of obligations on these portals) eliminates or weakens the few investor protections that exist under the general crowdfunding exemption, such as requirements to conduct due diligence on issuers, provide suitability advice, notify purchasers of amended offering documents, or remove misleading materials from their websites. Given that early-stage start-ups are more likely to experience failure than seasoned issuers, there should be strengthened investor protections under this exemption, not fewer protections. FAIR Canada urges the CMRA to reconsider adopting this exemption, and, barring that, recommends that it introduce the changes discussed below.

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<sup>5</sup> See also: FAIR Canada Comment Letter RE: BC Notice 2014/03 – Notice and Request for Comment on Start-Up Crowdfunding (June 18, 2014)

- 2.12. CMRA Reg. 45-501 prohibits investment funds and companies that are not reporting issuers in any Canadian or foreign jurisdiction from raising funds under the start-up exemption. Following the approach of the U.S. Securities and Exchange Commission, the CMRA should prohibit companies from using this exemption if they have failed to file annual reports, been disqualified from selling securities, or “have no specific business plan.”<sup>6</sup>
- 2.13. We strongly believe that all funding portals should be subject to a registration requirement. Registration will better enable the CMRA to evaluate the effectiveness of this start-up crowdfunding exemption, and to monitor portals and issuers for non-compliance. We also note that there is no comparable registration exemption for funding portals under U.S. securities legislation.<sup>7</sup>
- 2.14. Under s. 13(i), we recommend that, in addition to the requirements currently set out under (i) and (ii), funding portals be required to ensure all persons who enter their funding portals complete an interactive basic knowledge tutorial before being able to view offerings. Funding portals should also be required to provide prominent online disclosure of the capital sought and raised on their sites, issuers’ success rates, instances of fraud, etc.
- 2.15. All funding portals should be required to conduct at least basic due diligence of prospective issuers’ offering documents, with a view to identifying errors, incompleteness, or misleading information. Similar to the provision that exists under s. 27 of MI 45-108, portals should be required to have issuers correct any problematic information prior to posting that information on their platforms.
- 2.16. We would also urge the CMRA to include a requirement similar to s. 28 of MI 45-108, which prohibits start-up funding portals from allowing issuers to use their platforms if they become aware of issuer non-compliance, misstatements, criminal activity by management, or other information that would give rise to concerns about whether the business was being conducted with integrity.
- 2.17. Under ss. 13(o) and 14(h), start-up funding portals are required to “make available to a purchaser through the funding portal’s website the offering document and the risk warnings.” This “make available” requirement must be an affirmative and proactive obligation. Portals should be required to furnish prospective purchasers with these documents and information in a prominent, accessible and navigable manner. Similarly, under s. 14(i), a funding portal should be required to promptly notify purchasers if it has received an amended offering document from an issuer. There is a serious risk that

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<sup>6</sup> CFR, Title 17, Chapter II, Part 227.100(b)(6).

<sup>7</sup> Under the SEC crowdfunding exemption, distributions must take place through a SEC-registered intermediary that is either a broker-dealer or a funding portal. See CFR, Title 17, Chapter II, Part 227.100(a)(3).

investors will not be made aware of material changes if portals are only required to make amended offering documents available on their websites.

- 2.18. We have serious concerns about s. 14(k). This provision enables issuers to reduce the minimum offering amount described in the offering document by the amount raised through concurrent distributions made under other prospectus exemptions. Investors who invest under a crowdfunding exemption might want to cancel their subscriptions if they learn that the issuer is unable to raise the minimum offering amount through crowdfunding (as this could be a signal that the market lacks confidence in the issuer). The issuer's ability to achieve the minimum offering amount through alternative exemptions (such as, for example, the FFBA or AI exemptions) would not necessarily alleviate investors' concerns about the viability of the issuer's business. Investors should be notified about an issuer's failure to achieve the minimum offering amount through the start-up crowdfunding exemption, and informed of their ability to submit a withdrawal notification pursuant to s. 13(r) of CMRA Reg. 45-401 and s. 142 of the Capital Markets Act.
- 2.19. We also oppose that s. 14(k) implicitly permits issuers to concurrently raise funds under the start-up crowdfunding exemption and MI 45-108's crowdfunding exemption. Enabling issuers to rely on these exemptions simultaneously heightens the risk that issuers will breach their compliance obligations (given the likely modest size of their compliance teams), and that the investor protection rationale will suffer. It seems possible, for instance, that investors could circumvent the investment limits that exist under the prospectus exemptions by simultaneously investing in an issuer under both the start-up and general crowdfunding exemptions. The CMRA should prohibit issuers from conducting distributions under these exemptions concurrently, and should impose a cooling-off period between offerings made through these different exemptions.
- 2.20. We strongly urge the CMRA to reduce the maximum amount that any one investor can invest under s. 14(o) from \$1,500 to \$500. In our view, this limit would be appropriate given the significant risk of loss investors face when investing in start-up ventures, as well as the lack of protections they are afforded under this exemption.
- 2.21. The CMRA should ensure that the same liability provisions exist under the general crowdfunding and start-up crowdfunding exemptions, in order to remove perverse incentives for issuers to favour the latter. To that end, we recommend that the CMRA grant purchasers a right of action against issuers for misrepresentations and/or untrue statements comparable to the rights that currently exist under ss. 9 and 10 of MI 45-108.
- 2.22. Start-up funding portals should have obligations with respect to investor complaints, including participation in the Ombudsman for Banking Services and Investments. They

should be required to have a formalized process for receiving and tracking complaints; to report potential fraud to police and securities regulators; and to notify investors on their portals as appropriate.

### ***Existing security holders exemption***

- 2.23. FAIR Canada supports the CMRA's decision to base the existing security holder exemption on OSC Rule 45-501. As detailed in the CMRA's commentary on the CCMR Prospectus Exemptions,<sup>8</sup> Ontario's exemption includes certain investor protection provisions that are broader than those under BC Instrument 45-534.
- 2.24. We note that s. 8 defines "record date" as the date that is "at least one day prior to the announcement date." In our view, the "record date" should be 30 days prior to the date of the announcement, to prevent potential abuse of this exemption by market participants, particularly by persons close to the issuer who may have access to information about the proposed offering.
- 2.25. The \$15,000 investment limit stipulated under s. 9(1)(j) is arbitrary. We suggest that the CMRA instead permit investors to purchase up to the number of issuer securities held as of the record date (for example, if an investor holds 10,000 shares, he can purchase up to an additional 10,000 shares).<sup>9</sup>

### ***Real estate securities***

- 2.26. We urge the CMRA to actively monitor the use of the real estate securities exemption by developers, to ensure compliance and to identify risks and possible abuses of an exemption that has not previously been applied in any of the CMR jurisdictions other than B.C.
- 2.27. We support the CMRA's decision to introduce a requirement for developers to file a report of exempt distribution when conducting distributions under this exemption.

### **National Instrument 45-106**

#### ***Family, friends and business associates exemption***

- 2.28. As the OSC identified in 2017, there are widespread issues of non-compliance with the family, friends and business associates exemption ("**FFBA exemption**"), including inadequate documentation of how purchasers qualify, the processing of trades for

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<sup>8</sup> See Commentary, p. 16.

<sup>9</sup> See also FAIR Canada Comment re: RE: Multilateral CSA Notice 45-312: Proposed Prospectus Exemption for Distributions to Existing Security Holders (January 20, 2014).

clients who do not qualify, and the failure to ensure risk acknowledgment forms are completed.<sup>10</sup> We would generally urge the CMRA to devote more regulatory resources, including enforcement, to ensuring compliance with this exemption.

- 2.29. We also note that the FFBA exemption is particularly susceptible to abuse because it can be relied upon by persons who engage in affinity fraud (i.e. the victimization of individuals with whom the person shares an affiliation, such as family, friends and social organizations). We urge the CMRA to closely monitor and track incidences of fraud that involve family and friends, take enforcement action where appropriate and make its findings publicly available.
- 2.30. FAIR Canada supports the CMRA's decision to require purchasers who rely on the FFBA exemption to sign risk acknowledgment forms. As noted above, though, we would urge the CMRA to test whether these forms are efficacious, and if not, to develop alternative means of ensuring investors appreciate the risks they are assuming when they invest under this exemption.

### ***Offering memorandum exemption***

- 2.31. FAIR Canada has a number of concerns about the offering memorandum exemption (the "**OM exemption**") that we have detailed elsewhere<sup>11</sup>, but we support the decision to adopt Ontario's OM exemption in the CMR Jurisdictions. In our view, Ontario's requirements prescribe investment limits that are better calibrated to an investor's financial means and knowledge of risk than is the case in the other CMR Jurisdictions' OM exemptions.
- 2.32. We support the decision to prohibit complex financial products from being distributed pursuant to the OM exemption,<sup>12</sup> as well as the prohibition on investment funds using this exemption.<sup>13</sup> We oppose the carve out of mortgage investment corporations from the investment fund exclusion.

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<sup>10</sup> See OSC Notice 33-748 and the OSC's Registrant Series: Exempt Market Dealers (EMD) (November 2017).

<sup>11</sup> See FAIR Canada Comment dated June 18, 2014 re: Multilateral CSA Notice of Publication and Request for Comment Proposed Amendments to National Instrument 45-106 *Prospectus and Registration Exemptions* March 20, 2014; See FAIR Canada Comment dated June 18, 2014 re: OSC Notice on Introduction of Proposed Prospectus Exemptions March 20, 2014

<sup>12</sup> See s. 2.9(2.1) (d).

<sup>13</sup> See s. 2.9(2.2).



- 2.33. We support the decision to prescribe that OM marketing materials be incorporated by reference into the offering memorandum, as this will ensure statutory liability applies to misrepresentations in marketing materials.<sup>14</sup>
- 2.34. We support the decision to require issuers to file their OM marketing materials and annual financial statements with the Chief Regulator. However, we would additionally urge the adoption of a regulatory review process for OM disclosures to assess and measure compliance with applicable OM requirements.
- 2.35. Finally, we note that the OSC has identified widespread issues of non-compliance with the OM exemption, including failure to collect information to assess compliance with the investment limits; failure to comply with the investment limits; and failure to comply with the risk acknowledgement form requirements. We strongly recommend that the CMRA increase the level of oversight of exempt market participants and conduct 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.

### ***Mortgages exemption***

- 2.36. FAIR Canada supports the decision to apply B.C.'s mortgages exemption to all of the CMR Jurisdictions. As we noted in our June 2018 comment letter,<sup>15</sup> retail investors need to be better protected from high-risk<sup>16</sup> real estate investments. We therefore welcome the removal of prospectus and registration exemptions for securities that are syndicated mortgages, as well as the adoption of Appendix A to Form 45-106F2 *Offering Memorandum for Non-Qualifying Issuers* and Form 45-106F3 *Offering Memorandum for Qualifying Issuers*.
- 2.37. Under s. 2.9(7) of NI 45-106, we recommend that purchasers be granted a right of action against mortgage brokers (in addition to issuers) if an OM contains a misrepresentation.

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<sup>14</sup> See s. 2.9(5.1).

<sup>15</sup> FAIR Canada Comment Letter RE: CSA Notice and Request for Comment on Proposed Amendments to National Instrument 45-106 Prospectus Exemptions and National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations relating to Syndicated Mortgages and Proposed Changes to Companion Policy 45-106CP Prospectus Exemptions (June 13, 2018).

<sup>16</sup> As the Canadian Securities Administrator acknowledged in its March 2018 consultation document, syndicated mortgages can be high-risk because they may be used to raise seed funding for real estate developments; they may be sold on the basis of projected values; they may not be fully secured; they may be subordinate to future financings; and they may be offered by issuers with no source of income. In addition, we note that there are almost no restrictions on who may invest in syndicated mortgage investments, or on the amounts that may be invested. See [https://www.osc.gov.on.ca/documents/en/Securities-Category4/ni\\_20180308\\_45-106\\_syndicated-mortgages.pdf%20](https://www.osc.gov.on.ca/documents/en/Securities-Category4/ni_20180308_45-106_syndicated-mortgages.pdf%20)

- 2.38. Under s. 2.36 of NI 45-106, we recommend that the CMRA restrict the volume of business that any one appraisal firm can provide to a given issuer group and/or mortgage broker, to help ensure appraisal firms maintain their independence. We also recommend that Appendix A to Forms 45-106F2 and F3 include disclosure language that cautions investors on placing undue reliance on appraisals, explain the main types of appraisals that can be generated (i.e. cost basis, comparable sales basis, economic value, fair value, etc.) and the limitations of each type.
- 2.39. Item 18 of Appendix A to Forms 45-106F2 and F3 requires mortgage brokers to certify that, to the best of their knowledge, the OM does not contain a misrepresentation. We support this requirement, but additionally recommend that the CMRA require mortgage brokers to undertake due diligence and certify that, to the best of their knowledge, information and belief, the OM provides disclosure of all material facts required under securities legislation.
- 2.40. Finally, we recommend that the CMRA review a certain percentage of the OMs involving the distribution of syndicated mortgages to ensure that market participants are complying with their disclosure obligations.

### ***Discretionary exemptions***

- 2.41. FAIR Canada opposes the amendments proposed in s. 7.1, which will enable the Chief Regulator to grant discretionary exemptions from NI 45-106 in its entirety. We urge the CMRA to instead adopt the more restrictive standard currently in place in Ontario, as articulated in s. 7.1(2), which only permits the regulator to grant exemptions from the reporting requirements set out under Part 6 of the instrument.

### **CMRA Regulation 11-501**

- 2.42. We oppose the proposed carve-out under s. 15(5) of CMRA Reg. 11-501 for statutory liability for misrepresentations in an offering memorandum made available or provided under certain exemptions, including the crowdfunding exemption in MI 45-108 (for non-reporting issuers) and the start-up crowdfunding exemption in CMRA Reg. 45-501. The threat of liability for misrepresentations is one crucial way to incentivize issuers to comply with their obligations when conducting distributions under this exemption.
- 2.43. We oppose the CMRA's decision not to extend section 16 of CMRA Regulation 11-501 as previously indicated in the Commentary to the initial draft regulations under the Capital Markets Act.
- 2.44. We support the CMRA's decision to include offering memoranda delivered under the OM exemption, the (original or amended) crowdfunding offering document delivered under the crowdfunding exemption, and the offering document made available under

the start-up crowdfunding exemption, as “prescribed disclosure documents” for the purposes of a right of rescission under s. 142 of the Capital Markets Act.

- 2.45. We support the CMRA’s proposal to revise s. 24 of CMRA Reg. 11-501 to provide that securities distributed under the existing security holder exemption will be subject to Part 13 of the Capital Markets Act (which establishes civil liability for secondary market disclosure).

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 Frank Allen at 416-214-3443/frank.allen@faircanada.ca or Marian Passmore at 416-214- 3441/marian.passmore@faircanada.ca.

Sincerely,



Canadian Foundation for the Advancement of Investor Rights