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ENFORCEMENT ISSUES ASSOCIATED WITH PROSPECTUS EXEMPTIONS IN CANADA*

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SUMMARY

This paper examines the regime of prospectus exemptions in Canada. The focus is on the enforcement process, and to this end the article includes an empirical examination of enforcement actions by both the securities regulators and the Investment Industry Regulatory Organization of Canada (IIROC).

The end in view is two-fold; to provide a description of the exempt market and enforcement efforts, and to comment on whether enforcement resources are properly deployed. The latter necessarily requires a critical examination of the nature of the various exemptions, their purposes, and whether they are appropriately crafted to achieve their desired ends. That in turn requires an analysis of which issuers use the various exemptions, what types of securities are issued, and who the buyers are. Unfortunately, the Canadian data falls far short of painting a comprehensive or reliable picture of the exempt market.

This is a product of many factors. Notably, many exempt financings need not be reported to the regulators. Moreover, many small private companies do not report their exempt financings even when required to do so. The extent of the under-reporting problem (from both causes) is illustrated by data from Statistics Canada suggesting that in 2014, there were about 156,000 exempt financings across Canada. However, in that year, only about 7,125 exempt financing reports were filed with the regulators.

Understanding the nature of the exempt market is also hindered by the fact that not all of the provincial regulators compile statistics relating to the use of the various exemptions, and even among regulators that provide statistics, these are not published on an annual basis. Added to this, the published statistics that we have fall far short of painting a comprehensive or picture of the exempt market. The regulators do not compile cross-tabulated statistics relating to the nature of the issuers, the types of purchasers, the amount of capital raised, and the types of securities issued. Nor do they keep statistics on redemptions of prospectus-exempt securities, thus potentially yielding a material overstatement of the net amount of prospectus exempt financings each year.

The inability to comprehensively describe how the exempt market is used makes it difficult to determine if the exemptions are achieving their stated purposes, and

* This research was financially supported by the Government of Canada via a partnership with Western Economic Diversification.

whether the body of exemptions is appropriately crafted. This difficulty is particularly great in relation to exemptions that depart from a strict investor protection rationale and which are designed to address perceived capital gaps in the funding landscape. Appropriately crafting such exemptions requires a finely honed understanding of where and why capital gaps exist in the Canadian funding landscape, and the mechanisms by which these may be addressed. Such analysis, unfortunately, has been lacking.

Prospectus exempt securities are mainly purchased by governments, institutions, corporations, and retail investors. Because retail investors possess a heterogeneous degree of investment knowledge and sophistication, the greatest investor protection issues are likely to arise in respect of such investors. These dangers may be mitigated by the involvement of a registrant in the purchase of an exempt security, since every registrant is charged with the duty to "know your client" and to make a judgment about the suitability of all client investments. Even in such cases, however, retail investors are not free from risk. As noted below, there are many enforcement cases in which retail investors (most often with the complicity of the registrant) misrepresent their qualifications on "know your client" forms and invest in securities with unsuitable risk/return characteristics. In addition, there is the danger that either the issuer or the registrant will misrepresent the risk/return characteristics of the exempt security to the retail buyer, again resulting in the purchase of an unsuitable investment.

An examination of enforcement efforts by securities regulators and IIROC indicates that enforcement proceedings almost invariably involve retail investors. Securities regulators, who typically hear cases involving non-registrants, tend to impose rigorous sanctions. Severe sanctions are amply justified in order to deter wrongdoing, particularly as many cases involving abuse of the prospectus exemptions by non-registrants likely go unreported and hence unremedied.

IIROC, which hears complaints involving registrants, tends to mete out less severe sanctions than the securities regulators. This gives rise to a concern that, because IIROC is funded by the investment industry, it has a tendency to be lenient on those who provide the financial support for its existence. Alternatively, the difference in sanctions may simply be a function of the fact that cases involving non-registrants (i.e. those heard by the securities regulators) tend to involve more serious conduct, particularly fraud. Further inquiry is indicated.

One of the most important results from the data is conspicuous by its absence: namely, disciplinary cases involving exempt market dealers (EMDs). EMDs, which are permitted in all jurisdictions, may participate only in prospectus-exempt financings. Like investment dealers, they are impressed with KYC and suitability duties. However, unlike investment dealers, they are not required to belong to IIROC or any other SRO, and none exists for EMDs (who are regulated only by the securities regulators). Securities regulators should give serious consideration to requiring the creation of an SRO for EMDs.

There is a vast discrepancy in cost between prospectus financings and exempt financings for which there is no mandatory disclosure. The regulators have addressed this in part by providing an intermediate disclosure vehicle in the form of the offering memorandum (OM) exemption. However, the rules relating to the OM vary materially from province to province, making it difficult for an issuer to effect a cross-country financing. The OM will not be a realistic alternative for most multi-province issuers unless and until there are harmonized rules across the country. Alternatively, the OM could be made subject to the passport system, so that there is only one principal regulator for an OM issuance.

Lastly, the vast difference in cost between prospectus and prospectus exempt financings should inspire the regulators to give serious consideration to reducing the cost of a prospectus offering by moderating the burden of mandatory disclosure.

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QUESTIONS QUANT À LA MISE EN APPLICATION DANS LE CADRE DU RÉGIME DE DISPENSES DE PROSPECTUS AU CANADA*

Jeffrey MacIntosh

RÉSUMÉ

Cet article se penche sur le régime de dispenses de prospectus au Canada. On y met l'accent sur les processus de mise en application et, à cette fin, l'article propose un examen empirique des mesures prises par les autorités en valeurs mobilières et par l'Organisme canadien de réglementation du commerce des valeurs mobilières (OCRCVM).

L'objectif visé comprend deux volets : d'une part, décrire le marché dispensé et les efforts de mise en application et, d'autre part, voir dans quelle mesure les ressources de mise en application sont adéquatement déployées. Pour ce dernier point, il est nécessaire de faire un examen critique de la nature des diverses dispenses, d'en connaître les objectifs et de voir si elles permettent d'atteindre les buts visés. À cette fin, il faut pousser l'analyse afin de savoir qui sont les émetteurs ayant recours aux diverses dispenses, quels types de valeurs mobilières sont émises et qui en sont les acheteurs. Malheureusement, les données au Canada ne sont pas suffisantes pour brosser un portrait complet ou fidèle du marché dispensé.

Nombre de facteurs expliquent cette situation. Entre autres, plusieurs types de placements dispensés ne doivent pas obligatoirement faire l'objet d'une déclaration devant les autorités. Qui plus est, plusieurs petites compagnies privées ne déclarent pas leurs placements dispensés, et ce, même quand elles y sont tenues. Les données de Statistique Canada illustrent bien l'étendue de cette sous-déclaration (pour les deux causes mentionnées) puisque sur les quelque 156 000 placements dispensés recensés au Canada en 2014, il n'y a eu que 7 125 rapports consignés auprès des autorités compétentes.

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La compréhension du marché dispensé est aussi obstruée par le fait que ce ne sont pas toutes les autorités provinciales en valeurs mobilières qui recueillent des statistiques sur le recours aux diverses dispenses; et même parmi celles qui le font, les statistiques ne sont pas publiées sur une base annuelle. De plus, les statistiques disponibles ne permettent pas de brosser un portrait complet et fidèle du marché dispensé. Les autorités en valeurs mobilières ne tiennent pas de statistiques recoupées quant à la nature des émetteurs, aux types d'acheteurs, au montant des capitaux mobilisés ou aux types de valeurs mobilières émises. Elles ne tiennent pas non plus de statistiques sur le rachat de titres dispensés de prospectus, donnant ainsi lieu à une surévaluation potentielle du montant net des placements dispensés de prospectus pour chaque année.

En raison de l'incapacité de décrire adéquatement l'utilisation du marché dispensé, il est difficile de déterminer si les dispenses permettent d'atteindre les objectifs visés ou si le cadre des dispenses est conçu adéquatement. Cette difficulté est particulièrement grande dans le cas des dispenses qui dérogent au principe strict de la protection des investisseurs et qui visent à remédier aux écarts de capitaux perçus dans l'univers des placements. Pour une mise en place adéquate de ce type de dispenses, il faudrait avoir une excellente connaissance de ces écarts au Canada (pourquoi existent-ils, où se trouvent-ils?) ainsi que des mécanismes qui permettent d'y remédier. Une telle analyse fait malheureusement défaut.

Les titres dispensés de prospectus sont principalement achetés par les gouvernements, les institutions, les entreprises ou les investisseurs particuliers. Puisque ces derniers possèdent un niveau inégal de connaissances et de compétences en placements, c'est chez eux qu'on rencontre le plus grand risque de problèmes liés à la protection des investisseurs. Ces risques peuvent être atténués en faisant intervenir une personne inscrite dans l'achat d'un titre dispensé, puisque que tous les inscrits ont le devoir de « connaître leur client » et d'apprécier la pertinence de chaque placement du client. Même ici, les investisseurs particuliers ne sont pas à l'abri de tout risque. Tel qu'indiqué ci-dessous, il existe plusieurs cas de mise en application où les investisseurs particuliers (le plus souvent avec la complicité de la personne inscrite) se présentent de façon inexacte sur les formulaires visant à « connaître le client » et font des placements dans des valeurs mobilières dont les caractéristiques du risque par rapport au rendement sont inappropriées. De plus, il y a le danger que l'émetteur ou la personne inscrite présente de façon erronée, à l'acheteur particulier, les caractéristiques du risque par rapport au rendement; ce qui donne encore lieu à l'achat d'un placement inadéquat.

L'examen des données venant des autorités en valeurs mobilières et de l'OCRCVM indique que les mesures d'application de la loi concernent presque invariablement des investisseurs particuliers. Les autorités en valeurs mobilières, qui se retrouvent habituellement devant des cas impliquant des personnes non inscrites, ont tendance à imposer de lourdes sanctions. Ces sanctions sévères sont amplement justifiées et visent à prévenir les actes fautifs, notamment puisque nombre de cas où il y a abus du recours à la dispense de prospectus par des personnes non inscrites sont susceptibles de ne pas être déclarés et, par conséquent, non résolus.

L'OCRCVM, qui reçoit les plaintes impliquant des personnes inscrites, a tendance à infliger des sanctions moins sévères que les autorités en valeurs mobilières. Cela est préoccupant puisque l'OCRCVM, qui est financé par le secteur du placement, est enclin à se montrer plus indulgent envers ceux qui en assurent l'existence. En revanche, la différence dans les sanctions pourrait simplement résulter du fait qu'il y a peut-être plus souvent dans les cas impliquant des personnes non inscrites (c'est-à-dire, ceux qu'entendent les autorités en valeurs mobilières) des actes répréhensibles, notamment de la fraude. Il y a lieu ici de pousser l'enquête.

Un de résultats les plus importants tirés des données est mis en évidence par un manque : il s'agit des cas disciplinaires où entrent en jeu des courtiers sur le marché dispensé (CMD). Les CMD, qui sont permis dans toutes les juridictions, peuvent intervenir uniquement dans les placements dispensés de prospectus. Comme les courtiers en valeurs mobilières, ils sont soumis aux devoirs de connaissance du client et de convenance au client. Cependant, contrairement aux courtiers, les CMD ne sont pas tenus d'adhérer à l'OCRCVM ou autre organisme d'autoréglementation. Il n'existe pas de tel organisme pour les CMD (qui sont réglementés uniquement par les autorités en valeurs mobilières). Les autorités devraient donc sérieusement considérer la création d'un organisme d'autoréglementation pour les CMD.

Il y a forte divergence de coûts entre les placements avec prospectus et les placements dispensés pour lesquels la divulgation n'est pas obligatoire. Les autorités ont traité en partie ce problème en proposant un moyen intermédiaire de divulgation sous la forme de dispense au moyen d'une notice d'offre. Cependant les règles liées à cette notice varient d'une province à l'autre, ce qui rend difficile pour un émetteur d'effectuer un placement à plusieurs endroits du pays. La dispense au moyen d'une notice d'offre n'est donc pas un choix réaliste pour les émetteurs qui exercent dans plusieurs provinces, et ce, tant que les règles ne seront pas harmonisées partout au pays. Par ailleurs, la notice pourrait fonctionner selon le régime de passeport, de sorte qu'il n'y ait qu'une seule autorité compétente pour l'émission des dispenses au moyen d'une notice d'offre.

Pour terminer, la grande différence de coûts entre les placements avec prospectus et les placements dispensés devrait porter les autorités en valeurs mobilières à sérieusement considérer une réduction des coûts d'accès au financement en atténuant le fardeau de la divulgation obligatoire.

I. INTRODUCTION

In Canada, the default rule is that when a business enterprise issues securities, it must put together a complex document known as a prospectus. A central motivation for the prospectus requirement is investor protection; i.e., it is assumed that without the complex disclosure found in the prospectus, investors will have an insufficient basis upon which to make sound and informed investment decisions. Another is to facilitate the achievement of allocative efficiency by ensuring that the funds of net savers are directed to the net users of capital that promise the best risk/return trade-offs.

Assembling a prospectus is an expensive and time-consuming exercise. A long-form prospectus (used for initial public offerings) will rarely be fewer than 50 pages, and can easily run to 200 pages or more.[1] The legal, audit and accounting costs for a small offering are typically in the range of $200,000 to $500,000; for a larger offering, $500,000 to $1 million or more.[2] The typical IPO process will take approximately 100 days,[3] and during this time senior management will be able to devote very little time to actually running the business (as opposed to meeting with and answering questions from lawyers, auditors, underwriters, regulators, etc., and participating in sales efforts).

Luckily, there are a host of exemptions from the prospectus requirement. The exemptions are filters that allow investors to purchase securities in primary market offerings without the benefit of a prospectus, on the theory that cases will arise in which a prospectus is not needed to effect the investor protection and allocative efficiency goals. Thus, the prospectus exemptions are a central feature of the investor protection regime in Canadian securities law.

The thrust of this paper is to examine how the prospectus exemptions are enforced in Canada. In order to do so, a host of intertwined issues come into play, including the following:

1. An examination of the efficacy of the exemptive scheme (and corresponding enforcement efforts) requires a review of when the various exemptions are used and by whom. I begin by reviewing the record.
2. In order to go beyond the merely descriptive, and to address the normative issue of whether the types and levels of enforcement are appropriate, it is necessary to examine whether the exemptions themselves are appropriately drawn to effect the investor protection (and allocative efficiency) goals. Thus, a considerable part of the paper is devoted to:
    a) Enumerating the various rationales for the prospectus exemptions;
    b) Classifying each exemption according to its underlying rationale(s);
    c) Examining whether the different exemptions are properly crafted to achieve their underlying rationale(s);
    d) Determining which exemptions are most likely to leave unresolved investor protection issues requiring relatively vigorous enforcement efforts.
3. Many investors purchase prospectus-exempt securities through the services of a registrant, or securities market professional; that registrant is typically subject to "know your client" (KYC) and "suitability" obligations. Understanding the efficacy of enforcement efforts thus requires a review of registrant-related enforcement initiatives.

The last part of the paper examines the breadth and scope of enforcement efforts by securities regulators, the Investment Industry Regulatory Organization of Canada (IIROC), and the courts, and comments on the efficacy of these enforcement efforts. I find that in the main, enforcement

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1 See e.g., the April 9, 2007 prospectus of Anaconda Gold Corporation (available on sedar.com) which runs to over 200 pages.

2 See PWC, "Guide to Going Public in Canada," (April 2014), available at https://www.pwc.com/ca/en/transaction-service/publications/pwc-guide-going-public-canada-2014-05-en.pdf p. 27.

3 Ibid., 5.

efforts are appropriately centred on problems that arise in relation to retail clients and registrants advising retail clients on the purchase of exempt market securities. A number of recommendations are made, including:

a) Regulators should make more vigorous efforts to achieve an empirical mapping of the exempt market;

b) While investor protection concerns are foremost in the design of most prospectus exemptions, some (such as the crowdfunding exemption and the rights-offering exemption) appear to compromise investor protection in order to facilitate capital raising in particular segments of the market or in relation to particular types of offerings. These are not based on any systematic attempt to determine where market gaps exist in the funding of Canadian enterprise. An inquiry of this nature would shed much light on the appropriateness of the existing exemptive regime;

c) The idea of investor protection is capable of bearing a number of different meanings. Regulators, however, have never made any systematic attempt to define precisely what they mean by "investor protection", or how this idea relates to securities market efficiency or the idea of fairness in securities markets. Efforts should be made to address these important issues;

d) A regulatory lacuna exists in the case of exempt market dealers (EMD), which (unlike other securities market professionals) are unregulated by any self-regulatory organization. Regulators should give consideration to requiring the creation of an SRO for EMDs and mandating certain supervisory responsibilities;

e) To resolve provincial differences in the prospectus exemptions, the regulators should consider adopting a mutual recognition system for prospectus exemptions. Failing this, a nationally co-ordinated effort should be made to produce a master chart indicating precisely which exemptions are available in which provinces;

f) Regulators should (as they now do) vigorously enforce the KYC and suitability obligations of registrants. Sanctions should be particularly severe in cases involving induced misrepresentation, in which the registrant encourages the client to misrepresent their KYC information on account documents in order to invest in exempt securities;

g) Regulators should closely monitor the extent to which the new crowdfunding exemption is consistent with investor protection;

h) The large gulf in cost between financings requiring a prospectus and those which are prospectus-exempt raises the issue of whether the current prospectus disclosure requirements are excessive. Consideration should be given to further simplifying these disclosure requirements;

i) The sanctions meted out by IIROC tend to be less severe than those meted out by the securities regulators. There are a variety of potentially benign explanations for this result (such as the differential nature of the cases heard by IIROC and the securities regulators). Nonetheless, as IIROC is funded by its member firms (based on each firm's capital, number of registrants, trading activity and revenues)[4] further examination is warranted to determine whether IIROC's relative leniency is a function of its reluctance to sanction its own members.

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[4] IIROC, "IIROC History & FAQ," available at http://www.iiroc.ca/about/ourroleandmandate/Pages/IIROC-History-FAQ.aspx#3

II. THE SPECTRUM OF EXEMPTIONS

Exemptions come in a variety of types. At one end of the spectrum are what might be styled the wholesale exemptions, which remove the prospectus requirement without substituting any other form of investor protection. The accredited investor exemption is an example. If the purchaser satisfies the definition of "accredited investor", then that person may invest without hindrance in any issuer in any amount at any time.

Other exemptions might be styled the equivalence exemptions. These withhold the prospectus obligation while substituting informational requirements that essentially replicate the mandatory disclosure in a prospectus, or substitute an alternative suite of investor protection mechanisms. One example is the TSX Venture Exchange Offering Document (see Table 7), which essentially replicates prospectus disclosure. Another is the exemption for business combinations and reorganizations (also digested to Table 7), in which investors are protected by a combination of mechanisms including mandatory disclosure, shareholder votes and various forms of merit regulation.

Last, but certainly not least, there are a variety of hybrid exemptions. These relieve the issuer from the prospectus requirement but substitute one or more other investor protection mechanisms (which may include some quantum of mandatory disclosure), usually with a view to lowering the issuer's financing costs while maintaining an acceptable level of investor protection. Many exemptions are of this variety, including the negotiable short-term paper and promissory note exemption,[5] the rights offering exemption,[6] the offering memorandum exemption[7] and the crowdfunding exemption (the CF exemption).[8]

I first discuss what we know about the use of the prospectus exemptions. This discussion is helpful in determining where enforcement issues are likely to arise. I then discuss the rationale and empirical assumptions that lie behind the prospectus requirement and the exemptions. This too is an important ingredient in evaluating where enforcement resources should be concentrated. I next discuss the allocation of enforcement responsibilities among self-regulatory organizations (SROs), securities regulators and the courts, the types of cases that each hears, and the sanctions each metes out. Finally, I discuss the normative issue of whether enforcement resources are appropriately allocated.

III. WHAT DO WE KNOW ABOUT THE MARKET FOR PROSPECTUS-EXEMPT SECURITIES?

A. Incompleteness of the Data

1. The Reporting Obligation Does Not Include All Exemptions

Although there are on the order of 50 national prospectus exemptions,[9] exempt distributions need

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5 NI 45-106, s.2.35.

6 Ibid., s.2.1.

7 Ibid., s.2.9.

8 MI 45-108 (applying in Ontario, Quebec, New Brunswick and Nova Scotia). In Manitoba, the pertinent instrument is Blanket Order 45-502 ("Start-up Crowdfunding Prospectus and Registration Exemption"); in Saskatchewan, General Order 45-929 ("Start-up Crowdfunding Registration and Prospectus Exemptions").

9 The national exemptions are those agreed to and enacted in all provinces and territories. They are embodied in National Instrument (or NI) 45-106. In addition, many provinces and territories have jurisdiction-specific exemptions.

only be reported in connection with 10 of these.[10] Many of the most commonly used prospectus exemptions (such as the accredited investor exemption) give rise to reportable transactions. However, other important exemptions do not, such as the private issuer exemption, the negotiable short-term paper and promissory note exemption (widely used by financial institutions to raise large volumes of short-term money),[11] the rights offering exemption and the institutional debt securities exemption.

2. The TSX Venture Exchange Offering Exemption is Not a True Prospectus Exemption

While the TSX Venture Exchange offering[12] is a reportable exemption, it is arguably not a true prospectus exemption. Rather, it is an alternative form of public offering for companies that are listed on the TSX Venture Exchange, utilizing a short-form prospectus not unlike that in a non-exempt financing.[13] While it is appropriate to make such offerings reportable, it is inappropriate to classify such offerings as exempt market offerings. Doing so obscures the size of both the Canadian public and private markets.

3. The Under-Reporting Problem

Figures garnered from Ontario regulators and from Statistics Canada suggest that the vast bulk of exempt financings are not reported. Data from Ontario[14] indicate that in the first eight months of 2014, about 3,800 exempt financing reports were filed by issuers other than investment funds. These exempt offerings raised a total of $41 billion. Thus, the average money raised per filed report was $10.8 million. These 3,800 reports represented a total of 22,000 purchases; the average purchase (per purchaser per report) was thus $1.86 million.[15]

These figures are telling. It is clear that issuers who report their financial transactions are very large issuers raising a very significant amount of capital. It also seems clear from the magnitude of the average purchase that most of the purchasers are institutional buyers.

Projected over 12 months, this suggests that about 5,700 reports were filed in the course of the entire year by issuers other than investment funds. Since about 80 per cent of Canada's economic

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[10] In NI 45-106, these are:

(a) Accredited investor (NI 45-106, s.2.3);
(b) Family, friends and business associates (NI 45-106, ss.2.5, 2.6, 2.6.1);
(c) Offering Memorandum (until recently, not offered in Ontario) (NI 45-106, s.2.9);
(d) Minimum amount invested: Cash ($150,000) (NI 45-106, s.2.10);
(e) Minimum amount invested: Asset acquisition ($150,000) (NI 45-106, s.2.12);
(f) Petroleum, natural gas and mining properties (NI 45-106, s.2.13);
(g) Securities for debt (NI 45-106, s.2.14);
(h) Additional investment in investment funds (NI 45-106, s.2.19);
(i) Isolated distribution by issuer (NI 45-106, s.2.30);
(j) TSX Venture Exchange offering (NI 45-106, s.5.2).

In some cases, individual provinces have exemptions that are also subject to the reporting obligations (such as Ontario's "government incentive security" exemption. See Ontario Securities Commission Rule 45-501, ss.2.1, 6.1.)

[11] Vijay Jog, "The Exempt Market in Canada: Empirics, Observations and Recommendations," *SPP Research Papers*, The School of Public Policy, University of Calgary, March 2015, 10, 12 (note 45), 13, 18. Evidence presented in this paper supports this conclusion.

[12] TSXV Corporate Finance Policies, Policy 4.6, "Public Offering by Short Form Offering Document."

[13] See National Instrument 41-101, "General Prospectus Requirements," and Companion Policy 41-101CP.

[14] OSC "Backgrounder: Exempt Market Review," Nov. 5, 2015, 6.

[15] A further 2,100 reports were filed by investment funds, raising $80 billion in total, or $38,100 per filing.

activity occurs in Ontario, this suggests that in 2014 there would have been about 7,125 exempt financing reports filed in all of Canada, representing 41,250 individual purchases.

Data from Statistics Canada, however, suggest that these reported transactions constitute a small fraction of all exempt financings. Table 1 indicates that there are about one million active enterprises in Canada in any given year. Table 2 further indicates that approximately 60,000 to 80,000 new enterprises are created each year.

TABLE 1 ACTIVE CANADIAN ENTERPRISES

NUMBER OF EMPLOYEES	2011	2012	2013
1-4	681,020	693,760	750,180
5-9	182,460	184,680	194,680
10-19	98,270	99,710	105,280
20-49	57,830	59,770	62,850
50-99	17,290	18,080	18,880
100-199	6,690	6,860	7,100
200-249	1000	1,020	1,060
250-499	1840	1,850	1,850
500-999	760	780	790
1000+	790	750	750
TOTAL	1,047,940	1,067,260	1,143,430

Source: Statistics Canada, Table 529-0001: "Active enterprises with one or more employees, by North American Industry Classification System and enterprise size."

TABLE 2 ENTERPRISE BIRTHS

NUMBER OF EMPLOYEES	2011	2012	2013
1-4	47,870	56,950	64,780
5-9	6,770	6,920	8,040
10-19	2,520	2,710	3,280
20-49	1,280	1,360	1,780
50-99	340	370	430
100-199	70	100	100
200-249	10	10	10
250-499	0	0	10
500-999	0	0	0
1000+	0	0	0
TOTAL	58,870	68,420	78,430

Source: Statistics Canada Table 529-0002: "Employer enterprise births, by North American Industry Classification System and enterprise size annual (number)."

Not every enterprise will issue securities (e.g., those that are organized as sole proprietorships). Nonetheless, most enterprises issue securities as that term is defined in securities legislation, including partnership units, limited partnership units, shares and debt financing instruments.[16] Thus, the likelihood is that a large proportion of Canadian enterprises do in fact issue securities.

[16] See e.g., *Ontario Securities Act,* R.S.O. 1990, c. S.5, s.1 (definition of "security").

If we assume that only 10 per cent of the stock of Canadian enterprises raise fresh funds via a prospectus-exempt financing in a given year, that entails 100,000 prospectus-exempt financings. If we further assume that 80 per cent of the approximately 70,000 enterprises created each year issue securities, that accounts for an additional 56,000 prospectus-exempt financings. Adding together the financings by existing and new enterprises yields a total of 156,000 exempt financings per year.[17] While it is difficult to know if the same ratio of financings/individual investments observed in reported financings (5.79) applies, this would seem to be a defensible guess, yielding a total of 903,240 individual financings per year. Under this assumption, reported exempt investments account for only about 4.6 per cent of all exempt investments.

4. Reporting Bias: Large Versus Small Issuers

Under-reporting is a product of two factors. First, not all exempt market financings are legally required to be reported. Second, even where there is a legal reporting requirement, it is not always observed.

In respect of financings that are reportable, the figures just quoted strongly suggest that such financings are dominated by large issuers selling securities to institutional investors. This in turn suggests that the under-reporting problem is concentrated in financings effected by small issuers that mainly sell securities to retail investors. This is not at all surprising. Large issuers are much more likely to have internal compliance departments and easy access to legal advice. They are also likely to be subject to relatively close monitoring by regulators. All of these factors lead to a high rate of regulatory compliance. By contrast, most small issuers do not have internal compliance departments or ready access to legal advice, and tend to operate under the radar of the regulators. They can thus be expected to have a relatively low rate of compliance.

Moreover, large issuers are much more likely to rely on reportable exempt financings than small issuers. Data presented below indicate that large issuers sell securities in relatively large distributions to a relatively small number of buyers (very likely institutional), and rely on the accredited issuer exemption — the use of which is reportable. Small firms, by contrast, sell securities in small distributions to retail buyers. Many of these financings will be effected under the private issuer exemption, which is not reportable. They may also be effected under the family, friends and business associates exemption (FFBA), which is reportable. However, the reporting obligation may be honoured more in the breach than the observance.

5. The Duration/Redemption Problem

Reported data on exempt financings do not indicate the duration of the financing, or when securities that are issued are redeemed or otherwise retired by the issuer. This leads to a tendency to overstate the size of the exempt market.[18]

This concern is particularly pertinent to investment funds that are in continuous distribution. In a given year, for example, an investment fund might report the issuance of $100 million of exempt securities. However, in the same year, the fund may have also retired $100 million in securities, for a net exempt financing of $0. Indeed, the fund's net exempt financings would be negative if redemptions exceeded distributions.

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17 It may be that some of these new enterprises go public and raise funds through a prospectus offering. However, that number would be small. There are only slightly more than 4,000 listed public companies in Canada (approximately 4,000 on the TSX and the TSX-V, and about 300 on the Canadian Securities Exchange). More importantly, in any given year, there are at most several hundred newly listed companies.

18 Jog, 10-11, 13, 15.

This concern is not merely theoretical: exempt financings by investment funds constitute about two-thirds or more of all reported financings by dollar value.[19] The extent to which this problem leads to an overstatement of the size of the exempt market, however, remains unknown.

B. Empirical Assessments of the Exempt Market

The most comprehensive empirical assessments of the exempt market — based of course only on reported exempt financings — may be found in Jog (2015)[20] and the OSC's Exempt Market Review (2015).[21] The primary findings of these studies are summarized below.

1. The Size of the Exempt Market

Jog's data show that the exempt market is very large. While these data do not cover all provinces,[22] between 2010 and 2012 (inclusive), the total of all reported exempt financings in his sample amounted to $377 billion, or an average of about $125 billion per year.

The OSC's data — which cover only Ontario issuers — show the exempt market to be somewhat larger. In the first eight months of 2014, exempt financings totalled $121 billion. This equates to $181 billion on an annualized basis, which in turn (again assuming that Ontario represents 80 per cent of Canada's capital market activity) yields a derived nation-wide market of about $227 billion per year.

2. Investment Funds versus Other Issuers

Jog's Ontario-only data (Table 3) show that investment funds raised about three times more money via prospectus exemptions than did non-investment funds.

TABLE 3 INVESTMENT FUNDS VERSUS NON-INVESTMENT FUNDS

Ontario – Capital Raised by Investment Funds vs. Other (billions)				
Year	Investment Fund	Non-Investment Fund	Total	% of national total
2012	67.24	37.13	104.37	75.14%
2011	59.01	27.54	86.55	70.46%
2010	52.74	25.83	78.58	67.90%
2009	54.95	14.74	69.69	N/A
2008	71.92	20.24	92.16	N/A

Source: Vijay Jog, "Exempt Markets in Canada – Empirics, Observations and Recommendations," The School of Public Policy, University of Calgary, *SPP Research Papers*, vol. 8(10), March 2015, 13.

The OSC's figures for 2014 confirm this general picture. Exempt financings by investment funds constituted $80 billion, or 67 per cent of the total. Thus, in this data set the ratio of investment fund offerings to non-investment fund offerings was two to one.[23]

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[19] See note 18 and accompanying text.

[20] Jog.

[21] Ontario Securities Commission, "Backgrounder …" Appendix A.

[22] The data appear to include Ontario, Alberta, British Columbia and New Brunswick.

[23] OSC "Backgrounder …" 6.

3. Relative Use of Different Exemptions

As Table 4 indicates, in Jog's study the most widely used of all reportable exemptions, by two orders of magnitude, is the accredited investor exemption.[24] Unfortunately, however, Jog was unable to parse the aggregate usage statistics by type of issuer, size of issuer or type of investor.

TABLE 4 EXEMPT MARKET BY CAPITAL-RAISING EXEMPTIONS ($ BILLIONS)

	2.3 - Accredited Investor	2.5 - Family, friends and business associates	2.9 - Offering Memorandum	Other	Unknown	Total
2012	121.76	0.59	0.97	9.38	6.21	138.90
2011	86.93	0.35	0.55	6.69	28.30	122.83
2010	84.51	0.38	0.65	6.10	24.09	115.73
Total	293.20	1.32	2.17	22.17	58.60	377.45

Source: Vijay Jog, "Exempt Markets in Canada — Empirics, Observations and Recommendations," The School of Public Policy, University of Calgary, *SPP Research Papers*, vol. 8(10), March 2015, 13.

The OSC's statistics are similar. The OSC reports that, for non-investment fund issuers, "[t]he accredited investor exemption remained the most relied upon prospectus exemption by capital raised (92 per cent), filings (74 per cent) and purchases (64 per cent) in 2014."[25]

These figures indicate that, when compared to other exemptions, the accredited investor exemption:

a) Raised more capital per filing;

b) Raised more capital per purchase.

This lends credence to the view that the accredited investor exemption is dominated by large issuers raising relatively large amounts of money.

The statistics presented by Jog and by the OSC relate to dollar value, and not to number of offerings. It is likely that there are very many more small offerings by small firms than large offerings by large firms. This suggests that by number of offerings, rather than dollar value, the private issuer exemption and the family, friends and business associates exemption are likely to dominate.

In the OSC filings, the second most used exemption (again, by dollar value) was the $150,000 exemption.[26] It appears to have been used, however, in only about three per cent of the reported financings.

4. Reporting Versus Non-Reporting Issuers

Jog's data (Table 5) break out the reported data according to whether the issuer was a reporting or a non-reporting issuer. Over 2010-2012, non-reporting issuers raised over three times the amount of money raised by reporting issuers under the prospectus exemptions. The OSC reports a very comparable ratio of reporting to non-reporting issuers.[27]

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24 Jog, Table 1, 13.

25 Ontario Securities Commission, "Summary of Key Capital Raising Prospectus Exemptions in Ontario," Jan. 28, 2016, 3, available at https://www.osc.gov.on.ca/documents/en/Securities-Category4/ni_20160128_45-106_key-capital-prospectus-exemptions.pdf)

26 In 2014, this exemption could be used by individuals in Ontario. This is no longer the case.

27 The OSC report states (8):

> Only about one-quarter of the capital raised by non-investment fund issuers in 2014 was raised by reporting issuers. Non-reporting issuers represented the majority of issuers filing reports of exempt distribution with the OSC but this was more prominent among financial issuers (84%) than non-financial issuers (56%). Over half of the filings from non-financial reporting issuers involved issuers that were listed on the TSX Venture Exchange.

TABLE 5 EXEMPT MARKET BY REPORTING AND NON-REPORTING ISSUERS

Capital Raised by Reporting Status ($billions)				
Canada				
	Reporting	Non-Reporting	Unknown	Total
2012	27.73	98.05	12.51	138.29
2011	18.68	76.14	28.35	123.17
2010	13.81	31.65	69.83	115.30
Capital Raised by Reporting Status (per cent)				
	Reporting	Non-Reporting	Unknown	Total
2012	20.05%	70.90%	9.05%	100.00%
2011	15.17%	61.81%	23.02%	100.00%
2010	11.98%	27.46%	60.57%	100.00%

Source: Vijay Jog, "Exempt Markets in Canada — Empirics, Observations and Recommendations," The School of Public Policy, University of Calgary, *SPP Research Papers*, vol. 8(10), March 2015, 15.

If non-reporting issuers are subject to a serious under-reporting problem, these figures may greatly understate the extent to which exempt financings by non-reporting issuers dominate those by reporting issuers.

However, it is important to note that the universe of non-reporting issuers is far from homogeneous. It includes not only small commercial companies, but large investment funds that sell only to accredited investors, financial institutions and other issuers.

5. Security Type

There are few data available on what types of securities are issued under prospectus exemptions. Jog was only able to find data for a single year from Ontario and New Brunswick (Table 6). These data show that debt financings dominated equity financings by a factor of about four to one.

TABLE 6 TYPES OF SECURITIES

Capital Raised By Security Type – Non-investment Funds					
	Debt	**Equity**	**Other**	**Unknown**	**Total**
2012 $billions	27.38	7.05	2.61	33.61	70.65
2012 percentage	38.75%	9.99%	3.69%	47.57%	100.00%

Source: Vijay Jog, "Exempt Markets in Canada — Empirics, Observations and Recommendations," The School of Public Policy, University of Calgary, *SPP Research Papers*, vol. 8(10), March 2015, 15.

The OSC data indicate that slightly more than two-thirds (67 per cent) of capital raised in prospectus-exempt transactions was via debt financing, versus 26 per cent via equity, for a ratio of 2.6 to one. The OSC data also show that debt financings were, on average, nearly five times larger than equity financings, and that debt financings were larger in both public and private markets.[28]

[28] OSC Report, 7.

6. Issuer Type

The OSC reports the following in regards to the types of issuers utilizing the prospectus exemptions:

a) Of all non-investment fund issuers, 40 per cent were “financials” (which includes, *inter alia,* “private equity firms, consumer credit securitization vehicles, banks, mortgage investment entities and insurance firms);[29]

b) “[O]n average financial issuers raised significantly more per offering from a smaller pool of investors”;[30]

c) “Issuers headquartered outside of Canada represented 50 per cent of filings by financial issuers in 2014. The majority of these foreign issuers are U.S.-based”;[31]

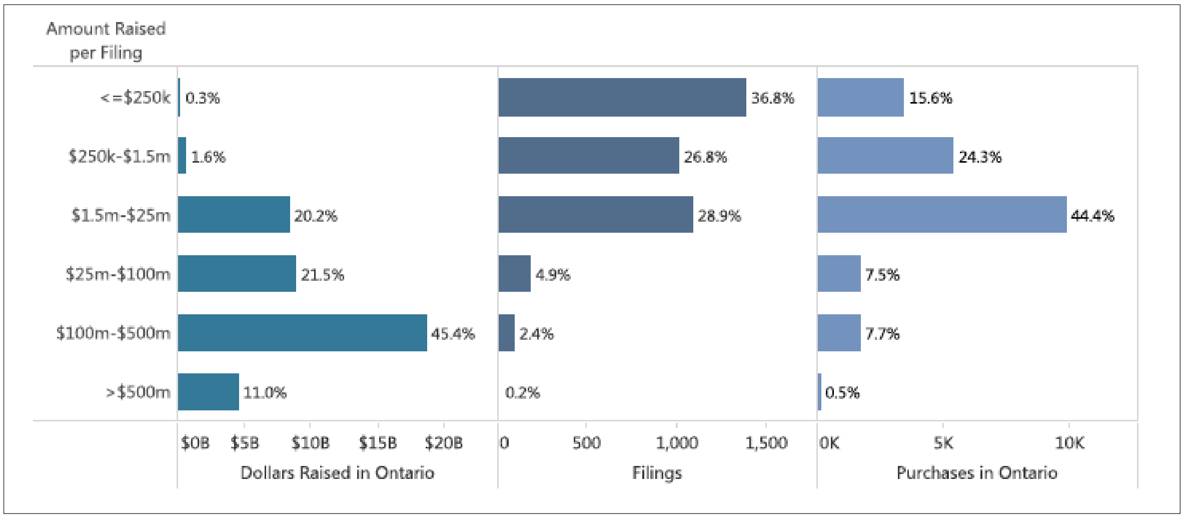
d) Among non-financial issuers, the energy and materials group accounted for 24 per cent of all funds raised;

e) The balance, in order, were consumer (20 per cent); real estate (16 per cent); industrials (14 per cent); tech, media and telecom (13 per cent); and other (13 per cent).

7. Amount Raised Per Filing

In respect of the amounts raised, the OSC reports a great deal of heterogeneity in fund-raising activity:

FIGURE 1 OSC DATA ON AMOUNTS RAISED



Source: Ontario Securities Commission, “Backgrounder — Exempt Market Review,” Nov. 5, 2015

Figure 1 shows that a large number of filings were associated with small raises of capital, while a small number of financings were associated with large raises of capital. Unfortunately, the OSC report does not indicate the nature of the issuers engaging in small and large financings.

29 Ibid., 5.

30 Ibid.

31 Ibid., 9.

8. Summary

Understanding the nature of the exempt market is important to understanding where enforcement problems are likely to arise and where enforcement resources should be directed. The data that we have are certainly useful. However, the data are also very incomplete and possibly quite misleading in some respects. Without cross-tabulations of the data, it is very difficult to get more than a general sense of the nature and extent of the exempt market.

Based on reported data, however, the following facts seem to emerge:

a) By dollars raised, investment funds are the largest users of the prospectus exemptions;

b) The accredited investor exemption is used far more often than any other exemption;

c) By dollars raised, non-reporting issuers exceed reporting issuers by a factor of about three to one;

d) Debt securities are issued approximately three or four times more often than equity securities;

e) Of non-investment fund issuers, 40 per cent are financial issuers, and these issuers raise large amounts of money from a small number of investors;

f) The users of the prospectus exemptions are highly heterogeneous, by type of issuer, size of issuer, industry of issuer, reporting issuer status, type of security issued and type of investor.

C. Significance of the Market Empirics for Enforcement Issues Related to Prospectus Exemptions

It would appear that by dollars raised, the exempt market dwarfs the public market. Obviously, for private companies, the exempt market represents the only market in which issuers may raise money. Even for public companies, exempt market financings are a vital source of capital. Former TSX Venture Exchange president John McCoach stated:[32]

> We [i.e., the TSX Venture Exchange] found that of the estimated $6 billion raised by TSX-V issuers in 2012, approximately $4 billion was raised on a prospection-exempt/private placement basis. Of the 1,844 non-IPO financings … 1,719 (93 per cent) of these were completed on a prospectus-exempt/private placement basis.

In a similar vein, Jog states:

> As can be seen above [in Table 6], the amounts raised through equity instruments in the exempt market were $7.05 billion in 2012. This can be compared with $4.8 billion and $1.2 billion raised on the TSX under initial public offerings in 2010 and 2011 respectively; $1.5 billion each raised by venture capital in 2010 and 2011; and $24 billion raised by TSX-listed companies through subsequent equity offerings in the same two years. Needless to say, the exempt market plays a significant role in Canadian equity markets, but most financing occurs through debt instruments.

These figures are startling and illustrate the foundational importance of the prospectus exemptions to the health of Canadian corporate enterprise and the Canadian economy. They also illustrate the importance of enforcement efforts. Overzealous enforcement efforts may undermine the economic function of the prospectus exemptions. On the other hand, given the size of the exempt market, under-enforcement may present great peril to investors.

The empirical record is useful in directing our attention to those sectors of the exempt market that are most likely to present enforcement issues. That is discussed below, but only after exploring:

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[32] Harry Jaako, "Sinking Northwest Exemption Threatens Start-Up Survival in B.C.," *Business in Vancouver*, March 2013. https://www.biv.com/article/2013/3/sinking-northwest-exemption-threatens-start-up-surv/ .

a) The empirical assumptions that underlie both the prospectus requirement and the prospectus exemptions;

b) The regulatory rationales for the prospectus exemptions;

c) The types of investors who tend to use the various different prospectus exemptions.

IV. THE RATIONALES UNDERLYING THE PROSPECTUS REQUIREMENT

The various securities regulatory statutes in Canada (and the rules adopted by securities regulators) specify that any issuer seeking to sell a security must assemble a prospectus for the benefit of prospective buyers. This document offers a great deal of information regarding the issuer and its business, including audited financial statements, off-balance sheet financing, material risk factors, the competitive environment in which the issuer operates, the market in which the issuer's securities will trade, the nature of the securities to be issued, the identities and backgrounds of directors and senior managers and their remuneration, related party transactions, and so on.

A number of empirical assumptions lie behind the prospectus requirement:

a) Issuers, left to their own devices (i.e., not confronted with mandatory disclosure laws applicable to primary market offerings) will fail to disclose all of the information that potential investors need in order to properly price the offering (the non-disclosure problem);[33]

b) Without mandated disclosure, investors will not be capable of properly evaluating the risk/return trade-offs posed by different investment offerings, and hence determining a fair price (the pricing problem);

c) There is a significant cohort of investors who are incapable of properly assessing their own ability to determine a fair price for an offering, who, if left to their own devices, are at risk of investing in unsuitable securities.

By itself, the non-disclosure problem is not troubling if investors can arrive at an unbiased estimate of the true worth of an offering based not only on what is disclosed, but on what is not disclosed.[34] Non-disclosure creates risk for prospective buyers, particularly as issuers have an incentive to disclose good information and withhold bad information. Indeed, poorer quality issuers are more likely than high quality issuers to engage in non-disclosure, since full disclosure will have a particularly negative impact on the price at which they will be able to sell their securities.

Unfortunately, if most or all issuers withhold disclosure of particular items of information that are useful in pricing an offering, it will be difficult for investors, *ex ante,* to distinguish high quality issuers from low (particularly in connection with IPOs, where the issuer has no public track record). This potentially creates an adverse selection dynamic in which prospective buyers draw highly negative inferences, in relation to all issuers, from non-disclosures. This adverse selection has the effect of inefficiently raising the cost of capital for high quality issuers.

High quality issuers have potential ways of addressing the adverse selection dynamic, however. The most obvious is effecting full disclosure of all items that buyers are likely to believe are important in pricing an offering. Another is by crafting corporate governance arrangements in a manner that empowers investors to monitor and discipline the managers effectively. Such merit- based strategies qualify as signals, in the manner in which that term is used in the finance literature, since they are prospectively less expensive for high quality firms than low.

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[33] Presumably, investors would prefer that the issuer disclose a particular item of information if the marginal cost of disclosure is equal to or less than the marginal benefit derived from disclosure.

[34] It is not necessary that all investors be able to perform appropriate discounting. All that is needed is that the marginal investors are sufficiently savvy to do so (e.g., institutional investors).

If signalling works effectively, and prospective buyers are unbiased discounters, all offerings will be correctly priced no matter what the level of disclosure, and there is no need for mandatory disclosure.

It is for this reason that the second assumption noted above is needed to justify the prospectus requirement; that is, that investors are not capable of evaluating non-disclosure risk in an accurate, unbiased fashion.

This arguably introduces a certain element of schizophrenia into the justification for mandated disclosure. An implicit assumption that lies behind mandated disclosure is that investors can appropriately evaluate items of information that are disclosed. However, if this is true, why are they not capable of evaluating the risks attendant upon non-disclosure? This seems to posit that investors are at once both sophisticated and unsophisticated.

The above arguments regarding the efficacy of mandated disclosure can be recast in terms of market efficiency. In an informationally efficient market, prospective investors are able to arrive at an unbiased estimate of the true worth of the securities offered based on all publicly known risks. Thus, the issuer bears the entire cost of inadequate disclosure. For this reason, the issuer has an incentive to provide investors with disclosure up to the point at which the marginal benefit of disclosure equals the marginal cost. Whether or not issuers actually do so, however, all offerings are a fair game insofar as, *ex ante,* they are correctly priced; all risks are appropriately discounted. This means that, *ex post,* on average*,* investor expectations are not disappointed. Thus, regulators need insist on neither mandatory disclosure to protect investors nor merit-based rules (i.e., all rules that require the issuer to do something other than simply disclose particular items of information, such as corporate governance requirements, or the imposition of mandatory escrow requirements on the occurrence of an IPO).

V. THE RATIONALES UNDERLYING THE PROSPECTUS EXEMPTIONS

A. Introduction

In the section that follows, I discuss the manifold rationales that underlie the exemptions, the empirical assumptions that underpin these rationales, and various problems that may detract from the efficiency of the exemption or raise investor protection issues. There are a wide variety of rationales (and more than is commonly supposed). All are digested in Table 7.

Historically, a plurality of prospectus exemptions in Canada has been based on the goal of investor protection. However, recent exemptions such as the CF and rights offering exemptions aim at addressing perceived gaps in the funding landscape, subject to some minimum investor protection threshold.

TABLE 7 PROSPECTUS EXEMPTIONS AND THEIR RATIONALES

"x" ((where x is a number) refers to the number of different versions of the exemption across the country
"MD" means mandatory disclosure is required
"MR" means that there is accompanying merit regulation
"R" means that the issuer must report the exempt financing to the regulator

GENERIC SAFE SECURITIES	SAFE SECURITIES SPECIAL SITUATIONS PRESENTING LITTLE RISK TO INVESTORS	SPECIAL SITUATIONS PRESENTING SPECIFIC RISKS TO INVESTORS THAT ARE ADDRESSED BY MANDATORY DISCLOSURE AND/OR MERIT REGULATION	SOPHISTICATION	ACTIVE PARTICIPANTS	CLOSE CONNECTIONS	OTHER PROTECTIVE MECHANISMS (i.e. EQUIVALENCE EXEMPTIONS)	CAPITAL GAPS: PRIVATE ISSUERS	CAPITAL RAISING: PUBLIC ISSUERS	ALTERNATIVE DISCLOSURE REGIMES	POLICY DRIVEN	ISOLATED DISTRIBUTION
GOVERNMENT DEBT SECURITIES -45-106, s.2.34(2) (a)-(c) (except Ontario), (e)) SUPRANATIONAL AGENCY DEBT SECURITIES -45-106, s.2.34(2)(f) INSTITUTIONAL DEBT SECURITIES -45-106, s.2.34 -2 [ROC: Canadian financial institutions (2.34(2)(d) -ONTARIO: OSA ss.73(1), (2) and 73.1(1), (2) and 45-160, s.2.34 (2)(d.1)]	CONVERSION, EXCHANGE, OR EXERCISE -45-106, s.2.42 -distribution of a security of the issuer (or of a reporting issuer) in accordance with the terms and conditions of a security previously issued by that issuer -1 RRSP/RRIF/TFSA -45-106 s.2.40 -1 SELF-DIRECTED REGISTERED EDUCATIONAL SAVINGS PLAN -45-106, s.2.43 -distribution of a self-directed RESP to a subscriber -2 (ON;ROC) -MR (distribution must be conducted by certain entities)	NEGOTIABLE SHORT-TERM COMMERCIAL PAPER AND PROMISORY NOTES -45-106, ss. 2.35, 2.35.1, 2.35.2, 2.35.3 -non-convertible unsecuritized and securitized short term debt -MR (credit ratings) -MD (securitized debt; information circular at outset, monthly reporting, timely disclosure reports) -1 -R CONTROL BLOCK DISTRIBUTIONS BY INSTITUTIONAL INVESTORS -45-106, s.4.1 -1 -MD (advance notice) -MR	ACCREDITED INVESTOR -45-106, s.2.3 -3 (Ontario, PEI (NI 45-106, s.2.3(2)), ROC) -R NOTE: Ontario's accredited investor exemption is embodied in part in the Ontario *Securities Act*, s.73.3(2), rather than in NI 45-106 $150,000 CASH EXEMPTION -45-106, s.2.10 -consideration paid for securities is no less than $150,000 in cash -no longer available to individuals -1 -R	PRIVATE ISSUER -45-106, s.2.4 -private issuer -2 (Ontario, ROC) -MR	PRIVATE ISSUER -45-106, s.2.4 -private issuer -2 (Ontario, ROC) -MR INCENTIVE COMPENSATION PLANS -45-106, ss. 2.24-2.29 -incentive compensation plans -directors, officers, employees, consultants -2.26-2.29 deal with transfers of incentive securities back to issuer, and between permitted persons -2 (slight variation for Manitoba permitted transferees) -MR for reporting issuers (participation must be voluntary) -more extended MR for non-reporting issuers	TSX VENTURE EXCHANGE OFFERING DOCUMENT -45-106, s.5.1 -1 -MD -MR -R BUSINESS COMBINATIONS AND REORGANIZATIONS -45-106, s.2.11 -business combinations and reorganizations (amalgamation, merger, reorganization, arrangement, dissolution, winding-up) -1 TAKEOVER AND ISSUER BIDS -45-106, s.2.16 -1	FAMILY, FRIENDS, AND BUSINESS ASSOCIATES -45-106, ss.2.5, 2.6 (Saskatchewan), 2.6.1 (Ontario) -3 (Ontario, Saskatchewan, ROC) -MR -R ACCREDITED INVESTOR -45-106, s.2.3 -3 (Ontario, PEI (NI 45-106, s.2.3(2)), ROC) -R CROWDFUNDING -MI 45-108 (Manitoba, Ontario, Québec, New Brunswick, Nova Scotia, Saskatchewan) -3 (Quebec; Ontario; ON/NB/NS) -MD -MR	RIGHTS OFFERING TO EXISTING SECURITY HOLDERS BY REPORTING ISSUER -45-106, s.2.1 -issuance of rights by reporting issuer -1 -MD -extensive MR	OFFERING MEMORANDUM -45-106, s.2.9 -3 (BC + NL; MAN, NT, NUN, PEI, YT; AL, NB, NS, ON, QUE, SASK -many individual province requirements -MD -MR -R	NOT-FOR-PROFIT ISSUER -45-106, s.2.38 -non-profit issuer that is organized exclusively for educational, benevolent, fraternal, charitable, religious or recreational purposes -1 -MR (no commission paid) ACQUISITION OF PETROLEUM, NATURAL GAS, OR MINING PROPERTY -45-106, s.2.13 -consideration paid is petroleum, natural gas, or mining property -1 -R	ISOLATED DISTRIBUTION -45-106, s.2.30 -1 -R

	REINVESTMENT PLANS -45-106, ss.2.2 and 2.18 -issuer reinvestment plan (2.2 re non-investment fund, and 2.18 re investment fund) -1 -MR SETTLEMENT OF ISSUER DEBT -45-106, s.2.14 -consideration paid is debt of issuer -1 -R	CONTROL BLOCK SALES INTO TAKEOVER BIDS -45-106 s.4.2 -1 -MD -MR ADDITIONAL PURCHASES OF SECURITIES IN AN INVESTMENT FUND -45-106, s.2.19 -additional purchasers of investment fund -investor initially paid $150,000 or more (and holds securities in fund with net asset value of $150,000) -1 -R INVESTMENT CLUBS -45-106, s.2.20 -distribution of securities of an investment club to its members -1 -MR CROWDFUNDING -MI 45-108 (Manitoba, Ontario, Québec, New Brunswick, Nova Scotia, Saskatchewan) -4 (Ontario; Quebec; New Brunswick, Nova Scotia, Ontario; all others) -MD -MR -R	$150,000 ASSETS EXEMPTION -45-106, s.2.12 -consideration paid for securities is no less than $150,000 in assets -1 -R			INVESTMENT FUNDS ADMINISTERED BY A TRUST CORPORATION -45-106, s.2.21 -2 (trust corporation cannot be registered in PEI) MORTGAGE BROKER/DEALERS -45-106, s.2.36 -3 (ON; ALTA, BC, MAN, QUE, SASK; ROC) SECURED DEBT REGISTERED UNDER PERSONAL PROPERTY SECURITY LEGISLATION -45-106, s.2.37 -2 (ON; ROC) VARIABLE INSURANCE CONTRACTS -45-106, s.2.39 -1 -MR BANK DEPOSITS -45-106, s.2.41				GOVERNMENT INCENTIVE SECURITY (ONTARIO) -Ontario Rule 45-501, s.2.1	

It is worthwhile noting that the prospectus requirement applies not only to primary market transactions, but to a number of secondary market transactions as well. This includes sales of securities out of a control block,[35] sales of securities that are subject to a hold period,[36] and in some cases secondary sales by the issuer's shareholders in conjunction with an IPO.[37] Both primary and secondary market prospectus exemptions are discussed below.

B. Proxy Slippage

It is impossible for the rules governing prospectus exemptions to determine, in respect of individual distributions, whether the rationale that underlies the particular exemption is met or not. Functionality demands that all exemptions use proxies of one kind or another. Thus, for example, prospectus exemptions based on investor sophistication eschew individualized judgments in favour of the use of proxies for sophistication. In like fashion, prospectus exemptions based on the idea that certain securities are generically safe use proxies to identify low-risk securities.

Determining the accuracy of these proxies is important in identifying situations in which enforcement issues are likely to occur. Where the proxy is highly accurate, it may be said that there is little proxy slippage. Conversely, if the proxy is highly imperfect and subject to wide confidence intervals, there is a high level of proxy slippage.

The idea of proxy slippage can be expressed in terms of a widely applied statistical construct — the likelihood of type I and type II errors. A type I error involves the rejection of a null hypothesis when it is in fact true (a false positive), while a type II error involves the failure to reject a null hypothesis that is false (a false negative).

Type I and type II errors implicate regulatory costs of a rather different nature. Generally speaking, a type I error will lead to investments being permitted in inappropriate circumstances. In the case of a sophistication proxy, for example, a type I error consists of recognizing a purchaser as sophisticated (and hence able to purchase exempt market products) when this is not in fact the case. Errors of this nature lead to a poor matching of investors to investments. This is likely to result in many investor complaints and hence the deployment of a non-trivial level of regulatory and judicial resources.

By contrast, type II errors prohibit investments from being made in circumstances where there is no good reason to do so. For example, in the case of a sophistication proxy, a type II error consists of rejecting the hypothesis of sophistication when the investor is in fact sophisticated. This type of error thus prevents investments from being made, resulting in a relatively modest deployment of regulatory and judicial resources. It is thus tempting to conclude that the natural tendency of regulators is to craft the prospectus exemptions in such a way as to produce significantly more type II than type I errors — i.e., with excessive investor protection. This will not only economize on budget and workload, but will also minimize the likelihood of regulatory reputational loss associated with investment scandals.

From an economic standpoint, both type I and type II errors result in allocative inefficiency, but by different means and with different consequences. Type I errors result in a mismatch between investors and investments. Type II errors prevent investments from being made — also resulting in allocative inefficiency — but without the potentially severe adverse distributional consequences for

[35] The definition of "distribution" in OSA ss.1(1) includes "a trade in previously issued securities of an issuer from the holdings of any control person"; see also NI 45-106 s.4.1. The assumption that lies behind presumptively requiring a prospectus for the sale of control-person securities is that such persons may have access to inside information.

[36] See generally NI 45-102. It also includes transfers of securities from a person to that person's RRSP (where the transfer would constitute a "distribution", as in the case of a control person); NI 45-106 s.2.40.

[37] Sales by a variety of insiders in conjunction with an IPO are sometimes subject to mandatory escrow periods; see NI 46-201 ("Escrow for Initial Public Offerings"). The escrow can be circumvented by qualifying the shares for sale in the IPO.

investors that often accompany type I errors. This suggests that the regulatory bias should in fact be on producing a higher number of type II than type I errors. A contrary factor, however, is that excessive investor protection may have economy-wide ramifications by depriving small firms of growth opportunities, leading to a dearth of innovation and a depleted supply of acorns to mature into large oaks. Clearly, further inquiry is warranted.

C. Repeat Players

An efficient securities market is a fair game (as that term is used by financial economists) in the sense that, on average, investors' expectations of return are exactly met (even though, in individual cases, actual returns may substantially depart from these expectations). The concept may be applied to both primary and secondary markets. In respect of secondary market purchases, the market is a fair game when the public trading prices of various issuers' securities fully reflect investors' risk-adjusted expectations of return. In the case of an individual primary market offering, the distribution is a fair game if the offering price achieves the same result.

Investors who are repeat players in particular types of primary market offerings benefit from a learning process. That is, by effecting iterations of primary market purchases, these investors can systematically compare *ex ante* expectations with *ex post* returns for particular types of primary market offerings. If the latter fall short of the former, these repeat players will presumably adjust their minimally acceptable terms of trade and communicate these to issuers, either directly (as where the offering is negotiated) or indirectly (by refusing to purchase an offering at the price offered).

The existence of repeat players is thus a potent investor protection mechanism, particularly if the repeat players are the marginal players responsible for setting the price of an offering of securities (via their willingness or unwillingness to purchase at a given price).

D. "Take It or Leave It" versus Negotiated Offerings

Where there is direct negotiation between the issuer and potential investors, both the quantity and quality of information conveyed to the issuer about its proposed offering will improve. This raises the likelihood that the offering will satisfy the fair game criterion.

E. The Safe Securities Rationale

1. Generic Categories of Safe Securities

Certain categories of securities are judged to be sufficiently safe that the vendor need not assemble a prospectus for prospective buyers. This includes, for example:

a) "A debt security issued by or guaranteed by the Government of Canada or the government of a jurisdiction of Canada";[38]

b) "A debt security issued by or guaranteed by a government of a foreign jurisdiction if the debt security has an approved credit rating from an approved credit rating organization".[39]

Other exemptions based on this rationale are indicated in Table 7.

The empirical assumption that drives the safe securities rationale is simple: these securities possess very little risk to investors. Hence, even without mandated disclosure, investors (whether sophisticated or not) will not be prejudiced by their purchase. The safe securities rationale is thus

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38 NI 45-106, s. 2.34(2)(a).

39 Ibid., (2)(b).

properly digested under the investor protection goal of securities regulation, since it assumes that investors purchasing low-risk securities do not require mandated disclosure.

The safe securities rationale generates relatively little danger of type I errors. A type I error consists of identifying a government security as safe when in fact it is not. The danger of type I errors seems minimal; i.e., most government securities that are identified by the rules as safe are in fact low-risk securities that pose little danger to investors.

In this case, a type II error consists of accepting the idea that government securities are not safe, when in fact they are. However, under existing rules, the proxy for safety is cast sufficiently wide that the danger of a type II error seems small. Overall, then, there is little danger of proxy slippage.

Governmental issuers dominate the safe securities category of prospectus exemption, and the bulk of these securities are sold to institutional investors who are savvy repeat players (in the context of an internationally competitive market where governments are price-takers rather than price-makers). This too emphasizes the minimal danger to investors.

2. Safe Securities or Types of Distributions: Special Situations Presenting Little Risk to Investors

There are a number of special situations digested in Table 7 in which there is little risk to the investors to whom securities are sold, including a number of both primary and secondary market distributions. In the former category, for example, is the conversion of one security into another, where the conversion privilege has been previously granted to the investor.[40] In the latter category falls the distribution of a security by an investor into that investor's RRSP.[41]

As in the case of generically safe securities, these prospectus exemptions are based on the investor protection rationale. Also, there seems to be little danger of type I or type II errors.

F. The Sophistication Rationale

1. Introduction

The most widely used prospectus exemptions (at least, among reported exemptions) are the sophistication exemptions, which are based on the empirical assumption that some investors are sufficiently sophisticated that they do not require the benefit of mandatory disclosure. The accredited investor exemption, which is supported by the sophistication rationale, is easily the most widely used of all exemptions. The second most widely used exemption — the minimum investment exemption — is also based (whether justified or not) on the idea of sophistication (i.e., any investor who can invest the minimum amount, or $150,000, in a single investment must be sophisticated).[42]

However, securities law uses different proxies for sophistication for different types of investors. Separate proxies apply to institutional investors, retail investors, securities market professionals, corporations and governments.

In this case, the hypothesis is that investor X is sophisticated. A type I error thus occurs when an investor is identified as sophisticated, when he/she is not. A type II error consists of concluding that investor X is not sophisticated, when he/she is in fact sophisticated.

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40 Ibid., s.2.42.

41 Ibid., s.2.40.

42 Recently, Ontario has revoked the use of the minimum amount exemption for retail investors.

2. Low Risk of Proxy Slippage: Institutional Investors

With some types of investors, the degree of proxy slippage is likely to be modest. An obvious case is that of institutional investors, which routinely qualify as accredited investors and hence may purchase securities without the benefit of a prospectus.[43] Securities law specifies a long list of types of institutions that qualify as accredited investors. Any institution not fitting one of the categories may nonetheless qualify as an accredited investor if it has more than $5 million in net assets.[44] While some of these institutions may not be sophisticated, the likelihood of a type I error seems small. Since few classes or types of institutional investors are excluded, the likelihood of a type II error is also small.

In addition, the costliness of mistakes is mitigated by the fact that institutional investors typically have the diversification and financial resources to withstand individual investment losses. This obviously has important implications for the deployment of enforcement resources, since securities purchased by institutional investors are rarely likely to present investor protection issues.

The likelihood of both type I and type II errors also seems small for three other categories of accredited investors: investment professionals,[45] corporations that qualify as accredited investors,[46] and governments and governmental entities.[47] Like institutional investors, these investors are likely to be sophisticated and to possess the resources to withstand losses.

3. High Risk of Proxy Slippage: Retail Investors

a. Type I and Type II Errors; Trade-offs

The biggest problems with proxy slippage arise in connection with retail investors, who may qualify as accredited investors based on net income, net financial assets or net assets.[48] The investor's sophistication in these cases ostensibly arises either because the investor is experienced and knowledgeable, or because he/she has the means to hire professional investment advisors.

This proxy for sophistication is much more likely to be inaccurate than the other proxies noted above. Persons of means may or may not be sophisticated investors, and may or may not hire sophisticated advisors. Thus, the likelihood of a type I error is material. Such errors expose investors to the risk of purchasing unsuitable investments. Investors whom the rules falsely identify as sophisticated are at risk of being enticed by negligent or unscrupulous issuers or investment advisors to put their money in unsuitable investments. This can lead to a host of enforcement issues (and economic loss).

Type I errors have a variety of solutions (all based on the assumption that the problem, and therefore the solutions apply only to retail investors). These are indicated in Table 8.

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43 NI 45-106, s.1.1 (definition of "accredited investor"). Qualifying entities are financial institutions (which include a "bank, loan corporation, trust company, trust corporation, insurance company, treasury branch, credit union, caisse populaire, financial services co-operative, or league) (part (a)); the Business Development Bank of Canada (part (b)); investment dealers (part (d)), pension funds (part (i)), private investment funds distributing only to accredited investors or non-individuals who purchase units costing at least $150,000 (part (n)), registered charities that are professionally advised (part (r)), and investment funds that are professionally advised (part u)).

44 Ibid., para. 1.1 (definition of "accredited investor", part (m)).

45 Ibid., s.1.1 (definition of "accredited investor", parts (d), (e), (e.1)).

46 Corporations may qualify as accredited investors in two circumstances: where the corporation has net assets of at least $5 million (NI 45-106, s.1.1 (definition of "accredited investor", part (m))), and where all of the beneficial owners are accredited investors (NI 45-106, s.1.1 (definition of "accredited investor", part (t))).

47 NI 45-106, s.1.1 (definition of "accredited investor", parts (f), (g), (h)).

48 Ibid., (j)–(l).

TABLE 8 SOPHISTICATION PROXIES AND TYPE I ERRORS

	REGISTRANT NOT INVOLVED	REGISTRANT INVOLVED
Properly Qualified Accredited Investor but Unsuitable Investment	• Eliminate non-brokered offerings by requiring, either in all cases or in relation to relatively risky offerings, that a registrant impressed with a duty of suitability be involved • Impose suitability obligation on the issuer • Raise the threshold for retail accredited investors • Set investor qualifications for non-brokered offerings higher than for brokered offerings • Impose severe penalties for issuer misrepresentations	• Vigorous enforcement of KYC/suitability duties
Non-Qualified Retail Investor Misrepresented as Qualified Investor	• Strict onus on issuer to ensure that investor is qualified	• Strict onus on dealer to ensure that investor is qualified • Vigorous enforcement of KYC/suitability duties

b. Properly Qualified Investor but Unsuitable Investment

In relation to investors who qualify for a prospectus-exempt offering on the basis of sophistication, but who are not in fact sophisticated, there are a number of potential ways of addressing type I errors in the case of non-brokered offerings. One obvious solution is to raise the threshold pursuant to which retail investors qualify as accredited investors. The problem with this is that lowering the likelihood of a type I error increases the likelihood of a type II error (i.e., treating some sophisticated investors as unsophisticated). Thus, we need to make judgments about the relative importance of these two types of errors. From an enforcement point of view, type I errors are likely to be costly, as they involve investors placing money in inappropriate investment vehicles. Type II errors are not likely to raise pressing enforcement issues (although they may invite breaches of securities law by investors seeking to illegally circumvent investment bars that appear to them to be unjustified, and also offer an unfair escape route from bad investments for sophisticated investors). The chief cost of type II errors is likely to be economic. That is, preventing sophisticated investors from investing in various enterprises will tend to dry up the pool of risk capital available to Canadian enterprises and therefore be costly from an economic perspective.

Unfortunately, such data as we have concerning the exempt market do not tell us if any particular alteration of the balance between type I and type II errors will make things better or worse. To answer this question, we need data that tell us what kinds of retail investors use the accredited investor exemption, and in relation to what kinds of issuers. We do not have these data.

Under certain conditions, raising the threshold for retail investors could have favourable consequences, by reducing the incidence of type I errors while not greatly increasing the incidence of type II errors. This might be the case, for example, if the accredited investor exemption is used mainly by large firms to raise money from institutions and wealthy retail investors, and if small firms rely mainly on the private issuer and FFBA exemptions to raise capital. In this case, raising the accredited investor threshold for retail investors will have a favourable impact.

If, on the other hand, small issuers — or some segment of small issuers — place great reliance on the accredited investor exemption to raise risk capital, effecting a change could have deleterious economic consequences for start-up enterprises and the economy as a whole. As indicated in Appendix D, high technology (HT) issuers are much more likely to have constrained capital-raising options than their non-high-tech (NHT) counterparts. They are more likely to have to fund their growth from the pockets of angel investors who do not qualify under either the private issuer or FFBA exemptions. Servicing the needs of such companies is important, as Canada's economy is increasingly dependent on the knowledge-based industries (KBI), and HT start-ups play a significant role in innovation and hence the health of the KBI sector. Indeed, the social return to HT investing is on the order of twice the private return.[49] Thus, although HT start-ups play a comparatively small role in the economy in terms of dollars invested, their economic significance is very great.

It may be that this problem is more apparent than real. At present, given the existing definition of accredited investor, the risk of a type II error may be quite low. If so, then increasing the likelihood of a type II error by decreasing the likelihood of a type I error would not have significant economic consequences.

There are a variety of potential solutions to curbing the likelihood of type I errors. The most extreme is to eliminate non-brokered offerings entirely by requiring the involvement of a registrant impressed with a duty of suitability. This is a cure that is likely to be worse than the disease. Insisting that a registrant be involved will raise costs for investors and make it more difficult for issuers to raise money, and the adverse impact will be greatest in respect of offerings by small issuers.

Another possible solution is to impress the issuer with a duty of suitability. This too is simply unworkable; issuers lack the professional qualifications to make this judgment, and it would be very costly to insist that they acquire such expertise.

Another approach would be to require that a registrant be involved in comparatively risky offerings involving retail accredited investors. The difficulty with this solution is that virtually any set of proxies for risk is itself likely to be subject to a significant likelihood of both type I and type II errors.

Yet another solution is to define the accredited investor category more strictly for non-brokered offerings. This seems a far more sensible approach than any of the aforementioned solutions and has a precedent in the graded distinctions that currently exist among those who qualify as permitted clients, accredited investors and eligible investors.

In brokered offerings, the solution to the problem of type I errors is far simpler; it is the vigorous enforcement of the KYC and suitability rules impressed upon registrants (and severe penalties for misrepresenting the nature of an investment to a client). This greatly reduces the likelihood of type I errors while not materially increasing the likelihood of type II errors.

c. Non-Qualified Investor Misrepresented as Qualified Investor

Whether a distribution is brokered or not, paperwork must be completed in which the investor represents himself or herself to be an accredited investor.[50] In general, the paperwork may misstate the investor's qualifications because:

a) An unqualified investor dupes an issuer or intermediary into believing that he/she is truly an accredited investor (self-misidentification);

b) An issuer or intermediary induces an investor to misrepresent himself or herself as an accredited investor (induced misidentification).

Self-Misidentification

The self-misidentification problem arises when an investor chooses to misrepresent to an issuer or a market intermediary that he or she is an accredited investor, when this is not the case. Self-misidentification will tend to result in a mismatch between the investor's financial goals, risk tolerance, ability to withstand loss, etc., and the investment in question.

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[49] Z. J. Acs and D. B. Audretsch, *Innovation and Small Firms*, (Cambridge, MA: MIT Press, 1990).

[50] NI 45-106CP, s.1.9.

IIROC and the securities regulators have addressed the self-misidentification problem, at least in part, by placing an onus on any issuer or intermediary involved in a distribution to exercise some level of due diligence to verify investors' representations that they are capable of taking advantage of a prospectus exemption.[51] Where registrants are concerned, this forms an integral part of the "know your client" and "suitability" obligations.

The administrative and judicial cases dealing with the misuse of prospectus exemptions suggest that cases involving registrant-induced misidentification are more common than cases involving self-misidentification. However, this may be the result of selection bias, insofar as cases involving self-misidentification will not typically result in any identifiable defendant.[52]

Registrant-Induced Misidentification

The registrant-induced misidentification problem is a variation of the self-misidentification problem. In this case, however, it is the issuer or the market intermediary who induces the investor to misstate his or her qualifications on attesting documents collected by the issuer or intermediary. This will typically be done to induce the investor to put money into an unsuitable investment that results in handsome commissions for the intermediary or a successful capital raise by the issuer. In the case of a brokered distribution, such conduct violates the registrant's suitability obligation to the client.

G. The Active Participants Rationale

1. Introduction

In some cases, prospectus exemptions are based on the fact that certain classes of purchasers, such as directors, officers, founders and control persons, are active participants in the enterprise. A prospectus is thus not needed for one or more of the following reasons:

a. Absence of Information Asymmetry

Direct participants already have an intimate knowledge of the enterprise (indeed, they are likely to have all the information that a prospectus would provide).

b. Participation in Control of the Issuer

Direct participants may possess or participate in the control of the issuer — a lever that can be used to protect their investments.

c. Absence of Incentives to Act Opportunistically

While direct participants might easily be tempted to take advantage of outsiders by selling them securities at an inflated value, they do not have an incentive to take advantage of themselves.

The private issuer exemption[53] (discussed in Appendix A), insofar as it allows those with close connections to the issuer to invest without a prospectus, is an illustration of the active participants rationale.

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[51] Ibid., s.1.9.

[52] I am grateful to an anonymous referee for this point.

[53] NI 45-106, s.2.4.

2. The Danger of Proxy Slippage

In this case, the hypothesis is that active participants are not investors for whom mandatory disclosure is a necessary investor protection measure. A type I error consists of rejecting the idea that active participants require mandatory disclosure when in fact they do. A type II error consists of accepting the idea that active participants require mandatory disclosure, when in fact they do not.

The danger of type I errors is minimal, for the three reasons just expressed. The danger of type II errors only arises if the group of active participants who may invest without a prospectus is narrowly drawn. However, the private issuer and FFBA exemptions are drawn widely enough that this does not seem to be a problem.

H. The Close Connections Rationale

1. Introduction

Some purchasers have close connections to direct participants in the enterprise. This class of persons includes relatives, friends and business associates of the insiders. Such purchasers are less at risk than arm's-length third parties for at least three reasons:

a) Those who are promoting the venture or otherwise closely associated with it, such as founders, directors, officers and control persons, are less likely to take advantage of people with whom they have a close and continuing personal or business relationship;

b) Those in a close relationship with insiders are in a better position than arm's-length third parties to judge the character and honesty of the insiders;

c) Those in a close relationship with the insiders are likely to have better access to information than arm's-length third parties.

2. The Danger of Proxy Slippage

The private issuer exemption[54] and the FFBA exemption[55] (both discussed in Appendix A) rely heavily on the close connections rationale. Both qualify persons who are close personal friends and close business associates of various active participants. They also qualify various close relatives of active participants (e.g., "a spouse, parent, grandparent, brother, sister, child or grandchild of a director, executive officer, founder or control person of the issuer").[56] For obvious reasons, these inclusions create a considerable risk of a type I error. By contrast, there is probably a minimal risk of a type II error.

3. Interpretational Licence

The danger to investors that is posed by type I errors is enhanced by the fact that the close personal friend and close business associates categories are subject to interpretational licence. In respect of the former, the securities regulators have stated:[57]

> For the purposes of both the private issuer exemptions and the family, friends and business associates exemptions, a "close personal friend" of a director, executive officer, founder or

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[54] Ibid.

[55] Ibid., ss.2.5, 2.6, 2.6.1.

[56] Ibid., ss.2.4(2) (the private issuer exemption).

[57] NI 45-106CP, s.2.7.

control person of an issuer is an individual who knows the director, executive officer, founder or control person well enough and has known them for a sufficient period of time to be in a position to assess their capabilities and trustworthiness.

Similarly, in relation to the close business associate category:

> For the purposes of both the private issuer exemptions and the family, friends and business associates exemptions, a "close business associate" is an individual who has had sufficient prior business dealings with a director, executive officer, founder or control person of the issuer to be in a position to assess their capabilities and trustworthiness.

These tests are highly subjective and lend themselves to abuse by opportunistic issuers or intermediaries.

4. Lack of Repeat Players

It is very likely that the vast majority of those who are close personal friends, close business associates and qualifying relatives are not likely to be repeat players in the type of transaction in question, again emphasizing the investor protection issues at play.

I. The Other Protective Mechanisms Rationale

In some cases, a prospectus is not needed because investors are protected by an alternative scheme of regulation. For example, securities may be issued pursuant to an amalgamation between two entities. Where this is the case, corporate law requires that the amalgamating entities prepare information circulars for their shareholders that essentially replicate the information that is required to be included in a prospectus, obviating the need for a prospectus. A number of such exemptions are indicated in Table 7.

In one case — the TSX Venture Exchange Offering Document exemption — the purported exemption is arguably not an exemption at all, in the sense that the information required in the TSX Offering Document is similar to (although somewhat less extensive than) the information required in a short form prospectus.

As these various protective mechanisms either replicate the protection that is afforded by a prospectus, or supply substitute protective mechanisms, there is little danger of type I or type II errors, and little reason to believe that there are serious investor protection issues.

J. The Capital Gaps Rationale for Private Issuers

A number of prospectus exemptions are motivated by more than simply a desire to protect investors. A principal aim is to address perceived capital gaps in the funding spectrum, subject to investor protection constraints.

The capital gaps exemptions (all of which are discussed in Appendix A) are available only for private companies[58] and include:

a) The FFBA exemption;

b) The private issuer exemption;

c) The CF exemption.

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[58] I use the phrase "private company" in the colloquial sense of a non-public company, and not in the strict technical sense (i.e., as that term is defined in NI 45-106).

To the extent that something other than strict investor protection motivates these exemptions, investor protection must necessarily be compromised to some degree.

The CF exemption differs from the FFBA and private issuer exemptions in a number of material ways. The FFBA exemption is a wholesale exemption. The private issuer exemption is subject to minimal constraints[59] and is also essentially a wholesale exemption. By contrast, the CF exemption is a complex hybrid exemption.[60]

There is little doubt that the extensive investor protection mechanisms accompanying the CF exemption are recognition of the particular dangers that the exemption poses for investors (i.e., there is a high risk of a type I error). With respect to investments by arm's-length third parties, the CF exemption extends the reach of the prospectus exemptions into hitherto uncharted territory. The FFBA and private issuer exemptions are premised on the understanding that all investors are either direct participants in the issuer or have a close connection to the issuer's principals. The only arm's-length third parties that are allowed into the fold are accredited investors. By contrast, under the CF exemption, capital will be raised entirely from arm's-length third parties, the vast majority of whom will be unsophisticated.

Further investor protection concerns arise from the following:[61]

a) Most investors will have minimal ability to evaluate the issuer's business plan, point-of-sale disclosure or continuing disclosure in any meaningful way;

b) Most investors will have minimal business experience, particularly in relation to start-ups;

c) Capital will be raised from a large number of investors, each holding a small stake. Thus, collective action and free rider problems will be severe. This virtually guarantees that CF investors will supply little or no effective monitoring or oversight of management;

d) Unlike many angel investors, CF investors will lack the protections afforded by a unanimous shareholder agreement;

e) Unlike many angel investors, CF investors will not be value-add investors, and will contribute no strategic value to the enterprise.

It has sometimes been argued that there is a collective wisdom to the crowd, such that "a very large group produces an emergent intelligence superior to individual investment decisions."[62] I do not find this argument persuasive.[63] While there may be an additive wisdom concerning the desirability or efficacy of a particular product or service, it is standard rote among angel investors and venture capitalists that much more is needed for a venture to succeed than a good product. Important

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59 The issuer must satisfy certain constraints in order to qualify as a private issuer. See NI 45-106, s.2.4.

60 While abandoning the prospectus requirement, it substitutes a wide range of investor protection mechanisms (summarized in Appendix A) that includes, *inter alia,* restrictions on the type of issuer, the type of securities that may be offered, the total proceeds of an offering, the maximum amount that may be purchased by an individual investor (with a sliding scale depending on sophistication), mandatory use of a funding portal run by a registrant, point of sale mandatory disclosure, continuing mandatory disclosure, generic and dealer-specific point of sale cautions, impermissible uses of proceeds, investor right of withdrawal, statutory liabilities for misrepresentation, a mandatory contractual right of rescission and damages, a risk acknowledgment form, resale restrictions and a prohibition on advertising. Participating registrants are strictly regulated and are required (*inter alia*) to conduct background checks on the offeror's principals, review information documents, monitor purchaser communications and so on (including, in some cases, a suitability obligation) to purchasers). See Appendix A for more detail.

61 See Jeffrey G. MacIntosh, "Extraordinary Popular Delusions and the Madness of Crowdfunding," *National Post*, Aug. 1, 2013, FP 9.

62 I borrow this apt phrase from the report of an anonymous referee.

63 MacIntosh, "Extraordinary Popular Delusions …" FP 9.

attributes include experienced and professional management, good timing, effective monitoring, aggressive marketing and effective strategic execution.[64] Crowdfunding supplies none of these things.

Evidence that the crowdfunding exemption is of questionable wisdom may be found in the performance of a very different kind of securities offering — the IPO. Evidence from around the world is consistent: investors in IPOs realize returns that, on average, substantially trail both the pertinent market index and a matched industry cohort of firms.[65] Moreover, this return appears to be concentrated in smaller IPOs catering mainly to retail investors.[66]

This evidence is significant because IPOs are associated with the highest level of investor protection that securities regulation offers — but the market for IPOs nonetheless does not satisfy the fair game criterion. Particularly given the infirmities in the crowdfunding model just outlined, it seems plausible to hypothesize that the returns to crowdfunding investors will be even worse.

The crowdfunding model is subject to another serious criticism. As Appendix D makes plain, if there is a funding gap that needs to be addressed, it is in relation to high-tech firms, and not conventional low-tech firms. The latter's funding needs would appear to be adequately addressed in many or most cases by the entrepreneur's own resources, those of family, friends and business associates, and loan capital provided by banks and similar institutions. High-tech firms are quite different in two respects. One is that there is usually a much longer lead time to the realization of revenue. The other is that bank loans are rarely available.

Crowdfunding, however, is a singularly inappropriate model for addressing the capital gap facing high-tech firms. As evidence from venture capital exits attests, even highly sophisticated venture capitalists have trouble separating winners from losers, and failure rates are extremely high.[67] This suggests that unsophisticated crowdfunding investors will essentially be shooting in the dark in picking their crowdfunded investments — hardly a recipe for the enhancement of capital market efficiency.

Perhaps the best that can be said about the crowdfunding exemption is that it is likely to prove substantially irrelevant to the Canadian fundraising landscape. Experience from jurisdictions that permit crowdfunding suggests that the annual contribution of crowdfunding to aggregate capital raised will constitute a very small fraction of one per cent.

K. The Capital Raising Rationale for Public Issuers

In late 2015 and early 2016, the OSC adopted four new prospectus exemptions in Ontario: the existing security holder exemption; the CF exemption; the family, friends and business associates exemption; and the offering memorandum exemption (although the latter two existed in other jurisdictions prior to the OSC's adoption).[68] Two of these — the existing security holders'

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64 See e.g., Thomas Hellman and Manju Puri, "Venture Capital and the Professionalization of Start-Up Firms: Empirical Evidence," 57 *Journal of Finance* 169, 2002.

65 See e.g., Jay R. Ritter, "The Long-Run Performance of Initial Public Offerings," 46 *Journal of Finance,* 1991*,* 3; Tim Loughran and Jay R. Ritter, "The New Issues Puzzle," 50 *Journal of Finance* 23, 1995.

66 Alon Brav, Christopher Gecy, and Paul Gompers, "Is the Abnormal Return Following Equity Issuances Anomalous?" 56 *Journal of Financial Economics*, 2000, 209.

67 Douglas J. Cumming and Jeffrey G. MacIntosh, "Venture Capital Exits in Canada and the United States," 53 *University of Toronto Law Journal* 101, 2003.

68 The existing security holder prospectus exemption came into force in Ontario on Feb. 11, 2015; the family, friends and business associates exemption on May 5, 2015; the offering memorandum exemption on Jan. 13, 2016; and the crowdfunding exemption on Jan. 25, 2016.

exemption[69] and the rights offering exemption,[70] apply only to public companies. As with the capital gaps exemptions, these exemptions are motivated by more than strictly investor protection.

The existing security holders' exemption allows existing security holders in a public company to purchase additional securities of the type being offered. There are no disclosure requirements. However, the offering is subject to a $15,000 limit per person per year (unless suitability advice is obtained from an investment dealer) and a four-month hold period.

The rights offering exemption allows security holders of a public company to purchase additional securities in the company by exercising rights distributed by the company. There are minimal disclosure requirements, and the securities received are freely tradable.

There is little reason to believe that existing security holders of a public company are in a better position to assess the risk and expected return of an offering than any other investor. Savvy investors hold diversified portfolios of securities, and most investors know little more (if indeed anything more) about each of the companies in their portfolios than other public market investors. Indeed, the primary protection for purchasers under these exemptions is the practical necessity of pricing the offering off the secondary market price. But if this is the case, it is not clear why there should not be an equivalent prospectus exemption in all post-IPO offerings.

L. Alternative Disclosure Regimes

The offering memorandum (OM) exemption is in fact an alternative disclosure regime with far less mandated disclosure than a prospectus. It is available to both public and private companies. The additional peril that reduced disclosure creates for investors is addressed by imposing annual limits on the amount that may be invested which vary depending on whether the investor is an eligible investor or not. Eligible investors are qualified on a basis very similar to accredited investors, but with quite sharply reduced net income and net asset requirements.

Clearly, the offering memorandum exemption raises the probability of type I errors. This does not necessarily mean that it is misconceived, however. It will no doubt be far cheaper to put together an offering memorandum than a prospectus. Nonetheless, the evidence presented in Table 4 and associated text suggests that the OM exemption accounts for a modest fraction of all exempt financing. Its modest success also demonstrates that it is not viewed as an alternative to a public offering by prospectus. Why this is the case is a potentially fruitful area for future research

M. Policy-Driven Exemptions

A small number of exemptions are based on industrial policy, such as the government incentive security exemption in Ontario.[71] These are based on furthering the interests of particular industries or sectors of the economy.

N. Isolated Distributions

A kind of residual clause exists for one-off exemptions that cannot be justified under any other exemption; the isolated distribution exemption. It is rarely relied on and serves mainly as a final recourse for issuers who cannot justify their distribution under any other exemption.

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69 OSC Rule 45-501, s.2.9.

70 NI 45-106, ss.2.1-2.1.4.

71 Ontario Rule 45-501, s.2.1.

O. Summary

Table 9 summarizes the dangers of type I and type II errors for the various types of exemptions just discussed.

TABLE 9 PROXY SLIPPAGE: TYPE I AND TYPE II ERRORS

Type of Error	Safe Securities	Sophistication (institutional investors)	Sophistication (retail investors)	Active Participants	Close Connections	Other Protective Mechanisms (i.e., prospectus equivalents or near equivalents)	Capital Gaps (Private Issuers)	Capital Raising (Public Issuers)	Alternative Disclosure Regimes (falling short of prospectus disclosure)
Type I	S	S	L	S	L	S	L	L	M
Type II	S	S	S	S	S	S	S	S	S

LEGEND: S = Small, M = Medium, L = Large

VI. WHERE ARE ENFORCEMENT ISSUES MOST LIKELY TO OCCUR? SOME CONJECTURES FROM FIRST PRINCIPLES

A. Least Likely Cases

1. Exempt Securities Sold to Institutional Buyers

Most institutional investors qualify as accredited investors, and so may invest without the benefit of a prospectus. As noted earlier, most institutional investors will indeed be sophisticated, and there is little likelihood that either type I or type II errors will result from allowing institutions to invest. Thus, it is relatively unlikely that prospectus-exempt sales to such buyers will depart from the fair game criterion, whether the securities being sold are debt or equity.

The empirics described earlier suggest institutional buyers are significant users of the exempt market.

2. Exempt Securities Sold to High Net Worth Individuals

High net worth individuals are very likely to be sophisticated investors and/or have the resources to engage the assistance of sophisticated market professionals. Unfortunately, it is not possible from the data to determine which offerings are sold to high net worth individuals.

3. Short-Term Debt Sold by Financial Institutions

Jog suggests that a primary user of the exempt market is financial institutions using the exempt market to raise short-term debt under an exemption specifically crafted for that purpose.[72] Such debt is sold to institutional buyers, thus presenting relatively few dangers of abuse.

4. Exempt Securities Sold by Public Companies

Public companies sell exempt securities at or near the prevailing market price. Public companies are subject to extensive mandatory disclosure requirements, including the requirement to file an

[72] See Jog, 10, 12 (note 45), and Table 7 (16-17). NI 45-106, s.2.35 exempts from the prospectus requirement the issuance of "a negotiable promissory note or commercial paper maturing not more than one year from the date of issue."

AIF, MD&A (with each set of financial statements), material change reports, business acquisition reports and proxy circulars. Moreover, all of this is available at no charge to all users on SEDAR, which is an online information library containing all publicly filed issuer documents. Thus, such distributions are subject to a relatively low risk of being mispriced.

There is a distinction in this respect, however, between large public companies that trade in deep markets and small companies that trade in thin markets. Larger public companies usually have many shareholders, many of whom are institutional. For this reason, these companies are likely to receive a great deal of scrutiny not only from institutional investment professionals, but from the press, analysts and regulators. By contrast, small public companies have relatively few shareholders, many or all of whom will typically be retail shareholders. These companies are not closely followed by any of the aforementioned constituencies. In addition, because of the small public float and thin trading, price discovery will tend to be far less effective than for large public companies. Obviously, there is more danger that the public market price will fail at any given time to represent the best estimate of the true or intrinsic value of the issuer. For this reason, exempt distributions by small public issuers pose somewhat greater risks to investors.

B. Most Likely to Occur

1. Introduction

The prospectus exemptions seek to match investments to investors according to the latter's tolerance for risk (both psychic and financial), and investment experience and sophistication. Problems in achieving this matching are most likely to occur in relation to unreported exempt financings and retail investors for a number of reasons that are outlined below.

2. Unreported Exemptions

Non-reporting raises clear enforcement issues. However, it is not clear that there is any obvious solution. If regulators are unaware that an illegal financing has occurred, they obviously cannot act. They are likely to find out about illegal distributions only when an investment turns out poorly and disappointed investors seek regulatory redress. Given the large number of unreported and illegal exempt financings, it appears that this occurs in a small minority of cases.

3. Retail Investors: Proxy Slippage

While proxy slippage is not a significant problem for institutional investors, it is a very real problem for retail investors.

The problem of proxy slippage clearly arises in relation to the most important of the prospectus exemptions (at least by dollars raised) — the accredited investor exemption. While a possible solution would be to make it more difficult to qualify as an accredited investor, this would be a perilous practice. It could easily have deleterious consequences for small company efforts to raise capital, particularly for small high-technology issuers that have little access to credit markets and for whom angel investors are a vital source of funding.

The degree of proxy slippage should (at least in theory) be substantially less in the case of brokered offerings. In a brokered offering, a market intermediary such as a registered representative or exempt market dealer participates in the transaction. In such cases, the market intermediary has a duty to assess the suitability of the investment for each client, based on individualized factors such as investment knowledge, investment sophistication, financial goals, ability to withstand financial loss and risk tolerance.

As noted below, in the corpus of decided cases there are relatively few illicit exempt financings involving brokered offerings. However, brokered distributions are not exempt from problems; in the interest of earning trading commissions, the registrant has an incentive to shoehorn retail clients into unsuitable exempt offerings (with or without the client's complicity).

There is potent evidence that retail investors are poor shoppers when it comes to the purchase of registrant services, and are very often dissatisfied with the performance of their investment advisor.[73] A comprehensive investigation of the European Market,[74] for example, found that:

> … retail financial services are one of the sectors characterized by substantial market malfunctioning. In particular, the 2010 Scoreboard shows that the market for "investments, pensions and securities" ranks worst out of fifty consumer markets for overall market performance; worst for ease of comparing products and services sold by different suppliers; worst in trust that suppliers will respect consumer protection rules; fourth worst in experiencing problems; and worst for overall satisfaction. The financial environment has evolved so much that consumers are often ill-prepared to make sound decisions about increasingly complex retail financial products. The inability to benefit fully from this market is in part due to limited financial literacy or asymmetric information, but it may also be directly related to instincts driving consumers towards choices which are inconsistent with their long-term preferences. Recent evidence shows that consumers often have limited time to fully understand complex retail financial products. "Herding" instincts and over-reliance on experts' advice may also limit rational reflection.

Thus, although economists often rely on the discipline induced by repeat players and vendor reputation to produce an element of consumer protection, these controls do not seem to work in the retail market for registrant services.

Table 10 indicates that "trading without registration and/or prospectus and/or exemption" is responsible for 17 per cent of all investor contacts with the Ontario regulators, which is more than any other category. This suggests that illicit exempt financings are an important issue confronting securities regulators (although the OSC offers no data on how many of these complaints were sustained, or the number and dollar value of the securities involved).[75]

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[73] This is consistent with the view, endorsed by most financial economists, that retail traders are noise traders; i.e., unsophisticated investors who trade on noise rather than real information. See e.g., Brad M. Barber, Terrance Odean, and Ning Zhu, "Do Noise Traders Move Markets?" EFA 2006 *Zurich Meetings Paper*, September 2006, available at SSRN: https://ssrn.com/abstract=869827 or http://dx.doi.org/10.2139/ssrn.869827.

[74] "Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective: Final Report," November 2010, available at http://ec.europa.eu/consumers/financial_services/reference_studies_documents/docs/consumer_decision-making_in_retail_investment_services_-_final_report_en.pdf.

[75] I am grateful to an anonymous reviewer for pointing out these qualifications. It may be that a majority of complaints involve retail purchases of relatively modest numbers of securities representing a modest dollar value, in which case the OSC's figures would overstate the regulatory importance of illicit distributions.

TABLE 10 ONTARIO SECURITIES COMMISSION ASSISTANCE FOR INVESTORS, 2014-2015

Most common areas of contact with investors	
Trading without registration and/or prospectus and/or exemption	17 %
Information about public companies and investment offerings	11 %
Registrant services-related issues	11 %
Information about hearings, proceedings and orders	10 %
Checking advisor registration, prospectus or exemption	8 %
Abusive trading or market manipulation	7 %
Registrant misconduct, registrant-related (OSC) rules	7 %
Inadequate or misleading disclosure	7 %
Educational materials, resources for retail investors	3 %
Shareholder rights, director/officer responsibilities, corporate law	3 %
Scams / frauds / misrepresentations	2 %
Illegal insider trading	1 %
How and where to complain	1 %
All other	12 %

Source: Ontario Securities Commission Annual Report, 2015, 88 (based on 4,662 total contacts from investors to the OSC Inquiries & Contact Centre).

4. Retail Investors: Self-Misidentification

The self-misidentification problem arises when an investor chooses to misrepresent to an issuer or a market intermediary that he or she is an accredited investor, when this is not in fact the case.

Self-misidentification is a problem because it will tend to result in a mismatch between the investor's financial goals, risk tolerance, ability to withstand loss, etc., and the investment in question.

IIROC and the securities regulators have addressed the self-misidentification problem, at least in part, by placing an onus on any intermediary involved in the distribution, as well as the issuer, to make efforts to verify investors' representations that they are capable of taking advantage of a prospectus exemption.[76] Where registrants are concerned, this forms an integral part of the "know your client" and "suitability" obligations.

The administrative and judicial cases dealing with the misuse of prospectus exemptions suggest that cases of self-misidentification are rare. Much more common is registrant-induced misidentification.

5. Retail Investors: Registrant-Induced Misidentification

The registrant-induced misidentification problem is a variation of the self-misidentification problem. In this case, however, it is the issuer or the market intermediary who induces the investor to misstate his or her qualifications on attesting documents collected by the issuer or intermediary. This will typically be done in order to induce the investor to put money into an unsuitable investment that results in handsome commissions for the intermediary a successful capital raise by the issuer.

In the case of a brokered distribution, such conduct violates the registrant's suitability obligation to the client.

[76] NI 45-106CP, s.1.9.

6. Retail Investors: Issuer or Intermediary Misrepresentation of Investment Characteristics

In some cases, retail investors who technically qualify to make a prospectus-exempt investment will do so only on the basis of a misrepresentation by the issuer or intermediary as to the risk/return characteristics of the investment. The matching problem in this case is not a product of proxy slippage, investor self-misidentification or induced misrepresentation, but of these misrepresentations about the nature of the investment itself. Retail investors — even of the sophisticated variety — are more likely than institutional investors to fall prey to such misrepresentations, as they will typically lack the resources available to their institutional counterparts to verify representations regarding risk/return.

VII. ENFORCEMENT ACTIONS RELATED TO PROSPECTUS EXEMPTIONS

A. Introduction

In this section, I examine the deployment of enforcement resources with respect to the prospectus exemptions, by industry self-regulatory organizations, securities regulators and courts. The focus of this examination is on the decided corpus of cases relating to abuse of the prospectus exemptions.

In relation to firms carrying on a securities-related business, Canadian securities law specifies five categories of dealer registrant:[77]

a) investment dealer

b) mutual fund dealer

c) scholarship plan dealer

d) exempt market dealer

e) restricted dealer

The bulk of prospectus-exempt transactions involves investment dealers, mutual fund dealers and exempt market dealers. Relatively few (either in number or dollar value) involve scholarship plan dealers or restricted dealers.[78] Thus, in this paper, I deal mainly with the first three dealer categories.

Securities law requires investment dealers (but not exempt market dealers) to be members of IIROC.[79] In like fashion, mutual fund dealers must be members of the Mutual Fund Dealers Association of Canada (MFDA)[80] or, in Quebec, of the Chambre de la sécurité financière (CSF) (which assumes jurisdiction over group savings plan brokerage, financial planning, insurance of persons, group insurance of persons and scholarship plan brokerage). There is no SRO for exempt market dealers.

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77 NI 31-103, Part 7.

78 The category of restricted dealer is a sort of residual discretionary category. A market actor that fails to qualify under any of the other four categories of registration may apply to the regulators for discretionary permission to act as a restricted dealer. NI 31-103 states:

> The restricted dealer category in subsection 7.1(2)(e) permits specialized dealers that may not qualify under another dealer category to carry on a limited trading business. It is intended to be used only if there is a compelling case for the proposed trading to take place outside the other registration categories.

79 NI 31-103, s.9.1.

80 Ibid., s.9.2.

Where enforcement matters arise, dealers who are members of an SRO are subject to discipline by that SRO. Thus, IIROC hears matters relating to investment dealers, while MFDA and CSF hear matters relating to mutual fund dealers.[81] Since exempt market dealers (EMD) are not required to be members of any SRO, enforcement issues relating to EMD are dealt with by the securities regulators.

B. Compliance Reviews

As noted in Appendix B, one of the sources of regulatory oversight, for both SROs and the securities regulators, is *ad hoc* compliance reviews of dealers. The OSC conducts reviews of advisers, exempt market dealers, scholarship plan dealers and investment fund managers; IIROC conducts compliance reviews of the dealing operations of investment dealers and futures commission merchants; and MFDA conducts reviews of the dealing operations of mutual fund dealers.[82] The results of the securities regulators' compliance reviews are published annually in order to give guidance to dealers with respect to regulatory developments and initiatives, common compliance deficiencies, best practices, and more generally what is expected of each type of dealer overseen by the regulators.

The 2015 summary,[83] for example, indicates that in its compliance reviews the OSC found frequent failures on the part of EMDs to properly perform their foundational KYC and suitability duties, together with guidelines as to how these duties should appropriately be discharged.[84]

These compliance reviews play an important but largely invisible part of the enforcement process.

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[81] NI 31-103 formally transfers responsibility for oversight of the dealer's know-your-client and suitability obligations to IIROC and MFDA. See NI 31-103, s.3.16. It also transfers other core regulatory responsibilities as well as its enforcement jurisdiction: see NI 31-103, ss.6.2, 6.3, 9.3, 9.4, 10.2, 10.3, Appendix G.

[82] See "OSC Compliance Reviews" available at https://www.osc.gov.on.ca/en/Dealers_compliance-review_index.htm . The OSC website indicates that it selects firms for review on the following basis:

> The OSC typically uses a risk assessment model to select firms for compliance reviews. We send out a risk assessment questionnaire periodically to gather information about a firm's business operations. The information we receive is used to apply a risk ranking to a firm. This allows us to allocate resources more effectively and efficiently by targeting firms with higher risk rankings.

See Ontario Securities Commission, "OSC Compliance Reviews" available at https://www.osc.gov.on.ca/en/Dealers_compliance-review_index.htm . In addition, OSC has stated that if a firm is selected for review, it can expect that the OSC staff will:

- Interview the firm's senior management and other key employees;
- Examine the firm's books and records and financial transactions; and
- Assess the firm's internal controls, compliance system, disclosure, marketing practices, and policies and procedures.

Ontario Securities Commission, "If Your Firm is Selected for Review," available at https://www.osc.gov.on.ca/en/Dealers_firm-selected-review_index.htm . If the firm is not in compliance, the staff may take a number of actions, including:

- Tracking and monitoring the firm or individual;
- Conducting a follow-up review;
- Imposing terms and conditions on registration, or referring the matter to the OSC Enforcement Branch.

See Ontario Securities Commission, "If Your Firm is not in Compliance," available at https://www.osc.gov.on.ca/en/Dealers_firm-not-compliance_index.htm . In addition, the OSC has published an "Exempt Market Dealer Compliance Field Review List of Books and Records Requested for Review" to let EMDs know what to expect in a compliance review. Ontario Securities Commission, "Exempt Market Dealer Compliance Field Review List of Books and Records Requested for Review," available at https://www.osc.gov.on.ca/documents/en/Dealers/da_20100409_emd-books-records.pdf .

[83] Ontario Securities Commission, "Annual Summary Report for Dealers, Advisers and Investment Fund Managers Compliance and Registrant Regulation," OSC Staff Notice 33-746, Sept. 21, 2015.

[84] Ibid., 51. The 2015 report also discusses recent amendments to the rules that limit the scope of EMD activities. It also indicates that, as a result of the four new exemptions adopted in Ontario in 2015 and 2016, dealers relying on the exemptions are expected to "establish, maintain and apply internal controls and procedures to monitor compliance with the new prospectus exemptions and to manage the risks associated with its business in accordance with prudent business practices."

C. IIROC Enforcement Actions

1. Registrants and Exempt Market Financings

Understanding IIROC enforcement proceedings related to the abuse of prospectus exemptions necessarily entails some understanding of registrants' role in prospectus-exempt financings, the manner in which IIROC regulates registrants and the sanctions that IIROC has at its disposal for disciplining registrants who misbehave.

Where an issuer seeks to sell securities, the default rule is that either the issuer itself or any market intermediary that assists in the distribution must be registered (i.e., licensed).[85] The registration system is designed to ensure that securities market professionals have sufficient integrity, education, training and financial soundness to properly carry out their intermediary function and serve their clients.

Generally speaking, when securities market lawyers and regulators refer to the "exempt market", they are referring to the market in which securities may be sold free of both the prospectus requirement and the registration requirement. Indeed, in most cases in which a prospectus exemption is available, a corresponding registration exemption is also available.[86]

In many cases in which money is raised via a prospectus-exempt financing, it will be difficult or impossible to find a registrant who is willing to act as an intermediary. This includes small firms, firms raising small amounts of capital, and firms doing business in areas currently disfavoured by market participants and therefore by registrants. Thus, the principal mechanism for effecting investor protection lies in the design of the exemption itself.

Nonetheless, it is not uncommon for investors (particularly retail investors) to place their investments — including those that are prospectus-exempt — through a registrant such as an investment dealer[87] or an exempt market dealer.[88] This adds a layer of investor protection to these purchases, since these market intermediaries are impressed with a legal duty to gather information from their clients regarding their financial situation, tolerance for risk, investment experience, investment sophistication, investment time horizon and other matters (the so-called "know your client" duty,[89] referred to below as the KYC duty), and to assess the suitability of trading in the client's account based on those factors.[90] The obligation to assess suitability applies to the type of account opened by the client, every trade in the account, the trading strategy (whether originating with the investment advisor or the client), the composition, adequacy of diversification and liquidity of the client's portfolio, and other risk factors.[91]

The suitability duty applies even to orders the client initiates. Under securities regulatory rules, if the registrant believes that the client's trading instructions would effect a trade that is unsuitable for that client, the registrant must inform the client and refuse to complete the trade unless the client

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85 It is very rare for the issuer to be registered (and to use no intermediary). In virtually all cases where a firm offers securities via a prospectus, a professional underwriter will be hired to sell the issue. Where an intermediary is used in an exempt offering, that intermediary must be registered in at least the "exempt market dealer" category.

86 Most of the exemptions are set out in NI 45-106, although many of the provinces have additional exemptions set out in their own rules.

87 NI 31-103, s.7.1(1).

88 Ibid.

89 Ibid., s.13.2.

90 Ibid., ss.13.2(1) states:

> A registrant must take reasonable steps to ensure that, before it makes a recommendation to or accepts an instruction from a client to buy or sell a security, or makes a purchase or sale of a security for a client's managed account, the purchase or sale is suitable for the client.

91 See generally Jeffrey G. MacIntosh, *Brokers Duties to Investors* (forthcoming, LexisNexis Canada).

instructs the registrant to proceed nonetheless.[92] IIROC rules go even further, requiring the client to certify in writing that he/she/it has been instructed that the registrant believes the trade to be unsuitable but that the client wishes to proceed in any case. IIROC decisions suggest that in some circumstances, the registrant should unconditionally refuse to execute an unsuitable trade.

In addition, the duty to assess suitability arises whether the intermediary's client is sophisticated or unsophisticated, subject only to narrowly drawn exceptions. Generally speaking, only clients who are at the top end of the sophistication totem pole are not subject to the suitability duty. That includes Canadian financial institutions[93] and so-called permitted clients. The latter is defined in a manner very similar to the accredited investor category of prospectus exemption, but includes mostly institutional investors and excludes all but the wealthiest individual investors.[94]

In this respect, the suitability obligation evinces an element of paternalism, insofar as it seeks to protect clients — even a wide range of sophisticated clients — from their own bad investment choices, at least where the registrant believes that a proposed trade is unsuitable for the client (i.e., inconsistent with the client's financial means, ability to withstand financial loss, risk tolerance, investment horizon, investment experience and sophistication, and other factors).[95]

In short, orders for exempt market securities placed by investors through a market intermediary are subject to an additional layer of investor protection even where the exempt trade is formally subject to a registration exemption. The following section details IIROC sanctions in cases involving prospectus exemptions.

2. IIROC Enforcement Cases

A search was conducted in IIROC's online database for cases involving professional misconduct relating to the prospectus exemptions. In the 13-year period from March 2003 to the end of 2016, 18 cases yielding a decision were found — all of them involving registrant misconduct in relation to retail clients.[96] In these 18 cases, 15 individuals[97] and four corporations were sanctioned. Tables 11-15 indicate the nature of these cases and their disposition.

Three types of respondents were sanctioned in the various cases: i) individual investment advisors (15); ii) individual supervisory personnel and branch managers (four[98]); iii) registrant firms (four).

Table 11 indicates that there were two legal bases enlisted by IIROC as grounds for finding that individual registrants had acted inappropriately: failure to properly carry out the individual registrant's KYC/suitability obligations, and the broad-textured rule against conduct unbecoming by registrants. In the case of compliance personnel, the legal basis was the conduct unbecoming rule. In the case of registrant firms, it was the conduct unbecoming rule, failure to ensure that individual investment advisors carried out their KYC/suitability obligations and a specific IIROC rule requiring proper supervision of investment personnel.

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92 NI 31-103, s.13.3(1), (2).

93 Ibid., s.13.3(3).

94 Ibid., s.1.1. See also NI 31-103, s.8.22.1 (dealer registration requirement does not apply to a trade in non-convertible short-term debt if the purchaser is a permitted client).

95 I do not mean to suggest that this is necessarily a bad thing. Indeed, investment firms are arguably well situated, at low cost, to perform a highly useful gatekeeper function that many or most clients (even sophisticated ones) would be comfortable accepting *ex ante* as an implicit part of their contract with the investment advisor.

96 It is noteworthy that the Canadian Securities Administrators Enforcement Report for 2015 indicates that IIROC, MFDA and CSF concluded 112 enforcement cases in 2014 and 139 in 2015. *Canadian Securities Administrators Enforcement Report 2015*, 19. Thus, the IIROC database appears to digest only a fraction of the enforcement cases disposed of each year.

97 Four of the individuals were sanctioned both as investment advisors and as compliance officers or branch managers.

98 As I have noted, these four were also sanctioned as investment advisors.

Table 12 indicates the nature of the illegal distributions carried out. In about two-thirds of the cases involving individual registrants, the registrant was directly responsible for the breach of the exemption rules, either by deliberately attempting to disguise what the registrant knew was an illegal distribution, or otherwise inducing the client to invest where the registrant knew that no exemption was available. The remaining cases involve the registrant turning a blind eye to the client's self-identification as an exempt investor. Thus, there are no cases in the sample involving pure client self-identification without registrant complicity.

TABLE 11 LEGAL BASES FOR ADVERSE FINDINGS IN IIROC PROCEEDINGS

A. INDIVIDUAL INVESTMENT ADVISORS

ILLEGAL ACTS	NUMBER OF CASES	PERCENTAGE
Conduct Unbecoming[103]	15 of 15	100%
KYC/Suitability Failure[104]	5 of 15	33%

B. INDIVIDUAL COMPLIANCE PERSONNEL OR BRANCH OFFICERS

ILLEGAL ACTS	NUMBER OF CASES	PERCENTAGE
Conduct Unbecoming[105]	4 of 4	100%

C. REGISTRANT FIRMS

ILLEGAL ACTS	NUMBER OF CASES	PERCENTAGE
Conduct Unbecoming[106]	2 of 4	50%
Failure to Establish and Maintain a Proper Supervisory System[107]	2 of 4	50%
Failure to Ensure Investment Advisor Compliance With KYC/Suitability Duties[108]	2 of 4	50%

TABLE 12 NATURE OF ILLEGAL DISTRIBUTION

A. INDIVIDUAL INVESTMENT ADVISORS

Circumvention Of $150,000 Investment Requirement[109] by the Formation of an Investment Club, Partnership or Other Entity in Order to Disguise the Number of Beneficial Purchasers	4 of 15 (27%)
Inducing Clients to Purchase Securities Where No Prospectus Filed and No Prospectus Exemption Available	6 of 15 (40%)
Failure to Reasonably Inquire of a Client Whether He/She Qualifies for a Prospectus Exemption	5 of 15 (33%)

99 IIROC Bylaw 29.1, the conduct unbecoming rule, states:

> Dealer Members and each partner, Director, Officer, Supervisor, Registered Representative, Investment Representative and employee of a Dealer Member (i) shall observe high standards of ethics and conduct in the transaction of their business, (ii) shall not engage in any business conduct or practice which is unbecoming or detrimental to the public interest, and (iii) shall be of such character and business repute and have such experience and training as is consistent with the standards described in clauses (i) and (ii) or as may be prescribed by the Board.

100 IIROC Rules 1300.1(a), (p), (q), (r).

101 IIROC Bylaw 29.1.

102 Ibid.

103 IDA Regulation 29.27, IIROC Rule 38.1.

104 IIROC Rules 1300.1(a), (p), (q), (r).

105 The $150,000 exemption no is no longer available to individuals in Ontario.

B. INDIVIDUAL COMPLIANCE PERSONNEL

Failure To Properly Supervise Investment Advisor(s) To Ensure that No Securities Were Sold to Clients Without a Prospectus or a Prospectus Exemption	4 of 15 (all cases) (27%) 4 of 4 (cases involving compliance personnel) (100%)

C. REGISTRANT FIRM

Failure to Establish and Maintain a System of Controls and Supervision to Ensure that Clients Were Properly Qualified to Purchase Securities Without a Prospectus	3 of 15 (all cases) (20%) 3 of 4 (cases involving firm-level failure) (75%)
Failure to Investigate Whether Persons Representing Themselves as Accredited Investors Were in Fact Accredited Investors	1 of 15 (all cases) (0.67%) 1 of 4 (cases involving firm-level failure) (25%)

Table 13 presents summary statistics on the 15 cases in which individuals were sanctioned.

TABLE 13 IIROC SANCTIONS AGAINST INDIVIDUALS: SUMMARY STATISTICS

Type Of Sanction: Individuals	Number Of Cases (and %)	Average
Fine	15 of 15 (100%)	$42,070[110]
Costs	15 of 15 (100%)	$16,938[111]
Reimbursement	1 of 15 (0.67%)	Amount unknown
Disgorgement	3 of 15 (20%)	$3,450 (all cases) $18,070 (cases in which disgorgement was awarded)
Close Supervision	7 of 15 (47%)	7.5 months
Retake CPH Course	12 of 15 (80%)	N/A
Suspension	6 of 15 (40%)	N/A[112]
Lifetime Ban	1 of 15 (7%)	N/A

The four cases involving IIROC disciplinary proceedings against firms are digested in Tables 14 and 15. Table 11 indicates that the three legal grounds for sanctioning firms were: i) the conduct unbecoming rule; ii) the failure to establish and maintain a proper supervisory system;[109] and iii) the failure to ensure investment advisor compliance with the KYC/suitability duties. Although the second and third grounds arise under distinct IIROC rules, there is an obvious overlap. The second ground speaks to a generalized supervisory failure, while the third speaks more to a supervisory failure unique to the case at hand.

Table 15 presents summary statistics on the sanctions against industry firms.

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106 This figure reduces to $29,430 when one outlier is removed.

107 This figure reduces to $11,635 when one outlier is removed.

108 Both because there is one outlier of 15 years, and because the types of suspensions are not homogeneous, it does not seem appropriate to calculate an average.

109 In two of the four cases, the firm was found to have engaged in pervasive supervisory failure resulting in the sale of securities to a large number of clients where no prospectus had been filed and no prospectus exemption was available. One of these involved no fewer than 72 investment advisors: *Re Scotia Capital,* 2015 IIROC 27.

TABLE 14 IIROC SANCTIONS AGAINST INDUSTRY FIRMS

Case	Fine	Costs	Compensation of Clients	Disgorgement of Profits or Commissions	Rewrite Firm's Compliance Procedures	Internal Discipline of Persons Involved
1	$500,000	$0[114]	Y	$1,768 (profits)	Y	Y
2	$25,000	Indeterminate[115]	N	N	N	N
3	$2,000,000	$50,000	N	N	N	N
4	$150,000	$4,000	N	N	N	N

TABLE 15 IIROC SANCTIONS AGAINST INDUSTRY FIRMS: SUMMARY STATISTICS

Type of Sanction: Individuals	Number of Cases (and %)	Average
Fine	4 of 4 (100%)	$668,750
Costs	3 of 4 (75%)	$18,000[116]
Reimbursement	0 of 4 (0%)	$0
Disgorgement	1 of 4 (25%)	$440
Rewrite Firm's Compliance Procedures	1 of 4 (25%)	N/A
Internal Discipline of Persons Involved	1 of 4 (25%)	

D. Securities Regulatory Actions Related to the Enforcement of Prospectus Exemptions versus Other Subject Matters

As noted, the provincial and territorial securities regulators cede jurisdiction in cases involving registrants to IIROC, MFDA and (in Quebec) the CSF. Thus, reported cases emanating from the securities regulators involve non-registrants. These non-registrants have spearheaded or been involved in the illegal sale of securities without a prospectus or a prospectus exemption, in some cases falsely passing themselves off as registered dealers or advisors.

The nature of the securities regulatory enforcement process, as compiled by the Canadian Securities Administrators, is indicated in Appendix B, which indicates that the impetus for enforcement cases comes from two sources — internal and external. Internally, information related to abuse of the prospectus exemptions often comes from ad hoc or periodic reviews of registrant firms or individuals to determine whether the rules are being followed. However, if a problem regarding a registrant is detected, the case will be referred to the appropriate SRO for disciplinary action. Thus, in cases involving non-registrants, the main source of information is usually external (i.e., complaints from investors).

In their annual enforcement reports, the Canadian Securities Administrators compile statistics relating to enforcement actions. These reports indicate that more enforcement proceedings are undertaken in relation to illegal distributions than any other matter (see Table 16). The 2015 report, for example, indicates that of all enforcement actions commenced from 2013 to 2015, 48 per cent related to illegal distributions.[113] A similar percentage (52 per cent) related to enforcement matters concluded in the same period.[114] Thus, of all the issues that securities regulators deal with, illegal distributions consume the greatest enforcement resources.

110 The firm in question (Scotia Capital) was given credit for co-operation, as it voluntarily came forward when it discovered the failures to comply with the rules.

111 Set over for separate hearing, which does not appear to be available.

112 Of the three cases in which costs are known.

113 53 per cent in 2013, 45 per cent in 2014 and 46 per cent in 2015.

114 CSA Enforcement Report 2015, 14.

As Table 17 indicates, 26 per cent of all fines and administrative penalties levied by Canadian securities regulators in 2015 were levied in relation to illegal distributions.[115] The percentage was similar in 2014 (30 per cent) but substantially higher in 2013 (48 per cent).

TABLE 16 SECURITIES REGULATORY ENFORCEMENT ACTIONS COMMENCED IN 2013-2015

TYPE OF OFFENCE	2013	2014	2015
Illegal Distributions	144 (53% of total)	127 (45% of total)	123 (46% of total)
Fraud	56	81	64
Misconduct by Registrants	19	23	15
Illegal Insider Trading	13	7	14
Disclosure Violations	14	4	5
Market Manipulation	6	23	18
Other Cases	18	16	27
TOTAL	270	281	266

Source: CSA 2015 Enforcement Report, available at
http://er-ral.csa-acvm.ca/wp-content/uploads/2016/02/CSA_AnnualReport_English_20151.pdf, 13.

TABLE 17 SECURITIES REGULATORY ENFORCEMENT FINES AND ADMINISTRATIVE PENALTIES, 2013-2015

TYPE OF OFFENCE	2013	2014	2015
Illegal Distributions	$16,976,063	$17,600,090	$36,571,080
Fraud	$12,997,120	$23,038,461	$68,460,000
Misconduct by Registrants	$1,305,004	$7,476,755	$2,485,394
Illegal Insider Trading	$3,428,000	$87,850	$5,240,872
Disclosure Violations	$60,000	$79,500	$30,000
Market Manipulation	$75,000	$61,500	$24,187,450
Other Cases	$520,000	$7,895,000	$1,324,000
TOTAL	$35,361,187	$58,239,156	$138,298,796

Source: CSA 2015 Enforcement Report, available at
http://er-ral.csa-acvm.ca/wp-content/uploads/2016/02/CSA_AnnualReport_English_20151.pdf, 13.

Particularly striking about these figures is the large number of securities regulatory proceedings when compared to IIROC proceedings over a much longer period of time. The online IIROC database contains only 18 enforcement actions related to prospectus exemptions, covering the period 2003-2016. By contrast, in the three-year period from 2013 to 2015, the regulators brought 538 actions. However, the CSA Enforcement Report for 2015 states that IIROC, MFDA and CSF concluded 112 enforcement cases in 2014 and 139 in 2015.[116] While it is not clear how many actions were brought by each SRO, this figure suggests a loose equivalency between the number of IIROC disciplinary cases and the number of securities regulatory disciplinary cases (which in turn suggests the IIROC online database does not digest all enforcement proceedings).

[115] 2015 was characterized by a number of unusually large fines. *Re Zhu*, 2015 BCSECCOM 264 (B.C. Sec. Comm.) resulted in fines of $28 million for an illegal distribution (in addition to disgorgement orders in the amount of $42 million). *Re Rashida Samji, Rashida Samji Notary Corporation and Samji & Assoc. Holdings Inc.,* 2015 BCSECCOM 29 (B.C. Sec. Comm.) resulted in fines of $33 million (in addition to disgorgement orders in the amount of $10.8 million). *Re Lathigee et al.,* 2015 BCSECCOM 78 (B.C. Sec. Comm.) resulted in fines of $30 million (in addition to disgorgement orders in the amount of $21.7 million). *Re Poonian et al*., 2015 BCSECCOM 96 (B.C. Sec. Comm.) resulted in fines of $22.5 million (in addition to disgorgement orders in the amount of $7.3 million).

[116] CSA Enforcement Report 2015, 19.

E. Securities Regulatory Actions Related to Prospectus Exemptions: Characterization

The bulk of securities regulatory hearings related to prospectus exemptions are not enforcement proceedings, but regulatory hearings to decide whether to grant the applicant a discretionary prospectus exemption. Below, I summarize a random selection of 100 cases gleaned from the Westlaw database.[117] All of these cases arise after Jan. 1, 2000 — the date on which the multiple reliance review system (MRRS) came into existence.

The MRRS is a mutual recognition system pursuant to which the decision of a single provincial regulator (the principal regulator) is binding in the rest of the country.[118] It allows a market actor to apply to its principal regulator for a discretionary prospectus exemption that will apply nationally.

As can be seen from Table 18, only 11 (or 11 per cent) of the cases in the sample are enforcement cases in the strict sense (i.e., disciplinary proceedings related to abuse of the prospectus exemptions). Nearly half (46 per cent) of the cases were applications for discretionary exemptions made under the MRRS system. The balance (43 per cent) involved applications for discretionary exemptions made in a single province.

TABLE 18 MRRS-ERA SECURITIES REGULATORY CASES: A RANDOM SELECTION OF 100 CASES

TYPE OF CASE	NUMBER
Enforcement	11
MRRS Discretionary Exemption	46
Single Province Discretionary Exemption	43[123]
TOTAL	100

Table 19 supplies a breakdown of the types of applications made for discretionary exemptions under the MRRS system. The most common type of application by far is related to the prospectus exemption allowing for the sale of non-convertible short-term commercial paper without a prospectus. Many of these involved situations in which the issuer's commercial paper failed to meet the rating requirements of the exemption.

Of the 26 applications for relief in connection with the short-term commercial paper exemption, 19 were from commercial corporations — about two-thirds of which were large publicly traded corporations in the energy sector (and all Canadian-based companies). An additional six applications were from financial corporations, all of which were financing subsidiaries of large publicly traded corporations (mostly American or European).

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[117] The search parameter was "prospectus exemption." These 100 cases represent about 10 per cent of all of the cases concerning prospectus exemptions decided between Jan. 1, 2000 and the present.

[118] See MI 11-101 ("Principal Regulator System").

[119] One non-MRRS case involved the granting of discretionary exemptions in multiple provinces.

TABLE 19 MRRS DISCRETIONARY EXEMPTIONS

TYPE OF CASE	NUMBER
Short-Term Commercial Paper	26[124]
First Trade Relief for Institutional Investor	5
First Trade Relief for Employees Under Incentive Compensation Plan	4[125]
Allow Foreign Offering Documents to be Used as OM	3
Mutual Fund Deemed Not a Reporting Issuer	3
Permit Prohibited Representation (Stock Exchange Listing)	3
Related Mutual Funds	2
Registered Retirement Income Fund	1
Designation of Issuer as Reporting Issuer	1

Table 20 indicates the nature of the single-province applications for discretionary exemptions. All of the Alberta-only applications in the first row occurred between 2000-2005, and appear to be unique to that province and that period of time. The Ontario-only applications in the second row all occurred between 2006-2008, and again appear to be unique to that province and that period of time. If these applications are not counted, between 2000 and the present 67 per cent of the applications for discretionary relief were made under the MRRS system.

TABLE 20 SINGLE PROVINCE DISCRETIONARY EXEMPTIONS

Application by Registrant to Deal in a Specific Security Outside Its Normal Mandate (Alberta)	21
Approval to Act as Trustee Under s.213(3)(b) of the *Ontario Loan and Trust Corporations Act* (Ontario)	6
First Trade Relief for Institutional Holder	2
First Trade Relief for Employees Under Incentive Compensation Plan	2
Northwest Exemption	2
Purchase of Securities by Employees	1
Defined Contribution Pension Plan	1
Permit Prohibited Representation (Stock Exchange Listing)	1
Permit FOFI to be Used in OM	1
Other	6

Tables 21-26 summarize a random selection of 20 cases dealing specifically with enforcement issues, involving the sanctioning of 37 individuals and seven issuer corporations.

Table 21 presents summary statistics indicating the nature of the illegal acts found to have occurred in the cases in the sample involving individuals. All involve the facilitation of an illegal distribution. Virtually all of the cases also involve a breach of the registration requirement. This is because the securities regulators refer cases involving registrants to the appropriate SRO (e.g., IIROC).

The cases generally fall into a number of camps:

a) An unregistered individual innocently but illegally acts as an agent in facilitating the raising of money by an issuer;

b) An unregistered individual knowingly and illegally acts as an agent in facilitating the raising of money by an issuer;

[120] The total in this column adds to more than 46, given that more than one type of discretionary relief was requested in some applications.

[121] These are foreign companies with subsidiaries in Canada that are not reporting issuers and that wish to allow their employees to sell incentive shares in a foreign venue without the prospectus requirement.

c) An unregistered individual who is a director or officer of the issuer innocently but illegally facilitates the raising of money by an issuer;

d) An unregistered individual who is a director or officer of the issuer knowingly and illegally facilitates the raising of money by an issuer;

e) The distribution is for an issuer actually conducting a real business, but involves fraudulent misrepresentations in order to induce investors to part with their money;

f) The distribution involves the raising of money for a phony issuer with the proceeds of the distribution going directly or indirectly into the fraudster's pockets.

As Table 21 indicates, a high percentage (57 per cent) of the cases in the sample in which individuals were sanctioned involved fraud of one kind or another. Relatively few of these involved frauds with phony issuers. More often, the scheme involved fraudulent misrepresentations with a view to inducing persons to invest.

TABLE 21 ILLEGAL ACTS FOUND IN SECURITIES REGULATORY PROCEEDINGS: INDIVIDUALS: SUMMARY STATISTICS

ILLEGAL ACTS	NUMBER OF CASES	PERCENTAGE
1 - no registration	36 of 37 cases	97%
2 - facilitating illegal distribution	37 of 37 cases	100%
3 - making prohibited undertakings	5 of 37 cases	14%
4 - fraud	21 of 37 cases	57%
5 - activity contrary to the public interest	11 of 37 cases	30%

For all 20 cases, Table 22 indicates the monetary sanctions imposed on individuals who were found to have been involved in an illegal distribution.[122] Both these and the non-monetary sanctions arise under the regulators' so-called public interest powers. Ontario's *Securities Act* is typical. As indicated in Appendix C, the act enables the commission to make 15 different kinds of orders "if in its opinion it is in the public interest to make the order or orders …" Obviously, this confers a broad discretionary power on the commission. Moreover, the commission can find that there has been a breach of the public interest even in cases in which there has been no violation of the *Securities Act* or any other applicable regulatory instrument.[123]

Table 23 indicates the corresponding non-monetary sanctions employed in cases involving individuals. As noted, like the monetary sanctions, these sanctions arise under the regulators' public interest powers.

Table 24 indicates the relative frequency with which the different sanctions are used. In the case of the monetary penalties, the average amount of all fines, costs and disbursement orders is indicated. There are no amounts in the reimbursement category, because in the cases in the sample the funds used to reimburse investors are drawn from the disgorgement orders.

[122] Some sanctions have been omitted, such as reprimands.

[123] *Canadian Tire Corp. vs. C.T.C. Dealer Holdings Ltd.* (1987), 35 B.L.R. 117, 37 D.L.R. (4th) 94, 3 A.C.W.S. (3d) 443, 59 O.R. (2d) 79 (Ont. Div. Ct.). A subset of the public interest sanctions may only be enlisted in cases involving a breach of Ontario securities law, a defined term which includes a breach of the *Securities Act,* rules or regulations made under the act, and "in respect of a person or company, a decision of the Commission or a Director to which the person or company is subject" (*Securities Act,* ss.1(1), definition of "Ontario securities law"). Given the last part of this definition, this does not appear to require a violation of the *Securities Act,* or the rules or regulations. The director, for example, is given discretionary authority under the act to decide various matters not involving a breach of the act. Perhaps more important, a decision by the commission that a person or company has violated the public interest would appear to be "a decision of the Commission … to which the person or company is subject." This is not an issue, however, in the enforcement cases described herein, insofar as the respondents routinely breach either or both of s.25 of the act (requiring that persons engaged in "trading" be registered) and s.53 (requiring a prospectus for a distribution of securities, or an applicable exemption).

In the case of discretionary bans (such as a prohibition of acting as an officer or director of an issuer or other party) Table 21 indicates whether the sanction was permanent (Y (P)), or for a period of years (Y (x), where x is the number of years).

TABLE 22 INDIVIDUAL MONETARY SANCTIONS: SECURITIES REGULATORY PROCEEDINGS

Individual	Nature of Illegal Acts	Fine[128]	Costs[129]	Reimbursement of Investors[130]	Disgorgement[131]
1	1, 2	$150,000	$0	YES	$486,000
2	1, 2, 3, 4, 5	$200,000	$33,470		$165,000
3	1, 2, 3, 4, 5	$500,000	$33,470		$165,000
4	1, 2, 3, 4, 5	$650,000	$33,470		$165,000
5	1, 2, 3, 4, 5	$750,000	$33,470		$165,000
6	1, 2, 5	$7,500	$0	YES	$163,000
7	1, 2	$50,000	$5,000		$0
8	1,2	$0	$0		$0
9	1,2	$25,000	$5,000	YES	$887,500
10	1,2	$27,710	$0		$0
11	1, 2	$0	$0		$0
12	1, 2	$25,000	$25,000		$0
13	1, 2, 7	$200,000	$25,000		$0
14	1, 2, 5	$10,000	$10,000		$0
15	1, 2, 5	$10,000	$0		$0
16	1, 2, 4	$550,000	$38,300		$0
17	1, 2, 4	$550,000	$38,300		$0
18	1, 2, 4	$300,000	$30,000		$0
19	1, 2, 4	$15,000	$30,000		$0
20	1, 2, 4	$2,500	$5,000		$0
21	1, 2, 4	$2,500	$0		$0
22	1, 2, 4	$2,500	$0		$0
23	1, 2, 4	$2,500	$0		$0
24	1, 2, 4	$2,500	$0		$0
25	1, 2, 4	$2,500	$0		$0
26	1, 2, 4	$2,500	$0		$0
27	1, 2, 4	$2,500	$0		$0
28	2, 3, 5	$7,500	$1,000		$0
29	1, 2, 5	$0	$0		$1,500
30	1, 2, 5	$50,000	$25,000		$50,000
31	1, 2, 4, 5	$6,000,000	$0		$1,297,581
32	1, 2	$0	$0		$0
33	1, 2	$0	$0		$0
34	1, 2, 4	$20,000	$0		$0
35	1, 2, 4	$20,000	$0		$0
36	1, 2, 4	$20,000	$0		$0
37	1, 2, 4	$20,000	$0		$0

LEGEND

1	no registration
2	facilitating illegal distribution
3	making prohibited undertakings
4	fraud
5	activity contrary to the public interest
6	failure to ensure that investors were accredited

TABLE 23 INDIVIDUAL NON-MONETARY SANCTIONS: SECURITIES REGULATORY PROCEEDINGS

Individual	Personal Trading Ban[132]	Resign Position as Director/Officer of Issuer, Registrant and/or Investment Fund Manager[133]	Barred From Serving as Director/ Officer of Issuer, Registrant and/or Investment Fund Manager[134]	Barred From Becoming a Registrant[135]
1	Y (P)	Y	Y (P)	Y (P)
2	Y (P)	Y	Y (P)	Y (P)
3	Y (P)	Y	Y (P)	Y (P)
4	Y (P)	Y	Y (P)	Y (P)
5	Y (P)	Y	Y (P)	Y (P)
6	Y (P)	N	Y (P)	Y (P)
7	Y (1)	N	N	N
8	Y(5)	Y	Y (P)	N
9	Y(P)	N	Y (P)	N
10	Y(3)	N	N	N
11	N	Y	Y (5)	Y (P)
12	N	N	N	N
13	N	Y	Y (P)	Y (4)
14	Y(P)	Y	Y(10)	N
15	N	N	Y(3)	N
16	Y(P)	Y	Y (P)	Y (P)
17	Y(P)	Y	Y (P)	Y (P)
18	Y(P)	Y	Y (P)	Y (P)
19	Y(5)	Y	Y (5)	N
20	Y(4)	Y	Y (4)	N
21	Y(4)	Y	Y (4)	N
22	Y(2)	Y	Y (2)	N
23	Y(2)	Y	Y (2)	N
24	Y(2)	Y	Y (2)	N
25	Y(2)	Y	Y (2)	N
26	Y(2)	Y	Y (2)	N
27	Y(2)	Y	Y (2)	N

[124] The Ontario provisions are: OSA ss.127(1)2.1 (barring acquisition of securities); ss.127(1)3 (an order that none of the exemptions contained in Ontario securities law shall be available to the person or company).

[125] The Ontario provisions are: OSA ss.127(1)7 (resign as director or officer of issuer); ss. 127(1)8.1 (resign as director or officer of a registrant); ss.127(1)8.3 (resign as director or officer of an investment fund manager).

[126] The Ontario provisions are: OSA ss.127(1)8 (barred from serving as director or officer of issuer); ss. 127(1)8.2 (barred from serving as director or officer of a registrant); ss. 127(1)8.4 (barred from serving as director or officer of an investment fund manager).

[127] The Ontario provision is OSA ss.127(1)8.5.

28	Y(20)	N	Y (20)	Y (20)
29	Y(7)	N	Y (7)	Y (7)
30	Y(P)	N	Y (7)	Y (7)
31	N	N	Y (P)	Y (P)
32	N	N	N	Y (5)
33	Y(5)	Y	Y(5)	Y (4)
34	Y (P)	N	Y (P)	N
35	Y (P)	N	Y (P)	N
36	Y (P)	N	Y (P)	N
37	Y (P)	N	Y (P)	N

TABLE 24 INDIVIDUAL SANCTIONS: SUMMARY STATISTICS[128]

TYPE OF SANCTION: INDIVIDUALS	NUMBER OF CASES (AND %)	AVERAGE
Fine	32 of 37 cases (86%)	$275,100 (all cases) $318,100 (in cases awarded)
Costs	16 of 37 cases (43%)	$10,040 (all cases) $23,200 (in cases awarded)
Reimbursement	3 of 37 cases (8%)	N/A
Disgorgement	10 of 37 cases (27%)	$71,840 (all cases) $265,800 (in cases awarded)
Personal Trading Suspension or Ban	31 of 37 cases (84%)	N/A
Resign Positions as Director/Officer Etc.	22 of 37 cases (59%)	N/A
Prohibition From Acting as Director/Officer Etc.	33 of 37 cases (89%)	N/A
Preventive Order that the Individual May Not Become a Registrant for a Period of Time or Permanently	17 of 37 cases (46%)	N/A[136]

All 20 of the cases in the sample involved corporate issuers (some, a significant number). However, in only seven of these cases were sanctions levied against these issuers. The main targets of enforcement proceedings are typically the individuals involved.

As can be seen from Table 25, the main sanctions levied against corporations are monetary (as opposed to a combination of monetary and non-monetary in the case of individuals). An additional type of order sometimes levied against an issuer, particularly in cases involving fraud, is a cease trade order, such that no person may trade in the securities of the offending issuer.

[128] An average may not be computed given the indefinite nature of the permanent bans.

TABLE 25 SECURITIES REGULATORY PROCEEDINGS: CORPORATE SANCTIONS

Corporation	Nature of Illegal Acts[137]	Fine[138]	Costs[139]	Reimbursement of Investors[140]	Disgorgement[141]	Other
1	1, 2	$25,000	$0	Y	$887,500	
2	1, 2	$800,000	$0	N	$0	
3	1, 2	$25,000	$25,000	N	$0	Corporation to offer right or rescission to all investors who are not accredited
4		$500,000	$0	N	$0	Issuer undertakes to sell to investors only under a specific exemption
5	1, 2, 4	$550,000	$38,300	N	$0	
6	1, 2	$10,000	$5,000	N	$0	Corporation to offer right or rescission to all investors who are not accredited Corporation loses trading exemptions for 7 years Corporation to prepare audited financial statements for regulator
7	1, 2, 4	$20,000	$0	N	$0	

TABLE 26 CORPORATE MONETARY SANCTIONS: SUMMARY STATISTICS

TYPE OF SANCTION: INDIVIDUALS	NUMBER OF CASES (AND %)	AVERAGE
Fine	7 of 7 (100%)	$275,715
Costs	3 of 7 (43%)	$9,760 (all cases) $22,770 (in cases awarded)
Reimbursement	0 of 7 (0%)	$0
Disgorgement	1 of 7 (14%)	$126,785

The corporate sample is small. Nonetheless, as a comparison of tables 24 and 26 indicates, the average fine levied against individuals was approximately the same as the average fine levied against corporations. While costs were ordered much more frequently against individuals than corporations, the average amount of the fines awarded was very similar both overall and in respect of only those cases in which costs were ordered.

One conclusion to be drawn from the above statistics is that the securities regulators have chosen to focus more on sanctions directed against individuals involved in illegal distributions than on the issuers. This seems appropriate, insofar as not all of the shareholders of an issuer may be complicit in violations of the distribution rules, and sanctions directed at the issuer penalize the innocent as much as the guilty.

The number of different types of sanctions against individuals is greater than that against issuers. In addition to monetary sanctions, it is commonplace with respect to individuals to order a ban on personal trading, either for a period of years, or permanently. It is also common to order that the individual resign any position that he/she holds as director or officer of an issuer, and/or an

[129] The coding follows that found in Table 21.

[130] In Ontario, an administrative fine of up to $1 million may be imposed for each failure to comply. OSA ss.127(1)9.

[131] In Ontario, the costs of an investigation may be awarded under OSA s.127.1.

[132] In Ontario, reimbursement of investors is an outgrowth of the commission's powers under ss.127(1)10 to order disgorgement of illicit gains ("If a person or company has not complied with Ontario securities law, an order requiring the person or company to disgorge to the Commission any amounts obtained as a result of the non-compliance."). These amounts may then be applied for the benefit of third parties designated by the commission: OSC s.3.4(2)(b).

[133] In Ontario, disgorgement may be awarded under ss.127(1)10. See preceding footnote.

investment fund manager, and/or a registrant, and to refrain from becoming a director or officer of one or more of these entities either for a period of years or for life.

The severity of the sanctions meted out is clear from the above tables. The severity is understated insofar as the monetary sanctions typically exceed by a factor of several times the amount of the individual's ill-gotten gains in the cases in the sample. If, as I have conjectured, the amount of non-compliance with the rules is far greater than regulators are (or can be) aware of, meting out severe sanctions is obviously an appropriate remedial strategy in order to discourage potential abuse of the rules.

F. Comparison of IIROC and Securities Regulatory Disciplinary Proceedings

A comparison between the sanctions meted out by securities regulators and those meted out by IIROC discloses a wide gap in severity. The average fine awarded by the securities regulators against an individual, for example, was $275,100, while that awarded by IIROC was just over $40,000. Similarly, the average disgorgement award against an individual awarded by IIROC was $3,450, versus about $72,000 for the securities regulators. While on average IIROC levied about $17,000 costs per individual and the securities regulators about $10,000, this does not come close to making up the gap in fines or disgorgement amounts.

In the cases in the sample, in both IIROC and securities regulatory proceedings, reimbursement of investors plays a small role. A broader survey of securities regulatory cases, however, suggests that reimbursement may occur more often than indicated in the cases in the sample. Regulators are legally entitled to order reimbursement of investors out of either the administrative fine or disgorgement amount.[134] It is not unusual for regulators to order that the administrative fine be employed for the benefit of third parties in general, and investors in particular.[135]

In terms of non-monetary sanctions, the focus of IIROC and securities regulatory proceedings is quite different. IIROC deals with registrants that have acted inappropriately, while securities regulators deal with non-registrants (both individuals facilitating illegal distributions and the issuers themselves). This conditions the types of sanctions available, since registrants may be disciplined *qua* registrants, while non-registrants may not. The regulatory solution in the latter case is to allow regulators to penalize respondents in non-registrant but business-related activities, such as being a director or officer of an issuer, investment fund manager or registrant.

In IIROC cases involving individuals, the non-monetary sanctions typically involve one or more of: i) a suspension or lifetime ban from acting as a registrant; ii) an order to retake the industry's foundational educational requirement, the *Conduct and Practices Handbook* course; iii) close supervision by the individual's employer for a period of time. IIROC non-monetary sanctions sometimes require the firm to reassess and rewrite its supervisory rules and protocols.

In securities regulatory cases involving individuals, the non-monetary sanctions typically involve one or more of: i) a personal trading suspension or ban; ii) an order that the individual resign all positions as a director or officer of any issuer, investment fund manager or registrant; iii) an order that the individual is prohibited from acting as a director or officer of any of the foregoing; iv) a preventive ban from becoming a registrant for a period of years or permanently.

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[134] In Ontario, see OSA ss.3.4(2)(b).

[135] See e.g., *Re Global Partners Capital* (2011), 34 OSCB 10023; *Re McCarthy* (2014), 37 OSCB 5639; *Re White* (2010), 33 O.S.C.B. 8893.

There are a variety of potential explanations for the substantial difference in the severity of IIROC and securities regulatory sanctions. These include the following:

a) The cases dealt with by securities regulators tend to involve a higher level of seriously abusive conduct, including fraudulent misrepresentation and fraudulently passing oneself off as a registrant;

b) The cases dealt with by securities regulators tend to involve significantly greater investor losses;

c) IIROC is restricted to disciplining registrants, while the securities regulators are not (and thus have a larger field of persons against whom sanctions may be meted out);

d) The gains realized by a broker on an illegal distribution (a commission) are much less than the gains realized by the management of an issuer (continuing employment, protection of existing equity holdings, opportunities for defalcation);[136]

e) IIROC, which is an industry-run SRO, is reluctant to mete out serious sanctions to its members, which are responsible for its financial maintenance.

The difference in sanctions may also be an artifact of the incompleteness of the IIROC online case database; it may be that the posted cases are not a representative sample of all IIROC disciplinary proceedings (i.e., IIROC has posted cases with relatively minor harm involved). Further investigation is warranted.

G. Court Cases Dealing With Prospectus Exemptions

There are many cases involving civil actions related to faulty usage of the prospectus exemptions. The plaintiff in these cases is almost invariably a retail investor who has lost money as a result of purchasing prospectus-exempt investments that performed poorly. The situations mirror the IIROC and securities regulatory cases noted above; i.e., the plaintiff is typically:

a) A client of a registrant firm suing the investment advisor and/or firm for failing to carry out their KYC and suitability duties properly;

b) An investor who was enticed to invest in prospectus-exempt securities by a person who purported to be a registrant but was not;

c) An investor who was enticed to invest in prospectus-exempt securities by virtue of misrepresentations by an agent of the issuer or by the issuer itself;

d) A fraudulent scheme to raise money for a non-existent issuer.

These cases are virtually always much more complicated than either the IIROC or securities regulatory cases noted above. In cases involving a registrant, the legal grounds for seeking relief are typically negligence, breach of contract, negligent misrepresentation, fraudulent misrepresentation and/or breach of fiduciary duty. Thus, the cases involve complex inquiries into such matters as whether the client was induced to invest by misrepresentation; whether the KYC process was appropriately conducted (e.g., the quality of the due diligence performed by the registrant); the accuracy and sufficiency of the account documentation; whether the registrant carried out its duty to inform the client of the risks of the proposed investment plan; whether the suitability duty was properly carried out; whether broad-textured rules setting out the standard

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[136] This point was suggested by an anonymous referee (whom I have quoted word-for-word).

of behaviour expected of registrants were observed;[137] the nature of the relationship between the registrant and the investor; the extent of supervision exercised over the investment advisor by the firm's compliance department and management personnel; the adequacy of the firm's supervisory protocols; whether industry rules and/or securities regulatory requirements were breached; whether the registrant had a conflict of interest; whether there was contributory negligence; whether the plaintiff appropriately mitigated his/her losses; whether the plaintiff ratified the trades that the registrant performed; whether aggravated or punitive damages should be awarded; the disposition of costs; whether to award pre-judgment interest; and whether the plaintiff's base loss should be scaled up by a market index factor.[138] This complexity does not easily lend itself to the generation of case statistics.

Cases involving non-registrants are sometimes relatively easy for the plaintiff to make out, insofar as the legal issues are relatively straightforward and the pertinent facts easily proven. This is true, for example, in cases involving non-registrants passing themselves off as registrants, insofar as this constitutes a fraudulent misrepresentation that is usually sufficient by itself for the plaintiff to succeed. Cases involving a fraudulent scheme to raise money for non-existent issuers are also legally straightforward and relatively easy to prove. The main difficulty in such cases is tracing the misappropriated funds so that the plaintiff can actually achieve a recovery.

While cases involving registrant defendants tend to be far more legally and factually complicated, they do have one saving grace; at least one of the defendants will typically be an investment firm with a deep pocket from whom recovery may easily be effected once a favourable verdict has been achieved.

Whatever the source of the plaintiff's losses, however, and whether a registrant is or is not involved, civil litigation is very expensive. It is not unusual for the plaintiff to incur costs in the hundreds of thousands of dollars (and very few of these claims are sufficiently large to entice a lawyer to accept them on a contingency fee basis). If the plaintiff loses, then under the costs rule that prevails in Canada, the plaintiff will usually be ordered to pay a significant proportion of the winning side's costs.[139] Even if the plaintiff wins, in the usual case, he/she/it will have to bear about half of their own costs. Thus, litigation tends to be an option only in cases involving stakes that are large relative to the prospective costs and risks, and only then for plaintiffs with sufficient cash flow to carry them through the litigation process, which typically extends over a period of many years.

Added to this is the risk that attends any commercial litigation; non-specialist judges frequently decide such cases, which is likely to lead to a relatively high error rate.

Those who have lost money due to the misuse of prospectus exemptions, particularly in cases involving relatively small stakes, are thus well advised to complain to IIROC or the securities regulators and hope that a hearing will be held in which a reimbursement order will be made (although as noted, the cases in the test sample involved relatively few of these orders).

H. Non-Uniformity of Prospectus Exemptions

An ongoing problem with the prospectus exemptions that is both a policy and an enforcement issue is the prevalence of local variations in the body of prospectus exemptions. This variation

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[137] These include the "ethical conduct" rule the "just and equitable" rule, the "not detrimental to the industry" rule, the "conduct unbecoming" rule, the "public interest" rule, the "good business practice" rule, the "fairly, honestly and in good faith" rule, the "absolute trustworthiness" rule, and whether the registrant appropriately discharged its gatekeeper role. See generally Jeffrey G. MacIntosh, *Brokers' Duties to Their Clients* (forthcoming, LexisNexis Canada).

[138] See MacIntosh, *Brokers' Duties …*

[139] The costs order may be partial indemnity, which typically requires the losing party to pay about half of the winning side's costs, or full indemnity, which typically requires the losing party to pay about 80 per cent of the winning side's costs.

arises both from differences in the ostensibly national exemptions found in NI 45-106 and from the existence of non-national exemptions arising only in one or a subset of the provinces and territories.

In the former category, the OM exemption has three different variations across the country (see Table 7). While it is subject to the passport system, the issuer does not have the luxury of choosing its principal regulator at large. Rather, the issuer's choice of principal regulator is determined by the location of its head office.[140] Since the principal regulator applies the rules that prevail in its own jurisdiction, this creates considerable national variation in the nature of the offering memorandum exemption available to different issuers.

The OM exemption is far from unique in this regard. Other ostensibly national exemptions with local variations (all digested in Table 7) include:

- accredited investor (three variations)
- private issuer (two variations)
- FFBA (three variations)
- government debt securities (two variations)
- institutional debt securities (two variations)
- incentive compensation plans (two variations)
- self-directed registered educational savings plans (two variations)
- investment funds administered by a trust corporation (two variations)
- mortgage broker/dealers (three variations)
- secured debt registered under personal property security legislation (two variations)

In addition, as noted, some of the exemptions apply only in certain jurisdictions. This includes, for example, Ontario's government incentive security exemption. The so-called northwestern exemption[141] applies only in British Columbia, Alberta, Saskatchewan, Manitoba, the Northwest Territories, Nunavut and the Yukon (with two variations). The crowdfunding exemption applies only in Manitoba, Ontario, Quebec, New Brunswick, Nova Scotia and Saskatchewan[142] (with three variations).

The variation of exemptions in different jurisdictions creates uncertainty for both market actors and enforcement personnel. It also creates heightened transaction costs for issuers and investors. In a non-trivial number of cases, issuers must expend time and money to determine which local exemptions — or which version of one or more national exemptions — are available.

Barring an agreement on complete national uniformity, which does not seem likely, one way to address this problem would be to allow issuers to choose their principal regulator. This would result in greater certainty for market actors in addition to creating something close to a *de facto* national regime of prospectus exemptions.

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[140] MI 11-102, s.3.1. If the head office is not located in a jurisdiction that is permitted to be a principal regulator, then the principal regulator is located in the jurisdiction with the most significant connection with the issuer.

[141] The northwestern exemption allows unregistered persons or companies to act as capital finders for companies when using one of four categories of prospectus-exempt trades: accredited investor; minimum amount; FFBA; or the OM exemption.

[142] MI 45-108.

VIII. CONCLUSION AND RECOMMENDATIONS

Earlier, I conjectured that enforcement issues are most likely to arise in connection with prospectus-exempt securities sold to retail buyers, due to the following:

a) proxy slippage
b) investor self-misidentification
c) registrant-induced misidentification
d) issuer or intermediary misrepresentation of investment characteristics
e) low frequency of repeat players
f) high frequency of "take it or leave it" as opposed to negotiated offerings

The cases canvassed in this paper strongly support the hypothesis that problems are most likely to arise in the case of retail investors. Proxy slippage, however, is an issue that tends to arise only where a market intermediary is involved. If there is no wrongdoing on the part of the issuer and no intermediary involved, the risk of proxy slippage falls on the investor, since there is no legal ground for a recovery should the investment perform badly. In this case, proxy slippage is a policy issue and not an enforcement issue.

Where a registrant is involved, however, proxy slippage becomes an enforcement issue, as registrants are impressed with KYC and suitability duties and may find themselves liable for poor investment results even if the client was formally qualified to invest in the prospectus exempt financing. Given the important gatekeeper role of intermediaries, it is obviously important to strictly enforce the full panoply of duties that registrants owe to their clients.

The cases canvassed suggest that securities regulators levy much more significant penalties than their SRO counterpart — IIROC — in sanctioning misuse of the exemptions. I have suggested a variety of benign explanations. Nonetheless, further investigation is warranted.

Misidentification of a non-qualified investor as qualified clearly raises enforcement issues. The bulk of these cases arise from induced misidentification rather than self-misidentification. Induced misrepresentation involves seriously aberrant conduct on the part of a market intermediary, and the comparative leniency of IIROC tribunals gives some cause for concern.

Cases involving misrepresentation of the investment arise in both brokered and non-brokered offerings, although this type of problem appears to be more common when no intermediary is involved.

One of the most important results from the data is conspicuous by its absence: namely, disciplinary cases involving exempt market dealers (EMDs). EMDs, which are permitted in all jurisdictions, may participate only in prospectus-exempt financings. Like investment dealers, they are impressed with KYC and suitability duties. However, unlike investment dealers, they are not required to belong to IIROC or any other SRO, and none exists for EMDs. This almost certainly reduces both the quality of monitoring and the likelihood of discipline should the dealer misbehave.

The absence of an EMD SRO does not mean that EMDs are unregulated. Responsibility for regulatory oversight falls to the securities regulators, who conduct ad hoc compliance reviews of EMDs with a view to determining whether the dealer is in compliance with its KYC and suitability duties and other broad-textured duties to its clients and the marketplace. Nonetheless, the absence of an SRO for EMDs, coupled with the lack of cases disciplining EMDs, suggests that this might constitute a lacuna in the enforcement apparatus. Securities regulators should give serious consideration to requiring the creation of an SRO for EMDs.[143]

Properly addressing both the descriptive and normative dimensions of the prospectus exemptions is hampered by the lack of comprehensive empirical data. We still have only a very general picture of which issuers and investors use the exemptions, for what purposes, in what amounts, and with what level of returns to investors. Without these data, it is very difficult to know if the existing stable of exemptions enhances or inhibits the achievement of allocative efficiency and the protection of investors, and whether enforcement resources are being properly deployed. Regulators need to make a much more concerted effort to gather pertinent data.

On the normative side, many of the exemptions are based upon an idea — investor protection — that has never been rigorously defined by the regulators. It could mean any of a number of things. Investor protection might, for example, be entirely congruent with the financial economist's notion of a fair game, in which investors earn, on average, what they expect to earn. However, a market can be a fair game with very different degrees of variation around the mean (i.e., a low or a high standard deviation of returns). Thus, investor protection can also be conceived in terms not only of yielding a fair game, but of limiting the risk to which investors are exposed. There are many other possible interpretations and it would be helpful if the regulators were to define with greater precision what they mean by investor protection. It would also be helpful to indicate the relationship of investor protection to the other goals of securities regulation, namely market efficiency, fairness, and investor confidence in securities markets (and which of these takes precedence if there is conflict).

The exemptions are not based on a single rationale. While investor protection dominates, there are a variety of other rationales, including the enhancement of capital formation subject to investor protection concerns. However, the latter are not based on any systematic understanding of where capital gaps occur in Canadian capital markets. To the extent that enforcement resources are invested in policing exemptions whose underlying motivation is questionable, they are diverted away from policing other more important and better-motivated exemptions that make a much greater contribution to capital market efficiency.

The wide gulf between the high level of regulatory demands (and associated cost) of the prospectus requirement and the modest (or essentially non-existent) regulatory demands of many of the prospectus exemptions suggests some discontinuity in empirical assumptions and theoretical justifications. That is, the distribution of funding options tends to be bipolar; either investors are assumed to be highly sophisticated and in need of few or no regulatory protections, or completely unsophisticated and in need of a very high level of protection.[144] Particularly given the very high regulatory cost of a public offering by prospectus, it would seem to be appropriate to re-examine whether the extraordinary level of disclosure required in a prospectus is really cost effective.

The extraordinary costs and risks of civil litigation put such litigation out of the reach of most retail investors who have suffered losses from the misbehaviour of others (whether registrants or non-registrants). This is a serious failing in our system of justice, and allows many defalcations and investor predations to go unaddressed. The obvious solution is for both the securities regulators and the SROs to be far more aggressive in employing reimbursement orders than at present.

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143 An anonymous referee suggested that many EMDs are pooled investment funds that invest predominantly in real estate products, and that the risky nature of these products may constitute the principal source of investor defaults. If so, it suggests that EMDs are not adequately discharging their KYC and suitability duties — either because they are aware of the risks and not properly screening clients and/or communicating these risks, or they are failing their know-your-product obligation (which is an integral part of the suitability obligation).

144 As I have noted, the hybrid exemptions fall somewhere in between, although typically close to the low regulation end of the spectrum.

In closing, whether the enforcement efforts described in this paper are sufficient to address abuses associated with the prospectus exemptions is unclear. By and large, enforcement efforts appear to be directed at the right targets. Nonetheless, whether the fines and punishments meted out are adequate to deter wrongdoers remains an open question. It is likely that there will never be definitive answers. If there are indeed something in the vicinity of 156,000 non-prospectus financings per year in Canada, mostly by small, unsophisticated business enterprises selling securities to investors who are not legally advised, it would be surprising if there were not a far greater number of abuses than are reflected in the relatively small number of cases that actually come to the attention of IIROC, the securities regulators, and the courts. Indeed, if most enterprises and investors participating in the exempt market are not legally advised, we would posit a region of disconnect between enforcement sanctions and the deterrent effect resulting from those enforcement actions. Sanctions are most likely to have the most potent deterrent effect in relation to repeat players such as registrants, and it may make sense to concentrate enforcement efforts on these types of market actors.

APPENDIX A

A SELECTION OF PROSPECTUS EXEMPTIONS

Table 1, compiled by the Ontario Securities Commission,[145] summarizes the features of some of the more widely used prospectus exemptions, all of which have recently been amended by the Ontario Securities Commission and the Canadian Securities Administrators. These are discussed further below.

Table 1: Comparison Table of Key Capital Raising Prospectus Exemptions in Ontario

	Accredited Investor	Crowdfunding	Existing Security Holder	FFBA	Minimum Amount Investment	OM	Rights Offering
Who can use the exemption?	All companies[1] and investment funds	Canadian companies except blind pools	Public companies listed on specified exchanges	All companies	All companies and investment funds	All companies	Public companies[2]
Who can buy securities under the exemption?	Accredited investors	Any investor	Existing security holders holding the type of security being offered	Specified principals of the company, specified family members, close personal friends, close business associates	Non-individual investors	Any investor	Rights to purchase a security issued by the company are distributed to each security holder. Rights holders may exercise their right to acquire the security.
Are there limits on how much investors can invest under the exemption?	No	Yes, for retail investors and accredited investors	Yes, unless suitability advice is obtained from an investment dealer	No	No, but the purchase price of the securities must be at least $150,000	Yes, for individual investors except accredited investors or investors who qualify under the FFBA exemption	No
Is disclosure required to be provided to investors at the point of sale?	No	Yes	No	No	No	Yes	Yes
Do investors have the right to withdraw from the investment after buying the securities?	No	Yes	No	No	No	Yes	No
Are the securities subject to restrictions the first time they are resold?	Yes	Yes	Yes	Yes	Yes	Yes	Generally freely tradeable
Does a report of exempt distribution have to be filed with the OSC?	Yes	Yes	Yes	Yes	Yes	Yes	No

[1] References to companies in this document include corporate and non-corporate entities, but do not include investment funds.
[2] In general, a public company is a company whose shares are bought and sold by the general public on a stock market or exchange.

(Source: Ontario Securities Commission, "Summary of Key Capital Raising Prospectus Exemptions in Ontario: January 28, 2016," 3, available at https://www.osc.gov.on.ca/documents/en/Securities-Category4/ni_20160128_45-106_key-capital-prospectus-exemptions.pdf)

A. The Accredited Investor Exemption

1. How it Works

The accredited investor exemption uses proxies to identify classes of investors that are thought to be sufficiently sophisticated to be able to protect their own interests when purchasing securities without the benefit of a prospectus. Self-protection might take place through a variety of mechanisms or combination of mechanisms, including the ability to demand pertinent information from the issuer, and the ability to effectively evaluate the worth of an offered security given what is known and what is not known about the issuer.

[145] Ontario Securities Commission, "Summary Of Key Capital Raising Prospectus Exemptions In Ontario: January 28, 2016," available at https://www.osc.gov.on.ca/documents/en/Securities-Category4/ni_20160128_45-106_key-capital-prospectus-exemptions.pdf.

These proxies include:[146]

a) Institutional investors such as banks and other financial institutions, trust companies, pension funds, mutual funds (whether qualified by prospectus or selling only to accredited investors), and any other kind of institutional investor holding at least $5 million in net assets (other than a mutual fund);

b) Governments and agents of governments, including Canadian federal, provincial and municipal governments, foreign governments, Crown corporations, public boards and commissions, and school boards;

c) Registrants such as advisors and dealers;

d) Corporations and other entities (other than mutual funds) with net assets of at least $5 million;

e) Anyone else whom the securities regulators choose to recognize as an accredited investor.

Individual investors may qualify as accredited investors based on their financial assets (a defined term that includes only cash and securities), net assets or net income.[147]

2. Rationale Underlying the Accredited Investor Exemption

The accredited investor exemption is based on the sophistication rationale.

B. The $150,000 Exemption

1. How it Works

The $150,000 exemption qualifies any non-individual who is investing $150,000 or more in an offering of securities to purchase without the benefit of a prospectus.

2. Rationale Underlying the $150,000 Exemption

The $150,000 exemption has historically been available to both individual and non-individual investors, and has been supported by the sophistication rationale, on the theory that investors who are able to put $150,000 into a single investment must be well-heeled and therefore sophisticated. For obvious reasons, this premise has often been questioned, and NI 45-106 was recently amended to make it unavailable to individuals.

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[146] NI 45-106, s.1.1 (definition of accredited investor).

[147] Per NI 45-106, s.1.1, qualifying individual investors are:

(j) an individual who, either alone or with a spouse, beneficially owns financial assets having an aggregate realizable value that before taxes, but net of any related liabilities, exceeds $1,000,000,

(k) an individual whose net income before taxes exceeded $200,000 in each of the 2 most recent calendar years or whose net income before taxes combined with that of a spouse exceeded $300,000 in each of the 2 most recent calendar years and who, in either case, reasonably expects to exceed that net income level in the current calendar year;

(l) an individual who, either alone or with a spouse, has net assets of at least $5,000,000.

C. The Private Issuer Exemption

1. How It Works

The private issuer exemption[148] is illustrative of a number of the various rationales for prescribing prospectus exemptions. Under this exemption:

(i) The issuer must be a private company;

(ii) The number of shareholders (not including employees and former employees) cannot exceed 50;

(iii) The shares must be subject to restrictions on transferability.

If these requirements are met, then securities can be sold without a prospectus to a number of different classes of purchasers that fall roughly into the following camps:

a) *Insiders*

The categories of qualifying persons include directors, officers, employees, founders and control persons of the issuer as well as directors, officers and employees of an affiliate of the issuer.[149]

b) *Close Relatives of Insiders*

Also included are close relatives of the categories of persons just noted.[150]

c) *Close Personal Friends and Business Associates of Insiders*

A person who is a close personal friend or close business associate of persons with an intimate knowledge of the issuer is a permissible purchaser.[151]

d) *Existing Security Holders of the Issuer*

A person who is already a security holder of the issuer is a permissible purchaser.[152]

e) *Accredited Investors*

Accredited investors are permissible purchasers.[153]

f) *Secondary Market Transferees Closely Connected to Shareholders of the Company*

Several of the permissible classes of purchasers have been defined so as to allow secondary market transfers of securities. These include close relatives of the selling security holder or the selling

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[148] NI 45-106, s.2.4.

[149] NI 45-106, s.2.4(2)(a), (b).

[150] NI 45-106, s.2.4(2)(c) and (d) are:

(c) a spouse, parent, grandparent, brother, sister, child or grandchild of a director, executive officer, founder or control person of the issuer;

(d) a parent, grandparent, brother, sister, child or grandchild of the spouse of a director, executive officer, founder or control person of the issuer …

[151] NI 45-106, s.2.4(2)(e) and (f) are:

(e) a close personal friend of a director, executive officer, founder or control person of the issuer,

(f) a close business associate of a director, executive officer, founder or control person of the issuer …

[152] NI 45-106, s.2.4(2)(h).

[153] NI 45-106, s.2.4(2)(i).

security holder's spouse,[154] trusts or estates whose owners are permissible purchasers[155] and corporations that are controlled by permissible purchasers.[156]

g) *Persons Who are Not the Public*

Persons who are not the public are also permissible purchasers. This is a residual category that draws on established case law defining who is and who is not the public in relation to a given issuer. Two different tests have emerged with respect to whether a person is a member of the public. The "need to know" test is "whether the particular class of persons affected need the protection of the Act"[157] based on factors such as access to company information and sophistication. The second — the "common bonds of interest or association" test — is based on whether the purchaser has such common bonds of interest or association with a person or persons who have access to the sort of information that would be contained in a prospectus.[158]

2. Rationales Underlying the Private Issuer Exemption

The private company exemption is not answerable to any single exemption rationale. Accredited investors fit under the sophistication rationale. Insiders fit under the active participants rationale. Relatives, close personal friends and close business associates fit under the close connections rationale, as do persons who are already security holders. Depending on which test one adopts of who is and who is not the public, the granting of an exemption to a person who is not the public fits under either the sophistication rationale or the close connections rationale. The inclusion of secondary market transferees is to some extent justified by the close connections rationale, and is partly an administrative convenience to facilitate transfers from one legal form to another (while preserving the locus of beneficial ownership or transferring it to persons closely connected with insiders).

This shows that there is likely to be a high degree of variance in the characteristics of persons using the private issuer exemption. Even within individual categories, such as those who purchase under the close connections rationale, there will be a high degree of variance. Some will likely be given fulsome disclosure, while — no matter how close the ties between the entrepreneur and these investors — others will receive extremely modest disclosure about the entrepreneur's plans and the risks of the enterprise. Many of the latter ilk will invest on the strength of their ties to the entrepreneur alone, and will lack even the barest understanding of how to evaluate a prospective investment or the entrepreneur's chances of success.

It is thus not surprising that, in the financing trade, friends and family are often lumped together under the rubric of "love capital" investors. They invest not because they are sophisticated, or because the securities are inherently safe, or because their interests are otherwise protected, but simply out of love and affection (or at least friendship) and a desire to help a friend or family member down the road toward success.

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[154] NI 45-106, s.2.4(2)(g).

[155] NI 45-106, s.2.4(2)(k).

[156] NI 45-106, s.2.4(2)(j).

[157] *Securities and Exchange Commission v. Ralston Purina Co.*, 346 U.S. 119 (1953), at 125.

[158] *R. v. Piepgrass* (1959) 29 WWR 218; *R. v. Buck River Resources Ltd.*, (1984) 25 BLR 209.

D. The Friends, Family and Business Associates (FFBA) Exemption

1. How it Works

The persons eligible to take advantage of the FFBA exemption are essentially the same as those who are eligible to participate in an offering under the private issuer exemption.[159] However, under the private issuer exemption, the issuer must be a private issuer, as that term is defined, which requires that the issuer be a private company,, that there are restrictions on the transferability of non-debt securities, and that the issuer has no more than 50 shareholders (with some exclusions). By contrast, any issuer may use the FFBA.

2. Rationales Underlying the FFBA Exemption

The FFBA exemption is motivated by the same rationales that underpin the private issuer exemption.

E. The Offering Memorandum Exemption

1. How it Works

The offering memorandum (OM) exemption is in fact a hybrid between a prospectus offering and an exempt offering, insofar as use of the OM requires mandated disclosure, albeit considerably less than that which is required in a prospectus. All companies may use the exemption and all investors may purchase under the exemption. However, in addition to mandated disclosure, there are other investor protections that are absent under such exemptions as the accredited investor exemption, the private issuer exemption and the FFBA. Thus, for example, investors have withdrawal rights,, misrepresentation certificates are required,, the purchaser must sign a risk acknowledgment form, and the securities acquired under the exemption are subject to first-trade resale restrictions.

In addition, in some provinces and territories, there are caps on the amount that may be invested. In Alberta, Saskatchewan, Manitoba, Quebec, Prince Edward Island, Northwest Territories, Nunavut and Yukon, individual investors cannot invest more than $10,000 in a single issuer unless the investor is an eligible investor, which is defined in terms similar to the accredited investor definition, but with considerably lower net income, financial asset and net asset requirements. Ontario has its own unique investment caps.[160]

Other provincial differences exist. In addition, the Northwest Territories, Nunavut and Yukon do not allow any commissions or finder's fees to be paid to any person, other than to a registered dealer.

2. Rationales Underlying the OM Exemption

The OM exemption cannot easily be justified under any single rationale, although the capital raising and capital gap rationales are probably the best fit. Those provinces and territories that have investment caps that depend on whether or not the investor is an eligible investor appear to have drawn inspiration from the sophisticated investor rationale, although it is difficult to imagine that those who qualify as eligible investors are truly sophisticated.

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[159] The only material difference appears to be the failure to include "a person who is not the public" as an eligible purchaser in the FFBA exemption.

[160] See OSC "Backgrounder: Exempt Market Review," Nov. 5, 2015, 2.

The overlay of investor protections clearly invokes the investor protection rationale. However, it is clear that the OM exemption is not purely motivated by investor protection. Rather, it is more a case of facilitating capital raising subject to an investor protection constraint.

F. The Crowdfunding Exemption

1. How it Works

The crowdfunding exemption, like the OM exemption, is described in the table below.[161]

Type of Issuer	s.1 (definition of eligible crowdfunding issuer)	Issuer must be incorporated or organized in Canada, with the head office in Canada, a majority of directors resident in Canada, and principal operating subsidiary (if any) incorporated or organized in Canada or the U.S. -no blind pools or investment funds
Type of Security	s.1 (definition of eligible security)	-common shares -non-convertible preference shares -securities convertible into either of the above -non-convertible debt securities linked to a fixed or floating interest rate -units of a limited partnership -flow-through shares under the ITA
Maximum 90-Day Distribution Period	ss.5(1)(a)	
Total Proceeds	ss.5(1)(b)	$1.5 million in 12-month period
Investment Limits	Ontario: ss.5(1)(c) Other: ss.5(1)(d)	ONTARIO NON-ACCREDITED INVESTORS -$2,500 per distribution -$10,000 total in calendar year ONTARIO ACCREDITED INVESTORS WHO ARE NOT PERMITTED CLIENTS -$25,000 per distribution -$50,000 for all distributions in calendar year ONTARIO PERMITTED CLIENT -unlimited ALL OTHER JURISDICTIONS: NON-ACCREDITED INVESTOR -$2,500 per distribution ALL OTHER JURISDICTIONS: ACCREDITED INVESTOR -$25,000 per distribution
Issuer May Use Only a Single Registered Funding Portal	ss.5(1)(e)	
Point-of-Sale Mandatory Disclosure by Issuer	ss.5(1)(f), 12	1. Offering Document -mandatory representations -right of withdrawal -contractual right of action 2. Term Sheet 3. Video "other materials summarizing the information in the crowdfunding offering document"
Point-of-Sale Mandatory Disclosure by Portal of All Fees Charged to Issuer or Purchaser	s.35	"A funding portal must include on its online platform prominent disclosure of all compensation, including fees, costs and other expenses that the funding portal may charge to, or impose on, an eligible crowdfunding issuer or a purchaser."
Generic and Dealer-Specific Point-of-Sale Cautions by Portal	s.33	-the distribution has not been reviewed or approved in any way by a securities regulatory authority or regulator -the distribution is risky and may result in the loss of all or most of an investment -there will be limited ongoing disclosure -if the portal is a restricted dealer, they are not required to provide suitability advice -if they are an investment dealer or an exempt market dealer, they are required to provide suitability advice
Forbidden Use of Proceeds	ss.5(2)(a)	Cannot be used to "invest in, merge with or acquire an unspecified Business"

[161] MI 45-108 (applying in Ontario, Quebec, New Brunswick and Nova Scotia). In Manitoba, the pertinent instrument is Blanket Order 45-502 ("Start-up Crowdfunding Prospectus and Registration Exemption"); in Saskatchewan, General Order 45-929 ("Start-up Crowdfunding Registration and Prospectus Exemptions"). The references in column two of the table are to MI 45-108.

Non-Compliant Prior User	ss.5(2)(b)	Previously relied on CF exemption but is not in compliance with ongoing obligations (and, if reporting issuer, not in compliance with reporting obligations under securities law)
Closing Conditions	s.6	-right of withdrawal has expired -minimum proceeds have been raised -issuer has received risk disclosure statements
Representations by Issuer	ss.7(1)	REPORTING ISSUER -no misrepresentation NON-REPORTING ISSUER -no untrue statement of a material fact CERTIFICATE SIGNING REQUIREMENTS -in Appendix A of 45-108 -CEO, CFO, any two directors, promoters -different personnel for other kinds of issuers
Right of Withdrawal	s.8	Within 48 hours after the purchase agreement is signed
Contractual Right of Rescission and Damages	s.9	REPORTING ISSUERS -misrepresentation NON-REPORTING ISSUERS -untrue statement of material fact
No Advertising by Issuer	s.11	But may inform purchasers through portal that it is making an offering
No Advertising by Portal	ss.24(1), (2)	
No Commissions or Fees	s.13	
No Lending to Purchasers	s.14	
File Report of Exempt Offering With Regulators	s.15	
Continuous Disclosure	s.16 (financial statements) s.17 (annual statement of use of proceeds) s.18 (notice of specified key events)	NON-REPORTING ISSUER YEAR-END FINANCIAL STATEMENTS -complete set of financial statements for previous year (and year before, if they exist) delivered to regulator and made available to purchasers, within 120 days after end of fiscal year -if previously raised $250,000-$750,000 under prospectus exemptions, then must be review engagement -if previously raised $750,000 or more, audit engagement REPORTING ISSUER FINANCIAL STATEMENTS -silent on this, but usual standards would apply USE OF PROCEEDS -accompanies year-end financial statements NOTICE OF SPECIFIED KEY EVENTS (ON, NS, MB) -discontinuation of the issuer's business -change in the issuer's industry -change of control of the issuer
Risk Acknowledgment Form		
Resale Restrictions		NON-REPORTING ISSUER -can only be resold under a prospectus exemption or a prospectus REPORTING ISSUER -four-month hold period
Bookkeeping and Records	s.20	NON-REPORTING ISSUERS -specified records
PORTALS		
RESTRICTED DEALER FUNDING PORTAL		

A Restricted Dealer Can Only be Registered in the Crowdfunding Category	s.1 (definition of restricted dealer funding portal)	"restricted dealer funding portal means a person or company that (a) is registered in the category of restricted dealer under National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations, (b) is authorized under the terms and conditions of its restricted dealer registration to distribute securities under this Instrument, (c) acts or proposes to act as an intermediary in a distribution of eligible securities through an online platform in reliance on the crowdfunding prospectus exemption, (d) is not registered in any other registration category, and (e) in Ontario, is not an affiliate of another registered dealer, registered adviser or registered investment fund manager."
Except in Ontario, a Restricted Dealer Can be Affiliated With Another Dealer	s.1 (definition of restricted dealer)	See immediately above.
Restricted Dealers Can Only Do Crowdfunding	s.41	IN COMPLIANCE WITH MI 45-108 -see s.41, and see immediately above IF PURSUANT TO A DISCRETIONARY ORDER -"except in Ontario, a [restricted dealer can engage in a] distribution of securities made in reliance on a start-up crowdfunding registration and prospectus exemptive relief order granted by a securities regulatory authority or regulator, provided that the restricted dealer funding portal and a registered individual of the restricted dealer funding portal are in compliance with the terms, conditions, restrictions and requirements in this Instrument."
Many of the Key Registration Requirements Do Not Apply	s.21	-some carve-outs from NI 31-103, including -most education and proficiency requirements -requirement to belong to an SRO -suitability obligation -regulator may specify other terms, conditions, restrictions or requirements
Nebulous Proficiency Requirement	s.43	"43. (1) A restricted dealer funding portal must not permit an individual to perform an activity in connection with a distribution under the crowdfunding prospectus exemption unless the individual has the education, training and experience, which may include appropriate registration [but cannot be registered in another category], that a reasonable person would consider necessary to perform the activity competently, including understanding the structure, features and risks of the distribution. (2) For the purposes of subsection (1), the obligation to understand the structure, features and risks of the distribution does not include any obligation to assess (a) the merits or expected returns of the investment to purchasers, or (b) the commercial viability of the proposed business or distribution."
Cannot Provide Advice Re Purchase of Security or Re Borrowing to Buy Security	s.39 See below	
Cannot Designate a Chief Compliance Officer Unless Certain Tests Met	s.42 See below	
REGISTERED DEALER FUNDING PORTAL	s.22	-must be registered in one or other of existing categories, plus requirements specific to funding portals
Suitability Obligation for Investment Dealer or Exempt Market Dealer	s.22, ss.33(c)	
ALL PORTALS		
No connection with issuer	s.23	-portal, plus affiliates and officer, director, significant shareholder, promoter or control person, cannot own more than 10 per cent of the voting securities of the issuer
Must Ensure That Issuer Information is Fairly Presented	ss.24(3)	-"A funding portal must ensure that the information about an eligible crowdfunding issuer and a distribution of eligible securities of the issuer is presented or displayed on its online platform in a fair, balanced and reasonable manner."
Must Have Issuer Access Agreement With Issuer	ss.24(1), s.26	MUST HAVE SPECIFIED TERMS -issuer will comply with portal's policies and procedures -all posted material will be factually supported, with no promotional statement, misrepresentation or an untrue statement of a material fact or otherwise be misleading -both portal and issuer responsible for compliance with securities laws -business will be conducted with integrity ONTARIO -confirm that the portal is the agent of the issuer for the distribution

Must Conduct Background Checks	s.25	PERSONAL INFORMATION FORMS -"obtain a personal information form from each director, executive officer and promoter of the issuer" BACKGROUND CHECKS ON ISSUER AND VARIOUS INDIVIDUALS -conduct or arrange for background checks on issuer and each director, executive officer and promoter of the issuer
Must Review All Disclosure Material	ss.27(1)	-all disclosure material -must order issuer to correct any incorrect, incomplete or misleading disclosure
Must Review Information Documents and Background Checks	ss.27(1)	-PIFs (personal information forms) -background checks
Denial of Access and Termination	s.28	-portal must deny access if various tests are met, including: -the business may not be conducted with integrity -non-compliance with rules -disclosure contains a misrepresentation (reporting issuers) or an untrue statement of material fact (non-reporting issuers) -"the issuer or any of its directors, executive officers or promoters has pled guilty to or has been found guilty of an offence related to or has entered into a settlement agreement in a matter that involved fraud or securities violations."
Return of Funds	s.29	RETURN OF FUNDS IF: -the purchaser exercises its right of withdrawal -the requirements set out in section 6 (Conditions for closing of the distribution) are not met -the issuer withdraws the distribution -the distribution is otherwise terminated
Notification of Amended Offering Document	s.30	-notify each purchaser if an amended offering document becomes available
Removal of Distribution Materials	s.31	-immediately, if distribution withdrawn
Monitor Purchaser Communications	s.32	-if purchasers can post communications, monitor these to ensure that such statements are not at odds with the crowdfunding document or at odds with 45-108
Must Obtain Documents from Purchaser	s.34	-risk acknowledgment form -"except in Ontario, confirm and validate that the purchaser is an accredited investor if the acquisition cost is greater than $2,500," -"in Ontario, obtain from the purchaser, and validate, a confirmation of investment limits form."
Must Deliver Documents to the Issuer	s.36	-the purchase agreement entered into between the issuer and the purchaser -a risk acknowledgment form from the purchaser -except in Ontario, confirmation and validation that the purchaser is an accredited investor, if the acquisition cost is greater than $2,500 -in Ontario, a confirmation of the investment limits form for the purchaser
Point-of-Sale Mandatory Disclosure by Portal of All Fees Charged to Issuer or Purchaser	See above	
Generic and Dealer-Specific Point-of-Sale Cautions by Portal	See above	
Release of Funds to Issuer	s.37	-only when "the requirements set out in section 6 [Conditions for closing of the distribution] have been met"
Twice Yearly Reports to the Regulators of All Financings, etc.	s.38	-all completed distributions -all non-completed distributions -all those denied access to the portal
No Advice by Restricted Dealer	s.39	"(a) to purchase securities under the crowdfunding prospectus exemption or in connection with any other trade in a security, or (b) to use borrowed money to finance any part of a purchase of securities under the crowdfunding prospectus exemption or in connection with any other trade in a security."
Restriction of Referral Arrangements	s.40	-portal cannot enter into a referral arrangement -however, can compensate a third party for a referral
Cannot Designate a Chief Compliance Officer Unless Certain Tests Met	s.42	"(a) passed the Exempt Market Products Exam or the Canadian Securities Course Exam, (b) passed the PDO Exam or the Chief Compliance Officers Qualifying Exam, and (c) gained 12 months of experience and training that a reasonable person would consider necessary to perform the functions of a chief compliance officer for a restricted dealer funding portal."

Restricted Dealer Proficiency	s.43	43. (1) A restricted dealer funding portal must not permit an individual to perform an activity in connection with a distribution under the crowdfunding prospectus exemption unless the individual has the education, training and experience, which may include appropriate registration, that a reasonable person would consider necessary to perform the activity competently, including understanding the structure, features and risks of the distribution. For the purposes of subsection (1), the obligation to understand the structure, features and risks of the distribution does (2) not include any obligation to assess (a) the merits or expected returns of the investment to purchasers, or (b) the commercial viability of the proposed business or distribution.
DISCRETIONARY EXEMPTIONS	s.44	ROC -can be granted by the securities regulatory authority (i.e., staff) ONTARIO -can only be granted by the regulator

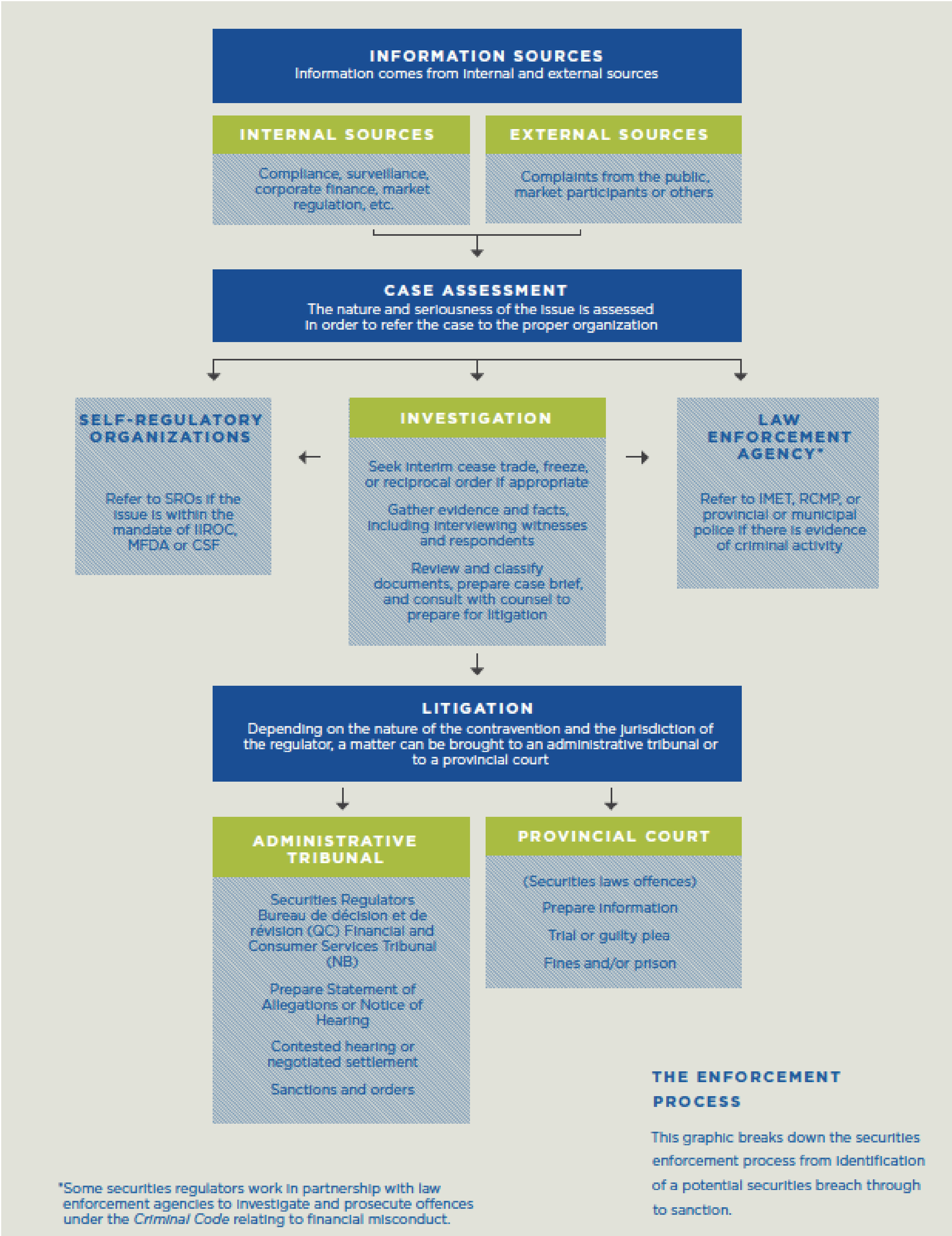
2. Rationales Underlying the Crowdfunding Exemption

The crowdfunding exemption is Canada's response to the U.S. *Jumpstart Our Business Startups Act* (or *JOBS Act*) signed into law in April 2012[162] and made effective by the SEC in May 2016. It is clearly designed to facilitate funding by small businesses, subject to the extensive investor protection constraints indicated above.

[162] See "Bill Summary & Status" - 112th Congress (2011 - 2012) - H.R.3606 - All Congressional Actions - THOMAS (Library of Congress); "The *JOBS Act*: Encouraging Startups, Supporting Small Businesses." https://obamawhitehouse.archives.gov/blog/2012/04/05/jobs-act-encouraging-startups-supporting-small-businesses. Retrieved May 28, 2017..

APPENDIX B

SECURITIES REGULATORY ENFORCEMENT PROCESS



Source: Canadian Securities Administrators Enforcement Report for 2015, 10.

APPENDIX C

ORDERS IN THE PUBLIC INTEREST

127. (1) The Commission may make one or more of the following orders if in its opinion it is in the public interest to make the order or orders:

1. An order that the registration or recognition granted to a person or company under Ontario securities law be suspended or restricted for such period as is specified in the order or be terminated, or that terms and conditions be imposed on the registration or recognition.

2. An order that trading in any securities by or of a person or company or that trading in any derivatives by a person or company cease permanently or for such period as is specified in the order.

2.1 An order that the acquisition of any securities by a particular person or company is prohibited permanently or for the period specified in the order.

3. An order that any exemptions contained in Ontario securities law do not apply to a person or company permanently or for such period as is specified in the order.

4. An order that a market participant submit to a review of his, her or its practices and procedures and institute such changes as may be ordered by the Commission.

5. If the Commission is satisfied that Ontario securities law has not been complied with, an order that a release, report, preliminary prospectus, prospectus, return, financial statement, information circular, take-over bid circular, issuer bid circular, offering memorandum, proxy solicitation or any other document described in the order,

    i. be provided by a market participant to a person or company,

    ii. not be provided by a market participant to a person or company, or

    iii. be amended by a market participant to the extent that amendment is practicable.

6. An order that a person or company be reprimanded.

7. An order that a person resign one or more positions that the person holds as a director or officer of an issuer.

8. An order that a person is prohibited from becoming or acting as a director or officer of any issuer.

8.1 An order that a person resign one or more positions that the persons holds as a director or officer of a registrant.

8.2 An order that a person is prohibited from becoming or acting as a director or officer of a registrant.

8.3 An order that a person resign one or more positions that the person holds as a director or officer of an investment fund manager.

8.4 An order that a person is prohibited from becoming or acting as a director or officer of an investment fund manager.

8.5 An order that a person or company is prohibited from becoming or acting as a registrant, as an investment fund manager or as a promoter.

9. If a person or company has not complied with Ontario securities law, an order requiring the person or company to pay an administrative penalty of not more than $1 million for each failure to comply.
10. If a person or company has not complied with Ontario securities law, an order requiring the person or company to disgorge to the Commission any amounts obtained as a result of the non-compliance.

Terms and conditions

(2) An order under this section may be subject to such terms and conditions as the Commission may impose.

APPENDIX D

FUNDING OPTIONS FOR HIGH-TECH VERSUS NON-HIGH-TECH FIRMS

A. Industry Canada 2012 Study

A study of the funding of small and medium-sized enterprises (SMEs) published by Industry Canada in 2012[163] states:

> In 2011, 36 percent of SMEs requested some type of external financing, with 26 percent requesting debt, 7 percent requesting leasing, 8 percent requesting trade credit, 4 percent requesting government financing and 2 percent requesting equity financing.
>
> Chartered banks were the main suppliers of financing to SMEs in 2011, serving 55 percent of financing requests, followed by credit unions or Caisses populaires (16 percent), government institutions (7 percent), leasing companies (4 percent), family and friends (2 percent), venture capital funds or angel investors (1 percent) and foreign banks (0.4 percent).

The following table, also taken from the study, shows that when SMEs apply for loans, they are rarely turned down. Indeed, even the smallest SMEs in the Industry Canada sample (one to four employees) have an 88.4 per cent approval rate.

Table 1: Debt Request and Approval Rate by Size of Business, 2011

		Request Rate	Approval Rate*	Amount Authorized/ Amount Requested Ratio
All SMEs	1–499 employees	25.5	89.9	94.0
Size of Business	1–4 employees	19.9	88.4	90.4
	5–19 employees	29.9	88.5	88.6
	20–99 employees	36.9	97.1	97.2
	100–499 employees	47.6	97.7	99.0

These figures suggest that for SMEs external funding is most often bank funding — and that when SMEs apply for bank funding, they usually get it. Moreover, only two per cent of the SMEs in the sample were interested in external equity funding.

These figures, however, tell far from the whole story. The Industry Canada sample is limited to firms already generating revenues.[164] That will exclude virtually all high-tech (HT) startups, since these typically engage in an extended period of research and development during which no revenues are earned.[165] Moreover, HT firms often lack collateral, which is almost always a

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163 See http://www.ic.gc.ca/eic/site/061.nsf/eng/02776.html.

164 The Industry Canada summary of the report states:

> The target population for the survey was private sector, for-profit, SMEs employing between one and 499 employees and generating between $30,000 and $50 million in annual revenues in 2011.

Ibid.

165 See e.g., Jeffrey G. MacIntosh, *Legal and Institutional Barriers to Financing Innovative Enterprise in Canada*, Discussion Paper 94-10 (Summer, 1994), Government and Competitiveness Project, School of Policy Studies, Queen's University; Paul Toriel, *Financing the New Economy: Towards a Positive Conspiracy: Businesses, Financial Institutions, and Government Partners in a Stronger Canada* (Ottawa: Industry Canada, 1994).

requirement to secure a bank loan. This lends further support to the view that the Industry Canada sample is dominated by non high-tech (NHT) firms.[166]

The Industry Canada data are consistent with the standard paradigm of small firm funding for NHT firms. Such firms will tend to rely initially on the resources of the entrepreneur, family and friends to get off the ground. Once these firms are earning revenue and have accumulated assets to be used as collateral (often supplemented by personal guarantees), they will then often seek bank financing (as did 26 per cent of Industry Canada's sample firms).

Also consistent with the standard paradigm of NHT firms, relatively few firms in the sample sought external equity financing. Angel investors invest far less often in NHT firms than HT firms; such investors seek potentially high-growth, high-return endeavours, and these are heavily concentrated in the HT arena.

As noted in more detail below, all of these sources of financing typically drawn upon by NHT firms are accommodated under existing law. Funding from family, friends and business associates will be obtainable under either the private issuer exemption or the FFBA exemption. Bank financing is explicitly excluded from the purview of securities regulation and thus requires no prospectus exemption.[167]

B. Industry Canada 2015 Study

A further Industry Canada study published in 2015 is broadly consistent with the view that Industry Canada's SME data are dominated by NHT firms. Table A (taken from the study) indicates the relative frequency with which different sources of funding are used by startup businesses. The most common source of financing is "personal financing used towards your business" — i.e., the entrepreneur's own funds. The second most common is "credit from financial institutions" and the third "financing from friends or relatives of business owner(s)."

A relatively small number of startup firms — 1.8 per cent — used either angel or venture capital financing, although for firms with 100-499 employees, the figure rises to 4.2 per cent. It is difficult to know what to make of this, however, since angel and venture capital financing, two quite different forms of funding, are lumped together. Small firms seeking seed or startup funding are likely to receive funding from angels but not venture capitalists, while larger firms with customers and revenue tend to rely on venture capitalists for expansion capital, and not angel investors. In any case, the meager reliance of firms in the sample on external equity again suggests that Industry Canada's data are dominated by NHT firms.

Table B shows sources of financing used to start up a high-tech business. While it is not entirely clear why it segregates "information and communications technologies" from "knowledge-based industries", the sources of financing are very similar for each. The data show that for high-tech firms:

a) The use of credit financing is far more modest;

b) The use of retained earnings is lower;

c) The use of trade credit from suppliers is far more modest;

d) The use of capital leasing is far more modest;

e) There is a greater reliance on angel and venture capital investing.

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[166] MacIntosh, Ibid; Toriel, Ibid.

[167] See e.g., *Ontario Securities Act,* 1(1) (definition of "security", part e).

All of this is consistent with the standard paradigm of funding sources for HT firms. HT firms will typically not be able to borrow funds (whether from banks, trade suppliers or via capital leasing), will not have retained earnings to draw upon, and will rely to a greater extent than NHT firms on angel and venture capital financing.

	Table A: Sources used to start up business (Source: "Survey On Financing And Growth Of Small And Medium Enterprises, 2014", Statistics Canada, November 27, 2015, Table 13)								
	Credit from financial institutions	Personal financing used towards your business	Financing from friends or relatives of business owner(s)	Retained earnings (from previous or other business)	Trade credit from suppliers	Capital leasing	Government loans, grants, subsidies and non-repayable contributions	Financing from angel investors and venture capital providers	Other
	%	%	%	%	%	%	%	%	%
1 to 499 employees	44.9	84.3	17.3	13.3	19.1	10.7	4.9	1.8	2.6
1 to 4 employees	39.9	84.7	14.8	12.2	15.5	8.1	4.2	1.1	1.7
5 to 19 employees	50.3	84.7	19.7	13.8	22.5	13.4	5.5	2.2	3.2
20 to 99 employees	54.6	81.9	25.0	18.0	28.1	15.9	7.5	4.0	5.9
100 to 499 employees	66.5	72.2	15.5	19.0	32.7	21.3	4.9	4.2	7.9

	Table B: Sources used to start up high tech business (Source: "Survey On Financing And Growth Of Small And Medium Enterprises, 2014", Statistics Canada, November 27, 2015, Table 13)								
	Credit from financial institutions	Personal financing used towards your business	Financing from friends or relatives of business owner(s)	Retained earnings (from previous or other business)	Trade credit from suppliers	Capital leasing	Government loans, grants, subsidies and non-repayable contributions	Financing from angel investors and venture capital providers	Other
Information and Communication Technologies (ICT)	20.0	92.7	14.7	10.7	6.0	4.0	6.0	6.0	4.0
Knowledge-Based Industries (KBI)	24.1	88.0	17.0	7.6	6.9	4.8	8.4	5.5	2.8

C. Prospectus Exemptions and NHT Firms

For NHT firms, many of the most prevalent forms of financing do not fall within the reach of the prospectus requirement and so no prospectus exemption is required. This includes borrowing from credit institutions, the entrepreneur's personal financing, retained earnings, trade credit, capital leasing, and government loans, grants, subsidies and non-repayable contributions.

A relatively small number of financing options involve the sale of a security and hence attract the requirement to either prepare a prospectus or identify an applicable prospectus exemption. This includes financing from friends, family and business associates, and (rarely) angels and venture capitalists. However, the current menagerie of prospectus exemptions is well crafted to suit these types of financings. The private issuer and FFBA exemptions cover most equity financing needs. The accredited investor exemption will accommodate those rare cases in which venture capital is drawn upon, and probably most angel investments as well.

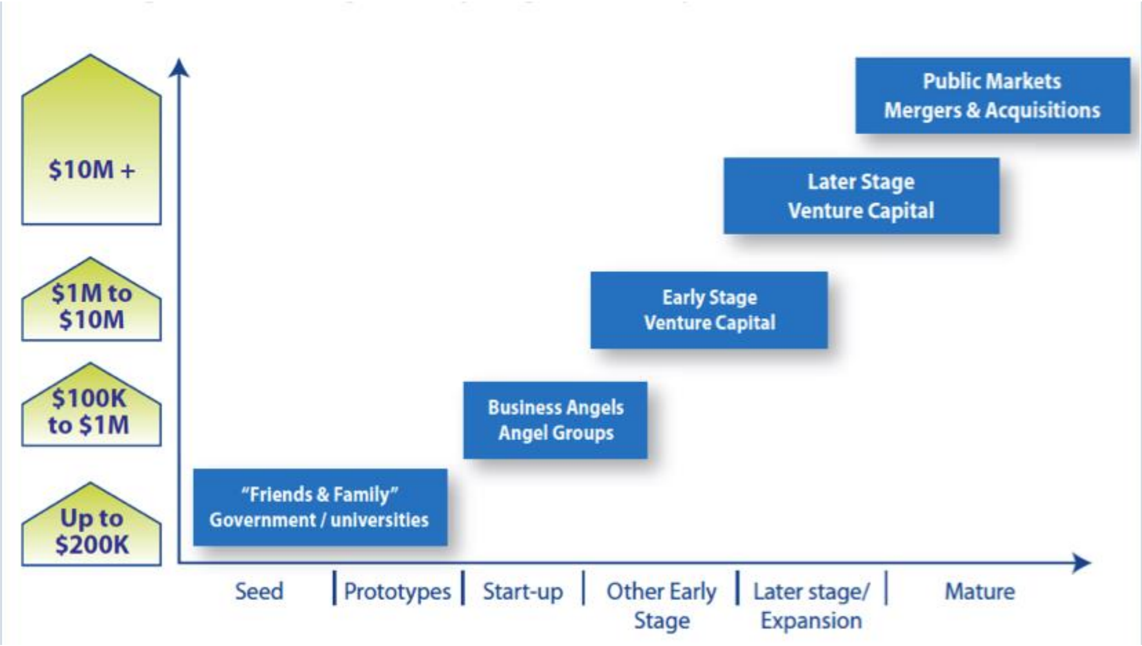
That these investments are easily accommodated under current law does not, however, suggest that NHT firms will never abuse the exemptions. The private issuer exemption, for example, employs a number of categories whose meaning is subject to a wide range of interpretations. Who, for example, is a "close personal friend" or a "close business associate"? These categories could easily be abused by firms raising money, and, particularly as there will rarely be a regulated market intermediary involved in the financing, abusers will only be held to account if things turn out poorly and one or more investors complain to the regulators or file a civil suit.

Similarly, those who are investing may misrepresent themselves as accredited investors when in fact they are not. The issuer may or may not make genuine efforts to determine if these representations are correct. Indeed, as discussed in the main body of the text, the sale of securities nominally made under the accredited investor exemption, but in fact made to non-qualifying purchasers, is one of the most common cases dealt with by both IIROC and the securities regulators.

D. The Jenkins Report

Figure 1, taken from the federally commissioned Jenkins Report,[168] indicates the spectrum of financing options available to HT firms. Clearly, HT firms draw upon many of the same funding sources as NHT firms. Starting at the left, the only difference between HT and NHT firms at the seed stage is the availability of government funding for HT firms. Once the firm begins commercialization, like NHT firms HT firms draw upon the entrepreneur's own resources and those of family, friends and business associates to finance their operations. In so doing, they use the same exemptions noted above (the private issuer exemption and the FFBA exemption).

FIGURE 1 FUNDING CHAIN BY STAGE OF DEVELOPMENT AND SIZE OF INVESTMENT



Source: Jenkins Report, Figure 7.1

After this early stage, one primary difference between HT and NHT funding sources is the conspicuous absence of bank (or other debt) financing for HT firms. This is reflective of the widely held view that, because of a high degree of information asymmetry, high risk, lack of cash flow and lack of collateral, bank financing (and other debt options) will rarely be available.

168 "Innovation Canada: A Call to Action," See http://rd-review.ca/eic/site/033.nsf/vwapj/R-D_InnovationCanada_Final-eng.pdf/$FILE/R-D_InnovationCanada_Final-eng.pdf.

The other difference is the heightened dependence of HT firms on angel investors, who are not usually accommodated under the private issuer or FFBA exemptions. As noted in the main body of the text, it is thus important that the threshold that qualifies retail investors as accredited not be set too high. In other words, in this context, it would seem that a different balance between type I and type II errors is appropriate. That is, type I errors (false positives) are comparatively less costly, and type II errors (false negatives) more costly.

Reinforcing this argument, HT firms make a contribution to the economy that is relatively great compared to NHT firms. The Jenkins Report hammers home a number of vital facts pertaining to Canada's economic future. First, the central determinant of economic performance is labour productivity. Second, labour productivity is largely a function of innovation, which is the province of HT firms. Third, Canada is not only doing poorly in the global innovation sweepstakes, but increasingly poorly over time.

With respect to the importance of innovation, the Jenkins Report states:[169]

> The material standard of living of a society depends on productivity — the value of goods and services produced per hour of work. A high level of employment is clearly important, and favourable movements in the world prices of a country's exports — for example, certain natural resources in Canada's case — can boost prosperity, at least for a time. But over the long run, it is labour productivity growth that drives increases in average per capita incomes and business competitiveness. Productivity growth, in turn, is primarily the result of innovation.

With respect to Canada's flagging success in the innovation derby, the Jenkins Report indicates that, relative to the U.S., Canadian productivity has been falling steadily since the 1980s:[170]

> Canada has a business innovation problem. The most telling indicator is Canada's subpar productivity growth, which has averaged a mere 0.6 percent over the 2000-2009 period, or less than half the average of 1.5 percent for all OECD countries (OECD productivity database, accessed November 2010). Relative to the United States (US), as depicted in Figure 2.1, labour productivity in Canada's business sector has fallen from approximately 93 per cent of the US level in 1984 to 71 per cent in 2009 — a quarter-century of relative decline that cannot be explained by temporary or one-time factors.

The Jenkins Report is far from unique in recognizing that innovation lies at the hub of our future prosperity. Indeed, the premier importance of spurring innovation has become something of a mantra to the governments of nearly every industrialized nation on the planet. To the extent that the prospectus exemptions make an important contribution to the health of our HT firms, it is important that the rules not be overly restrictive.

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[169] P. 2-1.

[170] P. 2-3. Figure 2.1, which graphically illustrates Canada's slippage relative to the U.S., is reproduced as Appendix A.

About the Author

Jeffrey MacIntosh holds the Toronto Stock Exchange Chair in Capital Markets at the Faculty of Law and is a past Associate Director and Director of the Capital Markets Institute at the University of Toronto. He holds law degrees from Harvard and Toronto, and a Bachelor of Science degree from M.I.T. He was appointed a John M. Olin Fellow at Yale Law School in 1988-89. He also served as a member of the Ontario Securities Commission Task Force on Small Business Financing in 1996.

Professor MacIntosh is the author (with Chris Nichols) of a widely read text book on securities regulation. He has also authored numerous articles on a variety of corporate and securities law topics, including directors' fiduciary duties, controlling shareholders' duties, corporate governance, minority shareholders' rights, takeover bids, insider trading, the legal mandate of the Ontario Securities Commission, the role of retail and institutional investors in Canadian capital markets, prospectus disclosure, continuous disclosure, the oppression remedy, shareholders' dissent rights, and whether Canada should move to a national securities regulator.

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