September 11, 2020

Ontario Capital Markets Modernization Taskforce

Attention: Walied Soliman, Chair
By Email to: CMM.Taskfoce@ontario.ca

Dear Sirs/Mesdames:

Re: Request for Comment - Capital Markets Modernization Taskforce Consultation Report

The Private Capital Markets Association of Canada (**PCMA**) is pleased to provide our comments in connection with Ontario's Capital Markets Modernization Taskforce Consultation Report dated July 2020 (the **Report**) as set out below.

About the PCMA

The PCMA is a not-for-profit association founded in 2002 as the national voice of the exempt market dealers (**EMDs**), issuers and industry professionals in the private capital markets across Canada.

The PCMA plays a critical role in the private markets by:

- assisting hundreds of dealer and issuer member firms and individual dealing representatives to understand and implement their regulatory responsibilities.
- providing high-quality and in depth educational opportunities to the private capital markets professionals;
- encouraging the highest standards of business conduct amongst its membership across Canada;
- increasing public and industry awareness of private capital markets in Canada;
- being the voice of the private capital markets to securities regulators, government agencies and other industry associations and public capital markets;
- providing valuable services and cost-saving opportunities to its member firms and individual dealing representatives; and
- connecting its members across Canada for business and professional networking.

Additional information about the PCMA is available on our website at www.pcmacanada.com.

The first section of our letter discusses select Taskforce recommendations following the numbering in the Report based on topics that are of importance to PCMA members. The second section outlines other PCMA recommendations we respectfully request the Taskforce consider as part of its deliberations and in contemplation of its final report.

PART I – COMMENTS ON SELECT PROPSALS

Proposal #1: Expand the mandate of the OSC to include fostering capital formation and competition in the markets.

Beyond all other recommendations put forth by the Taskforce, the PCMA believes that expanding the mandate of the Ontario Securities Commission (**OSC**) to include fostering capital formation and competition in the markets is of great importance. Since a large number of the Taskforce's policy proposals would have fallen within this currently non-existent mandate, it stands to reason that the absence of a capital formation and competition mandate is the first proposal and most significant issue that the Taskforce uncovered during its review.

As it stands right now, any policy decisions that "*provide protection to investors from unfair, improper or fraudulent practices*", "*foster fair and efficient capital markets and confidence in capital markets*", or "*contribute to the stability of the financial system and the reduction of systemic risk*" are good policy decisions, irrespective of disproportionate dampening effects on capital formation and competition. It's akin to the trite saying: "*give a man a fish and you feed him for a day; teach a man to fish and you feed him for a lifetime*". Expanding the mandate doesn't just instruct the OSC to think about capital formation and competition when enacting policy, it empowers them to give equal weight and consideration to these objectives as against potentially competing mandates. Before anyone can *expect* the OSC to fish, we have to tell them it's important.

The financial markets arose from the entrepreneurial pursuits of capital formation and competition. The idea that a regulator should act in opposition to these forces is misplaced and detrimental to Canada's place in the global economy. Our regulatory regime needs to create an environment where private enterprise and regulators work arm-in-arm to benefit Canadian investors and businesspeople alike. This means not just regulating backward to respond to what has already happened (and often finds its genesis in enforcement) but also by regulating forward to create new opportunities that have yet to be considered. Capital markets should be evolving under the stewardship of regulators.

At the PCMA, we see every day how participants in the private capital markets need this change. Capital formation and competition are the base ingredients of innovation, and innovation can be found in high concentration in the private capital markets. Every business begins with humble roots, but the investment banking industry uses the term "*nano-cap*" to refer to businesses with a market capitalization of *less than $50 million*. We refer to start-ups as "*ventures*" and assume they all aspire to become market-traded reporting issuers. What about *true* small businesses?

The capital market regulatory regime has seemed to distance itself from everyday Canadians and then lock the door behind itself through regulatory burden. An unintended consequence of the current regulatory system is that its supports large corporations on the flawed reality that the people who are able to easily access capital are those who can afford the armies of professional advisors needed to navigate the requisite red tape.

This is why pairing capital formation and competition into a single mandate is necessary. While big businesses may be frustrated by current regulation, small businesses are being crushed by it. No one is advocating for them, so they get ignored. The OSC should ensure all businesses are treated fairly, tempered by its existing mandates of investor protection, fairness and efficiency.

It would be a mistake for this Taskforce recommendation to not be accepted by the Ontario provincial government. It would be tragic for it to be enacted without reciprocated commitment to create real cultural change within the regulators themselves. Capital formation and competition should not carry a stigma within the regulators. It should instead be the goal of any modern governmental authority to promote with magnanimity the innovation that comes with them. At the PCMA, we not only support this recommendation – we implore all stakeholders to embrace it with an open mind to the wide-reaching benefits it will bring about.

Proposal #2: Separate regulatory and adjudicative functions at the OSC.

As the OSC seeks to be a modern and globally competitive capital markets regulator, it also continues to promulgate rules and regulations requiring enhanced corporate governance on capital markets participants. Accordingly, the PCMA agrees with the Taskforce's recommendation that it is time for the OSC to strengthen its own governance structure by ensuring the adjudicative process adheres to appropriate boundaries between rule-making and adjudicative decision-making by separating these functions.

As the Taskforce states, there is a growing consensus among policy-makers and legal experts, that a bifurcated model, with the regulatory and administrative functions separated, aligns with proper corporate governance practice. A number of previous expert panels on Ontario's capital markets have come to same conclusion. We have provided a summary of the *Report of the Fairness Committee to David A. Brown Q.C. Chair of the Ontario Securities Commission* dated March 5, 2004 (known as the "**Osborne Report**") in Appendix A.[1]

This model is particularly appropriate as the Taskforce is also recommending an increase in fines and enforcement rights for the OSC. A bifurcated model provides a fair and transparent adjudicative process absent any actual or perceived bias relative to the current structure.

As the Taskforce notes, the recently established Financial Services Regulatory Authority of Ontario (**FSRA**) has separate Chair and CEO positions and enforcement proceedings are brought to a separate tribunal, the Financial Services Tribunal. In addition, the proposed structure of the Cooperative Capital Markets Regulatory Authority contemplates a tribunal as a division of the cooperative regulator, as well as separate Chair and CEO positions. A similar structure is also used by the Competition Bureau of the Government of Canada.

[1] See the **Osborne Report** at: https://www.osc.gov.on.ca/documents/en/Securities/fyr_20040818_fairness-committee.pdf

Proposal #4: Move to a single SRO that covers all advisory firms, including investment dealers, mutual fund dealers, portfolio managers, exempt market dealers and scholarship plan dealers.

The PCMA has stated in the past and maintains that it does not support a self regulatory organization (**SRO**) for exempt market dealers in the current regulatory regime. There are several reasons for our position:

- The OSC and other provincial regulators have worked for over a decade with participants in the private capital markets;
- The current SROs have a historical and systemic bias against exempt market dealers;
- The current SROs have oversight of approximately 250 firms while there are over 500 firms with EMD registration, and over 500 firms with PM registration; and
- The inherent conflicts of interest with the SRO model.

The PCMA embraced the EMD category when it was created and the past chairman attended OSC Dialogue in 2007 to discuss the impact of the new category. Both the OSC and ASC had committees dedicated to EMD operations and the PCMA had a representative on those committees. Over the last decade the OSC and other CSA members have learned about EMDs and the other constituents of the PCMA. There have been positive results from this relationship such as the understanding that one size does not fit all and EMDs are different from investment dealers and mutual fund dealers.

At the same time, the SROs have been less than receptive to EMDs. IIROC appears to cling to the misplaced notion that firms registered as EMDs are engaging in regulatory arbitrage despite the fact that EMDs are subject to all the requirements of NI 31-103. IIROC has prohibitions in its bylaws and regulations for a member to have any ownership or directorship with an EMD. Of course, there is an exception for the bank-owned dealers and other large dealers. Based on anecdotal evidence, the MFDA members that have EMD registration seem to attract more detailed reviews than their counterparts. Furthermore, the MFDA does not allow members to be registered as portfolio managers.

The number of firms registered in the categories of EMD or PM surpass by a great number the firms that are registered as investment dealers or mutual fund dealers. Many of these firms are small but also some of the largest firms in the world have affiliates registered as EMDs (e.g. Blackrock, PIMCO, Nuveen). To add EMDs and PMs would increase the number of firms under the oversight of the SROs by approximately four-fold.

We noticed the omission of the IFM category in the Report and assume that all registrants would be under the oversight of the SRO. There are a large number of firms that are registered in the three categories of EMD, PM and IFM. This would increase the registrant load for the SRO by an even greater amount.

Finally, the SRO model is being abandoned around the world due to the inherent conflicts of interest. Even the National Association of Securities Dealers (**NASD**), now Financial Industry Regulatory Authority (**FINRA**) had to recreate itself to address the concerns raised by the Securities Exchange Commission (**SEC**). It is now considered a private regulator rather than an

SRO. The United Kingdom, Hong Kong, Singapore, Australia and others have all stepped away from the SRO model due to the conflicts of interest.

However, there are attributes of a single SRO which could be beneficial to the members of the PCMA. The regulatory regime in relation to the private capital markets is the least harmonized in Canada. It is made even less so by the unique interpretations of national instruments taken by the OSC and other members of the CSA. The Taskforce concept of a "single referee" would likely reduce some of the uncertainty faced by EMDs by harmonizing the regulatory approach to registration and compliance across Canada. In addition, maintaining the policy function at the CSA members will allow unique provincial matters to be addressed.

Proposal #5: Mandating that securities issued by a reporting issuer using the accredited investor prospectus exemption should be subject to only a seasoning period.

The PCMA is concerned that selling securities without any restricted period could be abused and pose an end-run to the closed system and not adequately protect retail investors (see example in Appendix B). Removing the restricted period could return Ontario securities legislation to circa 1970s era of securities regulation. We also realize that reporting issuers do not want to continue paying a private placement discount where they receive less proceeds to use to grow their business at the expense of arguably opportunistic investors, such as hedge funds.

The PCMA is not in favour of completely eliminating the restricted period at this time. However, we believe there needs to be a balance between investor protection and fair and efficient capital markets and shortening the restricted period to one month. A reduced restricted period would arguably reduce the private placement discount required of a reporting issuer relative to the time an accredited investor is required to hold such private placement securities. At the same time, it will preserve the integrity of the closed system and protecting investors.

We are also in favour of imposing the "reasonable steps" requirements recommended by the Taskforce. For example, including certain representations and warranties in an investor's subscription agreement regarding their investment intent to guard against purchasing such securities with a view to distribution.

Proposal #11: Allow exempt market dealers to participate as selling group members in prospectus offerings and be sponsors of reverse-takeover transactions.

The PCMA supports the Taskforce's recommendations to allow EMDs to be "selling group members" in the distribution of securities made under a prospectus offering. That would include Capital Pool Company (CPC) offerings[2], both in relation to initial public offerings and prospectus offerings in connection with a qualified transaction. This was permitted under NI 31-

[2] A unique listing vehicle, the CPC program provides an alternative, two-step introduction to the capital markets. The CPC program introduces investors with financial market experience to entrepreneurs whose growth and development-stage companies require capital and public company management expertise. Unlike a traditional IPO, the CPC program enables seasoned directors and officers to form a Capital Pool Company with no assets other than cash and no commercial operations, list it on TSX Venture Exchange, and raise a pool of capital. For more information go to https://www.tsx.com/resource/en/47.

103 and we disagreed when the OSC (and other CSA members) removed the ability of EMDs to participate in prospectus offerings in 2014. The PCMA argued against these changes in its comment letter to the CSA which can be found on the following link https://www.osc.gov.on.ca/documents/en/Securities-Category3-Comments/com_20140310_31-103_koscakb.pdf.

The number of IIROC firms has been shrinking for years and larger IIROC dealers do not want to participate in CPC prospectus offerings for early stage issuers. EMDs have often worked with early stage issuers in the exempt market and are being encouraged to work with IIROC dealers but have been prohibited from participating in prospectus offerings. The Taskforce's recommendation to allow EMDs to participate in prospectus offerings will help small to medium enterprises (**SMEs**) raise capital, provide investors with access to these types of issuers and promote the collaboration of capital raising in Ontario's capital markets among EMDs and IIROC dealers. The PCMA sees this as a positive step forward in helping Ontario's capital markets and investors.

Proposal #14: Introduce Additional Accredited Investor Categories

The PCMA supports the Taskforce's recommendation to expand the definition of an "accredited investor" (**AI**) under the accredited investor exemption set out in section 2.3 of National Instrument 45-106 – *Prospectus Exemptions* (**NI 45-106**). We believe expanding the AI definition will increase the number of AIs in Ontario and arguably increase the universe of Ontario investors who will have access to investment opportunities in the private capital markets and employment by Ontario issuers who will have access to more capital to grow their businesses, create jobs and stimulate the economy.

The PCMA agrees that if an individual meets the requisite proficiency standard to recommend an investment product for others, the individual should be able to make a similar investment decision for oneself. We note that in addition to courses referred to in the Report (Canadian Securities Course Exam; the Exempt Market Products Exam; the CFA Charter or the Series 7 Exam and the New Entrants Course Exam), there are other industry courses identified in NI 31-103 and under SRO regulations that could be considered as satisfying proficiency requirements to qualify an individual as an AI.

The PCMA further submits certain professional certifications and designations may also provide evidence of investor sophistication and such individuals should also be included in the AI definition. There are a number of examinations that test an individual's knowledge and understanding in the areas of securities and investing, and individuals must pass examinations to obtain the necessary professional certification. If there are concerns with whether individuals have the requisite experience, the Taskforce could also consider requiring an individual to self-certify that they are a sophisticated investor as is permitted in the United Kingdom.[3] The form used in the United Kingdom is found in Appendix C.

[3] https://www.legislation.gov.uk/uksi/2005/1529/article/50A/made

The Taskforce's recommendation to expand the AI definition is also in sync with developments in the United States. On August 26, 2020, the SEC adopted amendments to the "accredited investor" definition (the **US AI Amendments**). See https://www.sec.gov/rules/final/2020/33-10824.pdf. As the SEC stated in a press release, "Historically, individual investors who do not meet specific income or net worth tests, regardless of their financial sophistication, have been denied the opportunity to invest in our multifaceted and vast private markets. The amendments update and improve the definition to more effectively identify institutional and individual investors that have the knowledge and expertise to participate in those markets."[4]

The US AI Amendments allow investors to qualify as accredited investors based on defined measures of professional knowledge, experience or certifications in addition to the existing financial tests. The amendments also expand the universe of accredited investors by including any entity that meets an investments test to qualify as an AI.

Proposal #33: Allow for greater access to capital for start-ups and entrepreneurs.

The PCMA applauds the Taskforce's recognition of formalized Angel Groups as an important part of the private capital financing ecosystem. The reality is that every corporation in Canada, from the largest to the smallest, at one point in their evolution was a start-up, and in most instances, financed at least in part by "angels" (i.e. accredited investors and high net worth individuals) or groups of angle investors (**Angel Groups**).

Formalized Angel Groups are a relatively new phenomenon in Canada, only dating back to the early 2000's. As the Taskforce recognizes in its report, Angel Groups do not neatly fit within a category of registration under the Securities Act. This often leads to regulatory uncertainty relating whether Angel Groups can operate legally in the province of Ontario. They engage in a "trade" in securities, however, no clear advice has been given by the OSC relating to registration (or if registration is not required as done for venture and private equity investors). Angel Groups are left with the choice of either applying for registration as an EMD or seeking exemptive relief from registration (as a precaution). Both processes are costly and time consuming.

For the few formalized Angel Groups who have obtained EMD registration, the experience has not been satisfactory. Having a chief compliance officer (**CCO**), $50,000 in regulatory capital, insurance, proficiency standards, and obligations of know your client, know your product, and suitability determinations, simply do not fit their model.

More formalized Angel Groups are needed to encourage the formation of capital and to spur economic activity. In this regard, the PCMA supports the detailed recommendations and submissions of Angel Investors Ontario submitted to the Taskforce.

With respect to the AIO's submissions, we wish to reiterate it is only formalized Angel Groups who should be the subject of relief, i.e. groups who are not-for-profit and belong to an Angel umbrella group. This will prevent those who seek to form an Angel Group to avoid registration requirements and run the group for personal gain. In that regard, we note that a regime of No Action Letters (much like Advance Rulings from the Canada Revenue Agency and a well

[4] https://www.sec.gov/news/press-release/2020-191

established practice with the SEC) could be implemented to confirm the legitimate status of Angel Groups. We discuss No Action Letters in Part II of our comment letter.

Proposal #47: Give the power to designated dispute resolution services organizations, such as the Ombudsman for Banking Services and Investments (OBSI), to issue binding decisions ordering a registered firm to pay compensation to harmed investors, and increase the limit on OBSI's compensation recommendations

The PCMA is opposed to the Taskforce's recommendation to increase OBSI's compensation limit to $500,000 and make its decisions binding. We believe it will be deleterious to the industry, and potentially unconstitutional, in its current format. We do not believe this proposal strikes the right balance between investor protection and fair and efficient capital markets.

The PCMA rejects the position that non-acceptance of OBSI recommendations is a systemic industry problem; in fact, a majority of OBSI recommendations are accepted by industry. Prior to August 27, 2020, OBSI last published a "firm refusal" in 2016 (https://www.obsi.ca/en/news-and-publications/firm-refusals.aspx). PCMA members believe that any input received by the Taskforce suggesting that refusals are rampant is a case of re-framing a registrant's self-advocacy as a "refusal", when it may be for other bona fide reasons. OBSI decisions are rejected for various reasons by registrants, including when a firm believes OBSI was not fair and reasonable in its investigation and its reasoning and analysis in its decision did not support its conclusions or the law.

The fact that OBSI exists and a Commission gives aggrieved investors recourse are more than sufficient avenues for aggrieved investors to seek redress. As in other areas of life, access to justice is always a concern and just because someone has lost money, it should not give them an automatic right to sue with no cost to them for making a complaint or even if they lose.
The PCMA concerns are more fully discussed below.

- **Inconsistent with Burden Reduction** – With respect, this recommendation is increasing the burden on registrants and inconsistent with the Government's desire to support burden reduction. OBSI has for years sought to increase its powers and mandate when it is an informal dispute resolution mechanism and should remain so.

- **Creating Another Tribunal Creates More Bureaucracy** – This recommendation creates another tribunal with the power to make material binding decisions when OBSI is not a court of law nor a Securities Commission. This is concerning and inconsistent with a traditional view of an ombudsman or dispute resolution service in the capital markets. Currently, OBSI seeks to use persuasion to convince both an investor and registrant to agree with its findings which is what it should be doing as a dispute resolution body.

  To give OBSI binding powers and adjudicative functions; OBSI would have to be rebuilt. It would require a defined, transparent and far more robust set of processes and evidentiary standards to ensure that its standard of "fairness" is applied consistently and reasonably in accordance with Canadian legal principles. According to its own website, OBSI:

> "resolve[s] complaints using an informal, non-legalistic approach…We do not have the power to compel the attendance of witnesses, take evidence on oath or test evidence by cross-examination. We talk to both parties and interview others who have relevant information, but we do not conduct oral hearings. Such procedural mechanisms would not be necessary or helpful to our work as an ombudsman service."

It would be inconsistent with the Canadian legal system at large to allow claims for damages under $500,000 to be adjudicated in a forum where witnesses, oral evidence and cross-examination are unnecessary tools for civil justice. Furthermore, it would have the effect of amending all legislation, regulation and common law to be subject to the OBSI's self-determined "fairness" standard of application, raising serious constitutionality and rule of law concerns. By way of example, OBSI applies a limitation date of 6-years compared to the 2-year limitation period prescribed in most provincial jurisdictions. Would OBSI be empowered to unilaterally amend the limitation dates determined by provincial legislation?

We believe that this is not the Taskforce's intention, which the PCMA believes would require a revision of OBSI procedures, operations and personnel to align with Canadian legal principles. The cost of doing this would be immense, not to mention to burden imposed on market participants to learn a separate "pseudo-judicial" process for OBSI claims of less than $500,000.

- **Appeals** – The recommendation states that OBSI's binding decisions would have no right of appeal to the OSC. This is concerning since OBSI reviewing its own decisions is a conflict of interest. Binding decisions of up to $500,000 are serious amounts and registrants should have a right of appeal to the OSC contrary if this proposal is accepted. If the cost and expense of an OSC review is a concern and, the Taskforce does not wish to add such a burden to the OSC, it does so at the expense of natural justice for registrants.

- **Increasing the OBSI Limit to $500,000 –** $350,000 is a lot of money and increasing the limit every two years based on a cost of living adjustment (**COLA**) is a very high amount for any adjudicative body outside a court of law.

  As context, consider that the Small Claims Court in Toronto has a monetary limit of $35,000 and at least aggrieved plaintiffs have the matter heard before a judge with Rules of Procedure. Simply, the OBSI limit should not be increased, let alone adjusted for COLA and, if an aggrieved investor seeks a binding decision, they should go to Court to seek financial redress.

- **Binding Decisions will Increase Complaints** – The PCMA believes that the Taskforce's recommendation will dramatically increase the number of complaints and create additional bureaucracy. If a person can seek financial redress at no cost to themselves, only the other side, and they have no 'skin in the game' why would they not make a complaint anytime they lost money on their investment since they have nothing to lose. At least in the Ontario Small Claims Court, an unsuccessful party has to pay costs so they need to carefully consider any legal action they take. This would not occur if OBSI can make binding decisions which is unfair to registrants.

- **No Loss Calculation Methodology for Private Market Securities** – The PCMA is not aware of the OBSI having a loss calculation methodology for private market securities. Accordingly, we believe there is bias in its recommendations that all private market investments are unsuitable when investigating a complaint, rather than a percentage of an investor's investments. Meaning, it is easier for OBSI to say 0% of an investor's private market investments are suitable than, for example, 40% if an investor has 50% invested in the private markets. In this example, rather than determining that 10% may not be suitable, OBSI's bias is to say no private market investment is suitable.

  OBSI has a loss calculation methodology for public market securities but has not shared a methodology for private market securities which are generally illiquid securities. OBSI is currently requiring EMDs to buy back the investments from an aggrieved investor and hold them in inventory when they make a finding adverse to an EMD. EMDs do not hold securities and have no funds to make such purchases. Accordingly, this has caused problems for E&O carriers.

- **Impact on E&O Insurance Coverage** – There are only two insurance carriers that provide coverage for firms solely registered as EMDs in the market, with one looking at leaving so there will only be one. With increased limits and binding decisions of up to $500,000, there will be no insurance company to respond to claims (legal defence costs or damages). If there is no coverage, this may bankrupt EMDs. The assumption that an EMD can transfer its risk to an insurance company is false.

- **Impact on EMD Resources** – Responding to any OBSI complaint today is an extremely time intensive process for an EMD and dealing representative. There are many documents involved in a single private market investment (e.g., subscription agreement and schedules, the offering memorandum, related marketing materials, know-your-client form, net financial asset spreadsheet, suitability case, etc.). An EMD and dealing representative may also work with external counsel in this process and spend a considerable amount of time and money in their defence. There is no cost to an investor complainant, the burden is unfair to EMDs and dealing representatives.

- **Investors have no 'Skin in the Game' –** As stated above, investors are not required to pay for any costs of an OBSI investigation. However, EMDs have to spend considerable time, money in effort including cost of legal counsel and any appeal costs if they disagree with a binding OBSI decision.

  Such matters are compounded in the face of a failed offering in the private markets. Many investors will arguably lodge a suitability complaint in the face of a failed offering since they have nothing to lose. Disgruntled investors cannot seek financial redress in the courts since such issuers generally have bankruptcy protection. The only entity that an aggrieved investor can seek financial redress is an EMD which is easily done by lodging a complaint with OBSI.

The Taskforce should be recommending the imposition of complaint filing fees to reduce the risk of frivolous claims that have no consequences to an investor who loses. The present system is not fair to EMDs.

- **OBSI Staff Lack Education, Experience and Training in the Private Markets** – OBSI should not have the power to make binding decisions since its staff are not trained adjudicators. Many have taken the Exempt Market Product Exam but have not even made an investment through an EMD in a private market security. If OBSI staff do not have the requisite education, training and experience and are not adjudicators, then there is a higher likelihood that decisions will not be based on the law. Having skills involving suasion are quite different than adjudication skills. OSBI staff are also not securities regulators, so how can EMDs have confidence that they understand the law. How will EMDs have comfort that OBSI's decisions are in line with the decisions of the OSC or other CSA members?

  This matter is compounded in light of the Client Focussed Reforms with the introduction of the best interest (**BIS**) standard for conflicts of interest and putting the client's interest first (**PTCIF**) standard in connection with suitability determinations. This is in addition to a registrant's duty to act honestly, fairly and in good faith towards clients. These concepts are very difficult to understand and interpret for the OSC and other CSA members. PCMA members have concerns that binding OBSI decisions may not be reasoned and fair and based on applicable securities law.

  The PCMA is very concerned that OBSI staff, who are not lawyers, will be making decisions based on their own interpretations of law that are inconsistent with OSC or CSA member decisions or otherwise. For example, the BIS and PTCIF standards are difficult concepts to understand and are new, they do not come into effect until 2021. Without having the requisite education, experience and training in the interpretation of these new concepts, makes giving OBSI the power to make binding decisions of up to $500,000 very concerning to EMDs.

- **Multiple Forums for Same Misconduct** – In the face of alleged misconduct, there is no discussion on how an OBSI investigation will work in the face of an OSC or CSA member investigation involving the same misconduct. This would need to be clarified and what happens if a matter is before OBSI and the OSC? This raises concepts of double jeopardy.

  The PCMA believes a registrant would be treated more fairly with a CSA member investigation than an OBSI investigation. In such circumstances, if a matter is before the OSC or other CSA member, then the OBSI matter should be transferred to the appropriate Commission. An OBSI investigation should not be allowed to continue as this is not fair to registrants.

- **No Private Market Representation on OBSI Board** – The PCMA is concerned about the stewardship of OBSI since the OBSI board of directors has no representation from the private markets. It is difficult for private market participants to believe they will be treated fairly when the current OBSI board has no apparent experience or knowledge about the private markets. If OBSI's decisions will be binding, the composition of the OBSI board needs to require one or more individuals to represent the private markets. See current OBSI board at: https://www.obsi.ca/en/about-us/board-of-directors.aspx#

In sum, the PCMA believes giving OBSI the power to make binding decisions is inappropriate and does not strike the right balance between investor protection and fair and efficient capital markets. The fact that OBSI exists and a Commission gives aggrieved investors recourse are more than sufficient avenues for aggrieved investors to seek redress.

PART II – OTHER RECOMMENDATIONS

In addition to the above comments, the PCMA has outlined below other items of concern to its members. We would be pleased to have further discussions on these topics.

Designated Funding of the PCMA for Designated Purposes

The PCMA requests that the Taskforce recommend that the Designated Funds (as defined below) payable under sanctions imposed by OSC Hearing Panels, including administrative penalties and voluntary payments under settlement agreements, be used to provide funding, in part, to the PCMA for Designated Purposes (as defined below).

"**Designated Purposes**" means (a) the compilation of private market industry data and statistics which are not being maintained by the OSC and other CSA members yet form the basis of evidenced based regulation; (b) the education and training of EMDs and dealing representatives about applicable securities law, including the many changes involving the Client Focussed Reform (**CFR**); and (c) the creation of a new Exempt Market Product (**EMP**) Exam/Course that must be updated to reflect the wholesale re-write of the registration regulations under CFR.

As you know, an OSC Hearing panel may designate the funds payable under these sanctions in accordance with clause 3.4(2)(b) of the Ontario *Securities Act* (the **Act**). Specifically, this provision allows an OSC Hearing panel to designate the funds for allocation to, or for the benefit of, third parties or for use by the Commission *for the purpose of educating investors or promoting or otherwise enhancing knowledge and information of persons regarding the operation of the securities and financial markets* (the **Designated Funds**).

To date, the OSC is using Designated Funds to financially support, in part, Fair Canada for up to $500,000 per annum. The PCMA and Fair Canada are both not-for-profit organizations and seek to represent the interest of their members that includes knowledge, information and training about the "*operation of the securities and financial markets*". We believe it is unfair that the OSC funds Fair Canada while denying similar funding to the PCMA and other industry associations that provide an equally valuable and necessary service to their members. Such funding would be consistent with the use of funds set out in clause 3.4(2)(b) of the Act.

The PCMA has been self-funding since inception and greatly appreciates the financial support of our many members. However, using the Designated Funds, in part, to fund the PCMA's use of funds for Designated Purposes is critical for the functioning of the private markets especially for the creation of the EMP Exam/Course.

The PCMA worked with IFSE in preparing and launching the current EMP Exam/Course which took a very long time after many challenges and delays. We understand there is no current update of the EMP Exam/Course in progress. It is very concerning that new entrants to the private capital markets are being educated on EMP Exam/Course materials that are outdated. We also believe the Taskforce should be aware, and understand, that the PCMA lacks the financial resources to develop updated EMP Exam/Course materials to reflect CFR and it is not a safe assumption that it will be done by industry.

Accordingly, the PCMA submits that the Taskforce recommend that the OSC guidelines involving the use of Designated Funds be allocated to the PCMA for Designated Purposes.

Offering Memorandum Exemption

Ontario's SMEs are vital to the province's current and future economic prospects. SMEs are underserved by the large dealers and they are generally unable to access the public capital markets and may have challenges with doing traditional debt financing through banks. Consequently, private capital is an important funding source that SMEs rely on to finance and grow their businesses.

In Ontario, private capital is primarily raised under the accredited investor prospectus exemption. The pool of accredited investors in Ontario is limited. Recognizing this, the OSC's Exempt Market Advisory Committee recommended that Ontario adopt the offering memorandum exemption to, among other things, expand the pool of private capital available to SMEs. Since its adoption on January 13, 2016, the offering memorandum exemption has been underused. In 2017, only $136 million was raised under the exemption, with $126 million (93%) of this amount being invested in issuers from the real estate, financials and mortgage industries.[5]

We respectfully submit that the Taskforce recommend that the OSC should consider make the following improvements to offering memorandum exemption:

- revising of the form requirements set out in Form 45-106F2 – *Offering Memorandum for Non-Qualifying Issuers*, so that the required disclosure can be more readily incorporated into the issuer's existing accredited investor offering memorandum and so that it can be tailored to different issuers and industries. In our members' experience, the current form is too rigid, and it often leads to confusing, overly technical or repetitive disclosure;
- the investment limits imposed on eligible investors who receive suitability advice should be removed. The investor's dealer is best positioned to determine, in accordance with his

[5] According to OSC Staff Notice 45-716 – *Ontario Exempt Market Report 2018* (the **Report**) during 2017, 85% of private capital raised from individual investors and 90% of private capital raised from institutional investors was, in each case, raised under the accredited investor exemption. According to the Report, in 2017 individual investors invested approximately $1.87 billion under the accredited investor exemption; this represents approximately 2% of the total capital invested in Ontario's exempt market during that period.

or her professional judgment and the requirements under NI 31-103, the suitable investment amount;

- the requirement to include opening balance audited financials for issuers that are not engaged in an active business, i.e. special purposes vehicles, should be eliminated. The cost of producing audited nominal financial statements is not warranted and provides no protection for investors; and
- private investment funds, specific derivatives and structured finance products should be allowed to rely on the offering memorandum exemption. Alternatively, the OSC should narrow the type of "complex" issuers and/or products that they are targeting with this prohibition.

The PCMA's believe its recommendations, if adopted, will increase the pool of capital available to SMEs and reduce the cost of raising private capital under the offering memorandum exemption, without jeopardizing Ontario investors' interests.

Form 45-106F1 – *Report of Exempt Distribution*

An annual filing for Form 45-106F1 – *Report of Exempt Distribution* for all types of exempt securities should be considered. The CSA currently allows investment funds distributed under prospectus exemptions to file annually but all other exempt distributions have to be filed within 10 calendar days and depending on the jurisdiction of distribution, this may need to be filed three different ways. This is costly and time consuming. We understand that this would be a CSA effort and not solely the OSC.

In addition to recommending changing the frequency of the filing, the Taskforce should ask about the information that is being collected through this filing. Particularly, why is more personal information collected then for public market trades? (i.e., name, residential address, phone number and email) What is this information being used for? What is the goal of the information being collected? A lot of information has been collected; will data be provided on a summary level to registrants? Data is knowledge and knowledge should be shared. The Taskforce should consider asking that the quantum of information being collected on each purchaser be reduced and that the OSC provide summary market information to the public based on the data collected on a routine basis.

OSC Risk Assessment Questionnaire

The burden of having to complete a Risk Assessment Questionnaire (**RAQ**) every two years is too much. It should be once every four years and the results should be shared among all CSA members. While it may be construed as not wanting to provide information, it is about the time, money and effort in how this information is collected and then inputted into the RAQ.

The RAQ does not appear to appreciate what information EMDs have readily available versus have to collect manually, which for a large EMD firm, can take many, many hours. EMDs, unlike other dealer registrants, do not have the systems or technology service providers to easily provide the required data.

Late fees for Disclosure of Outside Business Activities

The Taskforce should recommend that the OSC eliminate late fees for outside business activities. Although there is a moratorium, we are concerned the OSC will bring them back. The late fees are $100/day and up to $5,000 per calendar year, and restart the next year. For example, when a DR may forget their accountant/lawyer set up a holding company a few years ago that they did not report. This financial penalty discourages reporting of changes and we understand it is not imposed by any other CSA member in Canada.

Directed Commissions

The Taskforce should recommend that the OSC explicitly allow directed commission payments to holding companies of advisors/dealing representatives. This is allowed for mutual fund dealing representatives but not other registrants. In 2016, IIROC did a paper but the concept was not implemented. See https://www.iiroc.ca/Documents/2016/f0b488e0-1e9d-45ba-8671-442936e254d8_en.pdf?white-paper-proficiency-directed-commissions&Response-to-Comments&October-6-2016. The Taskforce should explicitly allow individual registrants to structure their affairs in a tax efficient manner.

Customer Service

The Taskforce should recommend that service level standards be reviewed and take on more of a customer service approach. The OSC requires a more collegial approach that encourages compliance instead of one that threatens registrants with administrative penalties for perceived non-compliance. There needs to be more accessibility and availability of OSC staff to answer questions of registrants. The industry wants to deal with the regulator and not be directed to the OSC website or costly external counsel. The 'tone at the top' at the OSC should have a team-oriented approach. A 'we are open for business" or "how can I help you" approach. The industry is not the enemy.

The Taskforce should recommend that the OSC reports on whether standards are met (anecdotally, the PCMA has been advised by its members that registrations average 8 months for approval, twice as long as the published service standard of 4 months). Registration staff are the first contact for new registrants. The process of becoming registered can be very frustrating due to endless questions that, to potential registrants, seem unrelated to the business. Staff should review the application and send one list of questions rather asking a few questions every few weeks and sometimes asking questions already answered. This leads to new registrants starting out with a bad first impression of their regulator.

No Action Letters

The PCMA suggests that 'no action letters' similar to what is used by the SEC could ease some of the compliance burden. These letters address specific fact situations which provide guidance to registered firms and individuals on how the regulators will deal with these situations. In the current "us versus them" environment, self-reporting of new processes or innovations are not done by registrants for fear of enforcement action or administrative penalties.

No action letters would provide market participants with some confidence as the industry evolves and disruption continues. It will also allow the OSC and CSA members to keep current with innovations and new practices as it will encourage collaboration with the industry.

Need for Shared Chief Compliance Officer Model

The OSC's burden reduction report (published in November 2019) outlined on page 64 (Recommendations R-19, R-20 & R21) changes to the current constraining CCO model. Flowing from this, the CSA has proposed a CCO model where a CCO can to be employed by a single firm, and can then also work at a firm with a similar business model. This proposal will work for affiliated companies but forgets that many registered firms are also competitors. A firm is not going to allow its CCO to work for a competitor, nor is a firm really going to want a CCO from a competitor looking over its operations. Therefore, we highly recommend that the Taskforce suggests an independent contractor model, similar to the SEC, where the independent certified CCO provides oversight to a designated compliance officer who would provide the compliance presence at the registered firm.

The proposal for a shared CCO model is needed due to the shortage of CCOs industry-wide. One reason for the shortage is the stringent interpretation of the experience requirements by the securities regulators, and in particular, the OSC. For example, a person with years of experience in compliance in insurance or in banking or mortgage brokerage, is not considered relevant experience because it is not in the securities industry. The regulators could broaden their interpretation of relevant industry experience through a staff notice just as they have done with the registration of Client Relationship Managers (i.e. specialized Associate Advising Representatives).

In the past, the OSC has imposed terms and conditions on firms with poor compliance for the CCO to take the Osgoode Hall course on Regulatory Compliance & Legal Risk Management for Financial Institutions. There would appear to be a recognition by the OSC of the value of compliance in the broader financial industry. Compliance officers are charged with enforcing and monitoring compliance with laws and rules, they are not responsible for trading securities or providing investment advice. Broadening the interpretation of experience to risk management and compliance in other segments of the financial industry would increase the pool of CCO applicants.

Closing Remarks

We thank the Taskforce members for their hard work and commitment to improving Ontario's capital markets especially during the many challenges faced by everyone during the COVID-19 pandemic.

* * * *

We thank you for considering our submissions and we would be pleased to respond to any questions or meet with you to discuss our comments.

Yours truly,

PCMA COMMENT LETTER COMMITTEE MEMBERS

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PCMA Board of Directors

Appendix A: Summary of the Osborne Report

Reasons for a Separate Tribunal

As stated in the Osborne Report, the PCMA agrees that the OSC's adjudicative function should be removed from the Commission and be constituted as a completely separate tribunal, for the reasons outlined in the below excerpt from the Osborne Report. Bold below is added for emphasis.

1. "***The pervasive and widely held perception is that a "fair hearing" before the Commission cannot be obtained.*** *The perception is based on a number of factors:*

    (a) *The various capacities in which the Commission acts (policy-maker, investigator, prosecutor and adjudicator). The courts' acceptance of this structure in law has done nothing to dim this perception in fact.*

    (b) *Considerations of institutional loyalty make it difficult for Commissioners in their adjudicative capacity to act dispassionately. In high profile cases where substantial Commission resources have been devoted to bringing cases forward, it is difficult for the hearing Commissioners, as persons committed to the overall enterprise, to put that behind them when adjudicating. While they may believe themselves able to do so, subconsciously it must have an effect.*

    (c) *The Chair's links with staff and, in particular, in relation to the issuance of notices of hearing in high profile cases cannot be totally disregarded by the Commissioners presiding at the hearing. The more prominent cases have already gone through various levels (Director of Enforcement, Executive Director, Chair) and there is an institutional commitment to them. The Chair's involvement in the important cases continues throughout the hearing.*

    (d) *The existence of what appears to be an aggressive enforcement policy authorised by the Commissioners as a whole. Examples of this policy are seen at the staff level in the following: (a) in settlement discussions, the expressed position that the first offer is the best offer the respondent will receive, and if not accepted, the offers will worsen as the time runs; (b) a credit for cooperation policy, the effect of which is to penalize respondents for exercising their rights; and (c) the refusal of staff to ask a Commissioner to assist in settlement discussions. The frequently expressed concern is that this aggressive enforcement policy influences the Commissioners' approach to the cases that come before them in the exercise of their adjudicative function.*

    (e) *The increased penalties, career threatening consequences, enormous publicity, and the fact that the Commission almost always appears to win creates in the minds of some respondents and their counsel the impression that "the cards are stacked against them".*

(f) *The power of adjudicative panels to award costs against respondents (which are retained by the Commission) is seen by some as creating an economic conflict. This argument is compounded by the absence of any power to award costs to successful respondents.*

(g) *Enforcement, with its increased resources, has become much more aggressive with what appears to be little accountability.*

(h) *Commissioners are much more protective of staff in their hearings than they were in the past. Some believe this is because of the level of aggression which is now exhibited by respondents in the hearings. (Others more closely connected with staff believe just the opposite, i.e. that the Commissioners demand much more of staff in a hearing than they do of the respondents.)*

(i) *The home-court advantage. The widespread view is that staff choose to go before the Commission on a hearing rather than the courts because the onus of proof is lower, and they are not restricted by the criminal rules of evidence, including reliance on evidence acquired through the use of section 11.*

2. ***The concern that unarticulated policy considerations brought by the Commissioners from their policy-making function inform a sanction hearing**. Such hearings should not be used to develop policy. To do so undermines the integrity of the hearing process. At the very least, staff should be obligated to put policy issues on the table at the outset and argue for them.*

3. ***Further, there is very little policy involved in sanction hearings**. Typically, sanction hearings in their form are much more like a criminal trial.*

4. *In any event, there can be a **disconnect between the kinds of policy considered by the Commission** in its policy-setting capacity and those policy issues that arise at hearings.*

5. ***The concern that in their adjudicative decisions, the Commissioners apply the public interest jurisdiction based on their experience as Commissioners, without identifying the public interest standards in advance**. The public interest jurisdiction should be used to articulate standards and rules looking forward in order to prevent damage. It should not be used in an ex post facto fashion. Rule-making, guidelines, policies and speeches can set forth the appropriate standards. This would allow everybody to know in advance what the new standards are, and govern themselves accordingly.*

6. ***Section 127 proceedings are now for all purposes no different than contentious trials.** The major proceedings are complex trials. The Commissioners are poorly suited to participate in such proceedings, either as presidents or members of the panel. The recent appointment of litigation lawyers to provide this expertise is an admission of this reality.*

7. ***The Commissioners who are part-time are not in a position to commit to the time requirements of a long hearing**.*

8. ***The Commission, in order to ensure that its adjudicative function is free from an attack based on a perception of bias, reasonably apprehended or actual, has gone to great lengths to create a partition between Enforcement and Commissioners****. The Chair, as the chief executive officer, is the exception. The Chair takes an active role in overseeing Enforcement and its major cases, both before and after the issuance of a notice of hearing. This structure has led to a malfunctioning of the Commission. Enforcement, which is one of the most important branches, operates on its own without its priorities, policies or practices being subjected to the Commissioners' advice and oversight. Enforcement has been described as a "black hole" within the Commission.*

9. ***The absence of involvement on the part of the Commissioners as a whole is of concern not only from the functional point of view, but from the legal as well.*** *The Commissioners are the board of directors of the Commission, a corporation without share capital, with the responsibility of overseeing the management of the financial and other affairs of the Commission. This, of course, includes the enforcement branch. This responsibility cannot be delegated to the chief executive officer.*

10. ***If the adjudication function were to be removed from the Commission, there would be no need for the separation of Enforcement from the Commissioners.*** *The Commissioners as a whole would be entitled to take a hands-on approach to the establishment of enforcement priorities, practices (including a protocol to govern the settlement process) and planning. This is particularly important currently. Perhaps as a by-product of the much more aggressive enforcement policy of the present Chair, there is a large informed opinion that Enforcement acts without effective accountability and restraint in exercising its mandate. It is essential for the Commissioners to exercise their corporate responsibilities and take control of Enforcement, especially when the Commission is publicly emphasising proper corporate governance. Absent the impediment of the partition, the Commissioners would be free to focus on enforcement priorities, establish the appropriate oversight safeguards, and speak with one voice without fear of tainting the adjudicative process. The Commissioners, without the internal bifurcation, could move collectively and decisively to safeguard the capital markets.*

11. ***The Commission exhibits in its adjudicative functions a "crisis of confidence".*** *It is overly sensitive to external criticism of its decisions, especially in the media. This results in a failure to develop consistent enforcement policies, priorities and practices, leading to confusion both within the Commission and in staff's dealings with those outside. The removal of the adjudicative function would mean that the Commission would no longer feel responsible for the adjudicative decision- making.*

12. ***Many of the concerns set forth above will only intensify into the future since the aggressiveness of Enforcement is unlikely to abate and, if anything, will probably increase.***

13. ***Some have also raised the issue of the constitutionality of the current structure.*** *If these concerns are justified, it would follow necessarily that the structure would have to be*

changed. However, our research has led us to conclude that, even with its increased powers, the Commission as now structured likely would survive constitutional scrutiny."[6]

[6] See page 12-17 of the Osborne Report.

Appendix B: Short Selling Example

The PCMA is aware of certain practices in the private markets where reporting issuers are concerned about a "private placement discount" or 'tax' to the trading price that they must offer investors in connection with a private placement and certain related short selling practices. The PCMA agrees it raises a number of policy concerns which need to be addressed by the Taskforce. As these concepts are complicated, we have provided background information and an example, to explain the policy concerns.

Background

- Canada's "**closed system**"[7] imposes "**restricted periods**"[8] and "**seasoning periods**"[9] when securities cannot be freely sold in the secondary market.

- Resale restrictions are intended to preserve the integrity of the "'closed system" of securities regulation. In other words, our closed system is based on the premise that "**retail investors**"[10] are presumed to need the protections of a prospectus (since there is an information imbalance between the issuer and the investor, and the investor needs the issuer to provide full, true and plain disclosure of all material facts to offset this imbalance and make an informed investment decision.

- In contrast, "**Sophisticated Investors**"[11], such as an accredited investor, are not afforded the protections of a prospectus because they are presumed to be sophisticated, to have an ability withstand loss and/or to protect themselves through access to professional advice - they can make an informed investment decision without a prospectus.

Resale Restrictions

- Resale restrictions are intended to ensure that a Sophisticated Investor, such as accredited investor, is genuinely purchasing the securities "*with investment intent*" and not "*with a view*

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[7] For readers of comment letter, securities can only be issued if they are qualified by a prospectus or pursuant to a prospectus exemption, like the accredited investor exemption under s. 2.3 of National Instrument 45-106 – *Prospectus Exemptions*. Generally, any securities issued by way of a prospectus exemption enter into a "**closed system**" in Canada and cannot be freely resold unless: (a) a prospectus is qualified for a secondary offering; (b) a prospectus exemption is available for the secondary trade; or (c) the original issuer of the securities is or becomes a reporting issuer in Canada and the applicable "restricted period" or "seasoning period" has expired. Resale restriction rules in connection with privately placed securities are regulated by National Instrument 45-102 – *Resale of Securities* ("**NI 45-106**"), which is applicable in all provinces.

[8] A "**restricted period**" imposes a minimum time that securities must stay in the closed system before they become freely tradable. In order to qualify for the restricted period treatment for securities, among other things: (a) the issuer must be a reporting issuer in a Canadian jurisdiction for the four months preceding the secondary trade; (b) four months must elapse from the original issuance before the secondary trade; and (c) the certificate (including any global certificate) representing the securities must contain a prescribed restricted-period legend. NI 45-102 provides that securities originally issued by a reporting issuer under certain prospectus exemptions (e.g., Accredited Investor Exemption and Offering Memorandum Exemption, among others, are subject to a four-month restricted period and are then freely tradable.

[9] NI 45-102 provides that securities originally issued under certain prospectus exemptions, by a reporting issuer are subject to a four-month *seasoning period* and then are freely tradable. A "**seasoning period**" is the period of time that an issuer must be a Canadian reporting issuer which is the requisite period of time in order for the it to establish a disclosure record on which secondary market investors can rely. NI 45-106 requires an issuer to be a Canadian reporting issuer for ***four months*** prior to any secondary trade when such securities become freely tradeable.

[10] For purposes hereof, a "**retail investor**" is an investor who does not purchase a security under a prospectus exemption; they purchase freely tradeable securities.

[11] For purposes hereof, an "**Sophisticated Investor**" is an investor who purchase securities from an issuer pursuant to a prospectus exemption under applicable Canadian securities law, such as an accredited investor under the accredited investor exemption set out in s. 2.3 of NI 45-106.

to distribution" (*i.e.,* immediately reselling the securities *or identical securities* from an existing holding or securities that are "borrowed" from a third party)

- If a Sophisticated Investor, such as accredited investor, is purchasing "with a view to distribution", they are simply acting as an unregistered underwriter and the issuer (perhaps inadvertently) is making an indirect distribution of securities to investors in the secondary market. See the definition of "underwriter" in s. 1 of the Ontario *Securities Act*.

- Since private placement securities are subject to resale restrictions, they are therefore sold at a discount to the current market price (the "**private placement discount"**). In theory, this is intended to offset the risk the Sophisticated Investor, such as accredited investor, is assuming by purchasing resale-restricted securities.

- Although resale restrictions are nice in theory, in practice, they may not work (at least for issuers where it is easy to "borrow" freely trading identical shares from another party)

- In practice, resale restrictions may simply operate as a "tax" on issuers and riskless money to rent-seeking hedge fund/arbitrage "investors" (*i.e.,* Sophisticated Investors, such as accredited investors) (**Hedge Fund investors**) where: (a) issuers do not get the full value for their shares; (b) investors in the secondary market do not get a prospectus and may not be Sophisticated Investor, such as accredited investor; and (c) Sophisticated Investor, such as accredited investor, are able to facilitate indirect distributions and monetize the spread between the market price and the discounted purchase price.

Simplified example:

- Assume a TSX-listed issuer is seeking to raise capital. The reporting issuer either has a liquid secondary market and/or friendly founders/institutional investors willing to "lend" shares (so freely trading shares are easy to borrow).

- A dealer proposes to the issuer a special warrant financing with a friendly offshore "investor" (usually a Hedge Fund Investor).

- On August 1, 2020, the dealer privately places 100 special warrants with the Hedge Fund Investor. The special warrants are priced at a discount to the market price of the reporting issuer's common shares (for purposes hereof, assume a 15% discount to the volume-weighted average price of the reporting issuer's common shares as of the date of the private placement.) The Hedge Fund Investor may also receive additional warrants as a "sweetener".

- The Hedge Fund Investor has also made arrangements to "borrow" 100 common shares from friendly founders/institutional investors.

- On August 1, 2020, Hedge Fund Investor sells 100 common shares (from existing holdings or "borrowed" from friendly founders/institutional investors) into the secondary market through the TSX.

- So Hedge Fund Investor has simultaneously <u>purchased</u> 100 special warrants from the issuer at a discount to market and <u>sold</u> 100 common shares to investors through the TSX at the market price

- The Hedge Fund Investor is not really an investor in any meaningful sense because the investor is simultaneously selling short (or selling out of existing holdings) another 100 common shares at the market price through the TSX. Its net position is 0.

- The reason for the Hedge Fund Investor participating in the financing is to capture the spread between the discounted purchase price and the market price on the resale – this is similar to a form of fee or sales commission for facilitating a financing.

- The dealer receives a standard dealer commission (e.g., 6% cash and warrants) for privately placing 100 special warrants with the Hedge Fund Investor. However, the dealer has not really done any work here. It has simply placed 100 special warrants with the Hedge Fund Investor.

- On September 1, 2020, the reporting issuer files a preliminary prospectus to qualify the distribution to the Hedge Fund Investor of 100 common shares underlying the 100 special warrants privately placed in August.

- On October 1, 2020, the reporting issuer receives a receipt for its final prospectus and distributes the 100 common shares under the prospectus to the Hedge Fund Investor. The Hedge Fund Investor then uses the 100 freely trading common shares to close out its short position (give them to the lender of the securities) or replenish its holdings.

- And then they repeat the process with another issuer.

- Now, we understand that this works for the Hedged Fund Investor if there is sufficiently liquidity and volume of trading of the securities of a reporting issuer that they are willing to take the risk that the trading price will not fall (or be less than the discounted trading price they acquired those discounted securities from the reporting issuer).

Why is this type of practice illegal and/or abusive?

- First, to the extent the Hedge Fund Investor sells short or resells out of existing holdings 100 shares into the market through the TSX <u>*prior to*</u> public disclosure of the special warrant transaction.

- Second, the reporting issuer, the dealer and the Hedge Fund Investor have arguably participated in an illegal distribution of securities to investors in the secondary market without providing those investors with a prospectus.

- The Hedge Fund Investor is practically acting as an "underwriter". It is simply acting as a conduit/intermediary to investors in the secondary market. It has not purchased 100 special warrants (the economic equivalent of 100 common shares) with investment intent; rather it has purchased a 100 special warrants "with a view to distribution" of another 100 common shares into the market, with a view to monetizing the 15% spread. The 15% spread is essentially the commission or fee for facilitating a financing into the secondary market. See the definition of "underwriter" in s. 1 of the Ontario *Securities Act*.

- This is a form of "backdoor underwriting" and undermines the integrity of the closed system because it is an "end run" around the resale restrictions.

Appendix C – Self Certification Form

Self-certification is permitted in the United Kingdom under *The Financial Services and Markets Act (Financial Promotion) Order 2005.* The form of Statement For Self-Certified Sophisticated Investor is set out below and is available on the following link https://www.fjpinvestment.co.uk/appendix-b/.

Statement For Self-Certified Sophisticated Investor
[United Kingdom]

I declare that I am a self-certified sophisticated investor for the purposes of the restriction on promotion of speculative illiquid securities. I understand that this means:

i. I can receive promotional communications made by a person who is authorised by the Financial Conduct Authority which relate to investment activity in speculative illiquid securities;

ii. the investments to which the promotions will relate may expose me to a significant risk of losing all of the property invested.

I am a self-certified sophisticated investor because at least one of the following applies:

(a) I am a member of a network or syndicate of business angels and have been so for at least the last six months prior to the date below;

(b) I have made more than one investment in an unlisted company in the two years prior to the date below;

(c) I am working, or have worked in the two years prior to the date below, in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises;

(d) I am currently, or have been in the two years prior to the date below, a director of a company with an annual turnover of at least £1 million.

I accept that the investments to which the promotions will relate may expose me to a significant risk of losing all of the money or other property invested. I am aware that it is open to me seek advice from someone who specialises in advising on speculative illiquid securities.