

Exempt Market Dealer Sales Practices

Adam Hillier
Senior Regulatory Analyst

Matias Pendola
Team Lead



Agenda

- 1 Fundamental sales practices obligations**
- 2 Information disclosure – key principles**
- 3 Issues we see – misinformation**
- 4 Delivery of offering document information**
- 5 Disclosure of key information in offering documentation**
- 6 Regulatory provisions, guidance and CSA decisions**



Fundamental sales practices obligations

- Duty to deal fairly, honestly and in good faith
- KYP/KYC/suitability – extension of duty of care
- CSA decisions – three stage process
 - Know the product
 - Determine if product is suitable for client
 - Disclosure of relevant information to client



Information disclosure – key principles

- Presentation focus – information disclosure
- Client must be able to make an informed decision
- Exempt market dealer
 - Must ensure client is aware of key product features and risks
 - Must disclose negative factors as well as positive factors
 - Must not provide “misinformation” – inaccurate, misleading or unsubstantiated information

Information disclosure – key principles

- Nature and extent of disclosure depends on circumstances
 - Knowledge and sophistication of client (KYC)
 - Client’s reliance on dealer (duty of care)
- Go beyond “flow of documents”
 - Offering memorandum and other issuer information
 - Risk acknowledgements
- Ensure client understands key product features/risks
- Disclosure cannot remedy KYP/KYC/suitability deficiencies



Issues we see

- Inadequate disclosure of key product features/risks
- Inadequate dealer conflicts of interest disclosure
- Misinformation about
 - The exempt market
 - Other products and competitors
 - Fees and costs

Misinformation – the exempt market

- Blanket statements about exempt market products
 - Low or no volatility versus publicly traded securities
 - Low or no correlation to publicly traded securities
 - Lower risk than publicly traded securities
 - Stating that stock markets have high volatility, low returns and poor performance
- Institutional investments in private equity and alternative assets
 - No disclosure of significant differences in circumstances and investment objectives versus individual investors

Misinformation – the exempt market

- Underselling the risk of the exempt market
- Concerns that investors do not fully understand the risks as observed in suitability recommendation notes
 - Unsubstantiated reduction of overall portfolio risk
 - Preserve investor wealth
 - Provide steady growth
 - Exempt market is not tied to the public markets and will help preserve capital

Misinformation – competitors and other products

- Impugning capital market sectors and competitors
- Issues observed with EMD marketing include stating or implying that
 - Competitors place their profits ahead of investor interests
 - Certain investment industry sectors are designed to mislead at the expense of investors
 - Most mutual funds are not worth purchasing
 - Money managers keep investors' money in losing investments

Misinformation – fees and costs

- Issuer commission payments
 - Disclose prior to trade
 - Explain potential impact on client's investment
- Unbalanced and misleading sales practices
 - Stating that issuer fees do not impact investors
 - Comparison of fees charged to mutual funds without including front-end charges associated with exempt market products

Delivery of offering document information

- Disclosure applies to all types of issuers and offering documents
 - Prior to or when the client agrees to purchase the security
- Tailor message based on client's sophistication and relationship with the firm
- Disclose and highlight all relevant key information
 - Best practice – product factsheet
- Obtain information from initial and ongoing know-your-product assessment and provide training to dealing representatives
 - Update to reflect material changes

Key information – compensation and fees

Fees – exempt market dealer	Fees – parties related to issuer	Other disclosures
<ul style="list-style-type: none">• Trade-related<ul style="list-style-type: none">• commissions• DSCs and trailer fees• Due diligence fees• Listing fees• Carried interest• Reimbursements• Marketing sponsorships	<ul style="list-style-type: none">• Offering fees• Debt raising fees• Management, operating and consulting fees• Carried interest• Performance fees• Fees related to sale or purchase of assets	<ul style="list-style-type: none">• General impact of fees on investment returns• Transaction fees• High water mark• Management fees that are unrelated to net asset value• Discretionary ability to pay additional fees

Key information – redemption and re-sale restrictions

- Redemption restrictions
 - Penalties
 - Maximum annual or monthly limits
 - Discretion to cancel or suspend indefinitely
- Outstanding and pending redemptions
 - Prior redemption suspensions
- Redemption notes
 - Registered plan implications

Key information – conflicts of interest

- Relationship between EMD and related or connected issuer
 - Price or fee differential when EMD has ownership stake in issuer or receives securities as part of offering
 - EMD or related parties manage the issuer
- Relationship between issuer and related parties
 - Price or fee differential when related parties are issued securities as part of offering
 - Manager, general partner, trustee or custodian of the issuer
 - Entities in charge of underlying business operations

Key information – related party transactions

- Asset purchases from related parties at marked-up prices
 - Relevant purchase and sale history
- Investing a material amount into a related party
- Loans from/to another related issuer or party
- Raising proceeds to
 - Cover accrued fees
 - Purchase securities from related parties



Key information – issuer structure

- Non-voting or subordinated securities
- Dilution risk
 - Potential issuance of senior securities
 - Existence of unexercised warrants or options
- Governance
 - Who holds a controlling interest
 - Lack of independent oversight – directors or trustees
 - Investor ability to influence issuer governance
- Prior penalties, sanctions and bankruptcy

Key information – valuation

- Offering price
 - Not based on net asset value or net book value
 - Based on future issuer projections
- Basis and frequency of net asset valuation
 - Lack of independent valuation
 - Manager discretion

Key information – basis for investor returns

- Expected return – growth vs. income
 - Projected returns based on tax credits (e.g. flow-through products)
- Return structure
 - Hurdle rates and carried interest
 - Equity returns are capped
 - Issuer with tranching securities
- Prior performance
 - Issuer for continuous or multiple offerings
 - Management with other projects or related issuers

Key information – material risks

Material risks to the issuer's business plan

- | | | |
|--|---|--|
| <ul style="list-style-type: none">• Blind pools• Manager's full investment discretion• Use of leverage• Litigation risk• Market risk | <ul style="list-style-type: none">• Interest rate risk• Credit risk• Cash flow risk• Exit risk• Foreign exchange risk• Foreign investment risk | <ul style="list-style-type: none">• Limitations to issuer insurance• Key commercial arrangements• Cash call risk |
|--|---|--|

Regulatory provisions, guidance and CSA decisions

- Sections 75.2(1), 92(4.1), 100(2), 206 and 209.1 of the *Securities Act* (Alberta)
- Sections 11.5, 13.2, 13.3, 13.4, 14.2 and 14.2.1 of National Instrument 31-103
- Sections 1.1 and 1.2 of National Instrument 33-105
- Section 2.9 of National Instrument 45-106
- ASC Notice 33-705, CSA Staff Notice 31-334 and CSA Staff Notice 31-336

Regulatory provisions, guidance and CSA decisions

- *Re Rustulka* (2020 ABASC 93)
- *Re Lamoureux* (2001 LNAABASC 433)
- *Re Daubney* (2008 LNONOSC 338)
- *Re Sterling Grace & Co.* (2014 LNONOSC 558)
- *Re Foresight Capital Corp.* (2007 BCSECCOM 101)

Thank You

