Risk of Non-Compliance, Financial Fraud, and Money Laundering in the Canadian Exempt Market

Research Project for Emerging Issues / Advanced Topics Course

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1. EXECUTIVE SUMMARY

The exempt market is a section of the Canadian capital market in which securities can be traded without the protections associated with a prospectus. The securities regulators permitted the exemptions as they acknowledge that some purchasers are sophisticated enough that the protection is not necessary. Specific conditions are set out in the available prospectus exemptions and investors must satisfy these conditions in order to purchase securities without a prospectus. The six commonly used prospectus exemptions include: Accredited Investor; Minimum Amount Investment; Private Issuers; Family, Friends, and Business Associates; Offering Memorandum; and Rights Offering. Equity crowdfunding is also gaining popularity as an emerging fundraising approach. To ensure proper investor protection, several provincial jurisdictions have recently adopted prospectus exemptions for trading of securities through equity crowdfunding.

The size of the exempt market is significant. Based on the reports released by various provincial securities commissions, the amount of funds raised through prospectus exemptions in 2014 was $121 billion in the province of Ontario and $16.5 billion in the province of Alberta. Between 2010 and 2013, the amount of funds raised in the province of British Columbia through the exempt market has surpassed that in the public securities market.

Despite the significant size of this market sector, few papers are available in the Investigative and Forensic Accounting profession to study the exempt market due to its private nature. This paper therefore aims to familiarize the Investigative and Forensic Accountants ("IFAs") who are interested in working in the Canadian exempt market with an overview of its characteristics, the applicable regulations, and the types of participants

involved. The risks of non-compliance, financial fraud, and money laundering associated with the trading of the exempt securities, and the common red flags, are also discussed.

The study of three notable legal proceedings presented in this paper reveals that unregistered trading, illegal distribution, and fraud are some common misconducts observed in the exempt market. Incompetence of the securities issuer and its dealers is one of the major issues associated with the risk of non-compliance. Their lack of knowledge in the regulations associated with exempt securities could result in accepting investments from investors that are not qualified for any prospectus exemptions, which could expose these investors to unmanageable financial risks. The risk of non-compliance can also couple with fraud, which usually involves misrepresentation of financial information or misappropriation of investor funds for other purposes or for personal enrichment. The financial frauds often lead to substantial financial loss to the investors.

This paper also studies the risk of money laundering associated with equity crowdfunding. Through the use of the Internet, crowdfunding enables a project or a business to fundraise from backers around the world through an online funding platform. However, the anonymous nature of the Internet could also make crowdfunding vulnerable to the risk of money laundering and terrorist financing. Organized crime groups or terrorists could exploit crowdfunding as a layering and comingling mechanism by masking unlawful activities with crowdfunding campaigns to businesses or projects that appear legitimate. The small amount of funds involved in each transaction could also make it more feasible to bypass detection from the financial intelligence unit.

To preserve the integrity of the exempt market as an important alternate avenue of financing, certain safeguards could be implemented to mitigate the risks. Possible

approaches include: obtaining better understanding of the risk and the threats to the Canadian exempt market through nationally harmonized data collection and analysis so that appropriate regulations can be administered; implementing nationwide regulations on crowdfunding; encouraging continuous education to securities issuers, dealers, crowdfunding portals, and investors; and imposing stiffer sanctions for misconducts.

2. INTRODUCTION

2.1. Motivation

The exempt market refers to a section of Canada's capital market where "securities can be sold without the protections associated with a prospectus"[1]. Although less well-known, the exempt market forms an important part of the Canadian's capital market. The annual dollars of capital raised in the exempt market in the past several years has been comparable to the funds raised through public offerings and the stock exchange.

Despite the sizeable amount of capital raised in the exempt market each year, few papers are available in the Investigative and Forensic Accounting profession to study this capital market sector. This motivates the writing of this research paper.

2.2. Objectives and Scope

This paper aims to provide Investigative and Forensic Accountants ("IFAs") who are interested in working in the exempt market sector with an overview of this unique section of the capital market. Regulatory legal framework relevant to the work of the IFAs will be studied. As well, the common misconducts observed in the exempt market, and the red flags that may suggest non-compliance of regulations or illegal activities will be illustrated. The increase of awareness could ultimately foster a sustainable and healthy economy for companies and businesses of all sizes.

This paper focuses on the Canadian exempt market and the relevant regulations. Sources of information for this research will include: publicly available information from the various securities commissions; publications by the other financial market regulators

[1] (Ontario Securities Commission, 2017b)

such as the Canadian Securities Administrators and FINTRAC; as well as articles, research papers, and journals published by the exempt market watchdogs. Legal proceedings that will be studied in this paper are cases arise from the Canadian jurisdictions.

2.3. Research Paper Organization

The organization of this paper is as follows:

Chapter 3. The Canadian Exempt Market

This chapter describes the Canadian exempt market, including the rationale of its existence, its size, and the key players involved. Commonly used prospectus exemptions are also studied.

Chapter 4. Risk of Non-Compliance and Financial Fraud

This chapter addresses the deficiencies often observed in the exempt market: unregistered trading, illegal distribution, and fraud. Three legal proceedings are studied to illustrate the risks of non-compliance and financial fraud in the exempt market.

Chapter 5. Risk of Money Laundering

This chapter discusses the risks of money laundering and terrorist financing in the exempt market; and in particular, the risk associated with equity crowdfunding. The common techniques of how organized crime groups could exploit crowdfunding portals for money laundering and terrorist financing purposes are studied.

Chapter 6. Implications for IFA in the Exempt Market

This chapter discusses the significance of the findings to the IFAs in understanding the risk of non-compliance, financial fraud, and money laundering in the Canadian exempt market.

Chapter 7. Conclusion

This chapter summarizes the findings in this paper. Suggestions on the appropriate safeguards and improvements on the regulations to mitigate the risks of non-compliance and illegal activities are also discussed.

3. THE CANADIAN EXEMPT MARKET

3.1. Background

In Canada, a person or a company that intends to distribute any securities to the public is generally required to first prepare and file a prospectus with the respective provincial securities commission and obtain an approval. The "person" in this context refers to individual, partnership, trust, syndicate, etc., and the securities could involve a wide variety of financial instruments including debt, equity, asset-backed securities, investment funds and derivatives. The prospectus is a comprehensive document that contains a full disclosure on the specific details of the issuer of the securities, including the business of the issuer, its affairs, management, and the securities being offered. "Full, true and plain disclosure of all material facts relating to the securities issued or proposed to be distributed" [2] must be provided in the prospectus, as this is required by the Ontario *Securities Act*, the BC *Securities Act*, or other applicable securities statutes. This prospectus requirement is a key regulatory requirement to protect investors' interests. It ensures the potential investors are provided with the relevant information about the issuer so that they can properly assess the risks of the investment and make informed investment decisions. For the securities issuer, however, raising capital under the prospectus requirement could be a lengthy and costly process.

The securities regulators acknowledge that there are circumstances where the purchasers of securities are sophisticated enough that they would not require the protection of a prospectus. With that acknowledgement and to maintain an appropriate level of investor protection, the securities regulators set out exemptions to the prospectus

[2] Securities Act, R.S.O. 1990, c. S.5, s 56(1); and Securities Act, RSBC 1996, c. 418, s 63(1)

requirement for issuers to offer securities to qualified investors without a prospectus when certain conditions are met. This arrangement is known as prospectus exemptions. The exemptions allow for a significant reduction in the cost of financing when the expensive preparation of a full-disclosure prospectus can be waived. This facilitates an alternative avenue for businesses at different stages of development, especially for start-ups and small and medium-sized enterprises (SMEs), to raise crucial capital in a cost-effective manner from qualified investors who are interested in growing their assets through higher-risk capital.

3.2. Size of the Exempt Market

The exempt market forms a substantial part of the Canadian capital market despite that it is relatively inconspicuous when compared to public offerings and stock exchanges.

The data collected by the various securities commissions could provide some insights about the capitalization of the Canadian exempt market. The study of the market is on the data collected from the jurisdictions of which their financial centres are ranked first 100 in the latest Global Financial Centres Index ("GFCI") compiled by the commercial think-tank Z/Yen Group[3]. These financial centres are: Toronto (Ontario), ranks 10th; Montreal (Quebec), ranks 14th; Vancouver (British Columbia), ranks 17th; and Calgary (Alberta) ranks 49th. Of the four financial centres studied, only the securities commissions in Ontario, British Columbia, and Alberta publish annual reports on the exempt market activities in its jurisdictions. As such, the analysis is focused on these three markets.

The analysis must be reviewed with the understanding that the data may not capture a complete view of all of the activities that take place in the exempt market. In particular,

[3] (Z/Yen Group, 2017)

the securities regulators collected the exempt market data through the Form 45-106F1 *Report of Exempt Distributions,* i.e. the exempt distribution reports, filed by the issuers. However, only certain types of prospectus exemptions require filings, which suggests that omission of unreported activities is possible. Furthermore, the data collection and reporting processes are not harmonized across provinces and the timing to release analytical results varies among different securities commissions. This imposes some challenges in comparing the exempt market activities across provinces. Nonetheless, the available data would provide valuable knowledge about the activities in the exempt market.

According to the report *Exempt Market Activity in Ontario* released by the Ontario Securities Commissions ("OSC") [4], the total amount of funds raised in Ontario through prospectus exemptions was $121 billion in 2014. Of that, 67% or $80 billion was raised by investment companies and funds, and the remaining 33% or $41 billion by non-investment fund issuers. In comparison to prior years, $45 billion was raised by non-investment fund issuers in 2013 and $43 billion in 2012. No data is available for the aggregate amount of funds raised by investment and non-investment issuers in those years.

The British Columbia Securities Commission ("BCSC") published the *Private Placement Review Program* report in June 2014[5], which summarized the exempt market activities in the province of British Columbia ("BC") between 2010 and 2013. Data available showed that the amount of funds raised in BC's exempt market has surpassed that in the public market. In particular, $7 billion was raised in the public market in 2012, compared to $20 billion in the exempt market. In 2013, $6 billion was raised from the public market, whereas $23 billion from the exempt market.

[4] (Ontario Securities Commission, 2014)
[5] (British Columbia Securities Commissions, 2014)

The 2016 report of *The Alberta Capital Market* prepared by the Alberta Securities Commissions ("ASC") [6] reported an aggregate amount of $27.6 billion raised in Alberta in 2012, with $13.9 billion through prospectus exemptions and $13.7 billion in the Toronto Stock Exchange ("TSX") and the TSX Venture Exchange ("TSXV"). The total amount of capital raised dropped to $21.3 billion in 2013, of which $10.8 billion was raised through the exempt market and $10.6 billion in TSX and TSXV. The total amount of financing reached its peak among these three years in 2014, in which $29.6 billion of capital was raised. Of that, about $16.5 billion was raised through the exempt market and $13.1 billion from the stock exchange. Table 1 summarizes these findings on the capital raised in the exempt markets of the three provinces between 2012 and 2014.

These data reveal the significance of the exempt market in the Canadian capital market. With billions of dollars raised in the market each year, robust regulatory enforcement is essential to protect investor interests and to foster sustainable economy.

	Provinces*		
Year	Ontario**	BC	Alberta
2012	> $43 billion	$20 billion	$13.9 billion
2013	> $45 billion	$23 billion	$10.8 billion
2014	$121 billion	n/a	$16.5 billion

* The amount of capital raised in the exempt market reported in Ontario and BC is by the amount raised in the province, whereas in Alberta, it is by the amount raised by issuers with principal jurisdiction in Alberta.

** Only capital raised by non-investment fund issuers in 2012 and 2013 are summarized above as the data for the total amount of fund raised in Ontario for those two years are not available.

Table 1. Summary of Capital Raised in the Exempt Markets in Ontario, BC, and Alberta between 2012-2014

[6] (Albert Securities Commission, 2016)

3.3. Key Players in the Exempt Market

In general, there are three types of parties involved in the exempt market: the issuer of the securities; the investor that provides the funding; and if applicable, the intermediary between the issuer and the investor that facilitates a transaction.

3.3.1. Issuers

Despite their stages of development, both reporting issuers (i.e. listed companies) and non-reporting issuers (i.e. private businesses) could participate in the exempt market. The securities distributed for capital financing, however, must rely on at least one available prospectus exemptions. Otherwise the distribution is prohibited and rendered illegal. While the trading of securities generally requires registration with the respective securities commissions, exemptions could also be available for issuers that are not engaging in the business of trading in or advising on securities. Details regarding the available prospectus exemptions and registration exemptions will be discussed in Section 3.4.2 and 3.4.3, respectively.

The OSC has provided some insights about the demographic of the issuers in the exempt market in its 2014 report[7]. Approximately 75% of the issuers that raised capital in Ontario in 2014 were non-reporting issuers, with a majority of them in the financial sector. Outside of this sector, the energy and materials group was the most active group of non-financial issuers by the amount raised, followed by the consumer groups and then the real estate groups. With respect to the types of securities distributed, the amount of capital raised through debt offerings was found to be larger in size than that in the equity offerings, although the equity securities represent about two thirds of all purchases and filings.

[7] (Ontario Securities Commission, 2014), *op. cit.*

In raising capital through prospectus exemptions, the issuer has the responsibility to determine whether an exemption is available. While the investors are likely to be the only party that know whether certain facts exist to qualify for the prospectus exemptions, the onus remains with the issuers to collect sufficient evidence to form a reasonable belief that the stated facts are true. Failure to do so would violate the securities laws and lead to possible enforcement actions.

3.3.2. Investors

Investors tend to have investment interests in certain types of businesses at a particular stage of development. Figure 1 identifies some common groups of investors and their typical participation in businesses categorized by different stage of development.

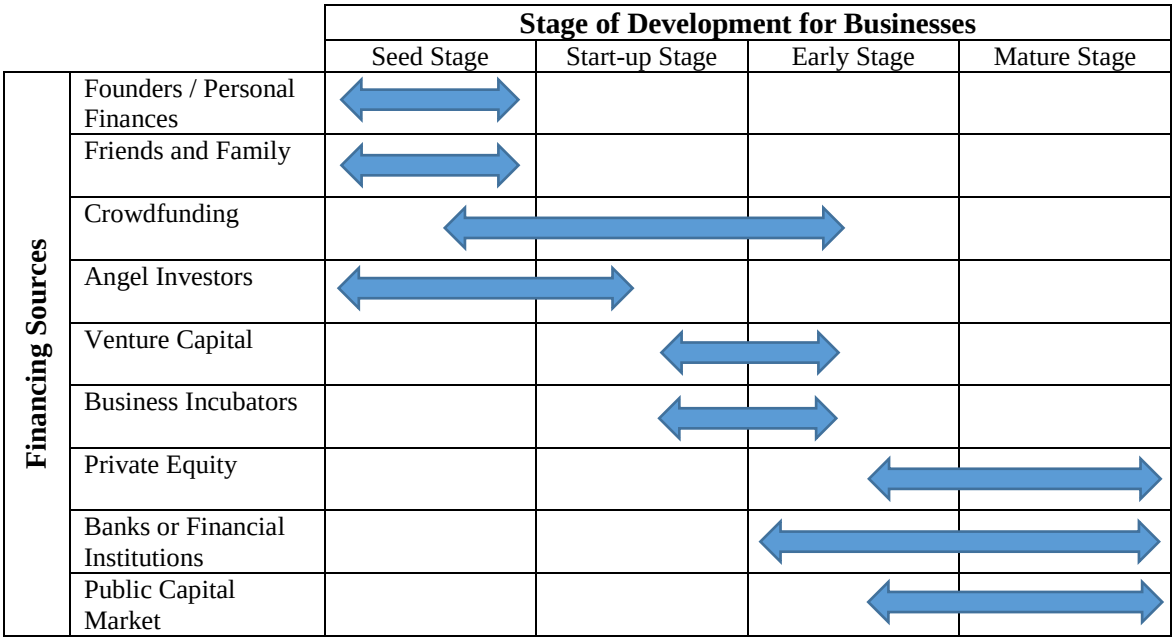

Figure 1. Source of Financing for Businesses at Different Stages of Development

These investors identified in Figure 1 could invest in companies and businesses through the exempt market so long as an available prospectus exemption is available. For

example, founders, friends and family, and angel investors can invest in start-up companies or SMEs through the prospectus exemptions for Accredited Investor or Family, Friends, and Business Associates. The exemption for Equity Crowdfunding is also available in some provinces. Small group of qualified investors, on the other hand, could invest in reporting companies through private placement by relying on prospectus exemptions such as Accredited Investor or Minimum Amount Investment.

Investments in the exempt market are typically exposed to higher investment risk as disclosure of the securities offered is minimal if not unavailable. Furthermore, as the securities purchased are not originally qualified by a prospectus, the investors are not permitted to sell the purchased securities to other persons unless the resale relies on another prospectus exemptions, or unless specific conditions set out in the "resale rules" described in the National Instrument 45-102 *Resale Restrictions* are met. As a general reference, securities of reporting issuers that are purchased through prospectus exemptions are subject to a four-month hold period before they can be resold without relying on a prospectus exemptions. Securities of non-reporting issuers, on the other hand, could not be resold until the issuer becomes a reporting issuer or unless resold through another prospectus exemption. In addition to that, there may exist no established secondary market for the securities of the non-reporting issuers, which further limits the ability for resale.

3.3.3. Intermediaries

The primary role of the intermediaries in the exempt market is to match securities issuers to qualified investors. They may act as dealers or underwriters for securities that are offered under certain prospectus exemptions, or act as dealers for any securities that are sold to clients qualified as purchasers of exempt securities.

Firms that trade and provide advice to clients on the securities traded in the exempt market must register as an Exempt Market Dealer ("EMD") with the respective securities commissions. Sales persons who work at the EMD firms selling exempt securities must also register as Dealing Representatives. Their conducts are governed by National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrants Obligations*.

The regulations further require the EMD firms to register a designated Chief Compliance Officer ("CCO") to manage and promote the day-to-day compliance of the firm in accordance with the securities law; and the firm must also designate an Ultimate Designated Person ("UDP"), usually the chief executive officer or sole proprietor of the firm, to ensure their business' overall compliance with securities law.

The education requirements for the individuals working in the EMD firms vary. While there are no specific education requirements for the UDP, the CCO and the Dealing Representatives must complete any one of: Canadian Securities Course; Exempt Market Products Exam; Chartered Financial Analyst (CFA) Charter with 12 months of relevant securities industry experience within the 36 months before registration; or Chartered Investment Manager Designation with 48 months of relevant investment management experience.

EMDs are different from full service investment dealers. Firstly, EMDs are restricted to trade for clients in the exempt market only, whereas full service investment dealers could trade for all types of clients including those participated in the exempt market. Secondly, full service investment dealers must be a member of the self-regulatory

organization, the Investment Regulatory Organization of Canada (IIROC) [8], but there is no similar membership requirement for EMDs.

The online funding portals that trade eligible securities in equity crowdfunding is an emerging intermediary in the exempt market. Currently there are two sets of regulations available in Canada that govern the equity crowdfunding activities. They are the *Multilateral CSA Notice 45-316 Start-up Crowdfunding Registration and Prospectus Exemptions* ("MCSAN 45-316") and the *Multilateral Instrument 45-108 Crowdfunding* ("MI 45-108"). Seven jurisdictions in Canada have adopted either one of these Multilateral Instruments, or both, to permit equity crowdfunding. These provinces are BC, Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick, and Nova Scotia. Details of these regulations will be described in Section 3.4.2.

In general, funding portals that rely on MI 45-108 must be registered as an investment dealer, EMD, or restricted dealer. Those that rely on MCSAN 45-316, on the contrary, could be operated by registered investment dealers or EMDs, or by persons relying on the start-up registration exemptions if certain conditions are met. Restricted dealers and those that rely on the registration exemptions are not permitted to provide investment advice to the purchasers with respect to the eligible securities; nor are they permitted to receive a commission or fee from the purchasers.

3.4. Securities Regulations in the Exempt Market

In Canada, securities regulations in each province and territory are independently governed by the corresponding provincial or territorial governments. The 10 provinces and 3

[8] IIROC is the nationwide self-regulatory organization that sets high-quality regulatory and investment industry standards to oversee all investment dealers and trading activity on debt and equity marketplaces in Canada. (IIROC, 2017).

territories each enact its own securities legislations and establish its own securities regulatory authority. There is no securities law nor regulatory authority at the Federal level.

In Ontario, for example, the provincial government enacted the *Securities Act (Ontario)* to govern the securities industry and the trading of securities in the province. An independent Crown corporation, the Ontario Securities Commission ("OSC"), is set up as the regulatory authority. Apart from regulating the capital markets in Ontario, the Commission is also granted rule-making authority by the *Securities Act (Ontario)* to set out more detailed regulatory requirements. These rules that are created under the *Securities Act (Ontario)* are legally binding. Violators of the rules could be subjected to enforcement action.

To coordinate and harmonize securities regulations across Canada, the provincial and territorial regulators together founded the Canadian Securities Administrators ("CSA"). The CSA provides a platform for the regulators to design policies and regulations that are consistent across the country to streamline the regulatory processes and to, ultimately, facilitate a smooth operation of the Canadian securities industry. In general, rules that are adopted by all jurisdictions are identified by the name "National Instrument". Those adopted by some but not all jurisdictions are identified by the term "Multilateral Instrument". Each jurisdiction incorporates the National Instruments and Multilateral Instruments in its own securities statutes and enforces the rules through the statutes accordingly.

A "passport" regulatory system[9] was introduced in 2004 in response to the regulation harmonization initiative. Under this system, market participants could enjoy

[9] (Canadian Securities Administrators, 2004)

automatic access to the capital markets in another Canadian jurisdiction by corresponding only with its principal regulator and complying with one set of harmonized laws. This is achieved either by mutual recognition of regulations among participating jurisdictions or by legal delegation of decision-making powers by the participating jurisdiction to the primary jurisdiction. The prospectus and registration exemptions are one of the regulations that is recognized by this passport system.

3.4.1. Scope of Securities Law

Securities laws are usually triggered when a distribution of securities is involved. The definitions of what constitute a "distribution" and what is a "security" must first be understood in order to comprehend when certain registration and prospectus requirements would apply.

A "distribution" is defined in Section 1(1) of the *Securities Act (Ontario)* as a "trade in securities of an issuer that have not been previously issued", in which a "trade" means "any sale or disposition of a security for valuation considerations" and also includes "any act, advertisement, solicitation, conduct, or negotiation directly or indirectly in furtherance of any the foregoing". The definitions for the terms are the same in other Canadian jurisdictions.

While the general public often regard "securities" as only bonds, debentures, notes, shares, etc., the definition of "securities" provided in the securities statutes has a much broader definition. In particular, it also includes, but is not limited to, "any document, instrument, or writing commonly known as security"; "any document constituting evidence of an option, subscription or other interest in or to a security"; and "any investment

contract". The Supreme Court of Canada further adopted the definition of an "investment contract" that constitutes a "security" in the leading case law *Pacific Coast Coin Exchange of Canada et al. v. Ontario (Securities Commission)*[10]. Two tests, namely, the "common enterprise test" and the "risk capital test", are used to determine the existence and creation of an investment contract, respectively. Under the "common enterprise test", an investment contract exists if the following three factors are present:

- a person invested his money;
- in a common enterprise;
- with the expectation of profit solely from the efforts of the promoter or a third party.

According to the "risk capital test", an investment contract is created when:

- an offeree (i.e. investor) furnishes initial value (i.e. an investment) to an offeror (i.e. an issuer);
- a portion of this initial value is subjected to the risks of the enterprise;
- the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrued to the offeree as a result of the operation of the enterprise; and
- the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

The broad definition of the term "security" gives rise to a wide scope of application of the securities legislation, and hence affects the context when the prospectus and registration requirements become applicable.

[10] (*Pacific Coast Coin Exchange of Canada et al. v. Ontario*, 1978)

3.4.2. Prospectus Exemptions

Securities distributed under the prospectus exemptions are mainly governed by the National Instrument 45-106 *Prospectus Exemptions* ("NI 45-106") and its *companion policy*. The National Instruments is legally binding, but the companion policy does not have the force of law as it simply provides guidance on the interpretation of the National Instrument. NI 45-106 sets out the circumstances in which the investors can purchase or sell securities without a prospectus and/or without the assistance of a registrant. As mentioned previously, the regulatory rules set out in the National Instruments are enforced through the respective securities statutes in the various jurisdictions. The adoption and modifications of the rules are at the discretion of the provincial or territorial jurisdictions and hence the requirements associated with a particular prospectus exemption could be different from one jurisdiction to another.

Included in NI 45-106 are six commonly used capital raising prospectus exemptions: Accredited Investor; Minimum Amount Investment; Private Issuers; Family, Friends, and Business Associates; Offering Memorandum; and Rights Offering. Each prospectus exemption has its own set of conditions and filing requirements. Some exemptions require no filing; and if required, the filing with the respective securities commissions is usually done subsequent to the distribution with no pre-approval required. Details regarding the key conditions and filing obligations for the six commonly used prospectus exemptions available under NI 45-106 as adopted by the province of Ontario are summarized in Appendix A. The regulatory details in the province of Ontario are illustrated as Ontario is the jurisdiction of Canadian's largest financial centre and the Toronto Stock Exchange ("TSX"). Among the available exemptions, the Accredited

Investor exemption was the exemption that issuers most relied on in Ontario in 2014 [11], followed by the Minimum Amount Investment exemption.

The prospectus exemption for equity crowdfunding was also introduced recently as this emerging capital financing approach gained popularity. Crowdfunding refers to a method of financing for a project or a business through small contributions on an online funding platform. This financing method used to be for specific projects that do not generally involve the issuance of securities. Equity crowdfunding subsequently emerged to enable businesses, particularly start-ups and SMEs, to raise capital from investors by issuing equity of the company in return.

As equity crowdfunding involves the issuance of the securities, it becomes subject to the securities law. In May 2015, the provinces of BC, Saskatchewan, Manitoba, Quebec, New Brunswick and Nova Scotia together adopted the *Multilateral CSA Notice 45-316 Start-up Crowdfunding Registration and Prospectus Exemptions*. Subsequently in January 2016, Ontario adopted the *Multilateral Instrument 45-108 Crowdfunding*, together with the mentioned provinces except BC. The regulations are not nationally harmonized. The remaining provinces and territories: Alberta, Prince Edward Island, Newfoundland and Labrador, Nunavut, Northwest Territories, and Yukon Territory, adopt no prospectus exemptions for equity crowdfunding. Details of the two equity crowdfunding regulations that are currently in effect are illustrated in Appendix B. A comparison chart on which prospectus exemptions are in effect in the corresponding Canadian jurisdictions is provided in Appendix C.

[11] (Ontario Securities Commission, 2014), *op. cit.*

3.4.3. Registration Exemptions

The registration requirement is triggered when a person, a company, or an online portal is engaged in trading and advising in securities for business purposes. While the definition of the term "trade" under the *Securities Act (Ontario)*[12] is provided above, an "adviser" within the context of securities legislation would mean a person or company "engaging in or holding himself, herself or itself out as engaging in the business of advising others as to the investing in or the buying or selling of securities". Depending on the type of activities the person or the company intends to carry out, these parties would be required to register as a dealer, advisor or investment fund manager. Persons, companies, or online portals that are registered with the securities commission to trade and/or to advise in securities are generally known as the registrants.

In other words, issuers that are not engaged in trading and advising in securities for business purposes could be exempted from the dealer or advisor registration requirement. Furthermore, since there is generally no requirement for issuers to distribute securities through a registrant, it is not uncommon for eligible issuers to raise capital on their own without engaging any intermediaries to minimize the cost of financing. Oftentimes, a corresponding exemption to the prospectus requirement is available for the registration requirement exemption. In the case of equity crowdfunding, however, the registration exemption is only available for funding portals relying on MSCAN 45-316.

3.4.4. Law Enforcement

The securities statutes are enforced by the corresponding securities regulatory authorities. In Ontario, for example, the Enforcement office of OSC enforces compliances with the

[12] Securities Act, R.S.O. 1990, c. S.5, s 1(1)

provisions of the *Securities Act (Ontario)*. It also forms partnerships with other law enforcement units to facilitate investigations across jurisdictions. More serious cases are oftentimes referred to the Joint Serious Offences Team ("JSOT"), which is an enforcement partnership between the OSC, the RCMP Financial Crime program, and the Ontario Provincial Police Anti-Rackets Branch. The decision of referral is usually determined by the sophistication of the planning and the scope of fraud. JSOT is responsible for investigating and prosecuting serious violations of law using provisions of the *Securities Act (Ontario)* and *Criminal Code.* Similar law enforcement structure is implemented in BC, of which the Enforcement Division the BCSC is responsible for the enforcement of the *Securities Act (BC),* and a criminal investigation team to investigate more serious securities offences. IFAs can be found in both enforcement units and the criminal investigation teams.

Cases brought before the tribunal by the securities commissions are civil proceedings. Civil standard of proof on a balance of probabilities is required; and the only sanctions available under the securities acts are administrative penalties or monetary compensations. The cases brought by JSOT before the Ontario Court of Justice or by BCSC criminal investigation team to the Crown Counsel, on the contrary, are criminal prosecutions. Criminal standard of proof beyond reasonable doubt is required. Harsher sanctions including jail sentences and fines available in the *Criminal Code* could be imposed to reflect the principles of deterrence.

4. RISK OF NON-COMPLIANCE AND FINANCIAL FRAUD

The governance and requirements on exempt market securities tend to be less stringent when compared to that on the securities offered under a prospectus. Unregistered trading, illegal distribution, and fraud are some common examples of misconducts found in the exempt market.

Unregistered trading involves the failure of issuers or intermediaries in registering or filing with the respective securities commissions in distributing or trading securities. It could also involve their failure to comply with conditions of registration exemption. The non-compliance is sometimes due to the inadequate knowledge of the issuers or intermediaries in the prospectus and registration exemptions; deficiencies in record-keeping on the distribution of securities through prospectus exemptions; or engagement of incompetent advisors that are not expert in the securities industry or the exempt market.

Illegal distribution arises when issuers or intermediaries sell or attempt to sell securities to investors without complying with the securities law registrations, trading, or disclosure requirements. As defined in the *Securities Act (Ontario)*, for example, the act of distribution arises when there is "a trade in securities of an issuer that have not been previously issued"[13]. In the case of exempt market securities, illegal distribution often involves distribution of securities that does not qualify for any prospectus exemptions. Sometimes, illegal distribution may also constitute fraud.

Fraud comprises of two elements: the intention to deceit and dishonest deprivation. It is often perpetrated through misleading investors with inaccurate or false financial information, inducing investments by promoting unrealistic returns, or using the investor

[13] Ibid

funds for any purpose other than the intended business, including personal enrichment. The type of fraud that is studied in this paper is primary on fraud involving securities that directly affect individual retail investors.

The Enforcement Report of 2016 published by the CSA[14] provided some insights on the securities enforcement in the capital market, the public and exempt sectors as a whole. Members of the CSA together commenced 54 proceedings, involving 72 individuals and 72 companies in 2016. The proceedings were commenced when a CSA member filed a notice of hearing or a statement of allegations. Of the 144 respondents, 57% were involved in the allegation of illegal distribution, and 16% were in fraud. A similar trend was found in 2015, where the CSA members have commenced 108 proceedings, involving 165 individuals and 101 companies. Of the 266 respondents, 46% were alleged to participate in illegal distribution, and 24% were in fraud.

A total of 109 cases were concluded in 2016 with the issuance of a final decision or an approval of a settlement, involving 168 individuals and 94 companies. Of that, 56% of the respondents were concluded to engage in illegal participation, followed by 19% in fraud. In 2015, 145 cases were concluded, involving 233 individuals and 117 companies. 50% were to have found participated in an illegal distribution, and 19% in fraud. As proceedings for the case could carry on into the next year, or beyond, depending on the complexity of the case and the number of respondents involved, the statistics on the proceedings commencement and the conclusion are not directly related to one another and should be studied independently. Despite that, both illegal distributions and fraud continue to be the top two types of offence found in securities misconducts.

[14] (Canadian Securities Administrators, 2016)

Three legal proceedings are studied in this paper to illustrate the risks of non-compliance and financial fraud in the exempt market. The legal proceedings were selected from cases featured in the CSA Enforcement Reports between 2014 and 2016.

4.1. Case study #1 – HRG Healthcare Resource Group Inc.

The legal proceedings of HRG Healthcare Resource Group Inc. ("HRG")[15] commenced by the British Columbia Securities Commission ("BCSC") demonstrates an example of non-compliance of the securities issuers in accordance with the securities law. The issuers, under the directing mind of its management, provided false or misleading statements to the securities commission and participated in illegal distribution.

HRG was an Alberta company that was extra-provincially registered in BC and was a non-reporting issuer (i.e. private company). The company operated a business to develop and commercialize a web-based, bedside medical records and entertainment system for patients in hospital. Between April 2010 and March 2012, HRG distributed over $5.6 million of its securities to 149 investors by relying on the Family, Friends and Business Associates and Accredited Investors prospectus exemptions. Alexander Downie ("Downie"), the director and founder of HRG, and Daniel Mohan ("Mohan"), director and chief executive officer, were involved in the financing. Neither Downie nor Mohan has ever registered to sell securities in BC.

Pursuant to this financing, HRG filed 13 exempt distribution reports ("EDR") with the BCSC for 67 investors. Although the capital raised was used for the intended business, the product was not a success and the company ran out of money before it can further improve the product. As a result, the investors lost all of their investments.

[15] (*Re HRG Healthcare Resource Group*, 2016)

Subsequent investigations conducted by BCSC revealed that about $4.45 million of the capital raised in this financing did not qualify for any prospectus exemptions. This involved the investments from 123 investors (out of 149). Although subscription agreements were available, only 15 of them were completed. Despite that, one agreement was found to contain incorrect information, thus rendered the distribution of securities to this investor illegal. For most of the incomplete agreements, the section that required the investors to indicate the type of prospectus exemption they qualified for was missing. Results of the investigation revealed that HRG has illegally distributed securities to 109 investors who were not qualified for any prospectus exemptions. The investment amount involved was $4.009 million.

Downie and Mohan both actively participated in the financing. Downie introduced 22 investors and Mohan 34 investors to purchase HRG securities, resulting in an aggregate investment of over $2.4 million. However, none of these investors qualified for any prospectus exemption. The conduct of HRG, Mohan, and Downie deprived unsophisticated investors from the protection of a prospectus. Oral testimony and written victim impact statements from the investors evidenced that the financial loss to the investors due to the HRG's failure has been significant.

Findings in the investigation revealed that Downie and Mohan failed to exercise due care in ensuring the subscription agreements were completed prior to the investment. They also failed to establish reasonable belief that the investors were qualified for the prospectus exemptions they relied on for their purchase. For example, no proper inquiry was conducted to verify the investor's financial status in relation to the use of Accredited Investor exemption. No proper due diligence was done either to identify the relationship,

and its nature, of the investor with a director or officer of HRG for the use of Family, Close Friends, and Close Business Associates prospectus exemption.

There were also issues with 10 out of 13 of the EDRs filed by Downie and Mohan on behalf of HRG. Those EDRs, which involved 31 investors, were found to contain false and misleading information where the descriptions of prospectus exemptions were in fact not available to the investors. The EDRs also failed to disclose the payment of $103,530 from HRG to Mohan as commissions for his capital raising efforts. Such disclosure of finder's fee was required by regulations.

Pursuant to the breach of the *Securities Act (BC)*, HRG was ordered to cease trade permanently. Mohan and Downie were also found liable as they "authorize, permit, or acquiesce in the contravention"[16]. No evidence of fraud was found in the case. Each of Mohan and Downie was ordered to pay an administrative penalty of $75,000, to immediately resign from any director or office positions, and to be banned from acting as director or officer and to trade and purchase securities for 7 years. Mohan was also ordered to disgorge to BCSC the $103,530, an amount equal to the commission he received, for his personal enrichment due to the illegal distribution.

4.2. Case study #2 – Rezwealth Financial Services Inc. et al

The legal proceedings of *Rezwealth Financial Services et. al*[17], commenced under the jurisdiction of Ontario by the OSC, demonstrates how a Ponzi scheme could be perpetrated in the exempt market. This is a relatively complex case that involved 9 respondents,

[16] Ibid
[17] (*Re Rezwealth Financial Services Inc.*, 2013)

including 5 individuals and 4 companies. They were found to have engaged in unregistered trading, illegal distribution of securities, and fraud.

Sylvan Blackett ("Blackett"), Willoughby Smith ("Smith"), Pamela Ramoutar ("Pamela"), Justin Ramoutar ("Justin"), and Daniel Tiffin ("Tiffin") were Ontario residents and the individual respondents in this case. Blackett was the director of 2150129 Ontario Inc. ("215 Inc."). Smith was one of the three directors of 1778445 Ontario Inc. ("177 Inc."). Pamela was the director of Rezwealth Financial Services Inc. ("Rezwealth"). Justin, son of Pamela, was the director and treasurer of Rezwealth. Tiffin was the director of Tiffin Financial Corporation ("Tiffin Financial"). All of these corporate respondents were incorporated in Ontario. During the time of the alleged misconducts between August 22, 2006 and December 31, 2009, all parties were either never registered or ceased to be registered with the OSC in any capacity.

The Ponzi scheme was perpetrated through the investment contracts offered by Blackett and Rezwealth. Blackett, personally and through 215 Inc., solicited Ontario residents to engage in foreign exchange trading ("forex trading") by holding himself out as a successful forex trader and claimed that he made good money at it. Two types of investment contracts were offered to investors: the monthly investment agreements with investment returns payable on a monthly basis, and the compound annual agreements with interest compounded and paid at the end of the term along with the principal. The rate of return offered by these agreements was at a fixed rate of 5% to 10% per month, i.e. 60% per annum to 120% per annum. Blackett claimed to the investors that the interest payments were guaranteed and those payments were funded by profits generated through their investments in forex trading. According to the testimonies of the investors, interest

payments were paid on time at least for the first few months, which oftentimes result in additional investments. However, no account statements were ever provided to the investors; and Blackett would not discuss the forex trading business in details.

Smith and 177 Inc., the associates of Blackett and 215 Inc., also solicited Ontario residents to invest in Blackett's investment agreements. Both Smith and 177 Inc. in turn would receive commission payments on investor referral, calculated at 10% of the principal amount invested by the referrals.

Rezwealth, on the other hand, solicited funds from Ontario residents to invest with Blackett and other forex traders or in other ventures. The investment products offered by Rezwealth evolved over time from pooling investor funds for forex trading to purchasing of promissory notes or debentures. Investors were told that their funds would be used for forex trading loans and other investments; and they were typically promised a guaranteed return of 2% to 5% per month, corresponding to 24% to 60% per annum, on their invested principal. The funds Rezwealth invested with Blackett were promised a return of 5% to 8% per month.

Tiffin and Tiffin Financial were promoters of the investment products offered by Rezwealth. In return for the investor referrals, Tiffin and Tiffin Financial would receive commission payments from Rezwealth, calculated at 2% per month, or 24% per annum, of the principal invested by the referred investors.

During the time period when the alleged misconduct took place, the parties together raised an aggregate amount of $9.1 million from at least 168 investors. Table 2 provides the breakdown of the amount of investments raised by each party and the referral fees received by the associates and/or representatives of Blackett and Rezwealth.

	#investors involved	$amount raised (in million)	$investment in Blackett (in million)	$Referral fee from Blackett	$Referral fee from Rezwealth
Blackett and 215 Inc.	56	$3.0	$3.0		
Smith and 177 Inc.	48	$1.2	$1.2	$137,000	
Rezwealth	45	$2.9	$0.57		
Tiffin and Tiffin Financial	19	$2.0			$517,000
Total	168	$9.1	$4.77	$137,000	$517,000

Table 2. Details of Investment solicited by Rezwealth Financial Services Inc. et al during the Time Period of Alleged Misconducts

The investment agreements offered by Blackett were characterized on their face as "loan agreements". Blackett would execute the agreements as a "borrower" and the investors were named as "lenders". Similarly, Rezwealth entitled its investment products as "Participation Agreement", "Subscription Form for Participating Debenture", "Promissory Note", and "Unsecured Debenture". In the decision of the OSC panel, it ruled that these agreements were in substance investments contracts, and hence securities, as they passed the "common enterprise test", i.e. the individuals invested their money in a common enterprise (the investment agreements) with the expectation of profit solely from the efforts of the promoter or third party (Blackett and/or Rezwealth). Also, the trading of the investment contracts were constituted a "distribution" as defined in Section 1(1) of the *Securities Act (Ontario)* as the investment products were not previously issued. Client solicitation and referral, including the act to meet with them and to discuss the nature of the investment with promised returns would constituted as an act in furtherance of trade.

None of the nine respondents were registered with the OSC in any capacity at the time the investors purchased the investment contracts. In selling and promoting these investment contracts – that is, securities – without registration, the respondents must rely on the prospectus and registration exemptions to comply with the *Securities Act (Ontario).*

Testimonials at the hearing revealed that in many instances, the investors of Blackett had funded their investments using their full-time salary, by selling their homes, using lines of credit, or redeeming pension funds, etc. The investors further testified that they did not satisfy the income or asset requirement of the Accredited Investors exemption under NI 45-106. No other prospectus exemptions were found available to these investors either. On the other hand, Rezwealth attempted to "repaper" the original set of investment agreements that were not in compliance with the *Securities Act* by requesting investors to fill in new documentations that included an appended "accredited investor" form. Despite its attempt to rely on the Accredited Investor exemption in the distribution of securities, Rezwealth could not satisfy its onus to prove that the investors were qualified as accredited investors at the time they invested. As the prospectus exemption and registration exemption cannot be proven as available, both Blackett and Rezwealth, as well as their representatives, were ruled to have engaged in unregistered trading and illegal distribution.

The investigation by the OSC forensic accountant further revealed that the funds invested in Blackett's investment contracts were used to pay other investors or for Blackett's personal enrichment, instead of for forex trading. An analysis of notable banking activities in the group of bank accounts used by Blackett and 215 Inc. during the review period of January 1, 2008 to April 14, 2009 showed evidence that the respondents diverted the investors' funds for purposes other than the intended forex trading. The source and use of funds analysis is illustrated in Table 3. The group of accounts comprised of: one account at TD Canada Trust ("TD") held by 215 Inc.; and one TD account, two Bank of Montreal ("BMO") accounts, and one account at Bank of Nova Scotia ("BNS") all held by Blackett.

Opening Balance	$22,044		
Source of Funds		Use of Funds	
56 investors	$3,018,649	Payments to Investors *(of which $62,000 was to Rezwealth)*	$1,383,122
Forex trading related entities	27,540	Forex trading related entities	542,430
		Smith	137,383
		177 Inc.	41,150
		Blackett and his family *(include: cash withdrawals, loan and mortgage payments, automobile payments, retail, phone and similar payments)*	705,254
		TD visa card payment	217,897
		Other credit card payments	102,804
	$3,068,233		$3,130,040
Ending Balance			nil

Table 3. Source and Use of Funds Analysis on Notable Activities in the Bank Accounts of Blackett and 215 Inc.

Of the $3 million investment received, an amount of $758,000 was from investors referred by Smith or 177 Inc. Rezwealth also paid $575,175 to Blackett, but $75,000 appeared to have never been deposited into the bank accounts of Blackett or 215 Inc. Instead, about $50,000 was found to be deposited to a bank account of a trading company by Blackett and another $25,000 cashed out by Blackett at a money mart.

Contrary to the claimed use of investor funds for forex trading, only a small fraction of the funds, i.e. about $542,430, was used for this purpose. During this period, Blackett paid close to $1.4 million to the investors. The amount of $27,540 received from forex trading entities during this same period would not be sufficient to fund the investor payments, suggesting that such payments would have been paid by sources other than proceedings from forex trading. The Ponzi scheme formulated by Blackett, personally and through 215 Inc., was cultivated through misrepresentations and using funds from later investors to pay early investors. The scheme eventually collapsed when Blackett and 215

Inc. were no longer able to pay the investors the guaranteed returns. Their misconduct resulted in actual investor losses of approximately $1.6 million.

Similar analysis was performed on a Rezwealth bank account held at Royal Bank of Canada ("RBC"), with the findings summarized in Table 4. The analysis consists of two review periods, with one between March 18, 2008 and December 22, 2009, and another one between July 1 2009, and December 22, 2009.

Period: March 18, 2008 – December 22, 2009			
Source of Funds		Use of Funds	
45 investors	$2,910,305	Payments to Investors	$671,194
Blackett & 215 Inc.	62,000	Blackett & 215 Inc.	575,175
Pamela and her children	39,000	Pamela and her children	509,747
Cash deposits	65,950	Cash withdrawals	56,114
		Tiffin and Tiffin Financial	517,000
	$3,077,255		$2,329,230
Period: July 1, 2009 – December 22, 2009			
Opening Balance	$110,000		
Source of Funds		Use of Funds	
45 investors	$970,940	Payments to Investors	$296,622
Blackett & 215 Inc.	-	Blackett & 215 Inc.	25,150
Pamela and her children	-	Pamela and her children	177,692
Cash deposits	-	Cash withdrawals	28,371
Other sources	150,000	Tiffin and Tiffin Financial	330,000
	$1,230,940		$857,835
Ending Balance			$60,528

Table 4. Source and Use of Funds Analysis on Notable Activities in the Bank Account of Rezwealth

Further review of the bank account activities showed that Rezwealth used the remaining funds in the account for operating expenses, payments to life insurance companies, loans to Smith and other individuals. The analysis evidenced the use of investor funds for purposes other than the intended business for forex trading loans, and other investments. Some amount were even spent for personal expenses of Pamela and her

family. The misconducts of Rezwealth under the directing mind of Pamela resulted in a loss of $2,239,111 to the investors.

	Prohibition			Penalties and Costs		
	Trade and acquire securities	Use of exemptions in Ontario securities law	Act as officer or director, registrant, and investment fund manager	Admin Penalty	Disgorgement	Cost of investigation and hearing
Blackett	Permanent	Permanent	Permanent	$500,000	$1,474,377	$110,000
215 Inc.	Permanent	Permanent	-	-		
Rezwealth	Permanent	Permanent	-	-	$547,899	$90,000
Pamela	Permanent	Permanent	Permanent	$250,000		
Jason	Permanent	Permanent	Permanent	$150,000	$51,158	
Smith	5 years	5 years	5 years	$25,000	$120,000	$37,658.18
177 Inc.	5 years	5 years	-	-	$41,150	
Tiffin	5 years	5 years	5 years	$25,000	$517,000	$15,000
Tiffin Fin.	5 years	5 years	-	-		

Table 5. Summary of Sanctions and Costs

The OSC panel ruled that all of the respondents have engaged in unregistered trading and/or furtherance of trades and illegal distribution of securities. Blackett, 215 Inc., Rezwealth, Pamela, and Jason were found to have engaged in courses of conduct relating to securities that they knew or reasonably ought to have known perpetrated a fraud on persons or companies. Furthermore, these respondents, other than Jason, were also found to have participated in acts of fraud through non-disclosure to investors of important facts, e.g. investment risks, unauthorized diversion of funds, use of corporate funds for personal enrichment, and unauthorized arrogation of funds or property. The directors of the company respondents were ruled to have authorized, permitted or acquiesced in non-compliance with the *Securities Act (Ontario)*. Sanctions and costs related to the decision are summarized in Table 5.

4.3. Case study #3 – Welcome Place Inc.

The legal proceedings of Welcome Place Inc. ("Welcome Place")[18] was commenced by the OSC in Ontario. A settlement agreement was reached in February 2016; as such, hearing and juridical review by the OSC were subsequently ceased. The case involved unregistered trading, illegal distribution of securities, and fraudulent conduct committed by the directing mind and an employee of the company. The case also demonstrates how affinity fraud, in which fraudsters exploit the trust and friendship that exist in groups of people having something in common e.g. ethnic group, can be seen in the exempt market.

Welcome Place was a Federal company with registered office in Mississauga, Ontario. The individual respondents in this case involved Daniel Maxsood ("Maxsood"), the founding director of Welcome Place, who legally changed his name from Muhammad Khan; Tao Zhang ("Zhang"), the spouse of Maxsood; and Talat Ashraf ("Ashraf"), the marketing manager of Welcome Place.

During the time of the allegations between March 1, 2008 and May 15, 2013, Welcome Place operated a training school in Mississauga, Ontario, to teach the public how to trade commodity futures contracts including foreign exchange and indices. Advertisements of the school were mostly made in South Asian community stations and papers, and were often in Hindi. The company claimed in the advertisements that students would be guaranteed a daily return of $200 to $300 by following the day trading methods taught by Welcome Place and using its trading software. Students were first invited to attend a free seminar taught by Maxsood to learn about the information and advice regarding day trading strategies. The seminars were taught in both English and Hindi.

[18] (*Re Welcome Place Inc.*, 2016)

Thereafter, Maxsood and his marketing manager, Ashraf, would solicit interested attendees to sign up for paid trading workshops, which were generally charged a tuition of approximately $5,000. Approximately 230 students signed up for the workshop during the time of the period in question, involving aggregate tuition fees of about $730,000.

Maxsood earned the students' trust through seminars and trading workshops. He also used the trading school to meet potential investors. He, together with Ashraf, solicited to the prospective investors to lend money to Maxsood and/or Welcome Place for other business opportunities. One of the investment projects Maxsood promoted was an import/export business which appeared to be operated by Oseka Co. Ltd. ("Oseka"). Oseka was a company incorporated in Bangkok, Thailand, in which Maxsood was a shareholder and director. Representations were made to the investors that they would receive monthly payments equal to 2% - 3% of their principal amount and the repayment of the principal would be made within 3-4 years. About 90 investors invested with Maxsood and/or Welcome Place, which involved a total investment amount of about $5.25 million.

In many instances, investors received promissory notes issued by Welcome Place and executed by Maxsood for their investments. This included at least 28 promissory notes issued to at least 26 investors totalling approximately $1,365,000. In other instances when formal promissory notes were not issued, investors would fund to Maxsood and Ashraf based on the understanding that the funds were payable for an investment. Some investors would indicate such understanding with a notation on the cheques. Investments from 64 other investors were raised without formal promissory notes, totalling to an aggregate investment amount of $3,885,000. The funds were deposited into several bank accounts under Maxsood and Welcome Place, and were co-mingled with the tuition fees.

The OSC ruled that the promissory notes and the investment funds were investment contracts and hence a "security" as defined in the *Securities Act (Ontario).* Since these securities were not previously issued, the dealing of them satisfied the definition of "distribution" in the *Securities Act*. The act of Welcome Place, Maxsood, and Ashraf to solicit investments through the trading school was considered furtherance of trade. Same ruling also applied to Zhang that she participated in an act of furtherance of trade as she received some of the investor funds. To distribute and trade securities without filing a prospectus with the Commissions, Welcome Place and its associates must rely on exemptions available for registration and prospectus requirements.

Investigations however revealed that many of the investors did not qualify as accredited investors nor did they meet applicable exemptions from registration and prospectus requirements. There were no inquiries made by Welcome Place nor its associates to confirm the investors' financial background prior to the investments. In fact, some investors were found to have funded the investments by borrowing or mortgaging their homes. Moreover, Welcome Place, Maxsood, Ashraf, and Zhang have never registered with the OSC in any capacity and there was no exemption to registration requirement available. As such, the OSC ruled that the parties were engaged in acts in unregistered trading and furtherance of trade; and involved in illegal distribution of securities.

The analysis on the use of investor funds also revealed that a significant portion of the funds were used for purposes other than the investment purposes communicated to the investors. Significant flow of funds in the bank accounts of Maxsood and Welcome Place are summarized in Table 6.

Ashraf was also found to receive a total of $262,000 from the bank accounts controlled by Maxsood as commission for investor referral or interest-free loans. Of the $5.25 million raised from the 90 investors, only about $1.1 million was used for the intended purpose of investing in Maxsood's import/export business, and approximately $1.88 million was paid to investors as monthly repayments. No payments from Oseka to either Maxsood or Welcome Place were identified in the period. With no other source of funding, the investor funds and tuition would have been used to make principal repayments to other investors. This is contrary to Maxsood's representation that the monthly payments were sourced from Maxsood or his business ventures. Furthermore, a large portion of the funds was also spent to support the lifestyle of Maxsood and Zhang. These activities contradicted with the representations Welcome Place, Maxsood and Ashraf made to the investors. At the time the settlement agreement was materialized, a total of about $3.23 million remains due and owing to the investors.

Source of Funds		Use of Funds		
Tuition fee from 230 students	$730,000	Monthly payments to investors		$1,880,391
28 promissory notes issued to 26 investors	1,365,000	To Zhang	From identified investors	21,000
Other investment funds raised from 64 investors	3,885,000		From Welcome Place	19,589
			From Maxsood	984,006
		Zhang's bank account in China		44,000
		Family of Maxsood and Zhang in Thailand and China		573,000
		Mortgage payment of a properties in Ontario owned by Maxsood and Zhang		382,000
		Credit card payments for Maxsood, Zhang and Welcome Place		271,000
		Oseka Co. Ltd.		1,141,000
		Other director of Oseka		21,000
	$5,980,000			$5,336,986

Table 6. Analysis on Notable Activities in the Bank Accounts of Maxsood and Welcome Place

Pursuant to the findings on the use of investor funds for purpose other than the intended investment, the OSC ruled that Maxsood and Welcome Place engaged or participated in acts, or courses of conduct relating to securities that they knew perpetrated a fraud on persons or companies. Welcome Place and Maxsood were also found to make false or misleading statements about matters that a reasonable investor would consider relevant in making investment decisions. For example, representations on the return of investment, use of investor funds solely for business purpose, and source of monthly payments were untrue. Maxsood also misled the investors by claiming that he has developed a successful trading methodology despite that he has no formal training in securities and has never been registered with OSC. Although he claimed that the trading methods would guarantee an annual return of 24% to 36%, no students made such returns but instead sustained losses.

	Prohibition			Penalties and Costs		
	Trade and acquire securities	Use of exemptions in Ontario securities law	Act as officer or director, registrant, and investment fund manager	Admin Penalty	Disgorgement	Cost of investigation and hearing
Welcome Place	10 years	10 years	-	$110,000	$2,967,901.52	$120,000
Maxsood	10 years	10 years	10 years	-		
Ashraf	5 years	5 years	5 years	$10,000	$262,186.00	-

Table 7. Summary of Sanctions and Costs

In their responses to seek approval of the settlement agreement, the respondents stated that they mitigated the situation by making additional repayment to investors and by cooperating in the investigation. They also indicated that they were not aware that their activities would be regulated by the commission. The settlement agreement was approved, with Maxsood, Ashraf, and Welcome Place reprimanded and the trading in any securities

of Welcome Place to cease permanently. Other major sanctions and costs are summarized in Table 7.

4.4. Case Analysis

The cases above illustrated the common misconducts of unregistered trading, illegal distribution of securities, and fraud that could happen in the exempt market. Investigation findings in these cases provide some insights on the characteristics of the misconducts. While some red flags are unique to the exempt securities, others may also be observed in different types of investments and/or other financial frauds. The warning signs observed in the cases are discussed below.

Ignorance of the Securities Laws

Non-fraudulent misconducts in the exempt market often arise from non-compliance with the securities legislations, in particular, the exemptions for prospectus and registration requirements. Broad definitions of the keywords such as "trade", "distribution", and "securities" in the Canadian securities legislations facilitate wide range of application to the securities laws. Ignorance of the issuers and their dealers on the applicable regulations could signal risk of non-compliance.

Respondents in *Welcome Place*, for example, indicated that they were unaware that their acts of investment solicitation for Maxsood's import/export business were indeed regulated by the securities laws. The incompetence of the issuers in understanding the requirements of the prospectus exemptions, or in filing timely, complete, and accurate Report of Exempt Distribution with the respective securities commissions, as in the case in *HRG Healthcare*, also impose additional financial risks to the investors. Their ignorance

and incompetence could impact the integrity of the exempt market, which may demotivate qualified investors from funding legitimate businesses.

Sales of Exempt Securities to Unqualified Investors

Individuals must meet the income and assets threshold to be qualified as an accredited investor. There must also exist a close relationship between the issuer and the investor before the prospectus exemption on the Family, Friends, and Business Associates could be relied upon. Trading of exempt securities is intended only for certain groups of individuals or corporations, which the securities regulators consider sophisticated enough to waive the protection of a prospectus, instead for the general public. As such, the regulators require the issuers and their dealers to establish a reasonable belief that the investors are qualified for the prospectus exemptions they intend to rely on prior to investing. The issuers and the dealers also have the duty to disclose the risks associated with the investment to the investors, including financing the investment through borrowed money. While selling securities without a prospectus to individuals that qualify for the prospectus exemptions does not violate the securities laws, the failure of the issuers and their dealers to conduct appropriate financial assessment on, and make necessary disclosure of investment risks, to prospective investors would suggest a red flag of non-compliance.

In *Rezwealth* and *Welcome Place*, a significant number of investors were found to be not qualified for any available prospectus exemptions. Many of them even invested with borrowed money from either using the line of credit or mortgaging their homes. No suitability assessments or inquiries of the investors' financial background were conducted by the issuers or their dealers before the investments. The misconduct exposed unsophisticated investors to significant financial losses when the investment failed.

Unregistered Investment "Professionals"

Individuals and firms engaging in the business of trading or advising exempt market securities are required to register as an EMD. The respondents in *Rezwealth* and *Welcome Place* were not registered with the securities commissions in any capacity, yet they acted as an advocate to promote and solicit potential clients to purchase investment contracts. Maxsood in *Welcome Place,* for example, was even found to have no relevant background and qualifications in the trading of securities. Unless registration exemptions are available, individuals and/or firms that solicit exempt securities to investors without proper registration or education background could be a red flag to non-compliance and possibly, fraud.

Inherent risk also appears to exist in this capital market sector when the EMDs are not required to register with a self-regulatory organization. Despite tighter regulations being enforced by the securities regulators to govern the conducts of the EMDs, the oversight appears comparatively loose when compared to full service investment dealers or mutual fund dealers who must also be members of the corresponding self-regulatory organization.

Incomplete or Inaccurate Investment Documents

Purchase of exempt securities must be properly documented. Prior to the investment, investors must complete and sign the section which indicate the type of prospectus exemptions they relied on. Filing the exempt distribution report with the respective securities commissions may also be required when certain prospectus exemptions were used. The issuers and their dealers have the responsibility to keep sufficient records that evidence *each* investment of exempt securities is in compliance with the available

exemption and that the exemption is correctly claimed. This should be done at the time the investment takes place, instead of retroactively. Investment documents that are incomplete and/or inaccurate could be a red flag of non-compliance with the securities regulations.

Investment agreements in the *HRG Healthcare* case, for example, were incomplete. A majority of the investors did not complete the section that required them to disclose the type of prospectus exemptions they relied on for the investment. In *Rezwealth*, on the other hand, existing documents were replaced with new documentation to include an accredited investor declaration form as an appendix and investors were requested to date the new documents retroactively. Some investors signed the form despite being not qualified as accredited investors, and others signed without indicating how they were qualified. No report of exemption distribution was ever filed with the OSC either, although Rezwealth Financial was required to do so. These misconducts were contrary to the public interest.

Rezwealth and *Welcome Place* also demonstrated how issuers could attempt to disguise the distribution of securities in the form of a loan agreement. The concept of "substance over form" should be considered in evaluating the true nature of a particular transaction.

Investments that Guaranteed High Returns with No Risk

All investments have certain degree of risk, and oftentimes greater returns imply greater risks. Fraudsters, however, often claim their investment products can generate guaranteed high returns with little or no risk. While this type of warning sign could be found in other types of investments, the same scheme is also present in the exempt market.

The investment contracts offered by Blackett in *Rezwealth*, for example, promised an annual return of 60% to 120%, whereas Maxsood in *Welcome Place* claimed that his

trading method could generate an annual return of 24% to 36%. In both cases the promoters indicated guaranteed returns to the investors. To the contrary, the claimed investment returns were proven unrealistic and the investors had suffered substantial financial losses.

Furthermore, in order to establish trust with the investors and engage them to increase their amount of investments, the fraudsters would often pay the first few months of interest on time. This usually leads to additional investments from the investors, and hence more significant financial loss when the fraudulent scheme eventually collapses.

Misrepresentation or Non-Disclosure of the Investment Details

Frauds related to the exempt securities often involve misleading and/or untrue statements about the investments. The businesses associated with the fraudulent scheme are often do not exist; and oftentimes operate as a virtual office with a P.O. box address. To conceal fraud, the fraudsters would provide little to no details about the investment and/or the nature of the businesses. Misrepresentation and non-disclosure of the investment details could suggest potential financial fraud.

Blackett in *Rezwealth,* claimed that the investor funds would be used for forex trading, whereas Maxsood in *Welcome Place* indicated that the use of investor funds was for his import/export business. In both cases, however, both Blackett and Maxsood were found to use the funds for making payments to earlier investors, for other investments, or for personal enrichment. The diversion of funds for other purposes was never communicated to the investors. The fraud was hence committed with the investor funds being used for a purpose other than the one communicated to the investors.

An investor in *Rezwealth* testified at the hearing that no account statements or detailed discussion about Blackett's investment contracts were ever provided. Upon further

inquiry, Blackett indicated that the investor did not need to know the details of the investment. Apart from the lack of disclosure, investment products or investment strategies that are overly complex could also be a red flag of financial fraud.

The use of investments from later investors to support payments for earlier investors is a typical Ponzi scheme operation. As seen in *Rezwealth*, the scheme can be perpetrated in the exempt market when it is coupled with the distribution of securities and the reliance on certain prospectus exemptions.

Complex Organization / Banking Structures

Both Blackett in *Rezwealth* and Maxsood in *Welcome Place* banked with many financial institutions, and the bank accounts were being held either under their personal name or under the company they acted as directors. Funds from investors were deposited into these accounts interchangeably. Payments made to the investors also switched between cash, bank drafts, or cheques. The complex banking structure and rotation of payment methods do not appear to have an apparent business purpose, yet they would certainly increase difficulties in tracing of the source and use of funds. Similarly, complex organizational structures with no apparent justification could also indicate a sign of fraud.

Investment Seminar

While legitimate investment seminars could educate attendees on investment strategies or products, these seminars could be exploited by fraudsters as a tool to defraud.

In *Welcome Place*, Maxsood advertised his trading school to the Hindi-speaking community. The first session of the seminar was free, as it was a bait to attract curious individuals. Maxsood and his marketing manager, Ashraf, then used this opportunity to identify and persuade interested clients to either sign up for expensive trading workshops

or to invest in Maxsood's new ventures. The investment seminars hosted by Welcome Place deviated from a legitimate presentation due to Maxsood's lack of relevant securities credentials, his solicitation of a trading method that guaranteed unrealistic returns with minimal risk, and his misrepresentation of the investment opportunities. Techniques used in this case demonstrate the red flags of suspicious investment seminars. These warning signs could be applicable to all types of investment seminars, including those that promote exempt securities.

Affinity Fraud

Perpetration of fraud through people with similar background is not uncommon, as it could be easier when a certain degree of trust has been developed among the group. Respondents in *Welcome Place,* for example, targeted the Hindi-speaking community, whereas Blackett in *Rezwealth* targeted the social circles, e.g. family and friends, of the earlier investors.

This type of fraud exploits the trust developed in the common group and can be seen in a variety of securities investments outside of the exempt securities. Red flags arise when dealers take advantage of their personal connections, or when a new person in a common interest group promotes investments with guaranteed high returns and low risks. Oftentimes the promoters also attempt to create a false sense of urgency or use aggressive sales tactics to solicit quick investments.

5. RISK OF MONEY LAUNDERING

Regulators and self-regulatory organizations have put in tremendous efforts in the past decades to combat money laundering activities in the capital markets. As the business world emerges, so are new approaches to financing and money laundering. Crowdfunding, for example, has emerged as one of the fastest-growing financing approaches since the millennium. In general, there are four main types of crowdfunding: equity, debt, rewards-based, and donation-based. Equity crowdfunding involves investment of money in exchange for the recipient company's equity; debt crowdfunding is the lending of money to the businesses or projects with subsequent repayment of the loan principal plus interest; rewards-based crowdfunding involves backers giving money in exchange for a new product developed and launched using the crowdfunding monies; and the donation-based crowdfunding solicits donations for social good.

Crowdfunding does not necessary involve the distribution of securities. When it does, as in the case for equity crowdfunding, the securities laws could become applicable. New regulations must therefore be designed and implemented to govern the financing activities and distribution of securities under this new financing method. However, only 6 out of 13 provinces and territories in Canada have implemented regulations related to equity crowdfunding; and there has not been any harmonized regulations adopted nationwide. Furthermore, since the other three common types of crowdfunding do not involve the distribution of securities, the securities regulators do not have the authority to govern these financing activities. Despite large amount of money have been raised for these financing initiatives, no corresponding regulations are in place.

5.1. Money Laundering through Crowdfunding

Equity crowdfunding can be vulnerable to exploitation by organized crime groups for unlawful purposes, such as money laundering and terrorist financing. Equity crowdfunding is often Internet-based and mostly involves start-up companies or SMEs. The widespread global access and anonymity of the Internet however could impose significant risks when criminal or terrorist groups exploit the platform to fundraise for criminal purposes. The typically low share price of the start-ups or SMEs also allow the criminals to facilitate a large volume of transactions with small amounts. The transactions could easily bypass the detection of the financial intelligence unit such as FINTRAC (Financial Transactions and Reports Analysis Center of Canada) as the dollar amount involved are often significantly lower than the reporting threshold of $10,000. Difficulties in detection also arise when the true purpose of an illicit funding campaign is masked with a fictitious start-up company that appears to legitimately rely on the equity crowdfunding exemptions. The use of the exemption could avoid the review of offerings and hence the detection of illegal activities by the corresponding securities commission.

Money laundering often comprises of three stages: placement, layering, and integration. Placement is the first stage in money laundering where cash proceeds of criminal activity is being placed into the financial system. Layering, the second stage, is achieved through layering of financial transactions that obscure the audit trail with the purpose to separate the cash proceeds from its illegal source. The third and final stage, integration, involves the movement of the laundered money into the economy so that the money can be returned to the criminal from sources that appear to be legitimate normal business earnings.

According to the Suspicious Activity Report ("SAR") Stats Technical Bulletin published by the Financial Crimes Enforcement Network ("FinCEN") of the United States in October 2015, crowdfunding sites have been found to be "used as a layering and comingling mechanism in money laundering and fraud schemes, often before participants withdraw funds or move them further through the financial system"[19]. The Financial Action Task Force ("FATF"), an intergovernmental organization founded by the G7, also expressed similar concern that organized crime groups could exploit crowdfunding portals for money laundering and terrorist financing purposes in its October 2015 Report[20]. There also exist threats to emerging terrorist financing which is often effected through money laundering.

There are a few common techniques through which crime groups can perpetrate the layering stage of money laundering through equity crowdfunding. They are listed below. Oftentimes, however, the crowdfunding portals themselves are not participants of the illegal activities.

- Seller of illegal goods, e.g. narcotics or firearms, may collude with its purchaser by masking the transaction with the purchaser posing as an investor in an equity crowdfunding campaign that purchases securities of a fake start-up company incorporated by the seller;
- The criminal can act as both the issuer and the investor in an equity crowdfunding transaction to launder the money from an illegal source. In particular, a fictitious company is incorporated for the equity financing, and the criminal then invests in the company with the proceeds of crime;

[19] (FinCEN, 2015)
[20] (FATF, 2015)

- Money from an illegal source may be funneled to various overseas jurisdictions through the use of multiple payment systems and instruments, e.g. e-wallets, credit cards, etc.), to send and receive funds. The amount of money sent through a crowdfunding campaign is often of a small amount and thus could be easily transferred without being detected by the financial intelligence unit or legal enforcement. The payment systems or instruments could also be registered under the name of a third party to conceal the illicit activity;
- The bank account of the legitimate start-ups issuer for the receipt of crowdfunding proceeds may have been altered by criminal groups in which the funds are diverted to their bank accounts instead.

Similar exploitation for terrorist financing could be possible through donation-based or rewards-based crowdfunding campaigns. For example, the true purpose of fundraising for terrorism is disguised by fundraising campaigns for charitable or humanitarian activities. The terrorists could set up fictitious non-profit organizations (NPOs) with follow-up blogs and photos posted on social media to make the campaign appear legitimate. To further conceal the illegal activities, ambiguous language is used in the advertisement of the crowdfunding campaign, or the text is replaced by images or videos to avoid detection by standard search engines.

It could be difficult to distinguish a legitimate crowdfunding campaign from a fraudulent one; and so is the continuous challenge to reveal the true identity of an individual as supporters, sympathisers, criminals, or terrorists from the Internet. Guidelines provided by FINTRAC, however, indicate that although a single indicator on its own is insignificant, a reasonable ground to suspect a money laundering and/or terrorist financing transaction

could be established if one indicator is coupled with others. The following summarizes a few red flags that may suggest a money laundering or terrorist financing activity is being perpetrated through crowdfunding:

- The issuer provides vague, minimal, or no disclosure on the business for which the crowdfunding is intended and provide no details on how the crowdfunding proceeds could be used;
- Suspicious source of funds deposited for the crowdfunding campaign. These could include: funds from overseas or an unknown source deposited in the personal account of the investor; or a collection of funds deposited from multiple accounts subsequently transferred to crowdfund a project or business;
- Funds raised from the crowdfunding campaign moved through a chain of electronic transfers, often through multiple jurisdictions; and follow by structured cash withdrawals. The purpose of the series of transactions is to conceal the source of funds and mask the final beneficiaries;
- Unusual ties between the issuers and the purchasers;
- Investment amount requested by the issuer in the crowdfunding campaign is remarkably inconsistent with other similar projects or initiatives.

5.2. Anti-Money Laundering Policies in Canada with respect to Crowdfunding

With MCASN 45-316 adopted in May 2015, and MI 45-108 came into effect in January 2016, at least one of the two multilateral instruments are effective in the provinces of Ontario and BC, the two largest securities market for equity crowdfunding. The securities regulators have commenced their first step to better govern the emerging equity financing.

No harmonization of the regulations, however, is currently in place. The complexity of the regulations and their inconsistencies in the conditions of exemptions for issuers, investors, and/or funding portals could create confusion for compliance and create loophole for exploitation. For example, while there is a residency restriction for purchasers relying on MCSAN 45-316 crowdfunding exemptions, there is no similar requirement for MI 45-108. Any investors, including those from organized crime groups, could possibly abuse this loophole to launder proceeds from a criminal source overseas. Secondly, while MI 45-108 restricts blind pools, i.e. companies that do not specify how the funds raised from the investors would be used, criminals could rely on the crowdfunding exemptions by pursuing MCSAN 45-316 instead as it does not have such restrictions. Thirdly, despite the requirement for issuers of securities to provide an offering document to the prospective purchasers, the documents are neither reviewed nor approved by the securities regulators[21]. Without systemic governance, criminals may exploit the loophole to disguise financing activities for illegal purposes with a crowdfunding campaign that appears legitimate.

Another concern to the risk of money laundering and terrorist financing is that the available exemptions are not nationally adopted. A total of 7 provinces and territories have yet to implement any regulations to monitor equity crowdfunding. With no proper rules to abide by in those jurisdictions, the risk of money laundering and terrorist financing may not be sufficiently mitigated. On the other hand, crowdfunding through debt, rewards-based, and donation-based campaigns also involves significant amount of money and could be exposed to similar threats in money laundering and terrorist financing since no associated regulations are currently in place.

[21] (Canadian Securities Administrators, 2009a)

Risks could also arise in the funding portals. Registered dealers that operates the funding portals must comply with the corresponding requirements set forth in NI 31-103 to implement a comprehensive system of compliance and internal controls and be in compliance with the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* to establish proper anti-money laundering (AML) policies. The internal control and AML policies of these portals are therefore anticipated to be effective at combating fraud and illicit activities. However, registration exemptions are available for funding portals relying on MCSAN 45-316 when certain conditions are met. These funding portals are operated by non-registrants and therefore adherence to the compliance requirements would be obviated. With no specific AML requirements set forth in MSCAN 45-316, the effectiveness of these exempt funding portals in combating money laundering is questionable.

6. IMPLICATIONS FOR IFA IN THE EXEMPT MARKET

The participation of the IFAs in the exempt market is not uncommon. They can be found, for example, in law enforcement units or criminal investigation teams of the various securities commissions; in the exempt market dealer firms or equity crowdfunding portals as the compliance officers; or as litigation consultants or expert witnesses engaged by regulatory bodies, lawyers, insurance companies or respondents in civil or criminal legal proceedings.

It is imperative for IFAs working in the exempt market to familiarize themselves with the relevant laws and standards, as that would affect the design and the framework of the investigative procedures and strategy for the engagement. The securities laws in the applicable jurisdictions, the National Instruments and Multilateral Instruments related to the exemption of prospectus and registration requirements are some of the unique standards applicable for engagements involving exempt securities.

While the interpretation of the applicable standards is a strict legal issue in which IFAs should not participate, in many instances their expertise could be required. For investigations involving exempt securities, the IFAs would compare and assess the information on hand to prove whether the specific requirements for each prospectus exemption have been satisfied. This could include, for example, the analysis of the net worth and annual income of the investors to verify their qualifications as accredited investors. To identify fraud, on the other hand, the IFAs would look at various indicators of fraud as described in this paper and exercise their professional skepticism in gathering relevant evidences to prove the allegations. In *Rezwealth* and *Welcome Place*, for instance, the IFAs performed the source and use of funds and lifestyle analysis on the respondents

to prove the allegation of fraud. They also conducted interviews with the investors to further prove the allegations of fraud, illegal trading of securities, and non-compliance. IFAs in those legal proceedings also assisted in the quantification of the investments raised by the wrongdoers or fraudsters. For investigations relating to allegations of money laundering or terrorist financing, the IFAs would be expected to work with legal authorities to identify warning signs of possible illegal activity, to recover misappropriated assets, and to conduct the trace of funds.

Understanding the characteristics of the common red flags associated with the risks of non-compliance, financial fraud, and money laundering could aid the investigative work of the IFAs in the exempt market. The increase of awareness could preserve the integrity of this section of the capital market and ultimately foster a sustainable economy for companies and businesses of all sizes.

7. CONCLUSION

This paper provided an overview of the Canadian exempt market with a review of its size, key participants, and applicable legal standards. Details regarding the conditions that qualify an investor to rely on the exemptions of the prospectus requirement, and to qualify an issuer or its promoters to be exempt from the registration requirement in the trading of securities were discussed.

The risks of non-compliance, financial fraud, and money laundering relating to exempt securities were illustrated by three notable legal proceedings. While *HRG Healthcare* described the risk of non-compliance, the *Rezwealth* and *Welcome Place* demonstrated how a Ponzi scheme and affinity fraud could be perpetrated in the exempt market, respectively. Although there already exists a wide variety of materials to educate investors on the red flags of investments scams, many of them focus on describing *what* constitutes an indicator of the scam without much elaboration on *why* such a sign would be an indicator and *how* the scam would be perpetrated. This paper thus analyzed the legal proceedings to facilitate a more in-depth understanding on how the risks would arise and the characteristics of the warning signs the IFAs should look for when conducting an investigation involving exempt securities.

This paper also studied the risk of money laundering and terrorist financing in the exempt market; and in particular, the risk associated with equity crowdfunding. In addition to illustrating the regulations currently enforced in the participating jurisdictions, this paper also described the concerns expressed by various international anti-money laundering organizations on how organized crime groups could exploit crowdfunding portals for money laundering and terrorist financing purposes. Possible techniques of how these illicit

activities could be perpetrated were studied to familiarize IFAs with the risks of money laundering in equity crowdfunding.

7.1. Recommendations on Safeguards and Mitigations

In preserving the exempt market as an alternate avenue of financing for Canadian companies and businesses without jeopardizing investor protection, securities regulators have been working closely with the industry to implement applicable rules to regulate the trading of securities that rely on exemptions of prospectus and registration requirements. Nonetheless, on-going refinements of the regulations would be crucial to the ever-changing securities market. Below summarizes a list of possible safeguards that could be implemented to mitigate the risks of non-compliance, fraud, and money laundering in the exempt market.

Harmonized Approach to Data Collection and Analysis. With the governance of the securities market at the provincial and territorial level, the approach of collecting and analyzing exempt market data is different from one jurisdiction to another. This may impose challenges in sharing valuable information across jurisdictions, understanding the exempt market activities in Canada as a whole, and more importantly, identifying potential risks and threats to the market participants and hence implementing appropriate regulations. The securities regulators may consider adopting a more harmonized approach in data collection and analysis.

Harmonized Regulations with Minimal Modifications. Although regulations set forth in the national instruments are adopted by all jurisdictions across Canada, each participating jurisdiction may modify the details at their discretion when adopting the regulations in the respective securities statutes. While this may make the regulations more

suitable for the local market, it could create confusion and thus increase the risk of non-compliance for issuers and dealers financing across multiple jurisdictions. Adoption of the harmonized regulations with minimal modifications in each participating jurisdiction may ease the confusion and better mitigate the risk of unintentional non-compliance.

Furthermore, regulations for equity crowdfunding are not harmonized. With its increase popularity, national instruments that govern the activities of equity crowdfunding should be adopted as soon as possible. Other types of crowdfunding should also be properly regulated by other legal enforcement authorities.

Education for Investors. Prospective investors are more likely to become the victim of an investment fraud or money laundering scheme if they do not perform sufficient due diligence prior to investing. This could include, but not limited to, conducting background checks on the investment professionals, researching the investment, and understanding the risks associated with the investment. Furthermore, while the growth of the Internet makes capital more accessible for legitimate businesses, it also enables criminals to seek funding from the general public regardless of ages. Education of investors should therefore not be limited to adults only. Instead, it should also become part of the secondary and/or post-secondary curriculum to better educate the youth about the red flags of investment fraud.

Education for Securities Issuers and Dealers. The legal proceedings studied in this paper reveal an issue that the non-compliance of the securities laws may be due to the lack of knowledge of the directing minds of the businesses or their underqualified dealers on the applicable securities laws. The risk of non-compliance appears to be higher with businesses financing independently without the use of any registered dealers e.g. EMDs.

Appropriate education for the directing minds of the companies to increase their awareness would be essential to mitigate the risk of non-compliance.

Detection and Sanctions for Violations of Securities Laws. Securities commissions such as the OSC have formalized processes to assess and review suspicious cases, including referral to the investigation team if indicators of non-compliance or fraud are found. To communicate a strong regulatory message, irregular, random audits may be conducted on filed exempt distribution reports to ensure compliance. Apart from that, the possible sanctions available under the securities acts are primarily administrative penalties or monetary compensations. The use of fines to deter violations of securities law may not be effective, especially when the convicted parties may have transferred their assets to innocent third parties or other jurisdictions, or when they have already exhausted all the investor funds prior to prosecution. The deterrence may become more effective if stiffer penalties, e.g. remedial penalties or increased frequency of transferring serious offence cases for criminal prosecution, could be imposed.

Self-Regulatory Organization for the EMDs. While EMDs must be registered with the respective securities commissions to trade exempt securities, they are not required to become a member of a self-regulatory organization. Incorporating this as part of the registration requirement would facilitate better oversight of the compliance of registrants and ultimately mitigate risks. Continuous education on the dealing and advising representatives working at the EMD firms, particularly on the know-your-client, know-your-product, and suitability rules; conflict and relationship disclosure; ethical conduct; and compliance requirements, would be essential to foster best practices for the trading of the exempt securities.

Involvement of Financial Institutions in Crowdfunding. Despite that the financial institutions may have done a full know-your-client assessment when the crowdfunding portals open a bank account at the institution, its subsequent role in the crowdfunding activity could be passive by merely holding the account for the crowdfunding portals for the flows of funds. However, the crowdfunding portals could likely benefit from working with financial institutions in combating money laundering and terrorist financing when the financial institutions already have the comprehensive anti-money laundering safeguards in place. Their cooperation could facilitate better monitoring of the volume of funds coming from the crowdfunding portals.

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APPENDIX A

Six Commonly Used Prospectus Exemptions under NI 45-106 as adopted by the Province of Ontario

	Accredited Investors	**Minimum Amount Investment**	**Private Issuers**	**Family, Friends, and Business Associates**	**Offering Memorandum**	**Rights Offering**
Eligible securities issuers to use this exemption	All companies including investment funds	All companies including investment funds	All private companies except investment funds with less than 50 shareholders (exclude employees)	All companies except investment funds	All companies except investment funds	Public companies, but not investment funds subject to NI 81-102 *Investment Funds*
Eligible purchasers to rely on this exemption	Individual or non-individual accredited investors satisfy certain assets or net income requirements *(see Note 1)*	All non-individual investors	• Founder, director, officer, or control person of the company issuing the securities • Certain family members, close personal friends or close business associates of the founder, director, officer or control person of the company • Current shareholder of the company • Accredited investors	• Founder, director, officer, or control person of the company issuing the securities • Certain family members, close personal friends or close business associates of the founder, director, officer or control person of the company	Any investor *(see Note 2)*	Existing shareholders who exercise their rights to purchase the security. The rights to purchase is issued by the issuer on a pro rata basis

	Accredited Investors	**Minimum Amount Investment**	**Private Issuers**	**Family, Friends, and Business Associates**	**Offering Memorandum**	**Rights Offering**
Maximum allowable investment	No limit	• No limit • Investment must be at least $150,000 and must be paid in cash	No limit	No limit	Non-eligible investors • < $10,000 total investment in last 12 months Eligible investors • < $30,000 total investment in the last 12 months Eligible investors who received suitability assessment and advice from registered dealers • < $100,000 total investment in the last 12 months Non-individual investors and accredited investors • No limit	No limit
Requirement of purchasers to sign Risk Acknowledgement Form	Yes Except for permitted clients as defined under NI 31-103	No	No	Yes Investors also require to disclose the category and length of relationship with founder, director, officer or control person of the company	Yes Two additional schedules required for individual investors	No

	Accredited Investors	Minimum Amount Investment	Private Issuers	Family, Friends, and Business Associates	Offering Memorandum	Rights Offering
Obligations of issuers to provide disclosure at point of sale	No	No	No	No	Yes An offering memorandum and any marketing materials must be provided	Yes Rights offering notice that gives investors access to the rights offering circular filed on SEDAR
Investors' right to withdraw purchase	No	No	No	No	Yes Within two business days from the date of purchase	No
Applicability of resale restrictions on purchased securities *(see Note 3)*	Yes	Yes	Yes	Yes	Yes	No
Filing requirement of issuers	• Corporate issuers must file a Report of Exempt Distribution within 10 days of the distribution • Investment fund issuers must file a Report of Exempt Distribution within 30 days after its fiscal year-end	• Corporate issuers must file a Report of Exempt Distribution within 10 days of the distribution • Investment fund issuers must file a Report of Exempt Distribution within 30 days after its fiscal year-end	n/a	Issuers must file a Report of Exempt Distribution within 10 days of the distribution	Issuers must file a Report of Exempt Distribution within 10 days of the distribution	n/a

Note 1. Asset and Income Requirement for Accredited Investors

Non-individual	Includes: • Certain Canadian financial institutions and Schedule III banks • Companies, limited partnerships, trust of estates with net assets > $5M • Entities held solely, directly or indirectly, by accredited investors
Individual	• Before-tax net income in each of two most recent calendar years, when alone > $200,000, with expectation to exceed the threshold in current year • Before-tax net income in each of two most recent calendar years, when combined with spouse > $300,000, with expectation to exceed the threshold in current year • Before-tax net worth (i.e. assets net liability), alone or with spouse, > $1M • Net assets, alone or with spouse > $5M

Note 2. Investors Category for Offering Memorandum Prospectus Exemption

Individual investors can be classified as eligible or non-eligible investors. For individuals to qualify as eligible investors, they must have:

- Net assets, alone or with a spouse > $400,000
- Before-tax net income in each of two most recent calendar years, when alone > $75,000, with expectation to exceed the threshold in current year
- Before-tax net income in each of two most recent calendar years, when when combined with spouse > $125,000, with expectation to exceed the threshold in current year

Note 3. General Resale Restrictions of Securities purchased under a Prospectus Exemptions

- For listed companies: 4 months
- For private companies: Indefinite, unless resale relies on another prospectus exemptions or with a prospectus

APPENDIX B

Comparison of the Key Regulations in the Equity Crowdfunding Exemptions MI 45-108 and MCSAN 45-316

	MI 45-108	MCSAN 45-316
Participating jurisdictions	• Ontario • Saskatchewan • Manitoba • Quebec • New Brunswick • Nova Scotia	• British Columbia • Saskatchewan • Manitoba • Quebec • New Brunswick • Nova Scotia
Expiry date of regulation	n/a	May 13 2020
Major components	• Crowdfunding Prospectus Exemption • Funding Portal Requirements	• Start-up Prospectus Exemption • Start-up Registration Exemption
Eligible securities issuers to use this exemption	• Any company incorporated with their head office in Canada • Blind pools and investment funds cannot use this exemption	• Any company incorporated with their head office in one of the MSCAN jurisdictions • Publicly traded companies cannot use this exemption
Eligible purchasers to rely on this exemption	Any investor	Investors must reside in one of the MCSAN jurisdictions
Registration requirement of funding portals	• Funding portal must be registered as one of investment dealer, EMD, or restricted dealer • Funding portals operating as restricted dealer cannot provide suitability advice about the of the purchase of the security	• Registered investment dealers or EMDs that operating a funding portal must comply with their existing registration obligations • Registration exemption is available if the funding portal meet certain conditions. Significant conditions include: o Provide no suitability advice on any investments listed on its platform o Receive no remuneration from purchasers o Provide information forms with each regulator in the MCSAN jurisdiction 30 days before first crowdfunding distribution o Collect from purchasers written acknowledgement on the offering disclosure and risk warnings prior to accepting purchases o Never been flagged as deficient by any regulators

	MI 45-108	MCSAN 45-316
Requirement of funding portals to conduct background check on issuers, or officers, directors or other key persons associated with the issuers	Yes	No
Maximum allowable Equity Crowdfunding amount by each issuer	< $1,500,000 in any 12-month period	< 250,000 in any one offering Issuer cannot conduct more than two offerings per calendar year
Maximum allowable investment from investors	<u>Each Retail Investor</u> • < $2,500 per offering • < $10,000 total investment per calendar year <u>Each Accredited Investors</u> • < $25,000 per offering • < 50,000 total investment per calendar year <u>Each Permitted Clients</u> No investment limits	< $1,500 per investor per offering for all types of investors
Requirement of purchasers to sign Risk Acknowledgement Form	Yes	Yes
Obligations of issuers to provide offering document to investors through a funding portal's website at point of sale	Yes	Yes
Ongoing financial disclosure requirements of issuers post-distribution	Yes	No
Investors' right to withdraw purchase within 48 hours of purchase or subsequent amendment in offering document	Yes	Yes
Filing requirement of issuers	Issuers must file a Report of Exempt Distribution alongside with the offering document and any additional materials within 10 days after the closing of the distribution	Issuers must file a Report of Exempt Distribution with the offering document no later than 30 days after the closing of the distribution

APPENDIX C

Available Prospectus Exemptions in Canadian Provincial and Territorial Jurisdictions

Prospectus Exemptions	**Applicable Regulations**	**Provinces and Territories**												
		BC	**AB**	**SK**	**MB**	**ON**	**QB**	**NFL**	**NB**	**NS**	**PEI**	**NU**	**NWT**	**YT**
Accredited Investor	NI 45-106	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Minimum Amount investment	NI 45-106	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Private Issuer	NI 45-106	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Family, friends, and business associates	NI 45-106	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Offering Memorandum	NI 45-106	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Rights Offering	NI 45-106	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Crowdfunding	MI 45-108	×	×	✓	✓	✓	✓	×	✓	✓	×	×	×	×
	MCSAN 45-316	✓	×	✓	✓	×	✓	×	✓	✓	×	×	×	×

Abbreviations:

BC: British Columbia
AB: Alberta
SK: Saskatchewan
MB: Manitoba
ON: Ontario
QB: Quebec
NFL: Newfoundland and Labrador
NB: New Brunswick
NS: Nova Scotia
PEI: Prince Edward Island
NU: Nunavut
NWT: Northwest Territories
YT: Yukon Territory