IIROC OCRCVM

VIA ELECTRONIC MAIL ONLY

September 17, 2012

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

c/o Gordon Smith
British Columbia Securities Commission
PO Box 10142, Pacific Centre
701 West Georgia Street
Vancouver, British Columbia V7Y 1L2
gsmith@bcsc.bc.ca

M^e^ Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22^e^ étage
C.P. 246, Tour de la Bourse
Montréal, Québec H4Z 1G3
consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: Canadian Securities Administrators' Review of "Minimum Amount" and "Accredited Investor" Exemptions (CSA Staff Consultation Note 45-401)

The Investment Industry Regulatory Organization of Canada ("IIROC") is pleased to offer comments on the "minimum amount" and "accredited investor" prospectus exemptions as part of your review of these two exemptions.

Our comments are largely reflective of those we provided to the Ontario Securities Commission (the "OSC") at in-person

Investment Industry Regulatory Organization of Canada
Organisme canadien de réglementation du commerce des valeurs mobilières
121 King St. West, Suite 2000
Toronto, ON M5H 3T9
Tel 416-364-6133
Fax 416-364-0753
www.iiroc.com

discussions held earlier this year. We thank the Canadian Securities Administrators (the "CSA") for seeking IIROC's comments as part of the consultation process, and in the interests of fostering maximum transparency in the policy-making process, our comments on the exemptions are set out below.

Please note that we have taken a holistic approach to analyzing the two exemptions under review. Rather than frame our comments below as responses to the 31 questions set forth in CSA Staff Consultation Note 45-401, we have organized our comments more thematically. We note, however, that they are, in substance, primarily responsive to questions 14, 15, 17, 22, 25, 26, and 27. We have also provided a summary of our key recommendations at the end of this letter.

Significant growth of the exempt market requires regulatory action

In June of this year, the OSC announced its intention to expand its pending regulatory review of the "minimum amount" and "accredited investor" exemptions "to consider the exempt market regulatory regime more generally… [including] whether the OSC should introduce other prospectus exemptions to facilitate capital raising for business enterprises." OSC Staff Notice

45-707, *OSC Broadening Scope of Review of Prospectus Exemptions*

(June 7, 2012) at 4 (the "June 7 Notice"), online: <http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20120607_45-707_prospectus-exemptions.htm>. IIROC believes that both the original CSA review and this expanded OSC review of the exempt market must take into account the growth of this segment of the market. According to figures attributed to the OSC, $130.6 billion in capital was raised through exempt distributions reported to the OSC in 2010 and $142.9-billion was raised in 2011. See Barbara Shecter, "OSC broadens review of growing exempt market", *Financial Post* (June 7, 2012) (online: http://business.financialpost.com/2012/06/07/osc-broadens-review-of-fast-growing-exempt-market/). These are not insignificant amounts, and their steady growth underscores the need for robust regulation of this segment of the market to ensure that we, as securities regulators, are adequately protecting Canadian investors.

This is particularly true given that numerous cases involving fraud on Canadian investors have arisen in the exempt market in recent years, resulting in significant losses for these

investors. For example, a recent OSC enforcement proceeding issued against two of the principals behind the First Leaside Group involves serious allegations of fraud resulting from the alleged intentional concealment of financial difficulties affecting certain exempt limited partnership securities that these individuals sold. Moreover, it has been reported that the limited partnerships at issue in the *First Leaside* matter did not provide any initial or ongoing financial disclosure—disclosure that may have allowed investors to assess the actual risks involved in purchasing exempt securities offered by the First Leaside Group of companies.

A number of other examples of fraud or alleged fraud in the exempt market have been reported in recent years. For instance, in a report issued in February 2011, the Canadian Foundation for Advancement of Investor Rights ("FAIR") detailed 6 major Canadian cases of securities fraud or alleged securities fraud involving unregistered firms or individuals between 1999 and 2009.[1]

These cases and others highlight the concern that the absence of registration requirements, coupled with inconsistent oversight of exempt market participants, enables unscrupulous individuals to perpetrate fraud on unsuspecting investors, for whom the risks may be compounded because of the absence of a prospectus. If so, this suggests that stricter oversight and stronger registration and ongoing filing requirements are in order. As part of their review, IIROC urges the CSA to consider imposing registration requirements on firms currently operating as exempt, unregistered dealers through the so-called "Northwestern Exemption" in particular (which was effected via blanket orders adopted in each of British Columbia, Alberta, Saskatchewan, Manitoba, the Northwest Territories, the Yukon Territory and Nunavut). In the alternative, we would encourage the adoption of regulations requiring unregistered dealers and exempt issuers to file, with securities regulatory authorities, both initial and ongoing financial statements in connection with each new offering; such financial statements should in turn be made available to the public. Any failure to file the required statements or any inadequacies in them should be met with strict enforcement by regulators.

"Minimum Amount" Exemption

[1] See FAIR, *A Report on a Decade of Financial Scandals* (Feb. 2011), online: http://faircanada.ca/wp-content/uploads/2011/01/Financial-scandals-paper-SW-711-pm_Final-0222.pdf.

Undue concentration risk

Maintaining a "minimum amount" exemption, whether based on the current $150,000 level or a higher, inflation-adjusted level, without imposing any other conditions, will not ensure that individuals utilizing this exemption are, in fact, sophisticated investors. Furthermore, the dollar-amount threshold, in isolation, may actually encourage individuals to overextend themselves or take on undue concentration risk in order to meet the minimum threshold amount and thereby achieve eligibility to purchase the investment product offered.

Some have suggested that regulators should add a maximum net worth percentage to the "minimum amount" exemption (e.g. the investment being made under the exemption must not represent more than 10% of the investor's net financial assets). Such a requirement, however, would simply restrict the availability of the exemption to individuals who also qualify as "accredited investors," thereby defeating the purpose of having a separate "minimum amount" exemption. Indeed anyone for whom $150,000 represents 10% or less of their total net financial assets would, by definition, have more than minimum $1 million in net financial assets required to qualify as an "accredited investor."

Moreover, IIROC is not aware of any empirical evidence suggesting that the "minimum amount" exemption facilitates the raising of material amounts of capital from sophisticated retail investors who do not qualify as accredited investors. In fact, as reported by the OSC, only $3.9 billion in capital was raised under the "minimum amount" exemption in Ontario in 2011—less than 5% of all funds raised in Ontario in the exempt market. See June 7 Notice at 1. To the extent that the CSA have at their disposal data indicating that the "minimum amount" exemption *is* a significant source of funding for small and medium-sized issuers in Canada as a whole, we would encourage the CSA to publish such data.

In any event, IIROC is concerned that the investor protection risks that the "minimum amount" exemption creates outweigh any potential capital-raising function that it may serve. Unless information is available that clearly demonstrates that this exemption facilitates significant capital formation that cannot be achieved through other means (such as through the "accredited investor" exemption), IIROC recommends that the "minimum amount" exemption be abolished.

To the extent that data are available to support the contention that the "minimum amount" exemption is fulfilling an important capital-raising function—for Canadian-based small and medium-

sized enterprises, in particular—IIROC recommends that the "minimum amount" exemption be limited to the sale of uncomplicated investment products that can be easily understood without extensive disclosure.

"Accredited Investor" Exemption

Investor sophistication

IIROC's view is that exemptions based on a dollar-amount threshold are not a good proxy for investor sophistication. We therefore believe that increasing the applicable dollar-amount thresholds will not ensure the sophistication of those who qualify as accredited investors.

IIROC also believes that the current "net financial assets" test to determine "accredited investor status needs to be re-examined. We are concerned that an individual who does not otherwise qualify under the "net assets" threshold or the "income" threshold may, nonetheless, qualify under the "net financial assets" test by using non-financial assets (e.g. real estate) as collateral to borrow money which is, in turn, invested in financial assets. For example, Client A who:

- has annual income of $150,000;
- owns a $2 million home; and
- has no financial assets and no liabilities

would *not* qualify as an accredited investor because Client A does not meet any of the three "accredited investor" thresholds (i.e. income, net assets, and net financial assets).

On the other hand, Client B who:

- has annual income of $150,000;
- owns a $2 million home;
- takes out a $1 million mortgage loan;
- uses the entire mortgage loan to purchase $1 million in financial assets; and
- has no other liabilities

would qualify as an accredited investor because Client B would meet the $1 million "net financial assets" threshold.

Given that both clients have $2 million in net assets, it seems inappropriate that leveraged Client B would qualify as an accredited investor, while unleveraged Client A would not. To eliminate this inequity, IIROC recommends that the calculation of "net financial assets" should take into account all liabilities, not just "related liabilities," given that, in some

cases, non-financial assets are being used to secure investment loans. Furthermore, for the purposes of assessing an investor's ability to withstand a loss, it is inappropriate and impractical to apply a differential treatment to liabilities on the basis of whether they were assumed to finance the purchase of a financial asset, as opposed to a non-financial asset. Indeed, in practice, it may be difficult—if not impossible—to ascertain an investor's true motivation in taking out a particular loan.

With respect to the issue raised in the CSA Staff Consultation Note regarding alternative qualification criteria for individuals, such as education, investment experience and work experience, IIROC is supportive of the adoption of such alternative criteria as useful indicators of investor sophistication. However, imposing a general requirement to determine that the investor is sophisticated may not be practical unless there are objective criteria for making these assessments. For example, if dealers, which have an existing suitability assessment obligation, are given the responsibility of assessing client sophistication, they will have a natural bias towards classifying the client as sophisticated; in addition, the approaches used to assess sophistication may differ from one dealer to the next. For these reasons, to the extent that new grounds for establishing sophistication are introduced, they must be specific and capable of being objectively measured, such as the criteria adopted in the United Kingdom in 2005 pursuant to the European Commission's Prospectus Directive (which requires an investor to meet at least 2 of the following 3 criteria: (1) a minimum average of 10 securities transactions of a significant size per quarter for the last four quarters; (2) a securities portfolio that exceeds a relatively large minimum value; and (3) a minimum of one year of employment in the financial industry in a professional position that requires knowledge of securities investment). We cite the European criteria only as an example and acknowledge that there may be other similar criteria that would be practical and appropriate. Whichever new criteria are chosen, the method(s) for verifying and documenting these criteria should be spelled out in regulations or guidance.

Certification of "accredited investor" status

IIROC urges the CSA to provide guidance on—or possibly even mandate—the specific methods that market participants should use for verifying and documenting an investor's qualification as an accredited investor. IIROC, however, does not recommend that the CSA require certification of "accredited investor" status by independent third parties. Such certifications may add significant transactional costs, particularly if they need to be

obtained on a repeated basis to ensure that previously qualified clients continue to meet the qualifications. In IIROC's view, a more pragmatic approach would be to require clients to self-certify the accuracy of the qualification information, along with all of the other Know-Your-Client information that is provided to, or obtained by, the dealer. Furthermore, the self-certification should be required to be supported by appropriate documentation, in accordance with standards prescribed in regulations or guidance issued by the CSA.

Mandatory disclosure

IIROC recommends that the CSA mandate a brief and easy-to-understand disclosure form for all exempt investments. This form could describe the eligibility requirements for an accredited investor, his or her most significant statutory rights with respect to the purchase, as well as the unique risks involved in an exempt market investment. The form, however, should be concise—not exceeding two pages—and written in plain language. This will not only promote consistency across the exempt market, it will also serve to:

- encourage investors to read, and better enable them to understand, the information being disclosed;
- help investors, who mistakenly believed—or were persuaded to believe—that they meet the eligibility criteria, to understand that they are ineligible to participate in an exempt market investment; and
- inform investors about their right to rescind their agreement to participate in a prospective exempt investment, despite meeting the qualification thresholds.

Imposing a maximum percentage of net worth

As pointed out by the CSA in Consultation Note 45-401, one of the four principles on which the "accredited investor" exemption is based is the investor's "ability to withstand financial loss." (Consultation Note 45-401 at 2.) Toward this end, IIROC encourages the CSA to consider incorporating into the "accredited investor" exemption an additional requirement that the investment represent no more than a specified percentage of the investor's total portfolio or net assets—perhaps in the range of 5 to 10%. Such a requirement would ensure that the potential loss of the entire exempt investment is one that the investor could sustain without dire financial consequences. It would also serve the related policy goal of discouraging undue concentration of an investor's portfolio in a single, potentially illiquid security.

Possible limitations to the "accredited investor" exemption

With respect to some of the possible limitations to the "accredited investor" exemption mentioned in the CSA Consultation Note, IIROC offers the following comments for consideration:

- limiting the "accredited investor" exemption to non-complex products would lessen the need to assess the sophistication of the investor, but could unnecessarily limit truly sophisticated investors from being able to participate in complex product offerings;
- limiting the "accredited investor" exemption to non-individual clients falsely assumes that non-individual clients are always sophisticated and are always more sophisticated than individual clients;
- a rule limiting the "accredited investor" exemption to non-individual clients may be vulnerable to circumvention through incorporation by the individual investor.

Decoupling dealer registration requirements and prospectus and dealer requirement exemptions

We note that the "accredited investor" threshold is currently used as a basis for an exemption from the prospectus requirements, an exemption from the registration requirements (in those provinces and territories operating under the Northwestern exemption), and for defining the scope of activity that can be conducted by an Exempt Market Dealer (EMD). The policy considerations that underlie the various exemptions and the scope of activity that an EMD can conduct are not necessarily the same. Consequently, it might be appropriate to consider decoupling the concept of "accredited investor" for purposes of firm registration requirements and registration exemptions from that of an "accredited investor" for purposes of determining whether a prospectus exemption should apply to a particular new securities offering. In other words, while the current "accredited investor" definition—or any modified version that may be adopted following this review—might make sense when determining whether a customer is "qualified" to purchase an exempt security with limited disclosure, the same criteria may not be appropriate for setting which type of dealer may service the client or whether a registration exemption should even be available.

Suitability

We note that National Instrument 31-103 - *Registration Requirements, Exemptions and Ongoing Registrant Obligations*

allows permitted clients to waive suitability requirements applicable to registrants. IIROC is of the view that individuals who are permitted clients should not be allowed to waive the suitability requirements that apply in an advisory account relationship. Rather, the waiver of the suitability obligation should only be permitted for clients who hold order execution service accounts. Furthermore, dealers that service such accounts should be prohibited from selling products made available under the "minimum amount" and/or "accredited investor" exemptions.

In addition, IIROC has noted that there appears to be a misunderstanding amongst some dealers that they have no suitability obligation when selling investments under the "minimum amount" or "accredited investor" exemption. IIROC suggests that any future amendments underscore the fact that the "minimum amount" and "accredited investor" exemptions only represent exemptions from prospectus requirements (and, in some provinces, pursuant to local orders, dealer registration requirements), and that, with regard to registered dealers, suitability requirements continue to apply to all investments sold by such dealers, including any investments sold pursuant to the "minimum amount" or "accredited investor" exemption.

Summary of Recommendations

To recap, IIROC recommends that the CSA undertake the following measures:

<u>"Minimum amount" exemption</u>

1. Abolish the "minimum amount" exemption.

2. As an alternative, restrict the "minimum amount" exemption to the sale of simple investment products that can be easily understood without extensive disclosure.

<u>"Accredited investor" exemption</u>

1. Require the calculation of "net financial assets" to take into account all financial liabilities, not just "related liabilities."
2. To the extent that new grounds for establishing investor sophistication are introduced, ensure they are specific and capable of being objectively measured.
3. Require investor clients to self-certify the accuracy of their qualification information.
4. Through regulation or guidance, impose specific documentary

or other verification requirements to ensure the accuracy and reliability of a client's self-certification.

5. Mandate a brief and easy-to-understand disclosure form for all exempt investments, which could include a summary of the eligibility requirements for an accredited investor, significant statutory rights of investors and the unique risks of an exempt market investment.
6. Incorporate into the "accredited investor" exemption an additional requirement that the investment represent no more than a specified percentage of the investor's total portfolio or net assets, e.g. 5 to 10%.
7. Decouple the criteria for "accredited investor" for purposes of individual or firm registration exemptions from the criteria used for purposes of determining whether a prospectus exemption should apply.
8. Prohibit the waiver of suitability requirements by retail clients.
9. Issue guidance reminding dealers of their existing suitability obligations, where applicable.

We thank you for the opportunity to provide our comments. Please do not hesitate to contact the undersigned should you wish to discuss any of the above comments.

Sincerely,

Richard J. Corner
Vice President, Member Regulation Policy