

February 24, 2012

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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

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Re: Review of Minimum Amount and Accredited Investor Exemptions

The Canadian Advocacy Council¹ for Canadian CFA Institute² Societies (the CAC) appreciates the opportunity to provide comment on the Review of Minimum Amount and Accredited Investor Exemptions

¹ The CAC represents the 12,000 Canadian members of CFA Institute and its 12 Member Societies across Canada. The CAC membership includes portfolio managers, analysts and other investment professionals in Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. See the CAC's website at <http://www.cfaadvocacy.ca/>

² With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®)

as put forth in the CSA Consultation Paper of November 10, 2011. Please see below the CAC's responses to the questions posed in the Consultation Paper.

Consultation questions

1. What is the appropriate basis for the minimum amount exemption and the AI exemption? For example, should these exemptions be premised on an investor's:

- financial resources (ability to withstand financial loss or obtain expert advice),
- access to financial and other key information about the issuer,
- educational background,
- work experience,
- investment experience, or
- other criteria?

We believe that the primary function of securities regulation is to foster fair and efficient capital markets and to protect investors from unfair, improper or fraudulent practices.

Exempt Distributions are a legitimate and important part of capital markets in Canada. We do not perceive them to be at a higher (or lower) risk of being used for unfair, improper or fraudulent purposes than exchange-traded securities except to the extent that less disclosure may serve to mask such purpose. Nor do we believe them to be inherently any more or less risky (in terms of price volatility) than many exchange traded securities – especially many junior resource securities. Compared with exchange-traded securities, the most significant risk of Exempt Distributions is generally their illiquid nature and the absence of full disclosure. These are the primary sources of exposure to risk that we believe need to be addressed in regulating this sector.

Investor protection will not come from changing income and asset thresholds. Investor protection will come from mandating sufficient disclosure of risk factors and holding registrants to a fiduciary standard.

2. Does the involvement in the distribution of a registrant who has an obligation to recommend only suitable investments to the purchaser address any concerns?

Yes. At a minimum, the obligation to recommend only suitable investments should be a pre-requisite to any Exempt Distribution transaction. At a minimum the registrant will have to evaluate the quality of information provided from a

designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.
<http://www.cfainstitute.org/aboutus/index.html>

professional perspective and in view of the KYC obligation (we appreciate there is some difficulty in making an advisor responsible for client choices) we recommend the adoption of a fiduciary standard so that registrants are required to recommend only those investments that are in the client's best interests.

3. Do you have comments on the issues described below?

Issues involving the minimum amount exemption

- **No assurance of sophistication.** The size of investment alone does not assure investor sophistication or access to information, particularly where the minimum amount exemption is used to sell novel or complex products without any accompanying disclosure. At most, the size of the investment is an indicator only of the investor's ability to withstand financial loss.
- **Current threshold for the minimum investment.** The current \$150,000 threshold for the minimum amount exemption was set in 1987 and has not been changed or adjusted for inflation since. The \$150,000 threshold is equivalent to over \$265,000 in 2011 dollars.^{1} Some stakeholders have suggested that the \$150,000 threshold is too low and allows unsophisticated, retail investors to participate in the exempt market. Conversely, if the threshold is increased, the exemption may not be available to investors who do not need the protections provided by a prospectus offering.
- **Impact of a minimum amount concept on investment decisions.** An exemption based on a minimum amount invested may cause an investor to invest more than business or investment considerations may dictate solely to meet the threshold; for example, by investing \$150,000 when it may have made more sense to invest only \$50,000. Similarly, a higher minimum threshold may cause an investor to make a single investment of \$150,000 or more when a staged investment in smaller increments may better protect the investor's interests.
- **Use of the exemption to raise capital.** The minimum amount exemption is widely used by issuers to raise capital in some jurisdictions. If the investment threshold was increased or the minimum investment exemption was repealed, this could affect capital raising, especially by small and medium sized enterprises.

We agree that transaction size alone does not imply any level of sophistication on the part of the investor, nor any suitability as to the appropriateness of the transaction. Transaction size does not even indicate ability to withstand a loss, as the minimum amount may represent a significant portion of the client's wealth, as you noted. Since we do not believe there is any merit to this exemption we do not believe that the solution to this problem is indexing the old minimum amount to the inflation rate.

Exempt Distributions are a very important tool used by small firms to raise capital and we believe that small firms that need capital should be able to raise capital under Exempt Offerings Rule. We recognize that the costs and requirements of being a Reporting Issuer are significant and represent an insurmountable barrier to entry to some small

firms, however the minimum amount exemption appears redundant when the other exempt provisions are considered that may apply to an investment of that size.

We believe that a Minimum Amount Exemption does not, in and of itself, foster fair and efficient capital markets nor does it, in and of itself, protect investors from unfair, improper or fraudulent practices.

However, we also are aware of the fact that some Exempt Distributions represent business deals between large and sophisticated entities – it is important to draw a distinction between these transactions and more widely held Exempt Distributions. A joint-venture between a few oil companies and a private investment fund with hundreds of investors are both examples of Exempt Distributions but we don't see the need for securities regulation in the former case. A brightline test of control (ability to appoint Directors, for instance) or a significant ownership test could be applied to determine which standard would apply.

4. Are there other issues you may have with the minimum amount exemption?

No, other than if its use is reserved for isolated trades or unusual circumstances where nothing else fits that the isolated trade exemption is available.

5. Do you agree with maintaining the minimum amount exemption in its current form?

No. We believe that the minimum amount exemption should be discontinued

6. How much should the minimum investment threshold be increased? Would your answer to this question change depending on whether:

- any disclosure is provided to investors, including risk factor disclosure?
- the purchaser is an individual, instead of an institutional investor?
- the security is novel or complex?
- the issuer of the security is a reporting issuer?
- a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?

The Minimum Amount Exemption is simply a 'minimum order size'. A minimum order size tells us nothing about the security being sold, nor anything about the registrant selling it. It only tells us that the buyer has, at least, "x": dollars. We do not believe that any amount, whether \$150,000, \$150.00 or \$150 million should be used as the sole grounds for an exemption to the prospectus distribution rules.

7. Should the \$150,000 threshold be periodically indexed to inflation?

No.

8. If we changed the \$150,000 threshold what would the impact be on capital raising?

We believe that other exemptions – all of which have some connection to the stature of the investor or prospectus like disclosure particularly the Offering Memorandum exemption - can be redrafted to ensure that capital raising can continue while ensuring adequate disclosure. Some provinces have dollar limits on Offering Memorandum but it seems inappropriate to obviate anyone paying \$150,000 the right of action for misrepresentation and disclosure available in that exemption yet it's only available to small investors. As we stated above, assuming this exemption is largely redundant.

9. Should individuals be able to acquire securities under the minimum amount exemption? Would your answer to this question change depending on whether:

- any disclosure is provided to investors, including risk factor disclosure?
- the security is novel or complex?
- the issuer of the security is a reporting issuer?
- a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?

We believe that all securities should be issued with sufficient disclosure of risk factors to allow the buyer to make an informed decision. Where a registrant is involved in selling these securities, we believe that registrant has duties to know your client and civil liability through an agent – client relationship and recommend that be increased to a fiduciary obligation to act in the best interests of his client, the purchaser of those securities.

We cannot emphasize enough the importance of full “offering memorandum level” disclosure and the importance of imposing a responsibility to act in the client’s best interests upon any registrant who profits from the sale of an Exempt Distribution to the public.

Categorizing securities as complex or novel is an unworkable standard and complex securities are likely overrepresented in market problems. Adequate risk disclosure should be sufficient to highlight any issues with regards to novel or complex securities.

10. If individuals are able to acquire securities under the minimum amount exemption, should there be any limitations?

We have recommended eliminating the minimum amount exemption but generally individuals should have the same opportunity to participate fully in capital markets as any other legal entity.

If we limited the use of the exemption to persons who are not individuals, what would the impact be on capital raising?

We have recommended eliminating the minimum amount exemption noting it is redundant so non individuals have other exemptions based on stature and assets but generally, any restrictions imposed on who may buy securities issued under a particular exemption will restrict the ability of firms to raise capital.

11. Are there alternative qualification criteria for the minimum amount exemption?

No, other than all the other exemptions which are available.

12. Are there other limitations that should be imposed on the use of the minimum amount exemption?

No.

13. Should the minimum amount exemption be repealed? Would your answer to this question change depending on whether:

- any disclosure is provided to investors, including risk factor disclosure?
- the purchaser is an individual, instead of an institutional investor?
- the security is novel or complex?
- the issuer of the security is a reporting issuer?
- a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?

Yes. We believe the minimum amount exemption should be repealed. We believe that, in all cases, Exempt Distributions, should provide full risk disclosure to prospective purchasers. We believe that, at a minimum, registrants have an obligation to recommend only suitable investments and would prefer to see all registrants held to a fiduciary standard.

We do not believe that individuals should be shut out from the Exempt Distributions market, nor that securities of reporting issuers, when issued as Exempt Distributions, should be treated any differently than securities of non-reporting issuers.

14. If the minimum amount exemption was repealed:

- would that materially affect issuers' ability to raise capital?
- is the AI exemption (in its current or modified form) an adequate alternative to the minimum amount exemption?

Repealing the minimum amount exemption would likely have little adverse effect on the ability of issuers to raise capital as there are a sufficient number of other exemptions, such as the Accredited Investor (AI) exemption which can be used.

15. Are there other options for modifying the minimum amount exemption that we should consider?

No.

Background

The terms of the current AI exemption, a background discussion of the exemption, and a summary of comparable exemptions under the exempt market regimes in foreign jurisdictions are included at Appendix B.

Issues involving the AI exemption

- **Current thresholds for income and assets.** The thresholds for individuals to qualify as accredited investors were originally set by the Securities and Exchange Commission (SEC) in 1982, and subsequently adopted by the CSA in the early 2000s. The thresholds have not been changed or adjusted for inflation since. Some stakeholders submit that these thresholds are too low by today's standards. The current threshold for an individual's income is \$200,000; in 2011 dollars, the threshold would be over \$443,000 based on 1982 dollars (the year of SEC adoption) or \$245,000 based on 2001 dollars (the year the Ontario Securities Commission first adopted the exemption).^{2} As with the minimum amount exemption, some say these thresholds are too low and allow unsophisticated, retail investors to participate in the exempt market, yet an increase in the thresholds may exclude investors who do not need the protections provided by a prospectus offering.
- **Qualification criteria.** Some stakeholders have suggested that income and asset thresholds are not adequate proxies for sophistication. Individuals may have significant wealth, but may lack investment or other experience that enables them to make an investment decision without the protections afforded by a prospectus offering.
- **Use of the exemption to raise capital.** The AI exemption is widely used by issuers to raise capital. If the exemption was changed or repealed, this could affect capital raising, especially for small and medium sized enterprises.
- **Compliance with qualification criteria.** Regulators have concerns that some individuals purchasing securities under the AI exemption are not, in fact, accredited investors.

Consultation questions

16. Do you have comments on the issues described above?

The concept of an Accredited Investor plays an important role in Canada's capital markets.

We do not believe that simply 'being rich' (by whatever dollar amount threshold) implies sophistication. Nor do we find that sophistication can be inferred by earning more than a prescribed annual income – or the corollary that failing to meet an income test infers a lack of sophistication. Unsophisticated people can win lotteries, and sophisticated people – even CFA charterholders - can earn less than \$200,000 per year. We do not believe that either an asset test or an income test should be used to screen out who is permitted to buy securities in an Exempt Distribution. We acknowledge that it is the main exemption in use and serves perhaps as a proxy for screening inappropriate investors but omits the key elements of information and advice.

It is important to recognize that in all of our comments, we believe that all investors – in all cases – are entitled to be informed of all of the risks associated with any investment. We are aware that this level of risk disclosure is not now the norm. If this were mandated, we believe that the gap between the protections afforded by prospectus financing and Exempt Distributions would narrow significantly. Holding registrants involved in Exempt Distributions to a fiduciary standard would also help to narrow this gap.

We propose that the Accredited Investor rule be amended so that any investor, regardless of their level of wealth or income, can purchase securities of an Exempt Distribution provided that the purchase represents only a small portion of their net worth (up to, but not exceeding 10% of their net assets - excluding primary residence) or, apply a requirement for a risk acknowledgement form executed by the investor and the registrant if this asset ratio is exceeded. If no registrant is involved, then the 10% would be the limit. We believe that this approach would still allow for capital- raising and would eliminate the problem of compliance with dollar-value thresholds.

While this proposal may seem surprising, we recognize that regulators can only try to protect people from dishonourable conduct on the part of unscrupulous promoters.

- Regulations cannot protect investors from price volatility – there is no rule preventing an investor from putting 100% of his money into a risky junior stock (or for that matter, a risky large-cap stock or leveraged ETF);*
- Regulations cannot protect investors from making ill-informed decisions – there is no rule preventing an investor from selling his gold jewelry to a kiosk in a shopping mall at a steep discount to fair market value;*
- Regulations cannot protect investors from making highly leveraged, speculative investments in real estate.*

17. Are there any other issues you may have with the AI exemption?

We believe the honour system of declaring oneself Accredited could be improved on to ensure investors are making true representations. Requiring more substantive proof and information to support the claim would result in only those that truly meet the standard using the exemption.

18. Do you agree with retaining the AI exemption and the definition of "accredited investor" in their current form?

No. We believe that limiting an investors exposure to any specific exempt distribution to a small percentage (up to 10%) of their net assets, excluding primary residence or imposing a requirement at that level mandating a specific risk acknowledgement form is executed along with the registrant or seller involved is a better approach to limiting investor risk.

19. What should the income and asset thresholds be? Would your answer to this question change depending on whether:

- any disclosure is provided to investors, including risk factor disclosure?
- the security is novel or complex?
- the issuer of the security is a reporting issuer?
- a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?

We believe that all securities should be issued with sufficient disclosure of risk factors to allow the buyer to make an informed decision. Where a registrant is involved in selling these securities, we recommend that registrants should conduct themselves in a manner consistent with a fiduciary obligation to act in the best interests of his client, the purchaser of those securities.

Categorizing securities as complex or novel is probably an unworkable standard. Adequate risk disclosure should be sufficient to highlight any issues with regards to novel or complex securities.

20. Should the income and asset thresholds be periodically indexed to inflation?

No.

21. If we changed the income and asset thresholds, what would the impact be on capital raising?

Capital raising is not easy for any issuer. Small issuers face additional challenges: few dealers are interested in small deals and finding investors without a dealer is a challenge to many small businesses. In addition, the USA is considering permitting small issuers to raise money through 'crowdsourcing' on the internet. We risk losing our young entrepreneurs if the rules of capital raising in Canada are too restrictive. Raising the income and asset thresholds will impair capital-raising.

Investor protection will not come from changing income and asset thresholds. Investor protection will come from mandating sufficient disclosure of risk factors and holding registrants to a fiduciary standard.

(c) Use alternative qualification criteria for individuals

Alternative qualification criteria for individual investors could be required such as:

- *investment experience* (for example, the investor has carried out transactions of a significant size in securities markets at a given frequency),
- *investment portfolio size* (for example, the investor's securities portfolio must exceed a specified amount),
- *work experience* (for example, the investor works or has worked in the financial sector in a professional position which requires knowledge of securities investment), and / or
- *education* (such as the investor has completed the Canadian Securities Course, achieved a CFA designation or has received an advanced degree in business or finance).

22. What qualification criteria should be used in the AI exemption for individual investors? Would your answer to this question change depending on whether:

- any disclosure is provided to investors, including risk factor disclosure?
- the security is novel or complex?
- the issuer of the security is a reporting issuer?
- a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?

We believe that exposure to any specific exempt distribution should be limited to a small percentage (up to 10%) of an investors net assets, excluding primary residence unless a specific risk acknowledgement is executed and filed with the registrant involved. In provinces where there are no registrants there isn't the added benefit of an advisor noting they have acknowledged the relative size of the purchase and presumably would discuss the significance of that within the KYC context. Where there is no registrant involved then the 10% threshold should be the maximum participation.

We believe that all securities should be issued with sufficient disclosure of risk factors to allow the buyer to make an informed decision. Where a registrant is involved in selling these securities, we believe that registrant has a fiduciary obligation to act in the best interests of his client, the purchaser of those securities.

23. If we changed the qualification criteria, what would the impact be on capital raising?

Any tightening of the criteria as to who may buy securities issued under Exempt Distributions will restrict the ability of firms to raise capital. Our recommendations are aimed at ensuring the existing qualifications are more assuredly met.

24. Should individuals be able to acquire securities under the AI exemption? Would your answer to this question change depending on whether:

- any disclosure is provided to investors, including risk factor disclosure?
- the security is novel or complex?
- the issuer of the security is a reporting issuer?

- a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?

We do not believe that the form of legal entity should be a criterion in determining who can acquire securities under the AI exemption. Individuals should have the same rights as corporations or institutional investors.

25. Should an investment limit be imposed on accredited investors who are individuals? If a limit is appropriate, what should the limit be? Would your answer to these questions change depending on whether:

- any disclosure is provided to investors, including risk factor disclosure?
- the security is novel or complex?
- the issuer of the security is a reporting issuer?
- a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?

We believe that exposure to any specific exempt distribution should be limited to a small percentage (up to 10%) of an investor's net assets, excluding primary residence with a risk acknowledgement procedure above that involving the registrant.

We believe that all securities should be issued with sufficient disclosure of risk factors to allow the buyer to make an informed decision. Where a registrant is involved in selling these securities, we believe that registrant has a fiduciary obligation to act in the best interests of his client, the purchaser of those securities.

Categorizing securities as complex or novel is probably an unworkable standard. Adequate risk disclosure should be sufficient to highlight any issues with regards to novel or complex securities.

26. If investment limitations for individuals were imposed, what would the impact be on capital raising?

Any tightening of the criteria by arbitrarily eliminating a category of investor under Exempt Distributions will restrict the ability of firms to raise capital and encourage gaming behaviour to exploit other exemptions favouring corporate entities.

Our recommendation is focused on ensuring compliance with the qualification criteria, and involvement of the registrant when a key risk level should be acknowledged. One way to improve compliance with the AI exemption would be to require an investor's accredited investor status to be certified by an independent third party, such as a lawyer or qualified accountant, but most easily by proof of financial position not unlike that provided to obtain credit.

27. Should this be considered in a review of the AI exemption?

No. Imposing the additional cost of independent third party certification will shrink the pool of available capital significantly. We would prefer to see any registrant promoting a security to be held to a fiduciary standard.

28. Do you agree with imposing such a requirement?

No.

29. Are there alternatives that we should consider?

We would prefer to see any registrant promoting a security to be held to a fiduciary standard. We believe that this would address any possible issues with compliance with a standard.

30. Are there other options we should consider for revising the AI exemption or for substituting an alternative exemption?

We will take this opportunity to restate our preference for a substitution of the AI exemption with the following proposed standard:

Any investor – regardless of their level of wealth or income - can purchase securities of an Exempt Distribution provided that the purchase represents only a small portion (up to 10%) of their net assets (excluding primary residence) unless a risk acknowledgement is executed by the investor and the registered advisor acknowledging the level of investment and the implications and risks were fully considered.

We believe that all securities should be issued with sufficient disclosure of risk factors to allow the buyer to make an informed decision. Where a registrant is involved in selling these securities, we believe that registrant has a fiduciary obligation to act in the best interests of his client, the purchaser of those securities.

Finally, in exploring this issue, we have concluded that the risks of getting poor advice or self-serving advice are at least as significant as any risk inherent in any security, whether prospectus-qualified or an Exempt Distribution. As important as the “protections” afforded investors by having prospectuses approved by regulators are, if the investors don’t read the prospectuses and rely solely upon an advisors recommendation, the regulation of the standard of advice is as important as the prospectus, if not more so.

We thank you for the opportunity to provide these comments and appreciate the time you are taking to review our concerns. Please feel free to contact us at chair@cfaadvocacy.ca on this or any other issue in future.

(Signed) Keith Summers

Keith Summers, CFA

Chair, Canadian Advocacy Council