

Kenmar Associates

Investor Education and Protection

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February 26, 2012

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CSA NOTICE AND REQUEST FOR COMMENTS Accredited Investor Exemption

Ref: http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20111110_45-401_consultation-note2.htm

We congratulate the CSA on this timely initiative. The Accredited Investor exemption (AI) has been controversial for some time. Kenmar Associates welcomes the opportunity to comment on these proposals.

By way of introduction, Kenmar Associates is an Ontario- based organization focused on investor education and protection via on-line research papers hosted at www.canadianfundwatch.com. Kenmar also publishes **the Fund OBSERVER** on a bi-monthly basis discussing investor protection issues primarily for retail investors. Kenmar routinely submit comments and generate ALERTS on proposed regulatory issues that could impact Main Street.

Historically, The minimum amount exemption and the AI exemption have been premised on an investor having one or more of:(a) a certain level of investing sophistication, (b) the capacity to withstand significant financial loss, (c) the

financial resources to obtain professional advice, and (d) the motivation / capability to carefully evaluate the investment given its size and make an informed decision. We have been constructively sceptical of this exemption for retail investors for years. The First Leaside Group collapse which had 1000 Accredited Investors with an average \$290,000 invested may be a useful case study of the exempt market and its workings. A Feb. 24, 2012 article on the Leaside case in the Financial Post noted: " *"I can't stop crying. How could we have been such fools?" said Jean, a southern Ontario retiree, after hanging up from a telephone conference call with the defunct firm's Chief Restructuring Officer and a lawyer retained by First Leaside's independent directors. The hastily convened call two weeks ago came a day after devastating news reached investors across the country: the firm's operations that had been essentially frozen following a regulatory probe would be wound up under court-sanctioned CCAA proceedings.... "How do people like Leo de Bever attach their name to something like this," asked Jean, who did not want her full name to appear in the paper. She said she doesn't want people outside her immediate friends and family to know that she must now contemplate a return to the workforce in the face of a potential six-figure loss.*"

It is our experience that a retail client's Net Worth or dollar size of investment alone does not assure investor sophistication or access to information, particularly where the minimum amount exemption is used to sell complex products with minimal accompanying disclosure. At best, the size of the investment or investor asset base is a rough indicator only of the investor's ability to withstand financial loss but not necessarily emotional distress or its physiological consequences. Further, Accredited investors may, in fact, be more at risk of being the target of investment fraud than non-accredited investors, given that many fraudsters adhere to the Willie Sutton school of target selection: go where the money is. [New York Mets' owner Fred Wilpon, Massachusetts School of Law Dean Lawrence Velvel, New York Daily News owner Mort Zuckerman, or Dreamworks chief executive Jeff Katzenberg, all of whom were accredited investors who lost money investing with Bernie Madoff.]

We define a subscription agreement /complex product as investments, whose terms and features are not likely to be understood by an average retail customer (as opposed to more traditional or plain vanilla investment instruments), where these products have a complex structure, are difficult to value (so that their valuations require specific skills and/or systems) and/or have a very limited or no secondary market (and are therefore potentially illiquid). For us, a firm whose primary business is in a foreign jurisdiction where the CSA member(s) cannot effect investigations/enforcement should be off limits to retail investors. Note that a recent report from the CPAB suggests that a significant number of Chinese businesses could melt down due to lack of transparency. So concerned is IOSCO

about investment suitability that they have launched a Consultation <http://iosco.org/news/pdf/IOSCONEWS225.pdf> on the issue of suitability of increasingly complex financial products.

Most issuers when conducting a private placement of securities provide each investor with a subscription agreement, investor questionnaire and certificate. Issuers often rely on these documents alone to satisfy themselves that an investor meets the financial requirements of an accredited investor. As has been frequently demonstrated, this is not fool-proof in confirming that a particular retail investor is truly an accredited investor. Regulators should require issuers to directly confirm that the statements made by each investor as to their status as an Accredited Investor are indeed correct to the best of that issuer's knowledge and that the statements have a reasonable air of being accurate, consistent and credible. As we understand the regulations, the *financial test* definitions are designed to treat spouses as a single investing unit – we believe this should be re-assessed or a requirement applied that would require the non-investing spouse to concur in writing with any investment falling under the AI exemption. Ref [http://www.bcsc.bc.ca/uploadedFiles/securitieslaw/policy4/45-106CP%20Prospectus%20and%20registration%20exemptions%20\[CP\].pdf](http://www.bcsc.bc.ca/uploadedFiles/securitieslaw/policy4/45-106CP%20Prospectus%20and%20registration%20exemptions%20[CP].pdf)

The AI issue is further complicated by a lack of fiduciary duty among those recommending and selling investments to AI Investors. Additionally, we are concerned about seniors. The elderly, especially those with substantial savings, appear to be a designated target of unscrupulous "advisers"; it is our view that special protections are in order. For seniors, capital preservation, dependable income/cash flow, time horizon, liquidity, de-accumulation profile, tax optimization and estate planning are key investment factors.

It is not only the investment product/security but also the nature of the trading strategy that could impact a retail investor. For example, we note that the OSC/CSA has found it necessary to issue Investor ALERTS regarding inappropriate investment leveraging.

As a general rule we have found prospectus disclosure alone, especially of complex products such as mutual funds, SPAC's ("blank cheque" investment's), hedge funds, leveraged/reverse ETF's and non-bank ABCP to have minimal protective value for retail investors.

We provide these comments and ideas for CSA consideration:

1. Raising the dollar limit to at least \$250,000 ,adjusted annually for inflation, would help prevent a large number of investor complaints/litigation . This should not be more than 10 % of Net Worth .(This should not be unreasonable given the prudent investment principles regarding diversification and liquidity that most/many institutional investors follow.) NOTE: The U.S.SEC recently adopted an amendment to the accredited investor Net Worth standard which excludes the value of an individual's primary residence. This was done pursuant to Section 413 of the Dodd-Frank Act which stipulates that the SEC "shall adjust any net worth standard for an accredited investor, as set forth in the rules of the [SEC] under the Securities Act of 1933, so that the individual Net Worth of any natural person, or joint net worth with the spouse of that person, at the time of purchase, is more than \$1 million (as such amount is adjusted periodically by rule of the [SEC]), excluding the value of the primary residence of such natural person...." Ref <http://www.sec.gov/news/press/2011/2011-274.htm> The CSA may want to consider netting out all real estate and illiquid, difficult to value and non-income producing assets such as fine art or jewelry from the Net Worth calculation (if this is not already the case).
2. Requiring a written Investment Policy Statement consistent with client personal and financial situation.
3. Requiring a industry standardized test for investment knowledge and experience; the test results would be reviewed by Compliance
4. Strong risk disclosure ; not boilerplate
5. Minimum professional qualifications for those selling securities that are covered by the exemption.
6. Honest "adviser" business titles that do not misrepresent or mislead
7. A "Client first" approach to financial advice – a fiduciary standard
8. Issuers should be required to take proactive steps when engaging agents to sell their securities to accredited investors. These steps include: (1) explaining the importance of compliance with the accredited investor exemption; (2) providing clear instructions to the agents; (3) supervising the agent's efforts; and (4) independently confirming each investor meets the definition of an accredited investor.
9. Issuers should also go over orally who is and is not considered an accredited investor with each potential investor. Issuers should then confirm the investor understands the definition as described to them. Under no circumstances should issuers fill in any part of the investor questionnaire or certificate required to be confirmed by the investor. Investors need to fill out these sections of the subscription documents in their own handwriting. Documents not filled out in full should be sent back to the investor to be completed before an issuer accepts that subscription or cashes that investor's cheque. Regulators should consider requiring that the investor initial ,under the accredited investor definition, in the subscription documents to confirm this section was indeed read and understood by the investor.
10. Mandatory membership in an independent dispute resolution process (IIROC arbitration might be an example if its \$500,000 limit was increased)

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Regulators should more clearly define what is considered adequate supporting documentation for AI status. We suggest issuers be obligated to obtain from investors a copy of one or more of the following:

- (a) Most recent Tax Return;
- (b) Notice of Personal Tax Assessment;
- (c) balance sheet certified by an independent accountant;
- (d) letter from independent accountant or legal counsel as to whether the individual meets the income , financial asset requirements and/or other criteria required to be considered an Accredited Investor. In any event , all dealers selling to AI investors should have documented procedures for ensuring unsuitable investments or financing are not recommended to retail investors.

We recommend that every three years the CSA review the "Accredited Investor" exemption provisions in their entirety and to engage in further rulemaking to the extent it deems appropriate for adequate investor protection.

As usual , timely, effective regulatory monitoring and enforcement are required to turn the good intentions of rules into investor protection reality for Main Street. It may not be inappropriate for one provincial securities Commission to be given regulatory oversight on behalf of the CSA .If this is not practicable, perhaps IIROC should act as SRO for this controversial industry segment.

Should you require any additional information, do not hesitate to contact us.

We agree with the public posting of this Submission.

Sincerely,

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cc British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission

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Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Registrar of Securities, Nunavut