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February 29, 2012

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West, Box 1903
Toronto, ON M5H 3S8

Dear Mr. Stevenson,

Re: CSA Staff Consultation Note 45-401 – Review of Minimum Amount and Accredited Investor Exemptions – Public Consultation

The Investor Advisory Panel (“IAP” or “Panel”) is an independent body that was appointed by the Ontario Securities Commission in August, 2010. We are charged with representing the views of investors and providing input on the Commission’s policy initiatives, including proposed rules and policies, the annual Statement of Priorities, concept papers and other issues. We are pleased to comment on the Canadian Securities Administrators’ review of the minimum amount and Accredited Investor (“AI”) exemptions.¹

OVERVIEW

The Investor Advisory Panel appreciates the regulatory objective to facilitate access to capital, particularly for small- and medium-sized enterprises, and to ensure the efficient operation of our capital markets. The exempt market is an important source of capital for many Canadian companies, particularly those in the resource sector operating in Western Canada.² Regulation of this market should not be so restrictive as to unduly limit the ability of businesses to raise capital (and therefore, to create jobs).

Yet we must be mindful of the tension between the objectives of investor protection and the efficiency of the exempt market and ask whether the current regime strikes the proper

¹ We extend our thanks to Chava Schwebel, J.D. student at the Faculty of Law, University of Toronto for her valuable assistance in the research and preparation of this letter.

² See e.g., 2011 Report of the Alberta Securities Commission, “The Alberta Capital Market: A Comparative Overview” (May 2011) at 23-26, online: <http://www.albertasecurities.com/news/ASC%20Publications/6116/ACM2011.pdf>

balance without compromising the interests of retail investors. While many investors in the exempt market are institutions (such as banks and pension, insurance, or mutual funds), exempt distributions are increasingly being marketed and made available to retail investors. These investors are far more vulnerable than their institutional counterparts because they have no “cushion” and are unable to bear losses to the same degree as institutions. Proportionality between maintaining market efficiency while protecting the interests of retail and institutional investors is critically important. *Caveat emptor* is not the right approach in these circumstances.

The CSA asks whether our recommendations regarding these exemptions would change “if a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser.”³ We believe that the presence of an explicit fiduciary or similar obligation on advisors to act in the best interests of their clients would mitigate at least some concerns about the potential for abuse of these exemptions. It would also reduce the need for regulators to become involved in private placements to ensure that investors make informed investment decisions. If this duty were in place, the existing thresholds, with minor modifications, might be appropriate. In the absence of such a duty, however, we recommend that there be tougher restrictions on investor eligibility requirements, such as those described below.

Furthermore, although CSA Notice 45-401 focuses on the minimum amount and AI exemptions, we believe that a more comprehensive review of the exempt market legislation is required. Other rules, especially restrictions on resale of exempt market securities, should be re-examined. Furthermore, the current list of exemptions, which are not harmonized across Canada in their entirety, add undue complexity for investors, thus reducing their overall understanding of, and access to, the exempt market.

SUBMISSIONS

Minimum Amount Exemption

We consider the minimum amount exemption to be fundamentally flawed. First, access to a certain amount of capital is a poor proxy for investor sophistication.⁴ Second, the exemption does not recognize where investors are in their life cycle, which is admittedly difficult to discern because of the changing demographics in Canada. For example, individuals entering or in retirement may be particularly vulnerable if they have accumulated significant amounts of capital but rely on these funds, and the income that these funds generate, to sustain them in retirement. These investors may need extra protection as they may have an illusion of financial sophistication (afforded in part by the minimum amount exemption itself) but lack sufficient expertise to make informed

³ CSA Staff Consultation Note 45-401 – Review of Minimum amount and Accredited Investor Exemptions – Public Consultation (“45-401”) at 7.

⁴ Philip Goldstein observes that “A wealth standard is both over- inclusive because it prevents knowledgeable investors that are not wealthy from purchasing suitable securities and under-inclusive because it allows wealthy but unsophisticated investors to purchase unsuitable securities”: see Philip Goldstein, Comment Re: SEC File No. S7-18-07 – Revisions of Limited Offering Exemptions in Regulation D (August 6, 2007), online: <http://sec.gov/comments/s7-18-07/s71807-1.pdf>.

investment decisions about exempt market products. Such investors are also more likely to be targeted by investment advisors soliciting investments in unregulated opportunities such as those available under certain exemptions.

Third, we believe that the current \$150,000 threshold is far too low. Adjusting for inflation since 1966, the originally established Ontario Securities Commission (“OSC”) minimum exemption amount would require raising the limit to \$665,000.⁵ Even if an investor has access to this amount, it could represent a high percentage of his or her net worth – for which the minimum amount qualification does not presently account.⁶ The exemption also requires that this amount be invested in a single product, which discourages diversification and may further the likelihood that investors are advised to make inappropriate investments or hold portfolios that are misaligned with their circumstances.

In light of these three important points, we believe that it would be useful to consider alternatives to the present form – and, in our view, availability – of this exemption. Thus we note the following policy alternatives:

- **Raising the minimum dollar amount.** This amendment would have the advantage of limiting the number of investors eligible for the exemption but could potentially deter investment diversification to an even greater degree. Raising the threshold would also leave unresolved other concerns regarding use of a single dollar amount to vet purchasers in the exempt market. Other proxies such as net worth or financial expertise may be more appropriate, but these may duplicate the existing criteria under the AI exemption.
- **Including a Risk Acknowledgement Requirement.** Certain provinces, such as Saskatchewan, permit investors to participate in certain exempt distributions (e.g. under the Family, Friends and Business Associates exemption) if they sign a “Risk Acknowledgement Form” in which they acknowledge the risks of a prospective investment.⁷ In other jurisdictions, such as British Columbia and the Maritime provinces, this option is available to investors under the Offering Memorandum (“OM”) exemption.⁸

⁵ The original exemption amount of \$97,000, established in 1966, is the equivalent of \$665,000 in today’s dollars after adjusting for inflation, according to the Bank of Canada’s inflation calculator, online:

<http://www.bankofcanada.ca/rates/related/inflation-calculator/>. The \$150,000 amount, meanwhile, was established in 1987 and is equivalent to over \$265,000 in 2011 dollars: 45-401 *supra* note 3 at 3.

⁶ Andrew Parkinson asks, “Should a proverbial securities lawyer, or other investor, that earns less than \$200,000 or has less than \$1,000,000 in assets [thus not qualifying under the AI exemption] be prohibited from purchasing units of an investment fund, unless that investor is willing to invest an amount that is greater than 75% of their annual income or greater than 15% of their asset base?” See Andrew Parkinson, Comment Re: the Draft NI 45-106 (March 16, 2005), online:

http://www.osc.gov.on.ca/documents/en/Securities-Category4/rule_20050316_45-106_com_parkinsona.pdf.

⁷ Section 2.6 National Instrument 45-106 *Prospectus and Registration Exemptions* (“NI 45-106”).

⁸ *Id.* s. 2.9(1).

The adoption of a risk acknowledgement form requirement is a credible alternative to eliminating the minimum amount exemption altogether, but we question whether a signed risk acknowledgement provides investors with sufficient protection. Members of the public often sign risk waivers without fully understanding them. Furthermore, a risk acknowledgement form may protect advisors more than investors if it shields advisors from the consequences of making unsuitable recommendations, while their clients bear the costs of acting on such recommendations.⁹

- **Requiring Independent Advice.** One of the theoretical underpinnings for the existence of a minimum amount exemption is the assumption that investors making investments of this amount can afford to protect their own interests (or hire a professional to do so). If this is true, then regulators should consider introducing a requirement that investors consult with independent advisors, such as qualified accountants or third-party financial advisors, prior to investing under this exemption.
- **Repealing the exemption altogether.** We endorse this alternative. The repeal of the minimum amount exemption would address concerns about redundancy, described above, and offer regulators greater scope for the refinement of the AI exemption. . Industry may challenge this alternative if they believe that a reduced number of exemptions would constrain the private placement of capital. We disagree with this perception and support repealing the exemption on the basis that a dollar investment amount, even one higher than the present threshold, is not a proxy for financial sophistication. The U.S. Securities and Exchange Commission (“SEC”) recognized this fact in 1988 when they repealed the minimum amount exemption, replacing it with an accredited investor exemption, on the grounds that: “size of purchase alone, particularly at the \$150,000 level, does not assure sophistication or access to information.”¹⁰

In short, monetary thresholds of certain fixed amounts are not reliable proxies for investor sophistication. If the exemption is not repealed, we believe that, at a minimum, it should be reviewed by the CSA every two years and the dollar amount adjusted to account for inflation.

Accredited Investor Exemption

Unlike the minimum amount exemption, the AI exemption incorporates asset and income thresholds and is a more nuanced mechanism with which to grant investors access to

⁹ *Id.* The OM exemption is also not available in Ontario unless used with another exemption: see Part IV OSC Rule 45-501. The introduction of the risk acknowledgement form without adoption of the OM exemption in the same form as other jurisdictions adds another layer of complexity that, absent harmonization of exemptions across the country, may be confusing for Ontario investors.

¹⁰ Appendix A of 45-401 *supra* note 3 at 9. The minimum amount exemption adopted by the SEC additionally required (as of its revision in 1982) that the \$150,000 amount could represent no more than 20% of an investor’s net worth: *id.* We recommend that a similar proportional test be included under the AI exemption – see our comments at p. 5, below.

securities distributions in the absence of a prospectus.¹¹ However, these standards are merely financial and may not ensure that investors are appropriately sophisticated to understand the risks of exempt investments. We support the review of the current criteria contained in the AI exemption and recommend:

- **Raising the asset and income thresholds.** To our knowledge, these thresholds have not been revised or adjusted (for inflation, among other things) in the 10 years since the OSC’s introduction of the exemption.¹² Unlike the prescribed minimum investment requirement, asset and income benchmarks provide some sense of investors’ financial resources or income-earning ability – although we question whether either is a realistic proxy for financial literacy and understanding of often-complex investments. At a minimum, the net income threshold should be revised upwards to at least \$245,000 - \$443,000 to account for inflation.¹³ Once properly re-established, we would strongly support (in fact, see no principled reason to disagree with) an automatic process to adjust periodically this limit to account for inflation. This would reduce the cost and administrative burden of reconsidering the level, yet again, at some indeterminate point in the future. The financial and net asset thresholds should also be revised to both exclude investors’ primary residence, as discussed below.
- **Adding a proportionality test of net assets, exclusive of investors’ primary residence.** We strongly recommend that the size of a particular investment be limited to a certain percentage of investors’ net worth in order to encourage diversification and to reduce investors’ downside exposure to an amount that they can “afford” to lose. This is even more important given the absence of both a statutory fiduciary duty in Ontario on the part of financial service professionals and a reliable way to link investors’ income or assets to financial expertise. A form of proportionality test would limit an investor’s losses to amounts that are more manageable for that particular investor. For similar reasons, we also suggest that the value of a purchaser’s primary residence should be excluded from both the financial asset test and net asset test available under the AI exemption.¹⁴ An individual may have substantial net assets (in excess of \$5

¹¹ The definition of “accredited investor” includes: “an individual who, either alone or with a spouse, beneficially owns financial assets having an aggregate realizable value that before taxes, but net of any related liabilities, exceeds \$1,000,000; an individual whose net income before taxes exceeded \$200,000 in each of the two most recent calendar years or whose net income before taxes combined with that of a spouse exceeded \$300,000 in each of the two most recent calendar years and who, in either case, reasonably expects to exceed that net income level in the current calendar year, and; an individual who, either alone or with a spouse, has net assets of at least \$5,000,000”: section 1.1 NI 45-106 *supra* note 7; 45-401 *supra* note 3 at 10.

¹² *Id.*

¹³ The CSA notes that the \$200,000 income threshold under the accredited investor exemption has not changed or been adjusted for inflation since it was set by the Securities and Exchange Commission (SEC) in 1982, and adopted in Ontario by the OSC in 2001. This amount is equivalent to over \$443,000 (based on 1982 dollars) or \$245,000 (based on 2001 dollars): 45-401 *supra* note 3 at 5.

¹⁴ Under subsection 3.5 of the Companion Policy to NI 45-106, only the financial asset test in paragraph (j) expressly excludes the value of an investor’s personal residence from a calculation of his/her financial assets. The net asset test under paragraph (l) considers an investor’s total assets, which includes the value of

million), but these assets may be largely non-financial and non-liquid if they primarily include home equity, or may otherwise be difficult to access.

- **Including benchmarks for education/expertise.** Regulations in the United Kingdom require investors to demonstrate expertise through, among other factors, frequency of investment transactions and practical experience in the financial services sector or related professions.¹⁵ The CSA could also consider allowing investors to demonstrate expertise, for example by adopting an online test or questionnaire to assess an investor's eligibility. Although this measure may be difficult to implement and monitor, we believe that it is important that all solutions be researched and considered in order to comprehensively address the "inconvenient truth" that financial tests alone may not ensure sophistication or access to information.
- **Requiring certification of accredited investor status.** Regulators have expressed the concern that advisors have sold investments under the AI exemption to unqualified investors.¹⁶ This type of abuse should not be allowed to slip under regulators' radar. It could be addressed by a certification requirement (by way of notarized document, for example) at or prior to point of sale, either by a senior representative of the vendor firm or an independent third party such as a lawyer or accountant.¹⁷

Thus, we argue that the AI exemption requires review. In particular we recommend: first, raising the income and asset amounts to account for inflation; second, capping the total investment amount at a percentage of the purchaser's net worth (e.g., 20%); third, excluding the investor's primary residence regardless of which asset test is applied to determine his or her "accredited status"; and, finally, requiring that all such investors be certified as "accredited" by a third party or senior representative of the investment firm. In addition to these four recommendations, the CSA may also want to consider including benchmark(s) for financial expertise, such as the size of an investor's securities portfolio,

his/her personal residence. Arguably, the value of an investor's home should be excluded under both of these tests.

¹⁵ According to the CSA's own research, investors in the U.K. are considered "qualified investors" and are exempt from the prospectus requirements if they "expressly ask to be so considered" and satisfy at least two of the following conditions: (i) the investor has carried out transactions of a significant size (at least 1,000 euros) on securities markets at an average frequency of, at least, ten per quarter over the previous four quarters; (ii) the size of the investor's securities portfolio exceeds 0.5 million euros, or (iii) the investor works or has worked for at least one year in the financial sector in a professional position which requires knowledge of securities investment: Appendix B of 45-401 *supra* note 3 at 12.

¹⁶ OSC Staff Notice 33-735 – Sale of Exempt Securities to Non-Accredited Investors, online: http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20110513_33-735_non-accredited-investors.htm

¹⁷ Ramandeep Gruwal, "Securities Regulators Launch Consultation on Changes to \$150,000 and Accredited Investor Exemptions" (Nov. 11, 2011), online: <http://www.canadiansecuritieslaw.com/2011/11/articles/securities-distribution-tradin/securities-regulators-launch-consultation-on-changes-to-150000-and-accredited-investor-exemptions/>. In Australia, purchasers who are "sophisticated investors" must present a certificate from an accountant which attests that the purchaser meets the minimum income and asset requirements of this exemption: Appendix B of 45-401 *supra* note 3 at 11.

number of trades made per quarter, educational background or professional credentials, or the adoption of a basic questionnaire to assess purchasers' financial sophistication.

CONCLUSION

We believe that the presence of a fiduciary duty for registrants and advisors is a threshold issue. Investors in the exempt market are especially vulnerable because they do not have the benefit of regulatory oversight or access to full information regarding these investments. These investors could potentially be subject to a different (i.e. lesser) level of regulatory involvement if a fiduciary obligation were in place.

Although the minimum amount exemption offers regulators a "bright line test" for investor eligibility,¹⁸ there is no assurance that these investors are financially sophisticated. Accordingly, we recommend that this exemption be repealed. By contrast, the AI exemption includes certain proxies for expertise. These proxies are primarily financial and, as discussed above, could be enhanced by the inclusion of requirements based on: education levels, experience and/or asset and income thresholds which account for an investor's capacity to absorb losses (while excluding investors' primary residence regardless of the financial test applied).

Ultimately, exemptions play an important role in facilitating private placements. However, greater ease of access to capital must be balanced against the need to ensure that investors are able and well-placed to make such investments without full disclosure of the associated risks. We recognize that investors should be accountable for their investment decisions. But the regulatory environment should not encourage poor decision-making by allowing advisors to sell inappropriate investments to their clients or encourage investors with inadequate financial expertise to take inappropriate risks, merely because a statutory exemption is available and no legal obligation exists which compels advisors to prioritize their clients' interests.

The requirement of a fiduciary duty on behalf of advisors to safeguard investor interests is of critical importance in considering the exempt market because the current statutory thresholds are only crude proxies for financial sophistication and not substitutes for the personal interaction between advisors and their clients. Paradoxically, financial advisors may be in the best position to assess the investment experience/ability of their clients and recommend only suitable investments (as they are expected to do). Yet in terms of incentives, i.e., their commission and fee-based compensation structure, and without the constraints imposed by a fiduciary duty, advisors may be the least well-placed to ensure that investor interests are actually protected. Unless these incentives change, for example, by the introduction of a fiduciary duty, it is arguable that the CSA should play an expanded role in overseeing the exempt market.

Moreover, we do not think that the proposed review should necessarily be limited to

¹⁸ Robert S. Murphy, Comment Re: Proposed National Instrument 45-106 – Prospectus and Registration Exemptions, Davies Ward Phillips & Vineberg LLP (March 17, 2005) at 5, online: http://www.osc.gov.on.ca/documents/en/Securities-Category4/rule_20050317_45-106_com_murphyrs.pdf

these two exemptions and would like to see a more comprehensive review of the exempt market legislation. As part of this broader review, the CSA should first consider reviewing the harmonization (or lack thereof) of exemptions. These exemptions are presently set out in National Instrument 45-106, yet the rules and available exemptions within the instrument vary considerably across jurisdictions. A nationally consistent body of rules regarding prospectus-exempt investments would reduce complexity, and thereby costs, for market participants and should be addressed as part of the proposed review. Second, other aspects of the exempt market should also be reviewed, such as the resale rules which require first purchases to hold on to their securities for a period of time once they have purchased under an exemption. The resale rules are extremely complex and difficult for the average investor, let alone the sophisticated investor, to understand.

In closing, the IAP looks forward to commenting further on the reform of the exempt market. While we believe that a more thorough review of the exempt market rules is required, we support this first step towards improved regulation of this market while balancing the objectives of investor protection and market efficiency.

Yours very truly,

The Investor Advisory Panel

Anita Anand, Nancy Averill, Paul Bates, Stan Buell, Lincoln Caylor, Steve Garmaise and Michael Wissell.