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February 29, 2012

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Dear Sirs/Mesdames:

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

The comments below are offered in response to the consultation process undertaken by staff of the Canadian Securities Administrators with respect to the minimum amount (**MA**) and accredited investor (**AI**) prospectus exemptions.

The starting premise of securities legislation is that a prospectus, and the "full, true and plain" disclosure it contains, is the key instrument for securing investor protection. Securities are to be offered to the public pursuant to a prospectus, and prospectus exemptions are just that, exemptions. The legislation considers the use of exemptions to be a privilege, and one that

can be taken away in the public interest, for example if market participants misbehave.[1] The reality today is that completing a prospectus filing and meeting the ongoing obligations of a reporting issuer are both complex, time-consuming and prohibitively expensive processes, making a public offering of securities impossible in practical terms for the vast majority of small and medium sizes enterprises (**SME**s). As a result, SMEs seeking to grow or expand must raise capital on the basis of one or more prospectus exemptions. The MA and AI exemptions are among the prospectus exemptions most commonly relied upon by SMEs because small and mid-size businesses are almost by definition not at a stage where they can interest institutional investors. At the same time, the MA and AI prospectus exemptions are among the few exemptions available to individual or retail investors.[2] It is important to get the rules right; otherwise we risk an environment in which retail investors are denied opportunities to participate in SMEs and SMEs are starved for capital.

It is against this background that regulators should consider the questions they have raised with respect to the MA and AI exemptions.

The Minimum Amount Exemption

A number of commentators have written to the CSA with concrete examples which illustrate some of the problems with the MA exemption.[3] The MA exemption is problematic for the reasons cited by the CSA: there is no assurance of investor sophistication or ability to access information at this size threshold. Furthermore, reliance on the MA exemption inevitably results in investors being overly concentrated. This problem may be ameliorated, but is not eliminated, by the responsibility of the investor's dealer (an exempt market dealer or other category of dealer) to make a suitability assessment. A trade may well be suitable for an investor without being the best possible investment option for the investor. Exempt market investors who trade in reliance on the MA exemption will tend to be less diversified than investors who are able to rely on the AI exemption. In practice, the MA exemption is most often used by investors who for one reason or another are unable to meet the definition of AI (or are unwilling to supply the detailed information that would establish them as an AI) and who choose to be more concentrated in their investment portfolio than is ideal, rather than forgo the investment opportunity altogether.

With respect to the MA exemption, we note that the $150,000 threshold appears elsewhere in National Instrument 45-106, *Prospectus and Registration Exemptions* (**NI 45-106**); for example under the asset acquisition exemption in section 2.12 and the exemption for top-up investments for investment funds in section 2.19. If it makes sense to do away with exemptions based on an arbitrary dollar amount, this approach should be carried through to other affected sections of NI 45-106.

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1 The Securities Act (Ontario) provides in section 127(1) that the Commission may make an order in the public interest that any exemptions contained in Ontario securities law do not apply to a person or company permanently or for such period as is specified in the order.

2 There are others: the exemption for founder, control person and family in Ontario, and family, friends and business associates in provinces other than Ontario. In Ontario in any event, these exemptions are fairly narrow and do not permit solicitation to any significant number of possible investors.

3 See for example the comment letter of David Kaufman, Westcourt Capital Corporation

The Accredited Investor Exemption

Some form of AI exemption is clearly needed to facilitate capital raising.[4] The approach suggested by National Instrument 31-103, *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) and CSA Proposed National Instrument 41-103 *Supplementary Prospectus Disclosure Requirements for Securitized Products* (**NI 41-103 Notice**) should be further explored and developed. We need and should have more than one class of "accredited investor".

With the introduction of the "permitted client" in NI 31-103, the CSA have recognized the important differences among participants in the exempt market with respect to their need for the investor protection measures afforded by the registration regime. In the NI 41-103 Notice, a different type of exempt investor is proposed for eligibility to purchase securitized product. So the regulatory regime already contemplates that the range of products and the types of market actors is too broad and too diverse to attempt to divide investors simply into one of two categories: exempt and non-exempt. In fact, judging by the comments submitted in response to the NI 41-103 Notice, there appears to be some consensus that complex securitized product is in fact not suitable for the average retail investor. From other quarters, there has been criticism that the current system unfairly excludes individual or retail investors from desirable opportunities, particularly in the case of public companies issuing securities on a private placement basis at a discount to market.

We respectfully suggest that consideration be given to amending the AI rules to provide for different classes of investors, each with different levels of investor protection needs and ability to withstand loss. Staff of the CSA would have to make the precise formulations as to the classes, but the broad outlines could be as follows:

- permitted clients along the lines set out in NI 31-103[5]. The intention would be to exclude most individual or retail investors. This class of market participants (banks, brokers, institutional investors) *whose function is to move capital around* should be able to do so relatively unimpeded, since they have the sophistication and market power to obtain the information they need and thus have little need of regulatory intervention to correct for information asymmetries;

- seasoned accredited investors: mostly, those accredited investors, excluding the permitted clients, described in NI 45-106. These investors could be high net worth individuals and smaller enterprises, but they are generally not persons involved in the capital markets on a day to day basis. These investors should be able to demonstrate in some fashion, through some combination of net assets, investment or other relevant business experience and educational attainment (a CA, MBA, CFA, CSC) that they

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[4] In the context of the CSA Consultation Note, we are concerned with capital raising primarily from individual investors and by issuers who are for the most part not reporting issuers. The AI exemption is also routinely relied upon when reporting issuers or other large entities raise capital via private placement. This is not the focus of the CSA Consultation Note.

[5] The definition of "eligible securitized product investor" in the NI 41-103 proposal truly excludes virtually all individual investors. We would not recommend making the threshold so high as to have this effect.

have some degree of sophistication and ability to withstand loss.[6] The seasoned accredited investors should have fewer constraints on their investment activities; however, the rules could make certain products, such as very complex structured or securitized product, off limits.

- Novice or junior accredited investors: there should be a new category for accredited investors who wish to participate in the exempt market, but are in need of additional constraints, by limiting, for example the amount such investors can invest in any given year and in any given investment. This could be reinforced by limiting the amount that an issuer could raise in reliance on this exemption.[7]

Going forward

In my respectful submission, the CSA should conduct a broader review of NI 45-106 beyond just the MA and AI exemptions. The goals should be to rationalize and harmonize where possible, so that there are consistent standards across the Canadian jurisdictions.

The obligation to file a prospectus and to obtain a receipt is generally an obligation of the *issuer*[8] of securities. In order to effect a distribution of its securities which complies with the legislation, the issuer must either have a receipt for the prospectus in hand, or have available to it one or more exemptions from the prospectus requirement. I make this observation to emphasize that the prospectus exemptions in NI 45-106 apply to the issuer (or selling security holder) and not to the purchaser. The requirement is for the issuer, and other parties involved in an exempt distribution, to ensure that there is a prospectus exemption available, and not on the purchaser of the exempt securities to "qualify". The issuer (and the issuer's agents) take the risk that they are engaging in a non-compliant distribution if the prospectus exemptions turn out not to be available. Looked at from that perspective, the policy objective should be to ensure this risk to the issuer is not so unmanageable or unknowable that it detrimentally inhibits capital formation. If the rules make it risky for issuers to raise money in reliance on the MA or AI exemptions, the effect will be an increase in the cost of capital. In fact, I would argue that this is the situation which obtains today: the high cost of capital for SMEs is partly a reflection of the degree of regulatory risk faced by issuers and their agents. And that degree of risk is driven by the uncertainty and lack of consistency surrounding the prospectus

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6 Although the prospectus requirement addresses the need for an investor to have access to full, true and plain disclosure, in many cases, the actual availability of information is less of an issue today. If anything, there is too much data about too many investment opportunities too often presented in such a way that making sense of it is very difficult. Mandating the delivery of disclosure documents probably does not result in better investor protection unless the disclosure documents can be made meaningful in some way. Coupling liability with disclosure is better, but as noted earlier, makes the prospectus option prohibitively expensive.

7 A form of this already exists in the Offering Memorandum exemption available under NI 45-106 in provinces other than Ontario. However, the rules are not uniform across the provinces, making compliance in more than one jurisdiction a challenge. Creating another, junior category accredited investor, available and uniformly applied across all the CSA jurisdictions would be preferable to the balkanized regime in place today.

8 In the case of a "control distribution" as defined in National Instrument 45-102 *Resale of Securities*, the prospectus requirement applies to the selling security holder.

exemptions most often utilized by the natural source of capital for SMEs, namely the individual investor.

In reviewing the prospectus exemptions as they pertain to individual investors, regulators should have regard to the following:

a) the proper role of intermediaries (dealers and advisors); under NI 31-103, there should be few retail investors who do not have the benefit of a registered intermediary with respect to their investment decisions[9];

b) we all have an interest in limiting losses by individuals so that such individuals do not make a claim on public resources; so some amount of enforced prudence (protecting investors from themselves) may be necessary. Hence for example a limit on how much an investor can invest without a prospectus;

c) however, the reality is that businesses do fail and fail with regularity; logically, in order to make money, investors need also to be able to lose money; investors losing money is not an indication of regulatory failure;

d) some degree of information asymmetry is inevitable and, some might argue, is partly what drives the capital markets; and the goal of policy cannot be to completely eliminate the effects of information asymmetry. Rather, the goal must be to intervene just enough to promote efficient capital markets;

e) access to and availability of information in and of itself is no guarantee that an investor will make wise and prudent investment decisions.

Getting exactly the right balance between investor protection and the facilitation of capital formation, particularly for SMEs, is surely difficult. But even if the perfect solution is elusive, that needn't stop regulators from making incremental improvements.

Sincerely,

Susan Han

The views expressed in this submission are my personal views only, and do not represent the views of anyone other than the writer.

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9 Although this is to ignore the effect of the so-called Northwestern exemption.