CSA CONSULATION NOTE 45-401

COMMENTS PROVIDED BY WESTCOURT CAPITAL CORPORATION

FEBRUARY, 2012

TO:

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

About Westcourt Capital Corporation (www.westcourtcapital.com):

Westcourt Capital Corporation (WCC) is registered in Ontario and British Columbia as an Exempt Market Dealer (EMD). Focused primarily on due diligence of exempt market products, WCC recommends investments to its high-net-worth clients, the vast majority of whom are accredited under Ontario's rules.

We speak frequently with individual investors of various descriptions from across the country. The following comments are provided with this "real world" experience in mind. We have found that many investors who ought to be able to invest in exempt market securities are unable to do so because of the arbitrary nature of the existing rules, whereas other investors, who we believe ought not to be investing in such products, are able to invest by virtue of their technical qualifications.

The following comments are in response to many of the questions posed in the CSA Consultation Note 45-401, "Review of Minimum Amount and Accredit Investor Exemptions". The numbered responses correspond to the numbered questions available HERE.

1. What is the appropriate basis for the minimum amount exemption and the AI exemption?

a. The basis for either the minimum amount (MA) or accredited investor (AI) exemption must be founded on the rationale for the existence of the prospectus requirements in the first place, since it is from those requirements that MA and AI investors are in fact "exempt".

   The basis of prospectus requirements can, we believe, be enunciated in one phrase: "informed investing". The basic purpose of a prospectus is to provide an opportunity for any investor to fully inform him or herself of the risks being assumed with an investment in any security. Whether they *actually* read a prospectus (or whether their advisor actually reads a prospectus) is deemed to be up to the investor. Rather, the fact that such detailed information is *available* is clearly at the heart of the prospectus rules. The prospectus rules do NOT embed a requirement of suitability of an investment for a given investor. The fact that any investor can open an account with a discount broker and trade without receiving advice on suitability demonstrates this point.

b. With this in mind, we believe that whatever rules may exist in order to allow certain investors to invest in non-prospectus-qualified securities should have the aim of achieving the same objective -- that the investor (at least in theory) be informed as to the nature of an investment and the risk involved with making an investment. That said, it is important that, in the absence of a prospectus, there be rules in place to ensure not only that the information is available to an investor, but that the investor is, in fact, informed at the time of making the investment[1]. This necessarily involves a level of subjectivity by a third-party arbiter (i.e. a registrant) and a clearly enunciated set of guidelines to help ensure suitability.

c. We specifically reject, however, the notion that an investor's financial resources, educational background, work experience, or investment experience should form the basis of an assumption of eligibility to make any investment under any circumstance. Rather, we recommend a regime in which these factors form an

[1] This raises the question of why we maintain that the "informed investing" be substantive and not only technical in the case of exempt market products, when only the latter is required for prospectus-qualified product distribution. If prospectus products were always issued publicly and were therefore liquid, this would be reason enough it itself, since liquidity addresses many other concerns. Since this is not the case (many prospectus products are sold privately and are wholly illiquid), we would maintain that there *should* be substantive "informed investing" in the case of prospectus products in addition to those distributed through the exempt market. This is not the point of this exercise, however, and we would be loathe to recommend only the technical approach in the case of the exempt market. We will leave a reconsideration of the wisdom of the rules pertaining to prospectus product to another forum.

integral part of the determination of *suitability* in the eyes of a truly arms-length, third-party registrant at the time of investment.

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?

a. Yes. Requiring that a registrant be involved in the transaction and that the registrant assess "know your client" (KYC), "know your product" and "suitability" with each investor in each prospective investment can, when honestly applied, address concerns. The registrant would be responsible to identify situations in which an investor is "qualified" but for whom a particular investment is not suitable.

b. We must point out, however, that a potentially unintended consequence of NI 31-103 is the registration of "sole purpose" EMDs by issuers. These EMDs may have names that are different than the issuers whose product they exclusively represent, but these are in no way arms-length arbiters. Even with the assumption of good-faith dealing by these EMDs, the unavoidable conflict of interest, in our opinion, undermines the role of the EMD (*i.e.,* as someone "looking out for the best interests of the client") and the objectives that NI 31-103 is designed to address.

3. Comments on issues described regarding the MA exemption

a. The MA exemption is, in our opinion, impossible to rationalize at any amount and should be abolished rather than reset. In addition to the fact that merely having $150,000 to invest in a single security (or $250,000 or $350,000 for that matter) says nothing about sophistication or the ability to sustain a loss of that magnitude, it creates the unintended consequence of investors investing $150,000 in a single investment where a much lower amount would have been more appropriate. In

<u>other words, the MA exemption *engenders* the very behaviour (*i.e.*, portfolio concentration in private, illiquid securities) these rules are designed to prevent</u>.

b. Additionally, there is a case to be made that the very existence of the MA exemption implies *de facto* suitability (*i.e.*, whether or not correct from a legal perspective, many advisors begin with an assumption of suitability when an investor is willing to invest $150,000 in a single security). Why else, the argument goes, would the exemption <u>exist</u> if not to create a specified dollar amount at which the investor is presumed to be informed, sophisticated, and insulated from prospective losses? We know of numerous situations in which the KYC and suitability assessment process is greatly reduced for orders in excess of $150,000 based in some way (whether implied or expressed) on this argument.

c. One could argue that reliance on this exemption (except in the case of certain very high net worth clients who have no interest in sharing the details of their financial matters with an EMD or issuer) <u>increases</u> the likelihood that a given investment is unsuitable for a client. Because of this, at WCC we ask this question: "If it weren't for the exemption, would you still be investing this amount in this investment?" If the answer is "no", we conclude that the investment is unsuitable on its face and refuse the trade.

d. <u>Finally, it is important to point out one way in which the MA exemption is "gamed".</u> We understand that it is not uncommon for issuers to sell securities to an investor based on the MA exemption, only later to redeem a portion of that investment so as to "top up" a future investment from the same purchaser that would otherwise be less than $150,000. (For example, investor invests $150,000 in January, and has another $50,000 to invest in June. Issuer redeems $100,000 in May, which, along with the "new" $50,000, makes a new $150,000 investment in June.) Because we do not believe that this violates the <u>letter</u> of the law as it pertains to the MA exemption (assuming that both investments were in fact suitable), but clearly violates the <u>spirit</u> of the exemption, it serves as another rationale for eliminating the exemption entirely.

e. To the extent that the repeal of the MA exemption would result in difficulties in capital raising, there are two points to be made. First, the goal of investor protection must be as important a consideration as ease of capital formation. Second, we propose changes to the rules below that would address this issue without sacrificing the protection of investors in order to satisfy the ability of issuers to raise capital.

Note: Questions 4-14 and 16 are covered by the answer above and the comments regarding a "new approach" below.

15. If the MA exemption were repealed: would it materially affect issuers' ability to raise capital? Is the AI exemption (in its current of modified form) an adequate alternative to the MA exemption?

a. With regard to the first question, see 3(d) above.

b. We believe that a modified AI exemption could replace the existing AI exemption and the MA exemption in its entirety and therefore eliminate the need for the archaic and irrational MA exemption.

Regarding the AI exemption, rather than answer the questions as posed, we will address what we believe to be the issues with the current regulations and propose wholesale changes that, while imperfect, represent an improvement over the current exemptions.

A. The existing list of exemptions under the AI Exemption are largely arbitrary and are not helpful, in our opinion, in determining whether a particular investor can or should make an investment in the absence of a prospectus. The most commonly used exemptions used by ordinary investors under these rules are those pertaining to annual income and financial assets.

   i. With respect to income, there is simply no correlation between income and investment sophistication. Consider a married couple where both are professionals. They have a combined annual income of $350,000 with $100,000 in student debt. They rent a condo and lease two vehicles. They have a negative net worth. And yet they are accredited.

   Now consider another couple who are both accountants who each make $140,000 per year. They have no debt, own an $800,000 house that is mortgage-free, $500,000 in RRSP securities and have $250,000 in cash in the bank. They are both avid investors and have 30 years of investing experience between them. They are not accredited.

   In the first example, the couple should not be accredited and yet they are under the current rules. In the second case, they should be accredited and yet they are not allowed to invest under the current rules.

   ii. With respect to financial assets, there are two concerns. The first is the exclusion of real estate within the definition of financial assets. The definition excludes all real estate, even income-generating real estate that is not the investor's residence. This means that a retired investor with a $3,000,000 apartment building generating $180,000 a year in income (assuming no other assets) is not accredited. However, if the investor held the same apartment building through a corporation, the shares could be included under "financial assets" and he would be accredited. This result cannot be what was originally intended by the AI exemption.

The second issue is with the definition of the word "securities" in the definition of financial assets. The rule does not expressly exclude non-tradable securities (such as shares in a private corporation), however it has long been assumed that "securities" means "liquid securities". This means that a person who privately owns 100% of the shares in a $2,000,000 transportation company (and doesn't take a reported salary in excess of $200,000 per year) would not be accredited (assuming no other assets or income). Since there are no exemptions that allow the company itself to invest based on its annual profits, this means there would be no way for the owner of the company to invest, whether on his or her own account or on that of the company.

One might argue that the two examples above are specifically designed to show the weakness in the rules and are not common. In fact, they are very common. Consider the type of individuals who invest in the exempt market. They tend to eschew the public markets in favour of smaller, more entrepreneurial ventures (whether speculative or not). It is exactly these types of investors who are most likely to be entrepreneurs themselves; owners of small businesses and income-producing real estate. Additionally, these individuals tend to "live off their company", meaning that their reported personal income is often a bad proxy for their lifestyle or spending power.

These are the very people -- successful, educated, sophisticated entrepreneurs -- who are most inappropriately excluded from AI status and therefore unable to make sound investments in exempt market products, even those issued pursuant to an offering memorandum (at least in Ontario, where there is no offering memorandum (OM) exemption).

These investors want access to investments they <u>understand</u>. The prospectuses, disclosure documents and financial statements of many public companies often are impenetrable to these individuals. There is no opportunity to meet with senior management in order to assess the soundness of a business model or to survey other qualitative aspects of the business. Rather, these individuals would prefer to have the opportunity to conduct in-person and in-depth due diligence on investment opportunities and managers, and are exactly the sort of people whom we should encourage to invest in small and medium-sized enterprises.

B. In order to establish a set of rules that allows issuers to raise capital and to protect investors in the absence of a prospectus, it is advisable to list the <u>objectives that the AI exemption ought to seek to meet</u>:

i. The rules should not be so cumbersome as to exclude relatively minor investments into private ventures.

ii. The investors, in the absence of a prospectus, should be put in a position in which they are able easily to collect information on a prospective investment.

iii. The investments, whether sold by prospectus or not, must be deemed to be suitable for investors based on the information collected in the "know your product", "know your client" and "investment policy statement" (IPS) process.

iv. The rules should operate neither to exclude investors who are informed nor to include investors who are not.

v. The rules should not be assumed to protect investors from their own stupidity or irresponsibility. There are no rules that prohibit someone from investing 100% of their investable assets into a publicly-traded penny stock through a discount broker (*i.e.* where there is no advisor involved and therefore no suitability calculus undertaken by anyone). Similarly, the rules in the exempt market should not be designed to make it impossible for a fully informed investor to "put it all on black" into an investment that he or she believes in. This is what happens every day with entrepreneurs and is an important part of a free market economy. (Note that the EMD will, and does, have the responsibility to advise against such a trade, but if the investor is determined to make the investment notwithstanding advice to the contrary, he or she should have that choice.)

C. With these objectives in mind, we suggest the following AI rules be adopted in the place of the existing AI exemptions (at least as they pertain to ordinary investors):

   i. The definition of "Financial Assets" (which would only be used to determine suitability and for (ii) below) be redefined so as to <u>exclude</u>:

      i. the <u>primary residence</u> of the investor (*i.e.* to include the value of all other real estate net of debt tied to that real estate)[2] and

      ii. securities for which it is either impossible or unfeasible to produce a reliable value (such as shares in a private company with wholly illiquid assets and goodwill tied directly to the owner).

   ii. Any investor would be able to invest the <u>greater of $5,000 or 10% of their Financial Assets</u> into any investment whatsoever (including those for

[2] Including real estate other than the primary residence of the investor in the calculation of Financial Assets necessarily involves valuating that real estate. This could be achieved using the assessed value for the property for tax purposes, although assessed values are notoriously low compared to the actual value, which can often be determined using recent sales data. Also note that excluding the primary residence is motivated by never having a situation in which an investor is forced into liquidating a primary residence in the event of a bad investment.

which no offering memorandum exists), subject to the determination of suitability by an EMD. No offering memorandum need be provided for these investments. The responsibility of "know your product" still lies with the EMD in these cases.

iii. CSA publish a KYC document and IPS template that must be used by all EMDs. Naturally, EMDs are able to add to these templates, but they must be used as a starting point. These documents are designed to establish knowledge, sophistication, financial wherewithal, risk tolerance, return objectives, and capital constraints.

iv. All provinces adopt a single short-form "Offering Document" that is in template form, addressing, in plain English, the nature and risks of the investment, as well as highlighting liquidity constraints. This Offering Document would pertain to any exempt market product.

v. All provinces adopt a single "Subscription Document" to be used for all exempt market investments.[3]

vi. All exempt market product not being distributed in small amounts described in (ii) above must be sold via the prescribed Offering Document and Subscription Document.

vii. All EMDs be provided with clear guidelines (with examples) of how to determine suitability, and be provided with resources at their respective securities regulators to seek <u>non-binding advice</u> regarding individual cases that are "grey". An EMD seeking to do his or her job and be compliant should not by default be confronted with the words "it's your responsibility to be compliant" or "call your lawyer" with issues regarding suitability.

[3] Such a document would most likely require a list of appendices that would outline, in clear English, items specific to the offering in question. The goal here would not be to provide less information in the Subscription Agreement that might currently be in a given agreement, but to standardize the format for such a document.

viii. Once armed with the above, the basic rule regarding exempt market investments should be suitability, based on the "know your client" "know your product" and "suitability" triangle. Although necessarily subjective, when combined with the Offering Document, Subscription Document, KYC, IPS and guidelines from above, this process is totally achievable.

Obviously the foregoing is nothing more than a suggested framework. The focus on suitability rather than arbitrary qualifying tests, however, is at the crux of what we believe would significantly ameliorate the current situation.

We have intentionally not discussed the differences in the exempt market in Ontario and other (particularly Western) provinces. We believe, however, that the first step in establishing a fair and reasonable framework moving forward would be to harmonize the exempt market rules across all provinces and territories. We believe that the "offering memorandum exemption" in the western provinces allows virtually anyone to invest any amount into any security offered through an offering memorandum, which all but nullifies the entire regulatory regime. In Ontario, however, where the AI rules reign, we believe that the rules are far too prohibitive from a capital raising point of view and do little to protect investors on the other side of the coin. In other words, the regulatory regime in Ontario, in our view, achieves few of the objectives articulated above.

We are happy to discuss the contents of this note with regulatory personnel at any time.

Westcourt Capital Corporation

Per: David R. Kaufman, President and Chief Compliance Officer