
From: Gordon Smith
Sent: Wednesday, February 29, 2012 3:26 PM
To: George Hungerford; Leslie Rose
Cc: Maria Seifert
Subject: FW: Accredited Investor
Attachments: CSA Staff Consultation.pdf

Comment letter

From: Suzanne Draskoczy [mailto:suz.draskoczy@altawestmortgage.com]
Sent: Wednesday, February 29, 2012 3:18 PM
To: consultation-en-cours@lautorite.qc.ca; Gordon Smith
Cc: comments@wemaonline.ca; info@amba.ca; Dave McKitrick
Subject: Accredited Investor

Please refer to attached letter.

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February, 2012

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Dear Sirs and Madams:

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

The Alberta Mortgage Brokers Association (AMBA) is the collective voice of the mortgage brokers industry in Alberta. AMBA develops a standard of excellence for its members through advocacy, education, information and networking. AMBA promotes ethical and sustainable industry practices for consumers and industry members.

Through the membership of AMBA a subcommittee was formed called the Private Lenders Forum; whose goal is to assist private lenders in the province of Alberta in the compliance with new securities regulation and develop an association of best practices for the private lending industry. The forum is composed of 28 companies across Alberta that provides financing to the real estate market. They are composed of Mortgage Investment Corporations, Syndication entities, Trusts, partnership and individual lenders.

With new national regulations the association has taken an active role to act in the best interests of the investors, consumers and the industry.

The Private Lenders forum would like to make a number of comments with respect to the Canadian Securities Administrators (CSA) review of CN 45-401. We understand that CSA is governed by the following mandate:

- Protecting investors from unfair, improper or fraudulent practices ; and
- Fostering fair and efficient capital markets and confidence in those markets.

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And is also guided by the following principles:

- Regulatory initiatives must effectively address the risks to investors and markets that are identified; and
- The benefit of any regulatory initiative must be proportional to its cost to industry and the restrictions it imposes on market participants.

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:

Our organization feels that a minimum amount for an exemption is not a good measure of determining an ability of an investor to take a financial loss. Through the training our industry receives as Exempt Market Dealers (EMD) tells us that a number of factors need to be considered to determine an individual's suitability for an investment. Age, savings, retirement, pensions, risk tolerance, education and knowledge of the business or a product.

At the very least the minimum should not be increased.

It is the obligation of the EMD to evaluate the client and determine if a client is suitable to invest in that certain investment. A simple dollar mark does not make someone accredited nor should it disqualify a person from investing.

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 firm or an individual that is distributing their own product would be registered as an EMD and has an obligation to ensure that suitability is performed. The knowledge of the product or the investment will allow an EMD to appropriately determine what is appropriate.

Does an EMD that is offering two products have a better capacity to determine what is suitable? What is an appropriate number of products that an EMD could offer that would make it not a concern?

At the end of the day it is the education and the experience and knowledge of the EMD that should be the focus of our industry to ensure that the right measures are used to perform suitability. An EMD who is distributing product that they are intimately involved in the distribution enhances the knowledge that can be passed to a potential investor because they understand the product they are selling, where a third party EMD may not be able to provide the level of sophistication to communicate the product risks.

3. Do you have comments on the issues described in background #3?

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

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 exist 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) increases 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. Finally, it is important to point out one way in which the MA exemption is “gamed”. 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 letter of the law as it pertains to the MA exemption (assuming that both investments were in fact suitable), but clearly violates the spirit 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.

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

The response provided above address this issue.

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

While we feel this arbitrary number we would support not changing it.

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

The minimum investment threshold while again arbitrary it should not be increased.

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

No there should not be any index to inflation. If it is determined that the threshold should not be removed then it is better to maintain the minimum for consistence and not continue to plague the industry with this arbitrary number that fails to provide the right measure of protection for investors.

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

From the mortgage industry it is very typical that investments to be made in the value of \$150,000 and this would impact the investment opportunities for our industry.

Especially in the area of syndication of mortgages where larger amount of funds are used in order to assemble the necessary funds to perform a transaction.

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

Disclosure should always be provided to the investor. We believe in plain, full and transparent disclosure. Whether an investor invests \$9,000 or \$150,000 this should not change at all.

- a) There are a number of assumptions that are made when we set a particular watermark as the determinate of insuring that an individual is qualified to make a certain investment. The idea that being able to invest the amount of \$150,000 in to one project is sufficient enough to qualify as very dangerous. This can often motivate an individual to place all of their investments in to one product. Through the Know Your Client and suitability we know that this is not prudent investment practices. As an industry we have to ensure that we have rules that support good investment strategies, any portfolio manager will tell you that some diversification in a portfolio is required.
- b) One change that now exists in our industry is Exempt Market Dealers are available to the general public to assist in making good investment decisions. This was not something

that was available in 1987 when an Accredited Investor and the exemption were introduced.

- c) The technology was also not available to give the general public as much information as is available now. This allows for a much higher level of sophistication than ever before.
- d) How we define sophistication has also significantly changed over the last 20 years as well. Financial wealth can be a very poor measure and many other factors need to be considered. (Example how close an individual is to retirement, disabilities, disposable income and many other factors) this all needs to be evaluated in assisting a client in making a sophisticated investment decision.
- e) Changing the rules for individuals that have had access to an exemption and then telling them that they no longer apply can be a very difficult and challenging issue. How can a regulation dictate that one day an individual is qualified and with the proposed increases no longer we qualified? If there was to be rule changes those that have used that exemptions in the past should be able to use it in the future.
- f) Consideration needs to be taken as to the experience and the background of an individual. For example a mortgage broker that is in the business of providing consumers with mortgages has industry knowledge and experience in the business that can allow them to make a better decision as to how to invest in a mortgage. Should this individual be told that he does not have the sophistication to invest in a mortgage? If he is not qualified who is? Other factors that should be considered:
 - a. Investment experience
 - b. Work experience
 - c. Education
 - d. Investment portfolio (not just net assets)
- g) In the mortgage industry there are investments in mortgages where the investment opportunity would require less than the minimum investment. How should issues like this be addressed?
- h) Another point to consider that that while net worth can be an indication of sophistication there are also those individuals that have a million dollar home, million dollar vacation property but very little in the way of investment assets.
- i) There also needs to be some consideration that placing the decision power entirely in the hands of the EMD. If all the exemptions were removed and EMD's had the capacity to

decide your investments there will be those that will benefit from the decision, therefore there does need to be guidelines.

- j) The reality is that it is just as easy to lose money in the stock market as it is in the exempt market.

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

See above

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

Institutional lending will be impacted for our business. Any fund that has assets less than that of a potential new threshold amount will not be able to join with other funds in a syndicate manner. This increases the exposure of the so called smaller fund as they will not be able to share the risks on larger deals and will strictly have to underwrite their own deals subject to 100% of the inherent risk.

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

See above

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

No there should not.

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

Discussed in number #3

15. If the minimum amount exemption was repealed:

- 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.

- b) 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.

- c) 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 understand. 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 objectives that the AI exemption ought to seek to meet:

- The rules should not be so cumbersome as to exclude relatively minor investments into private ventures.
- 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.
- 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.
- The rules should operate neither to exclude investors who are informed nor to include investors who are not.
- 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 exclude:

- the primary residence of the investor (*i.e.* to include the value of all other real estate net of debt tied to that real estate) and
- 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).

- 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.
- Any investor would be able to invest the greater of \$5,000 or 10% of their Financial Assets into any investment whatsoever (including those for 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.
- 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.
- 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.
- All provinces adopt a single "Subscription Document" to be used for all exempt market investments.³
- 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.
- 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 non-binding advice regarding individual cases that are "grey". An EMD seeking to do his or her job and be compliant
- 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 should not by default be confronted with the words "it's your responsibility to be compliant" or "call your lawyer" with issues regarding suitability.
- 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.

Conclusion

The Accredited Investor and minimum amount exemptions should not be changed for qualified Exempt Market Dealers that are sufficiently ensuring that the "Know Your Client" forms are being completed and suitability is considered.

Support

1. Investor protection has been significantly enhanced and improved over the past 20 years and Exempt Market Dealers have the knowledge and understanding to assist investors in making better investment decisions.
2. With the new KYC requirements, product issuers are required to get investor representations that they are in fact AI's. By requiring 3rd parties such as accounts or lawyers to attest to AI status would be very expensive, cumbersome and not allow the timely flow of investment capital.
3. All investors that are AI's or have \$150,000 to invest, by definition have the resources to engage third party professionals to evaluate investment opportunities on their behalf. A quality MIC or syndicator is always happening to deal with such professionals and answer their questions. If investors choose not to use their third party professionals before investing, that is their decision and should not affect our access to capital markets.

Alta West Mortgage Capital Corporation would like to thank the Canadian Securities Administrators for providing our industry an opportunity to respond to this issue and to take serious consideration for the impact this will have on our industry, investors and the Canadian public.

Yours truly,

Dave McKittrick

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