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February 29, 2012

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Re: CSA STAFF CONSULTATION NOTE 45-401
REVIEW OF MINIMUM AMOUNT AND ACCREDITED INVESTOR EXEMPTIONS

PUBLIC CONSULTATION

Dear Sirs / Mesdames,

We are writing in response to the Canadian Securities Administrators' (CSA's) Request for Comment on its review of the minimum amount prospectus exemption (the "MA exemption") and the accredited investor prospectus exemption (the "AI exemption") contained in National Instrument 45-106 *Prospectus and Registration Exemptions*.

This is a lengthy submission. Advocis is deeply committed to the principles of access to fair and efficient capital markets and the value of professional financial advice. Accordingly, while the essence of Advocis' position can be found in the Executive Summary and in the answers to Questions 3, 14, 23, 26 and 30, Advocis has responded at length upon the other questions asked by the CSA, as well as provided comment on the CSA's framework of reference.

Executive Summary

Advocis recognizes that it is beneficial for Canadians to have regulation in the exempt market which protects investors without unduly restricting the ability of issuers to raise capital and the ability of investors to access a broad range of products. Nevertheless, Advocis believes that any changes to the current MA and AI exemptions will have a significant impact on capital-raising in Canada, and on the number of investing options available to investors and their advisers. The danger of limiting or eliminating for individual investors the exemptions under which these exempt market products can be sold lies in the resulting adverse impact on liquidity, the value of existing products, and on the future willingness of investors to participate in the exempt market. Moreover, Advocis is concerned that the CSA's recent review of securitized products acknowledges the importance of securitization to the economy but then proposes rule amendments and new rules which could very well remove securitized products from the exempt market. Further restrictions of the ability of investors and issuers to participate in the exempt market will have potentially damaging consequences for the amount of available investment capital.

Reducing the ability to invest and raise capital will adversely affect the exempt market in general and the securitization market in particular and any such regulation should be incremental and retain as much of the status quo practice of Canadian issuers and investors as possible.

It is our view that modifications to the existing MA and AI exemptions should reflect the proper balance between investor protection and market integrity versus efficient access to capital. Eliminating the MA and AI exemptions for retail investors, or setting thresholds so high that only very wealthy individuals can participate in Canada's exempt market would be draconian responses to the problems currently associated with those exemptions. Indeed, the actions of dealers who fail to properly abide by “know your client” rules suggest that the problem does not lie with individual investors. The involvement of a registered financial advisor who is a member of an SRO would be a cost-effective, minimally disruptive and practical solution to the need for additional investor protection. Rendering the exempt market inaccessible to some or even all individual investors would harm the ability of small and fledging companies to raise capital; this would be poor public policy and not a preferred regulatory alternative. There is no evidence known to us that the existing MA and AI exemptions are on any meaningful scale responsible for market crises. If the CSA wishes to protect individual investors and promote market integrity, we suggest that the current regulatory regime be re-calibrated to properly respond to the actions of bad actors instead of radical changes which would effectively restrict the exempt market to the much-discussed "1%".

In summary, Advocis proposes keeping the current MA and AI exemptions, as well as introducing additional MA and AI exemptions:

> The MA exemption: We propose that the current $150,000 threshold be retained and indexed for inflation. In addition, the threshold amount should be dropped to $20,000 when the exempt market product is distributed through a financial advisor who is registered with an exempt market dealer and the product is managed by a registered portfolio manager and comes with an Offering Memorandum. Please see our answers to Questions 3 and 14 for more details.
>
> The AI exemption: We believe that the current threshold amounts should be retained and be indexed for inflation. In addition, a second, separate AI test should be introduced. This test would require that the exempt market investment be distributed

through a financial advisor who is registered with an exempt market dealer and comes with an Offering Memorandum. With these qualifications met, the current AI exemptions income and asset thresholds could be reduced by 50%. It would need to be delivered to the securities regulatory authority within 10 days after the distribution. Please see our answer to Questions 23 and 30 for more detail.

Risk acknowledgement form: Prior to the purchase of a product pursuant to our proposed additional MA and AI exemptions, the individual investor must sign a risk acknowledgement form. The use of a risk factor disclosure document required to be signed by the investor will provide regulators with further assurance that the investor has read and understood the risks. This document would provide the dealer with a degree of protection in regard to allegations of misconduct. Such a form is already used as the basis for exemptions by the British Columbia Securities Commission (please see Appendix A for a sample form, as well as our response to Question 23).

The exempt registrant would then report the purchase to the regulator as an exempt market transaction and provide the dealer (and the issuer, where appropriate) with a copy. It would need to be delivered to the securities regulatory authority within 10 days after the distribution.

An exempt markets course: Upon review of recent OSC rulings and orders, Advocis has concluded that the exempt market actor best able to evaluate the suitability of an exempt market product for individual investors is in many cases an exempt market registrant, including a financial advisor who has taken a recognized exempt markets course. While exempt market dealers and chief compliance officers are required to complete the Canadian Securities Course Exam and the Exempt Market Products Exam,[1] Advocis submits — given the growing complexity of exempt market products — that *all* exempt market registrants be required to complete an exempt markets course, to ensure a basic standard of proficiency is met by key parties to an exempt market transaction. This requirement would enhance the value of advice available to prospective individual exempt market investors.

Advocis: who we are

With more than 11,500 members organized in 41 chapters across Canada, Advocis is the largest and oldest voluntary professional membership association of financial advisors in Canada. Our members are independent owners and operators of small businesses and financial advisors and financial planners who are sales representatives of medium- and large-sized financial services companies, who provide comprehensive financial planning and investment advice, retirement and estate planning, and wealth and risk management expertise. Our members offer clients a prudent long-term perspective on managing a wide array of financial risks and meeting long-term financial goals. Our members are typically dual-licensed to provide life and health insurance as well as mutual funds and securities.

[1] In terms of proficiency requirements, an exempt market dealer's dealing representative must pass the Canadian Securities Course Exam, the Exempt Market Products Exam, or satisfy the proficiency requirements of an advising representative of a portfolio manager. An exempt market dealer's chief compliance officer must pass the PDO Exam (the Officers', Partners' and Directors' Exam or the Partners, Directors and Senior Officers Course Exam) and either the Canadian Securities Course or the Exempt Market Products Exam, or satisfy the proficiency requirements of a chief compliance officer of a portfolio manager. See CSA STAFF NOTICE 31-312, *The Exempt Market Dealer Category Under National Instrument 31-103 Registration Requirements And Exemptions*, August 7, 2009.

We strongly support consumer protection measures, including regulatory initiatives that benefit investors by helping them make more informed decisions, and that allow financial advisors to continue to conduct their businesses in a professional and efficient manner without undue regulatory burdens.

The CSA's framework for review

the CSA's mandate and principles of review

The *Consultation Note* identifies the reason for the review of the MA and AI exemptions as: "The global financial crisis and recent international regulatory developments have raised questions about the use of the minimum amount exemption and the AI exemption." That is, the consultation should be viewed in the context of the global harmonized regulatory initiatives to reduce systemic risk in the financial markets through the G-20 and other bodies.

In deciding whether changes to the minimum amount exemption and the AI exemption are necessary or appropriate, and if so, in developing recommendations for changes, the CSA notes that it will be governed by its regulatory mandate of:

- protecting investors from unfair, improper or fraudulent practices, and
- fostering fair and efficient capital markets, and confidence in those markets.

Further, the CSA states that it will also be guided by the principles that

- regulatory initiatives must effectively address the risks to investors and markets that are identified, and
- the benefits of any regulatory initiative must be proportionate to its cost to industry and the restrictions it imposes on market participants.

It is to these principles of identifying the risk to markets and proportionality of benefits to costs that Advocis will return to at various points of this submission.

evidence-based policy-making and the exempt market

Howard Wetston, the Chair of the Ontario Securities Commission, acknowledged at the recent OSC Dialogue 2011 the importance of evidence-based policy making as "key to better financial market regulation." With regard to the growing significance of the exempt market in Canada, Wetston said:

> The exempt market has become increasingly important for investors and issuers. The total exempt market in Canada is valued around $83 billion and Ontario's share of that market is 53%. In this province, Ontario-based issuers raised approximately $44 billion in 2010. New equity issues in 2010 across Canada were approximately $41 billion. It is clear that there has been a significant migration from public to private markets. What implications does this have for policymaking? Fact-based research will assist us in answering that question.

evaluating the framework of review with regard to the exempt market

Based on this framework of review, several points come to mind. First, no specific problems with the current exemptions in Canada are identified by the CSA. Second, the specific wording of many of the questions appears to derive from the CSA's assumptions that investors – in particular, individual investors – are acquiring securities from issuers relying on these exemptions in a dubious or even inappropriate set of circumstances. Third, it is a truism of securities regulation that the enhancement of disclosure and transparency is only one side of the

regulatory equation. Improved information disclosure to investors can be rendered ineffective if investors do not undertake – or lack the capacity to undertake – the requisite risk evaluation of the products they are considering.

Indeed, one of the recent criticisms of securitised products is that such products are being sold to investors who have failed to reach a comprehensive understanding of the products and their attendant risks. In such cases, to provide a greater degree of investor suitability, the regulatory response is typically two-fold:

(i) mitigation of individual investors' exposure to risky products by imposing an obligation on the issuers or distributors of such products to help ensure investors are offered products suitable for them; and/or

(ii) the creation of tests or exemptions for "accredited investors" and "sophisticated investors," which may include the need for the regulator to require that individual investors possess a skill set to help ensure that they comprehensively assess and manage the risks of a securitised exposure, or an assessment of the investor's financial status and other characteristics, such as the acumen needed to understand the product and assess and manage its associated risk.

The policy justification for (a), that is, for imposing sales practice rules on financial intermediaries, is based on the assumption that the product provider has better access to the information needed to make informed investment decisions and, thus, is better able to avoid the foreseeable losses resulting from investment transactions.

However, in the exempt market, the concept of information asymmetries becomes much more blurred than in traditional prospectus-driven securities regulation. Indeed, for some investments, including certain derivatives and funds indexed to currencies, spot prices in commodity markets, or broad-based indices, it is arguable that the issuer or distributor possesses no privileged information that is not also available to the investor. In such cases, the policy focus shifts from concerns about information asymmetry to the putative sophistication of the parties to the investment transaction — that is, the ability of the parties to evaluate the available information.

The differences in the respective ability to access to information by intermediaries and individual investors vary from product to product, but certain exempt market products, such as hedge funds, are sufficiently complex or esoteric that even relatively sophisticated individual investors are unable to devote the resources necessary to developing a comprehensive understanding of the products features, benefits and risk characteristics.

In such cases, regulation should offset such imbalances by shifting a portion of the responsibility for assessing information to registrants and other financial intermediaries. This is why Advocis believes that regulation is needed which requires that individual investors receive formal advice from a registrant. Simply warning investors of potential risks and prompting them to educate themselves before investing has proven to be insufficient time and again.

The balance of Advocis' responses and comments will be devoted to the policy area identified in (b), above – the creation of individual investor exemptions. However, we will return to the framework of review, as appropriate.

The questions

2. Principles underlying the minimum amount exemption and the AI exemption

1. What is the appropriate basis for the minimum amount exemption and the AI exemption?
As will be explained in greater detail below, the MA and AI exemptions can be based on a range of indicia, such as the characteristics of the individual, including financial resources (the ability to obtain expert advice or withstand financial loss), educational background, work experience, and investment experience.

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?

Yes. The *Consultation Note* points out that the MA and AI exemptions have historically been premised on an investor having one or more of:

- a certain level of sophistication,
- the ability to withstand financial loss,
- the financial resources to obtain expert advice, and
- the incentive to carefully evaluate the investment, given its size.

Advocis does not believe that any one of these factors is sufficient to ensure a suitable level of investor protection in the exempt market. Neither sophistication, nor wealth, nor education or work experience, nor the ability to pay for advice are sufficient in themselves to ensure that investors in the exempt market will not make bad decisions and take inappropriate risks.

For the individual investor in the exempt market who lacks significant investing experience, access to expert advice becomes a more compelling necessity. Accordingly, Advocis believes that the involvement in the exempt distribution of a registrant who has an obligation to recommend only suitable investments and is accountable to the investor with respect to those recommendations, would protect investors more effectively than the existing approach.

We believe that the registrant also should be accountable through membership in a professional association for financial advisors which requires the advisor put the interests of the investor ahead of his or her own.

3. Minimum amount exemption

Consultation questions

3. Do you have comments on the issues described above?
Regulators must understand that not all exempt market products are inherently high risk. In fact, some exempt market products are designed to aggressively mitigate risk in ways not available with traditional prospectus-based investments. The experience of Western Canada shows that there are many exempt market products with proven track records of 20-plus years without any net negative return for their investors.

Problems with the MA exemption
The problems identified in the CSA *Consultation Note* with the MA exemption involve the fact that the ability to meet the threshold amount is an imperfect proxy for the presence of investor

sophistication or access to information. Merely making an investment of a particular size in the exempt market in itself cannot provide assurance of investor sophistication or access to information – particularly, as the CSA observes, when the minimum amount exemption is used to sell novel or complex products without any accompanying disclosure. In such cases, it is safe to say, as the CSA does, that "the size of the investment is an indicator only of the investor's ability to withstand financial loss."

As stated in the *Consultation Note*, the current threshold for the MA exemption was set in 1987 and has not been changed or adjusted for inflation since. The $150,000 threshold would be equivalent to over $265,000 in 2011 dollars. However, the introduction into the exempt market of excessively complex or novel products, such as ABCP, has led some stakeholders to suggest that the $150,000 threshold is too low, and has led to the result that unsophisticated retail investors are participating in the exempt market via risky, complicated financial instruments.

The very presence of a minimum amount exemption can skewer investment decisions. For example, the current threshold of $150,000 may cause an investor to invest more than prudent business or investment considerations would dictate, merely in order to meet the threshold. As the CSA notes, an investor can be tempted to invest $150,000 when it may have been prudent to limit the investment to, say, $20,000, or to make a series of staged investment in smaller increments.

Advocis submits that a minimum amount investment size offers no assurance that the investor is sophisticated, will be able to make a sound investment decision, and will be able to withstand a loss. Over the years, many commentators have proposed that the exempt market investment size be measured in relation to the individual investor's overall portfolio or financial position in order for a third party to determine whether the heightened risk potential of the proposed investment is properly balanced by the ability of the individual to absorb loss. In addition to the problem of arriving at suitable means of measuring risk, capacity to bear a loss, and so on, there is also the problem of identifying who the third party should be. Advocis believes that the third party best able to evaluate the suitability of an exempt market product for individual investors is in many cases an exempt market registrant – including a financial advisor who has taken a recognized exempt markets course.

The difficulty of characterizing exempt market products

In general, exempt market products target higher-than-normal returns while offering limited liquidity options. Some are backed by tangible assets. However, the sole common characteristic of exempt market products is their exemption from the prospectus requirement. In practical terms, this means that exempt products is a category with tremendous diversity in product design. Even the basic taxonomy of the main exempt market products — principal-protected notes, limited partnerships, hedge funds, real estate investment trusts, flow-through shares of a principal-business corporation, and private placements to corporations — fails to capture the tremendous range of product variegation of — and risk associated with — exempt market products. Such categorical breadth, however, does indicate the unfeasibility of providing a single set of rules based on product type for regulating investor access to the exempt market.

Presently, the same set of rules govern investor access to a complex private business project with an Offering Memorandum, as well as the purchase of a relatively simple principal protected note. Clearly this is an odd state of affairs.

Advocis' proposal

Regulators do not differentiate between an exempt market investment which is "structured" (that is, managed) by a securities registrant, and an investment which is brought to market by a "promoter," most of whom are not registered, as is the case with a private real estate investment trust.

Accordingly, Advocis proposes the CSA make a distinction between a registered portfolio manager, whose status as a registrant should allow him or her to offer individual investors products under a revised set of rules. Non-registered entities who offer exempt market investments would not be eligible to participate under our proposed extended MA exemption (as described below). In such a regulatory scheme, if the products are sold by registrants, the investor is afforded a significant layer of protection. Regulating the access of individual investors to exempt market investments by segmenting the exempt market between products which come with a registered portfolio manager and high degree of information, and those that do not, would be a low-cost yet effective form of regulation. Such products would:

(i) be managed by a registered portfolio manager,
(ii) come with an Offering Memorandum with full disclosure of risks, and
(iii) provide audited financial statements.

Like a prospectus, an Offering Memorandum comes with statutory rights of rescission. As well, investors can seek redress in the event of a misrepresentation.

Advocis therefore recommends that where:

(i) exempt market products are distributed through a financial advisor who is registered with an exempt market dealer,
(ii) the product is managed by a registered portfolio manager;
(iii) it comes with an Offering Memorandum, and
(iv) the investor signs a risk acknowledgement form similar to that attached as Appendix A hereto, the MA threshold should be reduced to $20,000.

This threshold lowering would serve the dual purpose of increasing the capital available to companies participating in the exempt market, while also letting properly informed investors who cannot meet the current $150,000 MA threshold have access to the potential benefits afforded by exempt market products. The fact that these retail investors have sought and understood advice from a registered financial advisor would be, in terms of outcomes, tantamount to meeting a criterion for the assurance of sophistication.

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

(a) Maintain the status quo

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

As noted, the CSA's stated reason for the review is in the form of a brief comment on the global financial crisis. At this stage, the CSA has not provided any analytical data linked to a clearly identified harm or public policy goal. Therefore, maintaining the current threshold amount is clearly a prudent option.

However, in the interests of enhanced capital raising, and in providing investors with the greatest possible range of investment options, Advocis believes that the exemption should be revised downward to $20,000, provided the circumstances stated in our proposal above are satisfied.

(b) Adjust the $150,000 threshold

6. How much should the minimum investment threshold be increased?
Given our statements above, it comes as no surprise that Advocis believes there are significant policy arguments for not increasing the threshold amount.

Increasing the threshold amount, even if just adjusting for inflation, will mean that the exemption will no longer be available to investors who do not need the protections provided by a prospectus offering and who are currently participating in the exempt market. The impact of a threshold adjustment, in particular the resulting loss of capital in the exempt market, would not justify the additional protection afforded to a small number of investors – most of whom likely should not be participating in the exempt market without the benefit of expert financial advice. That is, the second principle identified by the CSA in its framework of review, the proportionality of benefits to regulatory costs, would be violated by an increase in the threshold amount.

To ensure that the benefits of any regulatory initiative must be proportionate to its cost to industry and the restrictions it imposes on market participants, Advocis would like to see a cost-benefit analysis done on the impact of raising the threshold of the minimum investment amount.

Nor would the CSA's mandate to provide investor protection be met by simply raising the size of the threshold amount. Participating investors in the exempt market would still be exposed to unfair, improper or fraudulent practices. The only changes from the *status quo* would be less capital in the exempt market; wealthier investors would still be exposed to the "bad actors."

In terms of the CSA's mandate to foster fair and efficient capital markets, and confidence in those markets, merely increasing the threshold amount would, as noted, simply drive down the amount of capital in the exempt market and, rather than increasing confidence in markets, in fact strengthen the perception that exempt markets are simply a rich person's investing arena.

Finally, in regard to the other guiding principle – that regulatory initiatives must effectively address the risks to investors and markets that are identified – solely adjusting the minimum amount exemption upward would fail to fulfil that principle. In contrast, the requirement that the investor sign a risk acknowledgement form would amount to an effective identification of and response to the level of risk in exempt market products.

In terms of potential options regarding the minimum amount exemption, the CSA states that, depending on the results of the consultation process, it may propose: (1) retaining the minimum amount exemption in its current form; (2) adjusting the $150,000 threshold; (3) limiting the use of the exemption to certain investors, such as institutional investors and not individuals; (4) using alternative qualification criteria; (5) imposing other investment limitations; or (6) repealing the exemption. While Advocis will comment on each of these options in more detail below, at this point we wish to state that Advocis strongly opposes option (3) and would wish to see a evidence-based analysis prior to the CSA pursuing to option (5).

To reiterate: Advocis would like to see the current MA exemption retained, with an option to further reduce the minimum amount threshold to $20,000 where the conditions of our proposal, as outlined in our answer to Question 3, are satisfied.

Would your answer to this question change depending on whether:
• any disclosure is provided to investors, including risk factor disclosure?

While we are in favour of full, true and plain disclosure, we do not believe that much reliance should be placed on the protection offered to the investor by disclosure. Regardless of how thorough the disclosure is and how much emphasis is placed on risk factors, and also regardless of how clear and understandable the disclosure may be, often the disclosure is not read or understood. We believe that in order to protect investors in the exempt market, even wealthy or sophisticated ones, regulators should look to the lowest common denominator and aim to protect investors who don't pay close attention to the disclosure.

And as noted above, with regard to many products in the exempt market, the small- to medium-sized enterprise or SME issuer may not have significantly better information than an institutional investor. Nonetheless, we would expect that with certain products the fact the issuer is a reporting issuer would offer some comfort to sophisticated individual investors that the information provided can be relied on to provide an accurate picture of the enterprise and the risks entailed in acquiring its securities.

• **the purchaser is an individual, instead of an institutional investor?**
Advocis strongly urges the CSA to retain the exemption for both the individual and the institutional investor, to avoid limiting investment options available to individuals and the amount of capital available to companies active in the exempt market. Elimination of the ability of the individual to invest in the exempt market would be a severely excessive way to try to protect individual investors from unfair, improper or fraudulent practices, and would limit the ability of investors and their advisors to diversify their portfolios via participation in the exempt market.

• **the security is novel or complex?**
Advocis does not believe that the policy focus of the MA and AI exemptions should be shifted from investors' capacities and capabilities to the products themselves. Product-by-product regulation in a field as dynamic, innovative and inventive as the exempt market would prove to be administratively impractical, if not impossible.

• **the issuer of the security is a reporting issuer?**
In general, the requirement of a reporting issuer would provide an additional layer of protection to investors motivated enough and capable of reviewing a reporting issuer's materials, and would help fulfill the CSA's mandate of fostering confidence in the capital markets.

• **a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser**?
As noted in our answer to Question 3, Advocis submits that if the distribution involves a registrant who is under obligation to recommend only suitable investments to the individual investor, the need for a substantial threshold requirement is greatly weakened. Accordingly, in those cases, along with the other conditions specified, the threshold level should be revised downward to $20,000.

7. Should the $150,000 threshold be periodically indexed to inflation?
The MA threshold should be adjusted periodically for inflation. However, we believe there is some advantage to having a stable, well-known, "round number" for the threshold. Accordingly, we do not believe that it is necessary to adjust the threshold annually. Instead, we would suggest adjusting the threshold upwards or downwards to reflect inflation (or deflation), whenever changes in the consumer price index would justify a larger incremental change, such as a change of $2,500.

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

Any increase in the exemption threshold would exert a downward pressure on capital raising. Conversely, the downward revision or elimination of the MA exemption would greatly benefit capital raising efforts for the SME exempt market issuers.

(c) Limit the use of the exemption by individuals

9. Should individuals be able to acquire securities under the minimum amount exemption?
Yes.

Would your answer to this question change depending on whether:

• any disclosure is provided to investors, including risk factor disclosure?
Advocis does not believe that introducing further disclosure requirements, beyond the current ones, will necessarily lead to improved outcomes. Such an addition will, however, increase costs and further reduce the ability of the exempt market issuer to raise capital – and ultimately restrict investors' choices.

In the exempt market, many SME issuers also operate without adequate resources to provide investors with ongoing disclosure, or particularly sophisticated risk disclosure. In such cases, individual investors are forced to rely on the distributor's reputation and past performance in structuring the investment transaction.

Further, it should be noted that while firms and institutional investors assign significant resources to research on information relevant to many exempt market products — such as property prices, default and prepayment rates on mortgages — in order to forecast the performance of certain investment products in the exempt market, individual investors typically lack the opportunity and resources needed to properly evaluate such due diligence.

• the security is novel or complex?
As stated above, Advocis does not believe that the policy focus should move away from investor protection to products.

• the issuer of the security is a reporting issuer?
Again, Advocis does not believe that introducing a special criterion for a reporting issuer will necessarily lead to improved outcomes. Such a criterion would work to the detriment of exempt market issuers which are SMEs, further reducing their ability to raise capital and ultimately restricting investors' choices.

• a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?
As noted, Advocis believes that one of the most important elements in protecting individual investors is the involvement in the distribution of a registrant who has an obligation to recommend only suitable investments, and is accountable to the investor with respect to the suitability of recommendations.

10. If individuals are able to acquire securities under the minimum amount exemption, should there be any limitations?
Advocis does not believe there should be any further limitations added to the minimum amount exemption. The previous Ontario-only rule, eliminated in 2001, did not require, as the new rule does, that the $150,000 be in the form of cash. Any further limitations on this rule would be

detrimental to the ability of exempt market issuers to access capital and investors' ability to access to a wider range of investment products.

11. If we limited the use of the exemption to persons who are not individuals, what would the impact be on capital raising?
Advocis believes that such a limitation on capital raising would be detrimental to the capital markets and to investors, unnecessarily reducing the amount of available capital, particularly for SMEs.

(d) Use alternative qualification criteria or impose other limitations

12. Are there alternative qualification criteria for the minimum amount exemption?
Advocis believes a "financial means" test would be a more appropriate mechanism for making exemptions than a blanket threshold amount. However, relying on dealers or issuers to conduct such a test is implausible for many reasons, including the obvious conflict of interest. Such a test could possibly be administered by requiring a registered financial advisor to conduct the test on his or her clients, as an extension of existing Know Your Client requirements.

13. Are there other limitations that should be imposed on the use of the minimum amount exemption?
No.

(e) Repeal the exemption

14. Should the minimum amount exemption be repealed?
No.

Would your answer to this question change depending on whether a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?
Advocis believes that the minimum amount exemption should be revised downward, subject to the conditions noted in our response to Question 3, above.

It is worth noting that the OSC did eliminate its minimum investment exemption in 2001, after concluding that requiring a minimum investment was not a good proxy for sophistication The threshold was reintroduced in 2005, for purposes of harmonization. During that interim period when Ontario had no MA exemption, capital raising efforts enjoyed an across-the-board boom. In *One Step Forward – A Study of the Economic Impact of OSC Rule 45-501 Exempt Distributions* (March 2003), the OSC stated, with regard to the elimination of Ontario's "$150,000" exemption:

> One restrictive element that was removed concerned the "$150,000" exemption. The monetary threshold was used as a screening mechanism to allow entry into this investment arena. The results show that there has been a significant impact at this range of investment. The ability to invest at these levels has not gone unnoticed. The present capital inflows of this transaction size overshadow the activity of the previous period from 1995-1998. Access to these investments has been made available to a broader investor base.
>
> The additional benefit of removing the minimum investment requirement is the reduction of risk to the investor. An investor's risk was increased under the previous framework because a minimum investment was required for these illiquid securities with decreased protection, regardless of the investor's risk tolerance. Investors can now benefit from not

being forced to be over-weighted in these securities and have the facility to diversify their risk across several prospectus-exempt securities, if so desired.[2]

Commenting on the impact of the removal of the minimum investment requirement of $150,000 in 2001, the report found that "There has been a significant impact on the size of financings with the removal," and that "The present [11-month] period's total trade activity is greater than under the previous rule. The number and the total value of the transactions have increased. The variety of transaction sizes has also expanded."[3]

The report concluded that:

> An examination of the eleven-month post-revision period's results has demonstrated that there has been a substantial increase in the exempt market's activity over the previously observed four-year period. The strength of the eleven-month figures when compared against the four-year totals points to a resounding endorsement of the new framework. Issuers are seeking more financing and seeking it more often. Overall, investors are willing to invest more. The volume of activity has multiplied. The distribution of transactions is dispersed over a wider range, with the majority of transactions having shifted down to smaller sizes. The increased activity has also attracted an increased number of larger issuances.[4]

More particularly, the report found that:

- In the pre-revision period, the five most frequent transaction sizes ranged from $150,000 to $500,000, with the most frequent transaction size being $150,000 with 257 transactions at that level.
- Presently, the five most frequent transaction sizes range from $1500 to $150,000, with the most frequent transaction size now at $3000 with 151 transactions…
- The median transaction size has dropped 52% from $522,447 to $250,000, indicating that half of the transactions in the present universe are at this level and below.
- The median investment size per individual has decreased 60% from $300,000 to $120,000, indicating that half of the investments are at this level and below.[5]

Advocis submits that this data, while certainly highly suggestive of a strong correlation (if not causation) between the elimination of the MA threshold and the dramatic improvements in capital-raising, is compelling fact-based evidence of the sort to which OSC Chair Howard Wetston referred and is strong enough for the CSA to consider revising downward or outright eliminating the MA exemption for individuals when they have engaged with a registered financial advisor and signed a risk acknowledgement form.

15. If the minimum amount exemption was repealed:

• would that materially affect issuers' ability to raise capital?

Yes. As suggested in our answer to Question 14 above, the lowering of the minimum amount would dramatically increase capital raising for a variety of issuers. A total elimination of the MA exemption, leaving only the AI exemption, would dramatically hamper capital raising.

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[2] Ontario Securities Commission, *One Step Forward – A Study of the Economic Impact of OSC Rule 45-501 Exempt Distributions* (March 2003), p. 6.
[3] *Ibid*, p. 5.
[4] *Ibid*, p. 5.
[5] *Ibid*, p. 6.

• is the AI exemption (in its current or modified form) an adequate alternative to the minimum amount exemption?
No. Advocis does not believe that a modified form of the AI exemption would be an adequate alternative to the minimum amount exemption. Advocis believes that the current exemptions should be retained, with the adjustments we describe elsewhere.

(f) Other options

16. Are there other options for modifying the minimum amount exemption that we should consider?
Advocis believes the *Consultation Note* and our response adequately canvass the viable policy options.

4. AI exemption

Issues involving the AI exemption
In the *Consultation Note*, the CSA reviewed several main issues raised by the AI exemption:

- current thresholds for income and assets,
- qualification criteria,
- use of the exemption to raise capital, and
- compliance with qualification criteria – in particular the fact that regulators have concerns that some individuals purchasing securities under the AI exemption are not, in fact, accredited investors.

Consultation questions

17. Do you have comments on the issues described above?
The fundamental question raised by the CSA with regard to National Instrument 45-106 is whether individual exemptions appropriately balance issuers' and investors' interests. The AI exemption allows issuers to raise capital without a prospectus if they are selling to certain investors who meet the criteria set forth in the legislation.

It is well-known that the "bright line" thresholds contained in the AI exemption are imperfect proxies for sophistication. Investing or financial risk sophistication – and hence the ability to dispense with the protection of the disclosure contained in the prospectus prior to investing – is imputed to the investor because he or she can meet one of the thresholds.

An investor can be wealthy, or highly paid, without being particularly shrewd or knowledgeable; income and asset thresholds are not reliable ways of determining whether someone should be considered a sophisticated investor who doesn't need the prospectus protection when buying securities. Exempting investors on such bases leaves many of them with little protection.

In *One Step Forward,* the OSC made the following observations with regard to the balance between protection and market efficiency:

> The premise for the prospectus-exempt regime is to reduce the regulatory burden surrounding issuance of securities, under certain conditions. The investor should be aware of the risk associated with the limited protection or recourse available to the investor in a non-prospectus environment versus the benefits derived from an issuer's ability to issue under reduced regulatory requirements (i.e. transaction details are reported post-trade).

> The added wrinkle in this “Accredited Investor” regime is that the investor is required to be judged “sophisticated” and willing to invest where there is no prospectus. The establishment of a “means test” or financial thresholds is a mechanism to screen the investor’s risk tolerance against their financial suitability to risk their assets.[6]

In terms of the "accredited investor" exemption, the study noted that:

> During the initial comment period in 1999, many commentators were concerned with the derivation of the thresholds in forming the Accredited Investor category. They commented that the thresholds for net income or net assets had become overly restrictive, creating a barrier to entry to the investors who could benefit most from this access. The long-term impact cannot be determined at this point. Presently, the results do indicate that a transition towards smaller transactions for the majority of trades has begun to take place.[7]

18. Are there any other issues you may have with the AI exemption?

Instead of having an AI exemption which is solely a proxy for sophistication based on income and asset thresholds, Advocis believes in adding a proxy for investment experience and knowledge based on the individual investor's engagement of an intermediary.

Advocis supports the policy reasoning behind the argument that regulators should require accredited investors to meet a test of "active knowledge" before they can be considered sufficiently sophisticated to participate in the exempt market.

A move to knowledge-based qualifications for the AI exemption would have two fundamental benefits: (1) investors would not be treated differently or unequally solely on the basis of their financial status; and (2) the securities industry, including issuers and advisors, would have the incentive to more actively educate clients.

However, the administration of such a knowledge-based exemption, as with any exemption based on trading frequency and portfolio size (as in the U.K.), would be problematic and resource-intensive. One option would be to mandate that this "active knowledge" be independently verified or certified by a dealer or issuer.

Given the OSC's recent discovery that exempt-market issuers and dealers are selling securities in reliance on the accredited investor exemption to retail investors who don't actually qualify as accredited investors, it seems unlikely that the CSA would entrust the task to dealers who have failed to collect enough "know your client" information to determine reasonably whether an investor can qualify as an accredited investor

Advocis submits that the solution lies with the registrant — such as a registered financial advisor who belongs to an appropriate self-regulatory organization or professional association. Such an advisor can independently verify or certify the "active knowledge" of a retail investor seeking to become an accredited investor. In the alternative, the advisor could act as the proxy for the "active knowledge" of the would-be accredited investor.

In British Columbia, the use of a risk acknowledgement form is required by the province's securities laws. In the British Columbia Securities Commission's words, "It is a clear, blunt statement of the risks associated with investing in securities when they are sold under an

[6] *Ibid*, p. 10.
[7] *Ibid*, p. 10.

exemption. It is only two pages – short enough to ensure that purchasers read it. It states in bold print immediately above where the purchaser is required to sign: 'I acknowledge that this is a risky investment and that I could lose all the money I invest.' The issuer must give a copy of the signed risk acknowledgement to the purchaser immediately after it has been signed."[8]

With regard to the accredited investor exemption, the Manitoba Securities Commission's *Investor Watch* on Exempt Market Securities states that:

> Securities law assumes that accredited investors can:
>
> - Access the information needed to assess an investment without the help of a prospectus.
> - Sustain the loss of their entire investment.[9]

The document also advises that before any exempt market purchase potential investors should consult a number of sources, including a registered financial representative.

(a) Maintain the status quo

19. Do you agree with retaining the AI exemption and the definition of "accredited investor" in their current form?

No.

(b) Adjust income and asset thresholds in the definition of accredited investor

20. What should the income and asset thresholds be?

In the interests of promoting both capital raising and investor choice, Advocis believes that the current income and thresholds should be retained.

No doubt a number of stakeholders will assert that these thresholds are too low by today's standards. The current threshold for an individual's income is $200,000; in 2011 dollars, the threshold would be over $443,000 (as based on 1982 dollars, the year of SEC adoption) or $245,000 (as based on 2001 dollars, the year the Ontario Securities Commission first adopted the exemption).

As with the MA exemption, some stakeholders will argue that the AI exemption thresholds are too low and allow unsophisticated, retail investors to participate in the exempt market. However, an increase in the thresholds will almost certainly exclude savvy investors who do not need the protections provided by a prospectus offering. More generally, any increase in the AI exemption's threshold levels will reduce the pool of eligible investors who can currently purchase securities issued under a prospectus exemption. Whether the increase is to $245,000, or $443,000, or another sum altogether, the resulting denial of access to exempt market offerings in which these investors would normally participate is unfair. For many issuers, especially SMEs, this could significantly affect their ability to raise capital and could result in higher costs for issuers who will have to seek alternative ways to raise capital. Ultimately, this will likely have a negative effect on the ability of issuers to engage in certain development or resource projects and would impair the

[8] British Columbia Securities Commission, *Private and Early Stage Businesses*, at http://www.bcsc.bc.ca/privateplacements.asp?id=2004.

[9] Manitoba Securities Commission, Investor *Watch: What are Exempt Market Securities?*, at http://www.msc.gov.mb.ca/media_events/investor_alerts/exempt.html.

mandate of providing both consumer access to investment options and fostering fair and efficient capital markets.

21. Should the income and asset thresholds be periodically indexed to inflation?
Yes. Advocis believes the current income and thresholds should be periodically adjusted for inflation. However, we believe there is some advantage to having a stable, well-known, "round number" for the threshold. Accordingly, we do not believe that it is necessary to adjust the threshold annually. Instead, we would suggest adjusting the threshold upwards or downwards to reflect inflation (or deflation), whenever changes in the consumer price index would justify a larger incremental change, such as a change of $10,000.

22. If we changed the income and asset thresholds, what would the impact be on capital raising?
It is worth recalling that the adoption of the accredited investor exemption gave life to the widely-held and well-capitalized private companies in Alberta – particularly in the oil and gas sector. Indeed, the exempt market is necessary to the Canadian capital markets and many small and medium-sized businesses have few or no realistic alternative mode of accessing capital markets.

Consequently, and in line with the framework of reference for this review established by the CSA, Advocis recommends that the CSA adjust the AI exemption in the least invasive way possible, so as not to undermine an exempt market system that in our view currently works well.

(c) Use alternative qualification criteria for individuals

As the CSA notes, a number of factors, including potential regulatory changes, could justify the development of new qualification criteria, including whether the issuer of the security is a reporting issuer, the security is novel or complex, disclosure is provided to investors (including risk factor disclosure), and if a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser. Advocis believes it is worthwhile to canvass the leading schools of thought with regard to the AI exemption.

Advocis also submits that past experience with more complicated exemptions provides evidence of the problematic nature of determining who fulfills exemption criteria. Prior to the implementation of National Instrument 45-106, Ontario had in place the closely-held issuer exemption (CHIE), and most other provinces had a private issuer exemption. Many stakeholders considered the CHIE to be cumbersome and difficult for issuers — and investors — to understand. As Anita Anand notes in "Towards Effective Balance Between Investors and Issuers in Securities Regulation":

> Regulators should seek to avoid this type of [CHIE] exemption, remembering that ease in accessing capital markets in circumstances where prospectus disclosure is not considered necessary is the purpose of the exempt market itself. Exemptions that are difficult to understand are difficult to comply with and therefore hinder the efficient raising of capital. By contrast, the AI exemption is more straightforward, with investors needing to be certain that they fall within one of the enumerated classes of the definition.[10]

In short, the original policy focus of the two exemptions under review here was not on issuers or products, but investors. Advocis recommends that the focus be kept on investors, since it is, for the most part, working. Accordingly, Advocis recommends retaining the original AI exemption,

[10] Anita Anand, Towards Effective Balance Between Investors and Issuers in Securities Regulation (Canada Steps Up), p. 50.

but with some modifications. It is to the issue of what modifications will best help the CSA meet its mandate that we now turn.

Academic and critical commentary on the AI standard

Advocis submits that there is a wealth of compelling academic and regulatory comment supporting the admittedly imperfect "bright line" standard, while at the same time we recognize that wealth is not always a useful or reliable proxy for sophistication. Advocis believes that the AI exemption's "bright line" threshold tests should be retained, but that an additional criterion be added to the AI definition.

In terms of the usefulness and limits of the current AI exemption, Advocis has canvassed much of the literature and offers the following summary in support of its own policy position.

As Anand observes:

> The AI exemption is an ideal example of the flexibility that needs to be contained in securities legislation, especially in the exemption themselves. Sophistication conceived in this way is preferable to other rationales underlying the exemptions such as relationship to the issuer… and the somewhat arbitrary $150,000 exemption now in place under National Instrument 45-106. While the $150,000 exemption is based on a sophistication of the investor concept, sophistication is defined narrowly by a relatively small monetary amount. Ultimately, this figure tells the issuer - and the regulator - very little about how sophisticated the purchaser is. It would do little to protect investors who may have $150,000 but who are not sophisticated in terms of their investing background. [11]

In *Canada Steps Up: Final Report (October 2006), The Task Force to Modernize Securities Legislation in Canada*, the Task Force noted that

> For individuals, the most commonly used private placement exemption is the “accredited investor” exemption. By measure of his wealth, an accredited investor is regarded as being sufficiently financially sophisticated (or to be able to afford sophisticated advice) to purchase securities without a prospectus. The Task Force received submissions from several parties indicating that the wealth of an investor is not an appropriate proxy for his financial sophistication. We agree. However, we have struggled to identify a more appropriate objective standard.[12]

Conversely, Advocis recognizes the problems associated with alternative criteria, especially in regard to the selection of objective metrics which seek to capture the more subjective concept of investor sophistication. The problems with the "bright line" test for the accredited investor is well known. The virtue is that it is an objective standard, and it can be determined with a high degree of accuracy and a low degree of cost which side of the AI exemption's "bright line" that the particular investor falls on.

An exemption for “qualified persons”— previous regulatory consideration

During the Standing Senate Committee on Banking, Trade and Commerce on June 8, 2005, Senator Michael Meighen observed that: "Sophisticated investors are defined by the amount of money they are willing to lose or invest. Should we seek a better definition, or perhaps have two

[11] Anand, p. 49.
[12] In *Canada Steps Up, Final Report*, The Task Force to Modernize Securities Legislation in Canada (October 2006), p. 96.

categories of investors — the non-sophisticated and the sophisticated — defined by a monetary value?"

Paul Bourque, then Senior Vice-President, Member Regulation, of the Investment Dealers Association of Canada, responded that "You have to pick an amount or line around which to draw the definition. Whether the best one has been chosen or not, it is one that we are familiar with. I am sure there are others."

Senator Meighen then asked: "Could you not say, 'How many years have you invested? Have you invested before in such and such?'" To this Mr. Bourque replied that "The analysis becomes more subjective and harder to manage and regulate. That is part of the reason we have very bright line tests."[13]

See, for example, the written submissions of the Prospectors and Developers Association of Canada in Volume VI of *Submissions To The Task Force To Modernize Securities Legislation*. In The *Prospectors and Developers Association of Canada*, at p 252, with regard to "sophisticated purchase rules" and the questions "Is wealth a proxy for sophistication? If not, is there a better definition?"

> With respect to sophisticated purchaser rules, we believe that the definition of the sophisticated purchaser should not solely be determined on the basis of wealth. We are of the opinion that, by virtue of their academic qualifications or work experience, some people do not require protection under the prospectus and disclosure system, and that it is unfair to deny them access to exempt trades where they do not meet certain wealth thresholds. The definition should be broadened to include persons whose academic qualifications or work experience give them particular knowledge of an industry or company. For example, "Qualified Persons" within the meaning of National Instrument 43-101 *Standards of Disclosure for Mineral Projects* ("NI 43-101") should be considered "sophisticated" in the context of investments in the mining industry and we believe that persons who are directors or officers of companies should be considered sophisticated purchasers in investments in companies with the same, or related, SIC Codes.

Given the foregoing comment and analysis, Advocis' position is that alternative qualification criteria for individual investors could be used to more effectively promote both capital raising and investor choice.

***The approach of the EU* Prospectus Directive**

In terms of alternative criteria for an AI exemption, Advocis notes that under the European Union's *Prospectus Directive* of May 30, 2001, which came into force in the United Kingdom on July 1, 2005, distributions to "qualified investors" are exempt from the prospectus requirements. The *Directive* allows Member States to choose to authorize resident individuals as qualified investors when they expressly ask to be so considered. Such individuals must meet at least two of the following criteria:

- investment experience: 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,

[13] From *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce.* Issue 14 - Evidence - Meeting of June 8, 2005

- investment knowledge: 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, or
- portfolio size: the size of the investor's securities portfolio exceeds 0.5 million euros.

These "qualified investors" are listed in the Qualified Investor Register, which is publicly available (the information contained in the register may be delivered electronically only to issuers and other offerers of securities).

In light of the U.K. model, many stakeholders will support additional criteria for accredited investors based on investment experience, or investment education, or knowledge similar to the EU's *Prospectus Directive*. Such criteria could include:

- investment experience (for example, the investor has carried out transactions of a significant size in securities markets at a given frequency),
- work experience (for example, the investor works or has worked in the financial sector in a professional position which requires knowledge of securities investment), or
- education (such as the investor has completed the Canadian Securities Course, achieved a CFA designation or has received an advanced degree in business or finance).

However, in terms of the CSA's suggestion that investment portfolio size alone could be a useful alternative criterion (for example, a rule positing that the investor's securities portfolio must exceed a specified amount), Advocis does not see any value in replacing or augmenting the "bright line" accredited investor test with a similar measurement based solely on the size of the investor's securities portfolio. Any such portfolio-based criterion should include a minimum frequency of exempt markets trading over a pre-defined period of time.

Moreover, the difficulty and cost of administering such an alternative criterion regime for accredited investors seems almost prohibitive, particularly when one considers the apparent rationale for the *Consultation Note*, to protect individual investors.

Broadening the AI category with the use of registered financial advisors or other registrants

In their article, "'Canada Steps Up'—Task Force to Modernize Securities Legislation in Canada: Recommendations and Discussion," Paul Halpern and Poonam Puri note that the Task Force to Modernize Securities Legislation in Canada recommended:

> broadening the category of individual regarded as an accredited investor under the private placement exemptions to include not only those who are wealthy, but also those who rely on a registered adviser. The limits on this exemption would be: (i) sales (utilizing the exemption) limited to no more than 50 investors for any one private placement, (ii) the issuer must be a 'reporting issuer', and (iii) a registered adviser would be prohibited from advertising to encourage investors to rely on this exemption and sales under this exemption would only be permitted to clients with whom the registered adviser had a pre-existing relationship.[14]

The Task Force was

> concerned that a large number of investors are shut out of the private placement market because of the size of their personal fortunes and recommended that the category of

[14] *Capital Markets Law Journal*, 2007, Vol. 2, No. 2. p. 200.

> individual regarded as an accredited investor be broadened to include not only those who are wealthy, but also those who rely on a registered adviser in making their decision to invest in the private placement. The financial sophistication of the registered adviser, which comes from professional training and accreditation, would be transposed onto his client.[15]

The Task Force recommended broadening the category of individual regarded as an accredited investor under the private placement exemptions to include not only those who are wealthy, but also those who rely on a registered adviser.

In the report *Canada Steps Up: Final Report October 2006 The Task Force to Modernize Securities Legislation in Canada*, the Task Force expressed concern regarding the accredited investor category and the position of retail investors attempting to access the exempt market:

> We are troubled that a large number of investors are shut out of the private placement market because of the size of their personal fortunes. We recommend that the category of individual regarded as an accredited investor be broadened to include not only those who are wealthy, but also those who rely on a registered adviser in making their decision to invest in the private placement. The financial sophistication of the registered adviser, which comes from his professional training and accreditation, would be transposed onto his client.[16]

The Task Force's proposed solution reads, in part:

> 5.52 Appropriate safeguards could be put in place to ensure that both the registered adviser and the investor acknowledge that the investor is relying on the adviser.[17]

Advocis will explain its proposed solution more fully in response to the questions posed below.

23. What qualification criteria should be used in the AI exemption for individual investors?
The current AI exemption provides an exemption from the prospectus requirement for individuals who:

- either alone or with a spouse, beneficially own financial assets which have an aggregate realizable value that before taxes, but net of any related liabilities, exceeds $1,000,000 CDN;
- have a net income before taxes exceeding $200,000 CDN in each of the two most recent calendar years or whose net income before taxes combined with that of a spouse exceeded $300,000 CDN in each of the two most recent calendar years and who, in either case, reasonably expect to exceed that net income level in the current calendar year; or
- either alone or with a spouse, have net assets of at least $5,000,000 CDN.

At present, regulators do not differentiate between an exempt market investment which is structured or managed by a securities registrant, and an investment which is brought to market by a “promoter,” most of whom are not registered, as is the case with a private real estate investment trust.

[15] *Ibid*.
[16] *Canada Steps Up: Final Report*, pp. 96-97.
[17] *Canada Steps Up: Final Report*, p 97.

As noted in the Executive Summary, Advocis recommends that a second AI exemption should be created for exempt market products which come with an Offering Memorandum and distributed through a financial advisor who is registered with an exempt market dealer. The individual investor would have to complete a risk acknowledgement form, which is described in more detail below.

In such cases, the income and assets thresholds would be revised downwards by 50%, meaning that these accredited investors would be individuals who:

- either alone or with a spouse, beneficially own financial assets which have an aggregate realizable value that before taxes, but net of any related liabilities, exceeds $500,000 CDN;
- have a net income before taxes exceeding $100,000 CDN in each of the two most recent calendar years or whose net income before taxes combined with that of a spouse exceeded $150,000 CDN in each of the two most recent calendar years and who, in either case, reasonably expect to exceed that net income level in the current calendar year; or
- either alone or with a spouse, have net assets of at least $2,500,000 CDN.

The use of a risk acknowledgement form

Given the foregoing, Advocis would propose the creation of a risk acknowledgement form that requires individual investors to engage with a registered financial advisor or other designated intermediary. Such a document would incorporate the previously noted Manitoba Securities Commission's *Investor Watch* on Exempt Market Securities. In particular, it would state that:

> Regulators in Canada's exempt market law expect that individual accredited investors can:
>
> - access the information needed to assess an investment without the help of a prospectus,
> - have consulted with a registered financial advisor, accountant or legal counsel about advisability of the exempt market transaction, and
> - are in a position to be able to sustain the loss of their entire investment.[18]

The risk acknowledgment form would also advise the exempt market investor, before any exempt market purchase, to:

- Determine the suitability of the investment for you. Seek advice from a registrant , such as a financial advisor, before investing. Do not hesitate to request information before you make a decision.
- Speak to the issuer, your legal counsel, and your financial advisor about the restrictions on resale before you buy. There may not be a secondary market for the issuer's securities.
- Ask the issuer, your legal counsel, or your financial advisor about the type of information the issuer is legally required to provide to you in the future.
- Be sure to get the information in writing.

An example of this form is attached hereto as Appendix A.

[18] Manitoba Securities Commission, Investor *Watch: What are Exempt Market Securities?*, at http://www.msc.gov.mb.ca/media_events/investor_alerts/exempt.html.

24. If we changed the qualification criteria, what would the impact be on capital raising?
As noted above, any upward revision in the asset/income thresholds for accredited investors would exert a negative effect on the raising of capital, especially for SMEs and for sectors which have shown a historical dependency on or sensitivity to raising capital in exempt markets, such as Alberta's oil and gas sector.

However, amending the AI exemption in the manner described by Advocis in its response to Question 23, above, would prove beneficial to the efforts of all issuers in the exempt market.

(d) Limit the use of the exemption by individuals

25. Should individuals be able to acquire securities under the AI exemption?
Advocis believes that in the interests of promoting fair and efficient capital markets, as well as a broad range of investor choice, individual retail investors must be allowed to continue to acquire securities under the AI exemption.

(e) Impose other investment limitations

26. Should an investment limit be imposed on accredited investors who are individuals? If a limit is appropriate, what should the limit be? Would your answer to these questions change depending on whether:

• the security is novel or complex?
Advocis is in favour of enhancing access for individual investors to less complex exempt market products. That said, with regard to the AI exemption, Advocis does not think that the CSA should be imposing additional or alternative exemption criteria on a *product-by-product* basis, especially where the type of security or its level of complexity was not the policy basis for the exemption in the first instance.

We believe that that the CSA should consider the circumstances of an investor exemption, the policy basis for it, and whether refinements should be made to the exemption to address any gaps on an over-all basis, and not on a product-by-product basis.

More specifically, in terms of additional disclosure for certain popular exempt market offerings, such as short-term securitized products, Advocis believes that most individual investors are currently receiving a significant amount of information and would not likely further benefit from receiving an offering memorandum in the prescribed form. In many cases this is the practice in the exempt market. For example, investors in non-short term securitized products issued in the exempt market are often sophisticated investors with substantial investment experience and significant investment portfolios. These investors typically purchase securitized products in well-documented transactions negotiated between the issuer and the purchaser's financial advisor, accountant and/or legal counsel. The individuals responsible for the purchase negotiations are primarily highly sophisticated professionals.

• a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?
Yes. In the event that the security can be described as novel or complex, the provision of advice from a registrant should eliminate any need for the introduction of additional criterion beyond the current AI exemption.

27. If investment limitations for individuals were imposed, what would the impact be on capital raising?

The impact on capital raising would be detrimental. Depending on the limitation(s) imposed, issuers would find their ability to raise capital hampered. Moreover, individuals currently invested in exempt market securities would find their desire to invest further capital in certain securities frustrated, and new issuers would find themselves disadvantaged vis-à-vis previous issuers who had distributed securities prior to the implementation of the investment limitation(s). Conversely, individuals not currently invested in exempt market securities would not, in the presence of an investment limitation, decide to invest in such securities.

(f) Compliance with qualification criteria

An issue with the AI exemption is ensuring compliance with the qualification criteria. One way to improve compliance with the AI exemption would be to require an investor's accredited investor status to be certified by an independent third party, such as a lawyer or qualified accountant.

28. Should this be considered in a review of the AI exemption?
Yes.

29. Do you agree with imposing such a requirement?
Yes.

30. Are there alternatives that we should consider?
Yes.

Leveraging the role of registrants, including advisors, to protect retail investors in the exempt market
Advocis believes that regulators could rely on the advisor-investor relationship to better protect individuals who are active in the exempt market. By its very nature, the accredited investor exemption assumes the individual investor has the sophistication and financial wherewithal to both make independent investment decisions and absorb losses. There is no more cost-effective way to provide clarification on the nature of such risk than with the advice of a competent advice provider who is also a registrant.

If the investor wants professional third-party advice, then he or she should consult a professional financial adviser. The addition of a requirement for a risk acknowledgement form will highlight for registrants, dealers and individual investors that the responsibility for the investment decision lies with the investor.

Requiring retail investors to consult with a registrant would help address OSC Compliance concerns regarding the Accredited Investor exemption.
In 2011, the OSC released *Staff Notice 33-735 – Sale of Exempt Securities to Non-Accredited Investors*. The *Notice* sets out the OSC's concern that some issuers and dealers are selling exempt securities in reliance on the AI Exemption to individual investors who do not meet the definition of Accredited Investor. As this raises significant investor protection concerns, one way to address this issue is to require an investor's accredited investor status to be certified by an independent third party, such as a registered financial advisor, lawyer or qualified accountant.

Recent OSC investigations or disciplinary activity are illustrative of the way in which requiring retail investors to consult with a registered financial advisor before making an exempt market investment would help address OSC compliance concerns. On May 13, 2011, the OSC

published its reasons for decision in *Goldpoint Resources Corporation, et al.*[19] In *Goldpoint,* investors were provided with definitions of "accredited investor" which inappropriately included real estate in the calculation of the financial asset test. Further, not every investor was asked about their financial position or whether they were an Accredited Investor. As a result, the steps taken by the respondents were found to be insufficient to comply with the AI Exemption. In respect of the financial asset and net asset categories, the OSC stated that the respondents should have determined whether each investor was an Accredited Investor based on the information investors provided to the respondents about their financial position.

The fact that investors provided a representation in the subscription agreement that they qualified as an Accredited Investor was not adequate. Quoting the Companion Policy to NI 45-106, the OSC confirmed that sellers must have a reasonable belief that an investor understands the meaning of the definition of Accredited Investor. Moreover, prior to discussing the particulars of an investment, sellers should discuss with investors the various criteria for qualifying as an Accredited Investor and whether such investors meet the criteria of an Accredited Investor, and request details on how such investors satisfy the tests in the definition.

As well, the OSC recently released a series of settlement agreements entered into between the OSC and Nelson Financial Group Ltd., Nelson Investment Group Ltd. and certain officers, employees and a registered dealing representative of the foregoing entities.[20] These "*Nelson* Settlements" demonstrate the OSC's need to continue monitoring of the application of the AI Exemption by issuers and dealers. In distributing securities of Nelson Financial, the Nelson Entities purported to rely upon the AI Exemption, although the OSC alleged that a significant percentage of the investors to whom securities were issued by Nelson Financial either did not meet the requirements necessary to qualify as accredited investors or there was insufficient information for the Nelson Entities and their employees and/or agents to make that determination.

Meanwhile, the OSC has indicated that it will continue to:

- monitor issuers and dealers who distribute securities under the AI Exemption, and
- take enforcement proceedings or other regulatory action against issuers and dealers who sell exempt securities under the AI Exemption to investors who are not Accredited Investors.

In light of this commitment by the OSC following the *Goldpoint* decision and the *Nelson* Settlements, Advocis believes that the regulatory burden on the OSC could be lightened by requiring a risk acknowledgement form signed by a registrant and the retail investor.

The OSC has found that many dealers do not collect adequate know-your-client (KYC) information to reasonably determine whether an investor is in fact an Accredited Investor.

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[19] *In the Matter of the Securities Act, R.S.O. 1990, c. S.5, as amended And In the Matter of Goldpoint Resources Corporation, Pasqualino Novielli, Brian Patrick Moloney and Zaida Pimentel*, (OSC bulletin release date: 13 May 2011), OSC Decision, online: OSC website.

[20] *In the Matter of the Securities Act, R.S.O. 1990, c. S.5, as amended And In the Matter of Nelson Financial Group Ltd., Nelson Investment Group Ltd., Marc D. Boutet, Stephanie Lockman Sobol, Paul Manuel Torres, H.W. Peter Knoll*, (OSC bulletin release date: 20 May 2011), OSC Settlement Agreements, online: OSC www.osc.gov.on.ca/documents/en/Proceedings-SET/set_20110512_nelson.pdf, www.osc.gov.on.ca/documents/en/Proceedings-SET/set_20110511_nelson-torres.pdf, and www.osc.gov.on.ca/documents/en/Proceedings-SET/set_20110516_nelson-sobol.pdf.

The OSC notes it is the responsibility of the issuer and the dealer selling the security to determine whether an investor may purchase exempt securities pursuant to the AI Exemption. The OSC further notes that while an issuer generally engages a dealer to distribute securities to investors, the issuer still has an obligation to ensure that a distribution of exempt securities through a dealer will be made in compliance with securities laws.

A registrant should be collecting adequate know-your-client information to accurately determine whether an investor is an Accredited Investor. The OSC has set out a non-exhaustive list of steps that dealers should take when selling under the AI Exemption.

As with issuers and their dealers, it would not be sufficient for registrants to simply rely on a client's verbal representations, or on the client's initialing or box-checking of the an accredited investor certificate.

Advisors can provide clarity for clients regarding the AI definition

Before the investor could purchase the security in reliance on the AI Exemption, the registrant would have to ensure that the investor client does in fact meet the definition of an Accredited Investor. While under the current exempt market regime, the responsibility of ensuring compliance is ultimately on the security's issuer, a registered financial advisor engaged by the investor would be in the same position as a dealer engaged by the issuer. In each instance the registered advisor or dealer is assisting in the distribution of the exempt securities to an investor. In such cases, in addition to the issuer, the dealer must also ensure that an individual investor meets the definition of Accredited Investor, and must also, among other things, comply with National Instrument 31-103 *Registration Requirements and Exemptions*, the "know your client" rules under NI 31-103, and any agency or underwriting agreement governing the distribution. Advocis proposes that any registrant assisting an investor in an exempt market securities transaction would also be duty bound to comply with the NI 31-103 requirements, including the "know you client" rules.

In specific, a registered financial advisor would be well positioned to assist investors in properly understanding the definition of Accredited Investor and eliminating the confusion which arises between the two concepts of "financial assets" and "net assets." With some dealers not explaining to clients that the client's personal residence or other real estate cannot be included in the calculation of their "financial assets," the result is that an individual does not in actuality meet the "financial assets" threshold necessary to be an Accredited Investor improperly becomes an exempt market investor.

Advocis submits that advisors can provide clarity for clients regarding the AI definition. A list of steps that registered financial advisors would take would be based on compliance with CSA Staff Notice 33-315 *Suitability Obligation and Know Your Product* and NI 31-103, which requires dealers to understand the general investment needs and objectives of their clients, whether the proposed investment is suitable and the attributes and risks of the securities recommended to clients:

- fully explaining the Accredited Investor definition to clients and in particularly elucidating the distinction between financial assets and net assets before completion of the KYC form,
- ensure the exempt security is suitable for the client. Even if the client qualifies as an Accredited Investor, a registrant must still assess the suitability of the investment product

by understanding the investment needs and objectives of their clients and the attributes and risks of the securities that they recommend, and

- not executing the risk acknowledgement form regarding the purchase of an exempt security if there is insufficient information to determine whether the client qualifies as an Accredited Investor.

(g) Other options

31. Are there other options we should consider for revising the AI exemption or for substituting an alternative exemption?
No.

Conclusion
Advocis, like the CSA and other stake-holders, believes that exempt-market players want regulation which maintains a balance between preserving the ability to raise capital and protecting investors. Advocis welcomes the regulatory reality that we have entered an era of consumer protection—and in some cases, consumer participation—in the policy process. Advocis supports rules that protect investors and enhance the professionalism of the exempt-market sector. However, the failure to recognize the role of the registered financial advisor is harmful to long-term, meaningful progress in consumer protection.

With a look to the CSA's framework of reference, Advocis believes that there is not sufficient evidence to indicate that the current rules in Canada governing the MA and AI exemptions need radical amending. Canada fared better than the vast majority of G20 nations during the financial crisis. Drastic changes to the existing regulatory framework which would limit or even eliminate the access of individual investors to the exempt market would be an attempt to fix a problem that does not exist – and indeed may never exist – in Canadian markets.

Advocis therefore suggests that both the MA and AI exemptions for individual investors be modified in the manner described above.

Finally, Advocis submits — given the growing complexity of exempt market products — that *all* exempt market registrants be required to complete an exempt markets course, to ensure a basic standard of proficiency is met.

We would be pleased to meet with you to further discuss our issues and concerns. Should you have any comments or questions you wish answered before any such meeting, please do not hesitate to contact the undersigned, or contact Ed Skwarek, Vice President Regulatory and Public Affairs at eskwarek@advocis.ca, or by calling 416-342-9837.

Sincerely,

Greg Pollock, M.Ed., LL.M., C.Dir., CFP
President and CEO, Advocis, The Financial Advisors Association of Canada

Dean Owen, CLU, CH.F.C.
Chair, Advocis, The Financial Advisors Association of Canada

c.c. 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

Appendix "A" – A Modified Version of the British Columbia Securities Commission's Risk Acknowledgment Form

Risk Acknowledgement Form

- I acknowledge that this is a risky investment.
- I am investing entirely at my own risk.
- No securities regulatory authority or regulator has evaluated or endorsed the merits of these securities or the disclosure in the offering memorandum.
- Regulators of Canada's exempt market expect that individual accredited investors can:
    - can access the information needed to assess an investment without the help of a prospectus,
    - have consulted with a registrant (i.e., a registered financial advisor) or an accountant or legal counsel about advisability of the exempt market transaction, and
    - are in a position to be able to sustain the loss of their entire investment.
- I will not be able to sell these securities except in very limited circumstances. I may never be able to sell these securities. *[Instruction: Delete if issuer is reporting]*
- The securities are redeemable, but I may only be able to redeem them in limited circumstances. *[Instruction: Delete if securities are not redeemable]*
- I will not be able to sell these securities for XX months. *[Instruction: Delete if issuer is not reporting or if the purchaser is a Manitoba resident]*
- I could lose all the money I invest.

I am investing $_____ [total consideration] in total; this includes any amount I am obliged to pay in future. _____ [name of issuer] will pay $_____ [amount of fee or commission] of this to _____ [name of person selling the securities] as a fee or commission.

I acknowledge that this is a risky investment and that I could lose all the money I invest.

_____ _____

Date Signature of Purchaser

_____

Print name of Purchaser

Sign 2 copies of this document. Keep one copy for your records.

WARNING

You have 2 business days to cancel your purchase *[Instruction: The issuer must complete this section before giving the form to the purchaser.]*

To do so, send a notice to [name of issuer] stating that you want to cancel your purchase. You must send the notice before midnight on the 2nd business day after you sign the agreement to purchase the securities. You can send the notice by fax or email or deliver it in person to [name of issuer] at its business address. Keep a copy of the notice for your records.

Issuer Name and Address:
Fax: E-mail:

You are buying Exempt Market Securities
They are called *exempt market securities* because two parts of securities law do not apply to them. If an issuer wants to sell *exempt market securities* to you:

- the issuer does not have to give you a prospectus (a document that describes the investment in detail and gives you some legal protections), and
- the securities do not have to be sold by an investment dealer registered with a securities regulatory authority or regulator.

There are restrictions on your ability to resell *exempt market securities*. *Exempt market securities* are more risky than other securities.

If you have received an offering memorandum
Read the offering memorandum carefully because it has important information about the issuer and its securities. Keep the offering memorandum because you have rights based on it. Talk to a lawyer for details about these rights.

You have received professional advice
To qualify as an Accredited Investor under the Accredited Investor Exemption, you must have received prior to purchase professional advice about whether the investment is suitable for you from a registrant. This advice must lead you to answer the following questions in the affirmative:

- Do you understand the risks?
- Do understand the product?
- Can you accept the risks?
- Can you afford the potential negative consequences?

To qualify as a purchase under the Minimum Amount Exemption, you must have received prior professional advice about whether the investment is suitable for you from a registrant.

- Pursuant to either exemption, be sure to determine the suitability of the investment for you through advice from a registrant. Speak to your financial advisor about the restrictions on resale before you buy. There may not be a secondary market for the issuer's securities. Ask the issuer and your financial adviser about the type of information the issuer is legally required to provide to you in the future. Do not hesitate to request information before you make a decision. Be sure to get the information in writing.

The securities you are buying are not listed *[Instruction: Delete if securities are listed or quoted]*

The securities you are buying are not listed on any stock exchange, and they may never be listed. You may never be able to sell these securities.

The issuer of your securities is a non-reporting issuer *[Instruction: Delete if issuer is reporting]*
A *non-reporting issuer* does not have to publish financial information or notify the public of changes in its business. You may not receive ongoing information about this issuer.

For more information on the exempt market, call your local securities regulatory authority or regulator. *[Instruction: Insert the name, telephone number and website address of the securities regulatory authority or regulator in the jurisdiction in which you are selling these securities.]*

[Instruction: The purchaser must sign 2 copies of this form. The purchaser and the issuer must each receive a signed copy.]