



February 29, 2012

To: British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

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Re: Submission of the Canadian Venture Capital Association in response to CSA Staff Consultation Note 45-401

Thank you for the opportunity to make a written submission in response to CSA Staff Consultation Note 45-401.

The CVCA – Canada's Venture Capital & Private Equity Association – is strongly opposed to any changes to the accredited investor exemption (the "**AI exemption**") that would reduce access to the exemption because it would make capital raising by CVCA members and the enterprises in which they invest more difficult. The consequences of such a change would be damaging to our industry, to the formation of capital in the private markets and to the financing of private companies across Canada. The CVCA does not see any need to change the AI exemption as it seems to work quite well in its current form and the CSA has not identified issues with it that would warrant change.

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The CVCA represents the majority of private equity and venture capital firms in Canada, with over 1800 members at approximately 150 member firms. CVCA members have over \$85 billion in capital under management, ranging from Canada's largest pension funds to first time funds with less than \$100 million in total capital. The overwhelming majority of CVCA member firms are professionals who raise capital from third party investors which is then deployed into portfolio companies; most of these portfolio companies have also raised capital in the private markets, typically prior to participation from CVCA members, but occasionally alongside them.

Most of the investment activity of CVCA members occurs across three market segments:

- Buyout is characterized chiefly by risk investment in established private or publicly listed firms that are undergoing a fundamental change in operations or strategy. Buyout funds are often called such, even if their mandates are not exclusively buy out related.
- Mezzanine is characterized chiefly by use of subordinated debt, or preferred stock with an equity "kicker", to invest largely in the same type of companies and deals as buyout funds.
- Venture Capital and Growth Equity, characterized generally by investment in earlier stage companies, mostly in technology businesses.

The lines between these various segments are not fixed, with new innovations in fund structures and investment strategies established on a continuous basis. Many CVCA member firms participate in more than one segment, either in different funds managed by the same firm, or in hybrid funds that participate in different categories inside a single capital pool.

Accordingly, our perspective is based on experience in financing individual companies as well as experience financing the formation of private equity and venture capital funds. In the financing of companies, our members' interests are largely similar to those of other market participants, so we propose to focus most of our comments on the importance of the AI exemption to the process of fund formation.

The AI exemption is a key building block to the formation of capital into funds that finance emerging companies, growth companies and larger more established businesses. Set out below are three examples of the significant reliance our industry places on the AI exemption in raising capital for fund formation.

Small Venture Capital Fund: An investor who has been active as a technology entrepreneur and a member of two venture capital firms many years, decided to leave his firm and set up his own venture capital fund. His investment focus is early stage technology which is a very active segment of the venture capital market and a major focus of job creation in technology today. He started with a very wealthy individual who agreed to invest a few million dollars, and on the strength of this lead order, was then able to secure additional funding of several million dollars

from a small number of other high net worth investors. With this initial funding in hand, he was able to raise several million more from accredited investors in amounts ranging from \$50,000 to \$200,000 per person. The total capital of \$15 million is barely enough to be viable as a fund, both in terms of the critical mass of capital required to create a reasonable portfolio, and the management fee resources to finance operations. Without the participation of the accredited investor group, this fund would not have been possible. The individual manager is earning very little on this small fund, but is viewing this as his entry point into the industry so that with strong investment performance, he will be able to raise a larger fund next time, and build himself into a stronger firm over time. This is a very common approach for new firms entering the market.

Next Stage Growth Equity Fund: A group of founders had together created, managed and sold a successful software business from start-up to several hundred million dollars in revenue, ultimately sold to a major multi-national corporation. The founders worked for the multi-national for a few years then decided to enter the investment business, focused on later stage growth companies in technology. These companies would typically have \$20 to \$40 million in revenues, modest profits (if any), but very strong growth, driving toward an IPO or sale to a strategic buyer. They used a two-step strategy to create their fund. First, they raised approximately \$10 million from accredited investors in amounts ranging from \$50,000 to \$250,000. This amount was sufficient for two investments – not enough to develop a full portfolio but sufficient to build a portfolio designed to "prove themselves" to institutional investors. Second, after two years managing these first two investments, they had developed a sufficient track record to attract capital from the institutional market, ultimately raising a total of \$65 million in a second closing of their fund. Following that second closing, they have sufficient critical mass to be viable in the market and have now made many investments.

Mid-Market Buyout Fund: One of the major private equity fund investors in the Canadian buyout market has raised three funds over the past 15 years, most recently a \$120 million fund that is currently investing in companies across Canada. Their investment focus is acquiring control of private companies from their founders in a variety of different businesses which are profitable, with revenues in the range of \$30 to \$50 million and profits in \$5 to \$20 million range – a key part of the Canadian economy. In their last fund, they raised approximately \$90 million from accredited investors and \$30 million from institutional investors. These accredited investors range from very wealthy families to numerous individuals in the range of \$250,000 to \$500,000 – a total of approximately 75 individuals. These individual accredited investors are a key component of their fundraising strategy, and the firm would not be viable without access to this market.

In each of these cases, the firms rely on their existing investor base to raise their next fund, with a strategy of building out their network of investors. It would be very damaging to fund formation if any change to the rules were to disqualify their existing investors from participating in subsequent investments in subsequent funds.

In addition to our members using the AI exemption as a means to raise money in their funds, the funds also use the AI exemption to make their investments and to finance those investee companies by raising money at the investee company level.

Generally, in our experience, the AI exemption works well, market participants understand it, and it is simple and easy to apply, with clear bright lines.

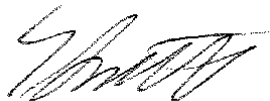
We understand that the AI exemption income and asset test was put in place many years ago, so there is a natural reason to question whether it should be adjusted for inflation. Our view is that it should not be adjusted because there are no significant problems and many benefits. The number of people who satisfy the AI exemption requirements is still an extremely small percentage of the population, and so it seems to us that it is still a reasonable threshold.

If any change is to be made, consideration needs to be given to grandfathering investors who are already active in the market. It would be damaging to investors to change the rules and force investors to divest or fail to be able to continue investing in this market. For example, if an investor was unable to participate in a follow-on financing round in a company because the investor did not satisfy the new AI exemption threshold, he or she could be significantly diluted and his or her investment seriously harmed.

Our detailed comments on the specific questions in the Staff Notice are set out in italics in the attached Schedule A. We are not aware of any part of our industry that relies on the \$150,000 minimum amount exemption. Accordingly, we have no strong views on that exemption and have not addressed questions 3 to 16 (inclusive) in our response.

We would be happy to continue to engage in a dialogue with the CSA as it considers the submissions received.

Sincerely,

A handwritten signature in black ink, appearing to read 'G. Smith', written in a cursive style.

Gregory Smith, CA-CBV
President, CVCA

Schedule A

Minimum Amount Exemption Consultation Questions

1. What is the appropriate basis for the minimum amount exemption and the AI exemption? For example, should these exemptions be premised on an investor's:

- financial resources (ability to withstand financial loss or obtain expert advice),
- access to financial and other key information about the issuer,
- educational background,
- work experience,
- investment experience, or
- other criteria?

Please explain.

It is not clear to us that there necessarily needs to be a defining principle. We think the issue is whether there is a problem with the current exemptions. The CSA has not provided any evidence that there is a problem that needs to be addressed with the AI exemption. In any event, the percentage of the population that qualifies under the AI exemption is very small. With respect to the minimum amount exemption, we don't have a view as we don't see that exemption being used.

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?

We do not think registrants need to be involved in AI exemption trades. Accredited investors are able to make a decision about whether they wish to seek advice or not. We think that compelling accredited investors to involve a registrant adds complexity and delay to the financing process, raises issues around compensation of the registrant for the exempt trade and potentially creates conflicts of interest for the registrant if the funds for the investment are being removed from the registrant's management (for which the registrant earns fees).

3. Do you have comments on the issues described above?
4. Are there other issues you may have with the minimum amount exemption?
5. Do you agree with maintaining the minimum amount exemption in its current form?
6. How much should the minimum investment threshold be increased? Would your answer to this question change depending on whether:
- any disclosure is provided to investors, including risk factor disclosure?
 - the purchaser is an individual, instead of an institutional investor?

- the security is novel or complex?
 - the issuer of the security is a reporting issuer?
 - a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?
7. Should the \$150,000 threshold be periodically indexed to inflation?
 8. If we changed the \$150,000 threshold what would the impact be on capital raising?
 9. Should individuals be able to acquire securities under the minimum amount exemption? Would your answer to this question change depending on whether:
 - any disclosure is provided to investors, including risk factor disclosure?
 - the security is novel or complex?
 - the issuer of the security is a reporting issuer?
 - a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?
 10. If individuals are able to acquire securities under the minimum amount exemption, should there be any limitations?
 11. If we limited the use of the exemption to persons who are not individuals, what would the impact be on capital raising?
 12. Are there alternative qualification criteria for the minimum amount exemption?
 13. Are there other limitations that should be imposed on the use of the minimum amount exemption?
 14. Should the minimum amount exemption be repealed? Would your answer to this question change depending on whether:
 - any disclosure is provided to investors, including risk factor disclosure?
 - the purchaser is an individual, instead of an institutional investor?
 - the security is novel or complex?
 - the issuer of the security is a reporting issuer?
 - a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?
 15. If the minimum amount exemption was repealed:
 - would that materially affect issuers' ability to raise capital?
 - is the AI exemption (in its current or modified form) an adequate alternative to the minimum amount exemption?

16. Are there other options for modifying the minimum amount exemption that we should consider?

Accredited Investor Exemption Consultation Questions

17. Do you have comments on the issues described above?

We think the AI exemption works well and does not need to be changed based on the experience of our members over many years and transactions. Any change that reduces access to the AI exemption would be damaging to our industry, to the formation of capital in the private markets and to the financing of private companies across Canada.

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

No.

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

Yes

20. What should the income and asset thresholds be? Would your answer to this question change depending on whether:

- any disclosure is provided to investors, including risk factor disclosure?
- the security is novel or complex?
- the issuer of the security is a reporting issuer?
- a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?

No. We think the exemption works well. We have not seen abuses or issues that cause us to think that change is necessary.

21. Should the income and asset thresholds be periodically indexed to inflation?

No. We think the levels are fine currently. That is not to say that they should not ever be changed but we think that they should be changed if they become clearly out of step. We don't think that level has been reached. The percentage of the population who qualify as accredited investors is still a very small percentage. Indexing the numbers is an administrative headache as the forms used with investors to certify that they are eligible to use the AI exemption will have to be continually updated and there will be uncertainty at certain times of the year as to what are the correct numbers. As well, inflation indices are not necessarily good or appropriate measures. For example, consumer price indices just measure consumer prices. They do not measure increases in income, which may not have changed during the corresponding period.

22. If we changed the income and asset thresholds, what would the impact be on capital raising?

Higher thresholds would result in less investment as fewer investors would qualify. The actual numbers are not determinable. However, as the number of eligible investors will decrease, it would be damaging to our industry, to the formation of capital in the private markets and to the financing of private companies across Canada.

Alternative qualification criteria for individual investors could be required such as:

- investment experience (for example, the investor has carried out transactions of a significant size in securities markets at a given frequency),
 - investment portfolio size (for example, the investor's securities portfolio must exceed a specified amount),
 - work experience (for example, the investor works or has worked in the financial sector in a professional position which requires knowledge of securities investment), and / 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).
23. What qualification criteria should be used in the AI exemption for individual investors? Would your answer to this question change depending on whether:
- any disclosure is provided to investors, including risk factor disclosure?
 - the security is novel or complex?
 - the issuer of the security is a reporting issuer?
 - a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?

We think the current criteria are satisfactory.

24. If we changed the qualification criteria, what would the impact be on capital raising?

Making the qualification criteria more onerous would reduce the number of investors able to access the exempt market and would reduce the amount of money that could be raised on an exempt basis. That would be damaging to our industry, to the formation of capital in the private markets and to the financing of private companies across Canada.

25. Should individuals be able to acquire securities under the AI exemption? Would your answer to this question change depending on whether:
- any disclosure is provided to investors, including risk factor disclosure?
 - the security is novel or complex?

- the issuer of the security is a reporting issuer?
- a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?

Our answer would not change. We think the exemption works fine for individuals and it essential to capital raising in our industry that access to that exemption be available to individuals.

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:

- any disclosure is provided to investors, including risk factor disclosure?
- the security is novel or complex?
- the issuer of the security is a reporting issuer?
- a registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?

We do not think any upper limit is required for individuals. Any upper limit would be very damaging to fund formation and to the financing of private companies, both of which depend on investment from accredited investors, often in very sizeable amounts on a per investor basis. We think accredited investors can afford to get advice if they want it.

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

It would be harmful to fund formation and financing of private companies as it would reduce the pool of available investors and would reduce capital raising.

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?

It will make the process more costly and it may not be possible for lawyers or accountants to provide the certification in any event. If investors want to lie about their status as accredited investors, the CSA should make an example of some who do and that should improve compliance. It is not fair to the honest investors who comply with the rules to require them to get certified because some investors lie. Those investors who lie are hurting themselves and no one else.

29. Do you agree with imposing such a requirement?

No.

30. Are there alternatives that we should consider?

Enforcement against investors who do not comply.

31. Are there other options we should consider for revising the AI exemption or for substituting an alternative exemption?

No. It should be left unchanged for the reasons mentioned above.