

FAIR

Canadian Foundation for
Advancement of Investor Rights

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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: Review of Minimum Amount and Accredited Investor Exemptions

FAIR Canada is pleased to offer comments to the Canadian Securities Administrators (the “CSA”) on the \$150,000 minimum amount prospectus exemption (“MA exemption”) and the accredited investor prospectus exemption (“AI exemption”) contained in National Instrument 45-106 *Prospectus and Registration Exemptions* (“NI 45-106”), as part of the CSA's review of these exemptions (the “Review”), published as CSA Staff Consultation Note 45-401 on November 10, 2011 (the “Consultation Note”).

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

FAIR Canada Comments and Recommendations – Executive Summary:

1. FAIR Canada welcomes the Review as a key step in restructuring the regulation of Canada's securities marketplace to enhance investor protection.
2. There is a need for data regarding the exempt market. It is important to identify where investor losses are occurring and the causes of such losses in order for regulation to focus on areas of higher risk. We recommend that the CSA publicize relevant information. If such information is unavailable, we recommend that the CSA undertake a study of the exempt market. We are not advocating any delay in the policymaking process, but rather encourage the CSA to make this information publicly available at the same time as the policymaking process unfolds.
3. FAIR Canada has found it difficult to provide meaningful comments in the absence of data regarding the exempt market. We have identified areas we believe to be of highest risk to investors, based on anecdotal evidence and particular cases as publicized in the press, and have made recommendations accordingly. We believe that it would have been beneficial for all stakeholders if exempt market data had been provided with the Consultation Note to assist stakeholders in providing constructive input. We understand that the exempt market is not insignificant in size, having been informed at the OSC public roundtables that it is a \$83.9 billion market, of which \$43.9 billion is in Ontario.
4. FAIR Canada believes that a best interest of the client/fiduciary standard should be imposed in respect of any investment recommendation, including recommendations about securities sold under prospectus exemptions, in order to ensure investors are better protected. FAIR Canada believes that all registrants who provide investment advice to retail investors should be subject to a best interest/fiduciary standard, and the need is particularly pressing in the exempt market.
5. Compliance with exempt market requirements must be improved.
 - 5.1. *Compliance – Qualification for exemptions* - Given concerns about investors purchasing in reliance on exemptions for which they do not qualify, FAIR Canada recommends that the CSA bolster and make public its compliance functions with respect to reliance upon the AI exemption, to ensure that only those who qualify purchase prospectus-exempt securities.
 - 5.2. *Compliance – Suitability* - Suitability requirements currently apply in addition to exemption criteria. We understand from anecdotal evidence that a number of registrants do not adhere to the current suitability requirements. As a result, FAIR Canada recommends better oversight of registrants' compliance with suitability, know-your-client, and know-your-product requirements and stronger public sanctions for non-compliance in these areas.
 - 5.3. The exempt market needs effective oversight in order for investors to be appropriately protected. This is essential to any reform of the exempt market.

6. FAIR Canada considers the presumptions underlying both the existing MA exemption and the existing AI exemption to be flawed; for example, that an individual is “wealthy” and potentially better able to weather a loss or able to pay for advice are not reliable proxies for investor sophistication (that is, the ability to understand the product, its associated risks and its costs) and, therefore, do not provide an acceptable level of investor protection.
7. FAIR Canada considers the MA exemption to be an inappropriate basis upon which to base a prospectus exemption. We recommend the repeal of this exemption. In the alternative, if the CSA determines the MA exemption to be appropriate, FAIR Canada recommends that the minimum amount remain the same, and that, in addition, the minimum amount not represent more than five percent (5%) of the individual’s investment portfolio.
8. FAIR Canada views the current qualification criteria of the AI exemption (that is, the income and asset thresholds) to be poor proxies for sophistication. FAIR Canada does not believe that the current AI exemption criteria alone ensure adequate investor protection. FAIR Canada suggests that this exemption be amended.
9. While it is clear that the existing AI and MA exemption qualification criteria are problematic, it is more challenging to determine alternative qualification criteria that are practical, achievable and adequately protective of investors. Given the lack of data on the exempt market and the aforementioned challenges, FAIR Canada has tried to the extent possible to take a practical approach to reforming the AI exemption such that the area of highest risk, where investor losses have been the greatest, be reformed on a priority basis. Our understanding is that the risks posed to investors vary considerably depending on (1) whether the security is that of a listed issuer or not; (2) whether the seller is a member of an SRO or not; and (3) whether the security is straightforward or complex. The revised AI exemption that FAIR Canada proposes would thus vary according to the type of issuer issuing the securities, the type of seller involved, and the complexity of the security:

Non-complex Products

(1) Securities of issuers listed on one or more Canadian exchange(s), sold through an SRO-member intermediary:

- 9.1. In order for an individual to purchase a prospectus-exempt security of a listed issuer, sold through an SRO member firm (such as the Investment Industry Regulatory Organization of Canada (“IIROC”) or the Mutual Fund Dealers Association of Canada (“MFDA”)), FAIR Canada proposes that the following apply:
 - I. The prospectus requirement does not apply to a distribution of a security if the purchaser purchases the security as principal and where
 - a. a registrant has a duty to act in the best interest of the client/fiduciary duty; and
 - b. a registrant ensures that the prospective investor meets the existing definition of “accredited investor” contained in section 1.1 of NI 45-106.
- 9.2. In FAIR Canada’s view, sales of securities of listed issuers, sold through SRO member firms, in reliance on the AI exemption, pose a much lower level of risk to investors and, as a result, are not in need of urgent reform.
- 9.3. It is our understanding that there are far fewer instances of non-compliance and investor

losses observed in reliance on the AI exemption by SRO member firms selling securities of listed issuers. As a result, we do not view this to be a high priority area in need of urgent reform, but we encourage regulators to conduct further research in this area, to make more information publicly available, and to review the exemption on a periodic basis.

(2) *Securities of issuers listed on one or more Canadian exchange(s), sold through a non-SRO-member intermediary AND securities of issuers not listed on one or more Canadian exchange(s), sold through an SRO-member intermediary*

9.4. The prospectus requirement does not apply to a distribution of a security if the purchaser purchases the security as principal and where

- a. a registrant has a duty to act in the best interest of the client/fiduciary duty; and
- b. a registrant ensures that the prospective investor meets the sophistication test that we propose (the “Sophistication Test”), which would require that an individual meet at least two (2) of the following four (4) criteria:
 - i. the investor has carried out transactions of a significant size (at least \$2,500) on securities markets at an average frequency of, at least, ten per quarter over the previous four quarters;
 - ii. the size of the investor’s securities portfolio exceeds \$1,000,000;
 - iii. 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 and has passed the Canadian Securities Course; or
 - iv. the investor is a registrant, registered with one or more securities regulatory authority(ies) in Canada.

(3) *Securities of issuers not listed on one or more Canadian exchange(s), sold through a non-SRO member intermediary*

9.5. The prospectus requirement does not apply to a distribution of a security if the purchaser purchases the security as principal and where

- a. a registrant has a duty to act in the best interest of the client/fiduciary duty;
- b. a registrant ensures that the prospective investor meets the Sophistication Test; and
- c. independent certification of the investor’s fulfilment of at least two of the criteria under the Sophistication Test has been obtained. This certification should be conducted by a third party with no financial interest in any transaction contemplated by that investor in reliance on the AI exemption.

Complex Products

9.6. FAIR Canada is of the view that risks to investors are likely increased when the security

being sold is complex. We urge the CSA to issue a separate consultation on the appropriate regulatory model for the sale of complex products, including whether the AI or MA exemptions (as currently defined or as revised in this submission) are appropriate exemptions for purchasers of complex products.

10. FAIR Canada is also very concerned about the implications of the Northwestern Exemption for investors. We recommend that the Northwestern Exemption orders be revoked given the significant investor protection concerns that have been publicized since that exemption was introduced.

1. FAIR Canada welcomes the Review as a key step in restructuring the regulation of Canada's securities marketplace to enhance investor protection.

- 1.1. FAIR Canada considers it crucial that an appropriate balance be struck between protecting investors and the needs of businesses (and, in particular, small and medium-sized business) to raise capital efficiently from private investors. However, FAIR Canada takes the view that the current system of prospectus exemptions cannot, by its very nature, succeed in striking this balance. A new system of exemptions must take its place in order to ensure a minimum level of investor protection.

2. There is a need for data regarding the exempt market.

- 2.1. There is a dearth of public information regarding the exempt market in Canada. We recommend that the CSA publish available information, and initiate a comprehensive study of the exempt market to identify areas of high risk to investors. We are not advocating any delay in the policymaking process, but rather encourage the CSA to make this information publicly available at the same time as the policymaking process unfolds. FAIR Canada is wary of calls for more research before any change is made, which could be viewed as a stalling tactic. It is essential that investor protection initiatives are introduced to prevent further abuse as soon as possible.
- 2.2. It is important to identify where investor losses are occurring and the causes of such losses, in order for regulation to focus on areas of higher risk. It is also important for all stakeholders, including investors, to have access to this information. We recommend that the CSA publicize any information it has regarding where funds are being raised; who is accessing securities in the exempt market; what they are purchasing; which intermediaries are involved; and where the losses occur and why. If this data is currently unavailable, we recommend that the CSA undertake such research to aid in assessing which parts of the exempt market are most in need of change to ensure that regulatory resources are concentrated in areas of highest risk to investors.
- 2.3. Canadian securities regulators have identified areas of concern in the exempt market, including a lack of registration, unsatisfactory suitability due diligence, and sales of exempt securities in reliance on the AI exemption to individual investors who do not meet the definition. We discuss these issues in further detail in section 5. We suggest that the CSA target these areas of concern as the process unfolds, and amend its priorities as the research identifies areas of greatest need.
- 2.4. FAIR Canada also recommends that issuers be required to disclose all securities sold pursuant to any MA or AI exemption to an information clearinghouse. The maintenance of a record of investments

made using these exemptions, available for investigation and study purposes by securities regulators, would provide an additional source of data that could be used to identify trends and areas that require further research.

3. Exempt market data in the Consultation Note would have improved quality of submissions.

- 3.1. FAIR Canada has found it difficult to provide meaningful comments in the absence of data regarding the exempt market. We have identified areas we believe to be of highest risk to investors, based on anecdotal evidence and particular cases as publicized in the press, and have made recommendations accordingly. We believe that it would have been beneficial for all stakeholders if exempt market data had been issued with the Consultation Note to assist stakeholders in providing constructive input. We understand that the exempt market is not insignificant in size, having been informed at the OSC public roundtables that it is a \$83.9 billion market, of which \$43.9 billion is in Ontario.

4. There is a need for a best interest/fiduciary obligation.

- 4.1. FAIR Canada believes that a best interest of the client/fiduciary standard should be a component of any MA or AI exemption in order to ensure investors are protected from unduly risky securities recommendations and have a better chance for redress in the event of mis-selling. FAIR Canada believes that all registrants who provide investment advice to retail investors should be subject to a best interest/fiduciary standard, and the need is particularly pressing in the exempt market.
- 4.2. The requirement for registrants to provide advice that prioritizes a client's best interest over all other interests, and that puts the client's best interest first in determining when and how that advice is provided, would better protect retail investors .
- 4.3. As we discuss below in section 5.13, FAIR Canada believes that the current suitability framework is inadequate (as currently interpreted) as a basis for the regulation of securities and of the activities of dealers and advisors. FAIR Canada takes the view that the fundamental requirement should be for registrants to put the client's best interest first.
- 4.4. **In order for the AI exemption to function with an acceptable minimum level of investor protection, FAIR Canada urges regulators to impose a best interest/fiduciary standard on registrants that provide investment recommendations.**

5. Compliance with exempt market requirements must be improved.

Compliance - Qualification for exemptions

- 5.1. FAIR Canada is concerned that many investors are being sold prospectus-exempt securities in reliance on the AI exemption despite the fact that they do not qualify under the current criteria. Given the absence of a prospectus to provide some protection for investors, we view this lack of compliance to be a critical issue which needs to be resolved; non-compliance and a perception of weak enforcement harms investors and weakens confidence in exempt market investing.
- 5.2. The Ontario Securities Commission (“OSC”) issued OSC Staff Notice 33-735 which identifies concerns regarding the sale of exempt securities by issuers and dealers to non-accredited investors. Notice 33-735 stated “we have found that many dealers do not collect adequate know-your-client (KYC) information to reasonably determine whether the investor is in fact an Accredited Investor.” In January 2012, the Alberta Securities Commission (“ASC”) issued Staff Notice 33-704, entitled Review

of Exempt Market Dealers. In Staff Notice 33-704, the ASC identified common issues such as unsatisfactory suitability due diligence, KYC non-compliance, and inadequate disclosure that were observed during compliance reviews of registered EMDs.

- 5.3. FAIR Canada's view is that the nature of the current accredited investor exemption system, which is self-policed by issuers and registrants that often have a conflict of financial interest with their clients, is a part of this problem. More careful policing and oversight of the exempt market is required in order to deal with these problems at their source.
- 5.4. Given concerns about investors purchasing under exemptions for which they do not qualify, FAIR Canada recommends that the CSA bolster and make public its compliance functions with respect to reliance on prospectus exemptions, to ensure that only those who qualify under the criteria purchase prospectus-exempt securities. Additionally, FAIR Canada recommends better oversight of registrants' compliance with suitability, know-your-client, and know-your-product requirements and stronger public sanctions for misconduct in this area.
- 5.5. Several decisions of securities regulators from the past year support the contention that some issuers and dealers are failing to properly ascertain that individuals to whom they sell exempt securities properly meet the AI exemption criteria. In *In The Matter of Skyline Apartment Real Estate Investment Trust, Skyline Incorporated and Skyline Asset Management Inc.*¹ ("Skyline REIT") the OSC found that at least \$13.4 million of REIT units were sold to at least 199 investors, some directly solicited by the issuer and others by third parties, where the AI exemption was improperly relied upon. The OSC also found (and the Respondents admitted) that the Respondents failed to ensure that the requirements were met for the exemption.
- 5.6. In *In the Matter of MRS Sciences Inc. (Formerly Morningside Capital Corp.), Americo DeRosa, Ronald Sherman, Edward Emmons, Ivan Cavric and Primequest Capital Corporation*² ("MRS Sciences") the OSC found that eight identified investors were sold shares of the issuer where the AI exemption was improperly relied upon. Furthermore, the Commission found that the respondents went out of their way to minimize the AI exemption requirements. In some cases, investors who said they were not accredited, or who were unemployed, were told that this did not matter; with other investors, no enquiries at all were made about the Accredited Investor status.³
- 5.7. In *In the Matter of Maple Leaf Investment Fund Corp., Joe Henry Chau, Tulsiani Investments Inc., Sunil Tulsiani and Ravinder Tulsiani*⁴ ("Maple Leaf Investment Fund") the OSC found that nine identified investors were sold shares of the issuers where the AI exemption was improperly relied upon. Investors had signed forms indicating that they met various exemptions when they did not; when one questioned the statements, she was told they were just "for decoration" and to "just sign". Another was told to sign, and that the forms were merely a "formality".⁵

¹ March 15th, 2011. Available online at http://www.osc.gov.on.ca/en/Proceedings_set_20110315_skyline.htm

² February 2nd, 2011. Available online at http://www.osc.gov.on.ca/en/Proceedings_rad_20110202_mrs-sciences.htm
³ *MRS Sciences* at paragraph 177.

⁴ November 9th, 2011. Available online at http://www.osc.gov.on.ca/en/Proceedings_rad_20111109_mapleleaf.htm

⁵ *Maple Leaf Investment Fund* at paragraphs 92 and 94.

- 5.8. In the *Aurora, Re*,⁶ case out of Alberta (also referred to as “*Concrete Equities*”) distributions were found to be illegal due to the manner in which prospective investors’ eligibility was purportedly assessed and sales were made to investors who were clearly not eligible. In *Concrete Equities*, some investors understood from sales presentations and representations that their investments would be secure and not high-risk; some were told that the risk acknowledgement was a formality, that every investment in Alberta requires it, and that the investment was not risky. Many investors were not eligible investors but signed documents indicating they were, often being told that statements to the effect that they were eligible investors (or the monetary qualifications) were a mere formality.
- 5.9. If some dealers and issuers are not complying with the current AI exemption requirements, there is no reason to suspect that raising the financial assets and income limits, for example, will have any positive effect. It is as easy to tell a prospective investor to “just sign” a statement that they have \$1,000,000 in financial assets as it is to tell them to “just sign” a statement that they have \$150,000 in assets.
- 5.10. In FAIR Canada's view, the OSC's observation that many exempt market dealers and issuers are failing even to collect the data required to establish accredited investor status, let alone to do proper due diligence on an investor's accredited investor status, is indicative of the inability of the current system to protect investors. The current, largely self-policing system which exists in the exempt market in effect places no control at all upon who is “accredited”. It seems that all one needs is the funds to buy. There is also often no suitability inquiries being undertaken, no disclosure of the large commissions that the seller is obtaining when investors purchase the exempt market security or the conflicts of interest which appear to be rife in this part of the market.
- 5.11. Given that EMDs are subject to lighter regulation, less oversight and do not form part of a scheme that provides compensation to investors in the event of insolvency, and given the lack of compliance by some EMDs with the current regulatory regime, FAIR Canada recommends that EMDs that are performing investment dealer- like activities should be required to join IIROC and not be permitted to avoid SRO-level oversight. We believe that this would result in better protection for investors, through closer supervision and heightened compliance requirements, as well as insolvency coverage through the Canadian Investor Protection Fund. We recommend that this regulatory loophole be closed as soon as possible.
- 5.12. Similar to the suggestion above in section 2.4, we recommend that each transaction be required to be reported to a clearinghouse administered by a securities commission or a third party. FAIR Canada believes that the reliability of the accredited investor system would improve significantly.

Compliance – Suitability requirements

- 5.13. FAIR Canada believes that the current suitability framework is inadequate (as currently interpreted) as a basis for the regulation of securities and of the activities of dealers and advisors. FAIR Canada takes the view that the fundamental requirement should be for registrants to put the client's best interest first.
- 5.14. Suitability requirements currently apply in addition to exemption criteria and many registrants do not adhere to the current requirements (as discussed above). The exempt market needs effective

⁶ *Aurora, Re*, 2011 ABASC 501. Available online at <http://www.albertasecurities.com/Enforcement/Enforcement%20Orders/AURORA%20Varun%20Vinny%20DEC%2020110923%203989965v1.pdf>.

oversight in order for investors to be appropriately protected. This is essential to any reform of the exempt market.

- 5.15. As noted in OSC Staff Notice 33-735, ASC Staff Notice 33-704, and the cases cited above, a lack of compliance with suitability requirements has been observed by securities regulators in the exempt market. Furthermore, at the CSA's Roundtable Consultation Sessions, FAIR Canada staff observed with concern comments made by registrants and others that indicated a lack of awareness of the current suitability requirements as they relate to sales in the exempt market.
- 5.16. FAIR Canada recommends that greater emphasis be placed upon the suitability requirements and our proposed best interest/fiduciary standard, through education and bolstered compliance efforts by CSA members. Stronger public sanctions for misconduct are also essential to ensure this basic element of investor protection is afforded to accredited investors.
- 5.17. In section 4, FAIR Canada recommends that a best interest of the client/fiduciary standard be imposed in respect of any securities recommendation. We would expect strong compliance efforts associated with the imposition of such a requirement.

6. Rationale for current prospectus exemptions unsound.

- 6.1. The rationale for the MA exemption and the AI investor exemption is that such investors are sophisticated, and able to withstand financial loss.⁷ "The financial criteria (net income or net assets) for eligible investor status are intended to identify investors who might be considered to have a degree of financial substance and, by extension, an ability to bear financial risk and withstand loss – or, at least, to obtain their own financial advice – such that they do not require the full protection of registrant involvement and a prospectus."⁸ [emphasis added] The OSC has also stated that "...in recognition of the relative sophistication of certain investors and their ability to withstand financial loss, securities laws permit the sale of securities to Accredited Investors without a prospectus."⁹
- 6.2. FAIR Canada considers the presumptions underlying both the MA exemption and the AI exemption to be flawed, and considers them particularly unsuited to the demands and challenges of an increasingly complex and challenging securities market. Both exemptions take, as their clear but unspoken premise, that individuals with a particular level of financial assets or income do not require the full protection of securities law. As such, dealers and issuers selling to such individuals are exempted from compliance with prospectus requirements, which are intended for the protection of investors. FAIR Canada considers these premises to be unjustified. That an individual is "wealthy" and potentially better able to weather a loss or able to pay for advice are not reliable proxies for investor sophistication (that is, the ability to understand the product, its associated risks, and its costs) and, therefore, do not provide an acceptable level of investor protection.
- 6.3. Under the current exemptions, it is possible for an investor who qualifies under the MA or AI exemptions to lose all or substantially all of their savings. Wealth or income is not a proxy for determining sophistication and the existing exemptions encourage promoters of poor products to target investors with sufficient wealth and/or assets. This damages market integrity and is insufficient

⁷ Andre Fok Kam. *A Canadian Framework for Hedge Fund Regulation: Canada Steps Up*. (2006). [http://www.tfmsl.ca/docs/V3\(2\)%20FokKam%20HF.pdf](http://www.tfmsl.ca/docs/V3(2)%20FokKam%20HF.pdf). [http://www.tfmsl.ca/docs/V3\(2\)%20FokKam%20HF.pdf](http://www.tfmsl.ca/docs/V3(2)%20FokKam%20HF.pdf).

⁸ *Aurora, Re*, 2011 ABASC 501.

⁹ OSC Staff Notice 33-735 – Sale of Exempt Securities to Non-Accredited Investors, (2011) 34 OSCB 5424.

to ensure an acceptable level of investor protection. Ability to absorb losses should not be used as a criterion of investor sophistication.

- 6.4. The purposes of securities regulation are to promote fairness, confidence and efficiency in the capital markets, and to provide protection to investors from unfair, improper or fraudulent practices.
- 6.5. In FAIR Canada's view, the need to protect investors from unfair, improper or fraudulent practices does not end when an investor holds an arbitrary amount of financial assets or level of income. Therefore wealth should not be employed as a criterion for an exemption from securities regulation, in the absence of other protections.
- 6.6. The reason that sophistication is important as a principle underlying the exemption is that investor sophistication contributes to a more level playing field between registrant and investor, potentially reducing opportunities for fraud, impropriety or unfairness. Financial assets and income are not sensible proxies for sophistication, due to the fact that many wealthy individuals are not necessarily sophisticated in financial matters and can be targeted by promoters of poor products or fraudulent schemes. A highly technical degree of knowledge is required to understand the features of securities and their risks and costs. Persons without exposure to finance (high net worth persons should not be presumed to have had financial training) will very often have difficulty understanding certain investments. Financial assets and income tests are both under-inclusive as well as over-inclusive; that is, sophisticated investors may be excluded on the basis that they have a lower level of financial assets and a modest income, but unsophisticated investors could be included on the basis that they are wealthy.¹⁰

7. FAIR Canada considers the MA exemption to be an inappropriate basis upon which to base a prospectus exemption.

- 7.1. We recommend the repeal of this exemption. In the alternative, if the CSA determines the MA exemption to be appropriate, FAIR Canada recommends that the minimum amount remain the same, and that, in addition, the minimum amount not represent more than five percent (5%) of the individual's investment portfolio.
- 7.2. Given that a large portion of the capital raised in the exempt market is raised using the accredited investor exemption, and given that the vast majority of persons availing themselves of a minimum amount exemption would fit within the current definition of an accredited investor (since a considerable amount of financial assets or income is needed to meet the minimum amount exemption threshold), FAIR Canada does not think it likely that the repeal of the minimum amount exemption by itself would materially affect issuers' ability to raise capital.
- 7.3. In FAIR Canada's view, investing a minimum amount does not in any way indicate a level of sophistication, nor can it be viewed as a measure of an investor's loss tolerance or ability to withstand loss. We agree with issues identified in the Consultation Note, including the fact that the MA exemption does not assure sophistication and that the minimum amount concept can have a negative impact on investment decisions.
- 7.4. More importantly, the MA exemption may encourage an investor to invest an amount in a prospectus-exempt security that is not in line with their investment objectives and could cause them

¹⁰ Finger, Wallis K. "Unsophisticated wealth: reconsidering the SEC's 'accredited investor' definition under the 1933 Act." *Washington University Law Review* 86:3 (2009).

to take on more risk than they would otherwise wish. In FAIR Canada's view, the minimum amount exemption may have the opposite effect to that desired; instead of being more careful when investing in the exempt market, unsophisticated investors can be successfully encouraged to be less careful (by being required to concentrate their investments in amounts above the minimum).

8. AI exemption is a poor proxy for sophistication.

- 8.1. Financial assets, in FAIR Canada's view, is not an appropriate criterion to substitute for knowledge, experience or sophistication. Exempting individuals or other persons on such a basis is inappropriate where there are no other institutional or regulatory constraints.
- 8.2. FAIR Canada does not believe that the current AI exemption criteria alone ensure adequate investor protection. FAIR Canada suggests that this exemption be amended as outlined below in section 9.

9. FAIR Canada recommends that the conditions for reliance on the AI exemption vary according to the securities being issued and the type of registrant involved.

- 9.1. FAIR Canada urges the CSA to reconsider the definition of accredited investor, as set out in section 1.1 of NI 45-106. We are of the view that sales of securities absent a prospectus require additional protection for investors.
- 9.2. FAIR Canada recommends that amendments be made to the current exemptions; we outline our suggested framework for non-complex products in sections 9.3 – 9.7 below. In FAIR Canada's view, the amended AI exemption we suggest below is fair to all investors, and treats investors equally regardless of the level of their financial assets. A knowledge, experience, and sophistication-based standard would treat all investors equally (since any investor may become accredited through education and training or through work experience). We also believe that distinguishing between non-complex and complex products is necessary in the interests of investor protection.

Non-Complex Products

(1) Securities of issuers listed on one or more Canadian exchange(s), sold through an SRO-member intermediary:

- 9.3. In order for an individual to purchase a prospectus-exempt security of a listed issuer, sold through an SRO member firm (such as the Investment Industry Regulatory Organization of Canada (“IIROC”) or the Mutual Fund Dealers Association of Canada (“MFDA”)), FAIR Canada proposes that the following apply:
 - i. The prospectus requirement does not apply to a distribution of a security if the purchaser purchases the security as principal and where
 - a. a registrant has a duty to act in the best interest of the client/fiduciary duty; and
 - b. a registrant ensures that the prospective investor meets the existing definition of “accredited investor” contained in section 1.1 of NI 45-106.
- 9.4. In FAIR Canada’s view, sales of securities of listed issuers, sold through SRO member firms, in reliance on the AI exemption, pose a much lower level of risk to investors, and as a result, are not in need of urgent reform.

- 9.5. It is our understanding that there are far fewer instances of non-compliance and investor losses observed in reliance on the AI exemption by SRO member firms selling securities of listed issuers. As a result, we do not view this to be a high priority area in need of urgent reform, but we encourage regulators to conduct further research in this area, to make more information publicly available, and to review the exemption on a periodic basis.
- (2) *Securities of issuers listed on one or more Canadian exchange(s), sold through a non-SRO-member intermediary AND securities of issuers not listed on one or more Canadian exchange(s), sold through an SRO-member intermediary*
- 9.6. The prospectus requirement does not apply to a distribution of a security if the purchaser purchases the security as principal and where
- a. a registrant has a duty to act in the best interest of the client/fiduciary duty; and
 - b. a registrant ensures that the prospective investor meets the sophistication test that we propose (the “Sophistication Test”), which would require that an individual meet at least two (2) of the following four (4) criteria:
 - i. the investor has carried out transactions of a significant size (at least \$2,500) on securities markets at an average frequency of, at least, ten per quarter over the previous four quarters;
 - ii. the size of the investor’s securities portfolio exceeds \$1,000,000;
 - iii. 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 and has passed the Canadian Securities Course; or
 - iv. the investor is a registrant, registered with one or more securities regulatory authority(ies) in Canada.
- (3) *Securities of issuers not listed on one or more Canadian exchange(s), sold through a non-SRO member intermediary*
- 9.7. The prospectus requirement does not apply to a distribution of a security if the purchaser purchases the security as principal and where
- a. a registrant has a duty to act in the best interest of the client/fiduciary duty;
 - b. a registrant ensures that the prospective investor meets the Sophistication Test; and
 - c. independent certification of the investor’s fulfilment of at least two of the criteria under the Sophistication Test has been obtained. This certification should be conducted by a third party with no financial interest in any transaction contemplated by that investor in reliance on the AI exemption.
- 9.8. Below, FAIR Canada will discuss the importance of the investor-focused elements of the approach it has suggested above.

Sophistication

- 9.9. FAIR Canada’s Sophistication Test, set out in subsection 9.6 b. above, is based in the rationale that a minimum level of knowledge, experience and sophistication with respect to investing is a more

appropriate proxy for sophistication than wealth and income. As stated above, we consider the presumptions underlying both the existing MA exemption and the existing AI exemption to be flawed; for example, that an individual is “wealthy” and potentially better able to weather a loss or able to pay for advice are not reliable proxies for investor sophistication (that is, the ability to understand the product, its associated risks and its costs) and, therefore, do not provide an acceptable level of investor protection. The Sophistication Test does not include a threshold for financial assets, net income, or net assets, as these are not a measure of sophistication.

- 9.10. Instead, the Sophistication Test requires that, in order to rely on this branch of the AI exemption, an investor meet at least two (2) of the four (4) criteria provided, each of which are a more reliable proxy for investor knowledge, experience or sophistication.
- 9.11. The Sophistication Test is a very similar approach to the framework used in the United Kingdom, as outlined in Appendix B of the Consultation Note.
- 9.12. The accredited investor system in the European Union relies on certain similar, knowledge-based provisions. The EU's *Markets In Financial Instruments Directive* (“MiFID”) defines a class of “professional” investors, known as “Professional Clients” to the relevant dealers, who are generally permitted to invest in the exempt market. MiFID defines a “Professional Client” as “a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs.”¹¹
- 9.13. The MiFID Directive generally defines a professional client in terms of knowledge and understanding; it sets out specific criteria related to net worth, frequency of transactions, and experience working in the financial sector in a professional position. It also provides for an assessment by the investment firm of the individual's expertise, experience and knowledge in order to be treated as a professional client in respect of all activities and services.

Complex Products

- 9.14. FAIR Canada is of the view that risks to investors are likely increased when the security being sold is complex. We urge the CSA to issue a separate consultation on the appropriate regulatory model for the sale of complex products, including whether the AI or MA exemptions (as currently defined or as revised in this submission) should be retained for complex products.
- 9.15. Complex products can be defined as financial products whose terms and features are not likely to be understood by an average retail customer (as opposed to more traditional or plain vanilla investment instruments), where these products have a complex structure, are difficult to value (so that their valuations require specific skills and/or systems) and/or have a very limited or no secondary market (and are therefore potentially illiquid).¹²
- 9.16. FAIR Canada provided its comments on the CSA’s Proposed Securitized Product Rules by letter dated August 31, 2011. In its submission, FAIR Canada provided its comments on the proposed substantive requirements for securitized transactions and the informational disclosure requirements which

¹¹ Markets in Financial Instruments Directive (MiFID), *Annex II: Professional Clients for the Purpose of this Directive*, online: < <http://www.markets-in-financial-instruments-directive.com/Annex2.htm>>.

¹² Technical Committee of the International Organization of Securities Commissions, “Suitability Requirements with respect to the Distribution of Complex Financial Products – Consultation Report” (February 2012) at page 10. (Also referenced in Kenmar Associates, Submission re CSA Notice and Request for Comments – Accredited Investor Exemption (February 26, 2012).)

would be required to meet the standards of other leading jurisdictions. We also proposed that securitized products should only be permitted to be sold to retail investors who have active knowledge of the specific products, their associated costs and risks and who understand the implications of the mandated disclosure documents, combined with independent certification of such active knowledge by an independent third party who has no financial interest in the transaction. Where investors are not able to understand the nature of the product, its attendant risks and costs, or the implications of the purchase and sale of such a product, we suggested that the securitized product should not be permitted to be sold to them.

9.17. FAIR Canada notes that new regulatory approaches for complex products are needed given that informational disclosure is increasingly seen as inadequate to protect consumers, particularly with respect to complex securities.

10. FAIR Canada is very concerned about the implications of the Northwestern Exemption for investor protection.

10.1. British Columbia, Alberta, Saskatchewan, Manitoba, the Northwest Territories, the Yukon Territory, and Nunavut have passed blanket orders¹³ (the “Orders”) that permit trading in a security in connection with a prospectus-exempt distribution, including the MA and AI exemptions, without requiring registration as an exempt market dealer (the “Northwestern Exemption”).

10.2. FAIR Canada views this to be a very dangerous exemption and believes it poses a real threat to investor protection and has led to investor losses (as noted in the press¹⁴ and during legislative hearings¹⁵). As noted by Kevin Falcon, B.C.’s Minister of Finance, upon the introduction of a bill to amend the *Securities Act*¹⁶ (B.C.) “we are concerned about the losses felt by some British Columbians who have participated in the exempt market, which is why we have introduced these amendments, which will improve investor protection while allowing this important market to continue to raise important dollars for our small businesses.”¹⁷

10.3. The exempt market dealer (“EMD”) registration category was introduced with the intention of increasing (or introducing) proficiency, conduct, capital and compliance requirements for those who participate in the exempt market in Canada. EMDs are also subject to know-your-client and suitability requirements.

¹³ See British Columbia Securities Commission Instrument 32-513, Alberta Securities Commission Blanket Order 31-505, Saskatchewan Financial Services Commission – Securities Division General Order 45-918, Manitoba Securities Commission Blanket Order 31-505, Northwest Territories Blanket Order 32-501, Yukon Territory Superintendent’s Order 2010/09, and Nunavut Blanket Order 32-501

¹⁴ David Baines, Vancouver Sun, “The readers speak: The B.C. Securities Commission must clean up the exempt securities market” (online: <http://www2.canada.com/vancouversun/columnists/story.html?id=4f3061d2-76a0-4b6b-aa6c-212d97c4336e>) and David Baines, Investment Executive, “B.C. exempt offering leaves investors sour” (online: <http://www.investmentexecutive.com/-/news-37493>) and David Baines, Vancouver Sun, “B.C. Securities Commission says it will review rules for sale of exempt securities” (online: <http://www2.canada.com/vancouversun/columnists/story.html?id=f8e3dc6b-8e4e-4d18-8275-efad3c24bb32>).

¹⁵ British Columbia, Legislative Assembly, Hansard, Vol. 28, No. 6 (22 November 2011) at 8967 (Hon. K. Falcon), online: <<http://www.leg.bc.ca/hansard/39th4th/h11122a.htm#8967>>.

¹⁶ R.S.B.C. 1996, c. 418.

¹⁷ *Supra*, note 15.

- 10.4. The Northwestern Exemption carves out an exemption wherein high-risk category products can be sold to investors, provided no opinion is given about the suitability of the product for the investor. We cannot help but wonder how a seller could market a prospectus-exempt security to an investor without some discussion as to the suitability of the security for that investor.
- 10.5. Additionally, this exemption precludes regulatory oversight and supervision, and provides an opaque space within which high-risk securities can be sold by unscrupulous individuals to unsuspecting investors.
- 10.6. FAIR Canada believes that there is an urgent need for the re-examination of the Northwestern Exemption and does not believe that this exemption is appropriate in the interests of investor protection.¹⁸

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-214-3443/ ermanno.pascutto@faircanada.ca, or Ilana Singer at 416-214-3491/ ilana.singer@faircanada.ca.

Sincerely,



Canadian Foundation for Advancement of Investor Rights

¹⁸ See CSA Staff Notice 31-312 dated August 7, 2009 at [http://www.albertasecurities.com/securitiesLaw/Regulatory%20Instruments/3/31-103/3270183-v3-CSA Staff Notice 31-312.pdf](http://www.albertasecurities.com/securitiesLaw/Regulatory%20Instruments/3/31-103/3270183-v3-CSA%20Staff%20Notice%2031-312.pdf). David Baines, Business Reporter at the Vancouver Sun has recent several articles about David Michaels who has preyed on seniors in the Exempt Market in British Columbia. See <http://www.vancouversun.com/Baines+Securities+Commission+says+will+review+rules+sale+exempt+securities/5063440/story.html>.