



Canadian Foundation *for*  
Advancement *of* Investor Rights

May 28, 2014

British Columbia Securities Commission  
Alberta Securities Commission  
Financial and Consumer Affairs Authority (Saskatchewan)  
Manitoba Securities Commission  
Ontario Securities Commission  
Autorité des marchés financiers  
Financial and Consumer Services Commission (New Brunswick)  
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland and Labrador  
Registrar of Securities, Northwest Territories  
Registrar of Securities, Yukon  
Superintendent of Securities, Nunavut

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**RE: Proposed Amendments to the Minimum Amount and Accredited Investor Prospectus Exemptions**

FAIR Canada is pleased to offer comments to the Canadian Securities Administrators (the “CSA”) on the proposed amendments to 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**”) published on February 27, 2014 (the “**Consultation Note**”). The proposed amendments follow CSA Staff Consultation Note 45-401 dated November 10, 2011 which indicated that the review of these two exemptions resulted from the global financial crisis and recent international regulatory developments.

FAIR Canada is a national, charitable 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](http://www.faircanada.ca) for more information.

### **FAIR Canada Comments and Recommendations – Executive Summary:**

#### **Need to Focus on Regulatory Mandate of Investor Protection**

1. FAIR Canada urges securities regulators to be mindful of the tension between the regulatory objectives of investor protection and fostering “fair and efficient capital markets”. We are concerned that far too much emphasis has been placed on capital-raising and not enough focus has been on protecting the investing public who provide the capital.

#### **Amount Invested, Wealth and Income Not Proxies for Sophistication**

2. FAIR Canada believes that the premise upon which the MA Exemption and AI Exemption are based may hold for institutional investors (such as banks, pension funds, and mutual funds) but not for retail investors and securities regulators must heed this critical observation in order to meet the regulatory mandate of adequately protecting investors.

#### **MA Exemption Should Not be Made Available for Individual Investors**

3. FAIR Canada supports the CSA’s proposed amendment to the MA Exemption and commends the CSA for recognizing that “...the amount invested is not a good proxy for sophistication or the ability to withstand financial loss for individual investors.”<sup>1</sup>
4. FAIR Canada urges further amendments be made to the MA Exemption so that unsophisticated individuals who control small companies or family trusts, or who are natural persons acting in the capacity of trustee, executor, administrator or personal or other legal representative are also not eligible to use the exemption. The rationale behind not permitting individuals to use the MA Exemption (that a certain amount of capital (\$150,000) is a poor proxy for sophistication and is also a poor proxy for the ability to withstand financial loss) would also be applicable to these entities or individuals.

#### **Fundamental Reform of AI Exemption Needed**

5. FAIR Canada believes that it is high time that the CSA acknowledge that income and wealth are not appropriate proxies for sophistication or the ability to withstand loss for individual investors. We

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<sup>1</sup> (2014) 37 OSCB (supp-2), dated February 27, 2014 CSA Notice and Request for Comment Proposed Amendments to National Instrument 45-106 Prospectus and Registration Exemptions Relating to the Accredited Investor and Minimum Amount Investment Prospectus Exemptions, at page 5.

urge the CSA to reconsider its position that it will not make any changes to the definition of accredited investor.

6. FAIR Canada proposed a “Sophistication Test” in its earlier submission dated February 29, 2012, which included both knowledge and experience requirements. This proposed test would treat all investors equally since any investor may become accredited through education and training or through experience along with independent verification that the individual meets the criteria. If adopted, the pool of accredited investors would have an adequate level of sophistication (that is, the ability to understand the product, its associated risks and its costs). FAIR Canada is disappointed that the CSA did not provide any comments on its view of a sophistication test similar to that of the UK, the EU or as proposed by FAIR Canada, despite the obviously flawed rationale underlying the existing AI Exemption for individuals.
7. The CSA should also consider building an educational course and examination which could qualify interested individuals in becoming an accredited investor.
8. FAIR Canada believes that the implementation of a sophistication test along with having an independent register of individual accredited investors and/or the introduction of an educational “accredited investor” qualification could result in the size of the pool of accredited investors being similar to that which presently exists while significantly increasing investor protection. It could decrease the need for the CSA to expend significant resources to police an exempt market composed of a large number of unsophisticated investors.
9. If the CSA rejects a sophistication test and relies on a purely financial test, FAIR Canada urges the CSA to implement reforms so it is better able to capture only those individuals who have the ability to bear financial risk and withstand loss and/or the financial ability to obtain their own financial advice. We make specific recommendations in this regard at paragraphs 4.9 to 4.12.
10. FAIR Canada recommends that there be independent certification of an individual’s qualification as an accredited investor. FAIR Canada urges the CSA to consider developing an independent registry similar to that used in the UK or the creation of an accredited investor registration number that could be issued by securities regulators or some other independent body or third party. Given widespread problems with unqualified investors being sold exempt market investments through the AI Exemption, some form of certification by an independent third party is necessary.

#### **Risk Acknowledgement Form of Little Use**

11. FAIR Canada believes that the risk acknowledgement form will do little to improve investor protection in the absence of more fundamental reforms, and in light of the widespread compliance issues and the lack of effective oversight. If the risk acknowledgement form is provided to the investor after they have decided to invest (that is, as they are completing the paperwork), it is not clear that it will provide meaningful protection for investors. Many behavioural biases, including confirmation bias, affect investor decision-making and the design and timing of information profoundly affects its impact and effect.
12. The provision of more boilerplate disclosure may not effectively warn investors about the risks, as the salesperson can easily get the prospective investor to gloss over the form as mere “paperwork”

or a “formality”. In addition, the risk acknowledgement form will likely be used to insulate the seller from claims, should the investor need to seek recourse through regulators or the courts.

13. FAIR Canada recommends that the CSA share its information on the investor experience with risk acknowledgement forms in the exempt market. We urge the CSA to publish information disclosing the effectiveness of the use of such forms in light of existing complaints, investigations, and enforcement proceedings where such forms were used. We also urge the CSA to conduct investor testing of the proposed form on individual investors to see whether it would help investors make better investment decisions.

### **Statutory Best Interest Standard Required**

14. FAIR Canada believes that a statutory best interest standard would help to ensure that investors are protected from recommendations to purchase securities that are not in their best interest to hold, and would provide investors with a better chance for redress in the event of mis-selling. While this would involve considerable changes relating to mis-aligned incentives, conflicts of interest and the remuneration structures (high up-front commissions, finder’s fees, referral fees etc.), we believe that such a standard is necessary, and is what investors expect.
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#### **1. Need to Focus on Regulatory Mandate of Investor Protection**

- 1.1. FAIR Canada urges securities regulators to be mindful of the tension between the regulatory objectives of investor protection and fostering “fair and efficient capital markets”. An appropriate balance must be struck between protecting individual investors and the needs of businesses (and in particular, small and medium-sized businesses) to raise capital efficiently from investors. While securities regulators profess that they believe they are striking the appropriate balance and that “[t]he Proposed Amendments are intended to enhance investor protection”<sup>2</sup>, we believe that the desire to facilitate capital raising has been given much greater weight than the imperative to protect investors. As a result, insufficient investor protection measures have been put forward. We are concerned that far too much emphasis has been placed on capital-raising and not enough focus has been placed on protecting the investing public who provide the capital.

#### **2. Amount Invested, Wealth and Income Not Proxies for Sophistication**

- 2.1. FAIR Canada’s understanding is that many of the exempt market’s investors are institutional investors (such as banks, pension funds, mutual funds, etc.). They are less vulnerable, better-able to obtain independent professional advice, and better-able to absorb losses than individual investors. It is important to be mindful of these differences in designing prospectus exemptions. The premise upon which the MA Exemption and AI Exemption are based may hold true for institutional investors but do not hold true for retail investors and this critical observation must be heeded by securities regulators in order to meet the regulatory mandate of adequately protecting investors.

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<sup>2</sup> (2014) 37 OSCB (supp-2), dated February 27, 2014 CSA Notice and Request for Comment Proposed Amendments to National Instrument 45-106 Prospectus and Registration Exemptions Relating to the Accredited Investor and Minimum Amount Investment Prospectus Exemptions, at page 5.

- 2.2. FAIR Canada supports the CSA's proposed amendment to the MA Exemption "...so that it is only available for distributions to non-individuals to address investor protection concerns associated with the use of the exemption to distribute securities to individual investors." The CSA notes that the MA Exemption amendment "...is intended to reduce the risk of individual investors over-concentrating their investable assets in one investment while retaining the efficiency of the exemption for corporate and institutional investors. ***It also addresses our concern that the amount invested is not a good proxy for sophistication or the ability to withstand financial loss for individual investors.***" (our emphasis added)
- 2.3. While the CSA has recognized the flaw in the MA Exemption's design and has proposed amendments accordingly, it has not done so for the AI Exemption. This is surprising given that the rationale for the AI Exemption is similar to that of the MA Exemption. One can only surmise that the willingness to amend the MA Exemption is due to the fact that it represents such a small part of the exempt market (3.7% of the total amount invested in the exempt market<sup>3</sup>; and relied upon less than 1% of the time for distributions to Canadian investors<sup>4</sup>, representing less than 1% of the total invested by Canadians<sup>5</sup>). Therefore, removing the availability of the MA Exemption for sales to individual investors would have a minimal impact on capital-raising. Members of the CSA may also have considered the fact that many of the persons who invest using the MA Exemption would qualify under the AI Exemption.
- 2.4. Nonetheless, FAIR Canada commends the CSA for recognizing that "...the amount invested is not a good proxy for sophistication or the ability to withstand financial loss for individual investors."<sup>6</sup> FAIR Canada believes it is incumbent upon the CSA to acknowledge similarly that income and wealth are not good proxies for sophistication or the ability to withstand loss for individual investors. We urge the CSA to reconsider its position that it will not make any changes to the definition of accredited investor and will "...continue to monitor developments in other jurisdictions."<sup>7</sup>

### 3. MA Exemption Should Not be Available For Individual Investors

- 3.1. FAIR Canada fully agrees that the rationale for the MA Exemption is fundamentally flawed.<sup>8</sup> Investment of a certain amount of capital (\$150,000) is a poor proxy for sophistication. It is also a poor proxy for the ability to withstand financial loss, as seniors and those nearing or entering retirement may have accumulated a significant amount of capital but will need to rely on these funds in their retirement years (both the capital and any income generated). In addition, requiring \$150,000 to be invested in a single product to rely on the MA Exemption may lead to overconcentration in a high-risk product.

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<sup>3</sup> See Consultation Note at page 3.

<sup>4</sup> See Consultation Note at page 3.

<sup>5</sup> See Consultation Note at page 3: "Based on this review, we estimated that individuals investing under the MA Exemption represented less than 1% of the total \$149.5 billion invested by Canadians in 2011."

<sup>6</sup> See Consultation Note at page 5.

<sup>7</sup> See Consultation Note at page 4.

<sup>8</sup> See FAIR Canada's submission dated February 29, 2012 to the CSA re Review of Minimum Amount and Accredited Investor Exemptions at section 6, pages 9 to 10.

- 3.2. FAIR Canada recommends that further amendments be made to the MA Exemption so that unsophisticated individuals who control small companies or family trusts, or who are natural persons acting in the capacity of trustee, executor, administrator or personal or other legal representative are also not eligible to use the exemption. The rationale behind not permitting individuals to use the MA Exemption would also be applicable to these entities or representatives.

#### 4. Fundamental Reform of AI Exemption Needed

- 4.1. The Consultation Note states that under the current AI Exemption, "...some individual investors may not understand the risks associated with exempt market investments". This is due to the fact that neither wealth nor income is a proxy for investor sophistication.<sup>9</sup> FAIR Canada urges the CSA to recognize that the basis of this exemption is as flawed as that of the MA Exemption. Fundamental reform of the criteria used for the exemption is needed.
- 4.2. FAIR Canada urges all members of the CSA to collect information about distributions made in reliance upon the AI Exemption (along with other prospectus exemptions) in order to inform the policymaking process, as well as compliance and enforcement efforts. The information that has been provided by securities regulators in the Consultation Note makes it clear that there is very limited available data upon which important policies are being determined. We urge securities regulators to make any necessary amendments to exemption-related filing requirements in order to collect better information and to make such information public. The ability of securities regulators to gather and analyze information about the exempt market is critical given its size and the recent emphasis on expanding prospectus exemptions so as to allow for greater capital-raising.
- 4.3. Data on the size and composition of the pool of accredited investors would make it possible to determine how changing eligibility criteria will affect the accredited investor pool and any potential economic consequences. Thus, for example, the following information would help inform the public policy process with respect to Canada's exempt market and the AI Exemption:
- (a) How many individual Canadians are sold exempt market investments on the basis they are accredited investors? If the AI Exemption represented 90% of the total amount invested in the exempt market in 2011<sup>10</sup>, how much of this was contributed by individual accredited investors versus institutional investors or permitted individuals? If a significant amount of the capital raised under the AI Exemption is actually raised from institutional investors (but this information is not known), fundamental reform of the AI Exemption for individual investors will not have a significant impact on capital-raising, but will significantly improve investor protection for retail investors.
  - (b) How large is the exempt market? The information provided by the CSA is not reliable given that it likely includes funds investing in other funds and investors redeeming in one fund and moving their capital to another fund. It is not limited to new capital investments as investment funds are not required to reflect redemptions when reporting distributions. The size of the exempt market could

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<sup>9</sup> We refer you to our submission dated February 29, 2012 at section 6, pages 9 to 10.

<sup>10</sup> According to the Consultation Note, at page 2.

therefore be materially overstated. FAIR Canada supports amendments that will allow for the collection of more accurate data.

- 4.4. The proportion of distributions to accredited investors that used a financial intermediary (a registrant) versus those distributed directly by the issuer would help inform whether implementing a best interest standard would help protect a majority of individual accredited investors who invest or would only help protect a smaller percentage.
- 4.5. FAIR Canada, in its February 29, 2012 submission, proposed a “Sophistication Test” which included both knowledge and experience requirements. This proposed test would treat all investors equally since any investor may become accredited through education and training or through experience along with independent verification that the individual meets the criteria. If adopted, the pool of accredited investors would have an adequate level of sophistication (that is, the ability to understand the product, its associated risks and its costs). Such approaches are used in the United Kingdom<sup>11</sup> and in the European Union<sup>12</sup>.
- 4.6. FAIR Canada is disappointed that the CSA did not provide any comments on its view of a sophistication test similar to that of the UK, the EU or as proposed by FAIR Canada, despite the obviously flawed rationale underlying the existing AI Exemption for individuals.
- 4.7. The CSA also should consider building an educational course and examination designed to qualify interested individuals in becoming an accredited investor.
- 4.8. The implementation of a sophistication test (along with having an independent register of individual accredited investors) and/or the introduction of an educational “accredited investor” qualification could result in the size of the pool of accredited investors being similar to that which presently exists while significantly increasing investor protection. This could also decrease the need for the CSA to expend significant resources to police the sale of products to an exempt market composed of a large number of unsophisticated investors. Such a test would also allow for appropriate access to the exempt market, in that it would allow all individuals full opportunity to become a qualified accredited investor upon demonstrating the necessary level of knowledge, experience and sophistication (that is, the ability to understand the product, its associated risks and its costs) while, at the same time, providing adequate investor protection.
- 4.9. If the CSA rejects a sophistication test and chooses to rely, instead, on a purely financial test, FAIR Canada urges the CSA to at implement reforms so it is better able to capture only those individuals who truly have the ability to bear financial risk and withstand loss and/or the financial ability to obtain their own financial advice.
- 4.10. The current asset and income thresholds have not been adjusted, to our knowledge, since their introduction. By doing nothing, securities regulators have expanded the pool of individual

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<sup>11</sup> The framework used in the United Kingdom is outlined in Appendix B to CSA Staff Consultation Note 45-401 at page 12.

<sup>12</sup> The accredited investor system in the European Union also 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”. See the 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>>.

accredited investors that come within the thresholds as a result of inflation and, in many cases, nothing more than the rise in market values of their RRSPs or cash realized from the sale of their homes. Arguably this has increased the number of investors who are neither sophisticated nor able to withstand the loss but who fall within the eligible pool. The United States Securities and Exchange Commission (“SEC”) set a \$200,000 net income level in 1982 which was later adopted in Canada. Why should the income level not be adjusted for inflation if this proxy is going to continue to be relied upon?

4.11. In addition, FAIR Canada recommends that other revisions be made so as to better refine what an individual can and cannot “afford” to lose as follows:

- Registered retirement savings and registered educational savings should not be included in the calculation of net assets as these are not amounts that investors can “afford to lose”. Pensions are off-limits and other registered retirement savings should be also.
- Both the financial asset test and the net asset test calculations should exclude the equity that a person has in their primary residence (their home) in order to limit an investor’s losses to amounts that are easier to bear.
- Consider limiting the size of any one investment (to a percentage of their existing portfolio of investments or percentage of their existing net worth) in order to reduce the risk of overconcentration and lack of diversification and so they can “withstand the loss”.

4.12. FAIR Canada would like to see data on the number of Canadians who meet the current income and net assets thresholds. While the CSA has provided information on the percentage of Canadians who meet the net income test, they do not provide data on the number of Canadians this represents nor the percentage or number of Canadians who would meet the net asset test. Adjustments to account for inflation may improve investor protection while not making a significant impact on capital-raising.

## 5. Widespread Non-Compliance

5.1. Currently there is widespread non-compliance with the rules and a lack of effective oversight in the exempt market. A whole host of serious compliance issues posing significant investor protection concerns have been noted by the securities regulators in CSA Staff Notice 31-334, CSA Review of Relationship Disclosure Practices dated July 18, 2013, OSC Staff Notice 33-740, ASC Staff Notice 33-704, and OSC Staff Notice 33-735 and in guidance issued in CSA Staff Notice 31-336.

5.2. FAIR Canada does not believe that the present Consultation Note provides fulsome information on the compliance issues that have been identified by CSA members in the exempt market, and in particular in relation to the MA Exemption and the AI Exemption. While it does list some of the problems that compliance and enforcement staff typically see with the MA Exemption, limited information is provided regarding the AI Exemption. The Consultation Note mentions that the CSA has proposed certain amendments to address investor protection concerns relating to the fact some individual investors may not understand the risks associated with exempt market investments or may not in fact qualify as accredited investors. In order to improve the policy-making process, FAIR Canada urges the CSA to be more transparent in providing information



about the problems that compliance and enforcement staff have encountered with the AI Exemption.

## 6. Risk Acknowledgement Form of Little Use

- 6.1. FAIR Canada believes that the risk acknowledgement form will do little to improve investor protection in the absence of more fundamental reforms, and in light of the widespread compliance issues and the lack of effective oversight. If the risk acknowledgement form is provided to the investor after they have decided to invest (that is, as they are completing the paperwork), it is not clear that it will provide meaningful protection for investors. Many behavioural biases, including confirmation bias, affect investor decision-making and the design and timing of information profoundly affects its impact and effect. We have seen no evidence that these considerations factored into the design of the risk acknowledgement form.
- 6.2. The provision of more boilerplate disclosure may not effectively warn investors about the risks, as the salesperson can easily get the prospective investor to gloss over the form as mere “paperwork” or a “formality”. In addition, the risk acknowledgement form will likely be used to insulate the seller from claims, should the investor need to seek recourse through regulators or the courts.
- 6.3. FAIR Canada recommends that independent certification of an individual’s qualification as an accredited investor would be preferable to inserting a risk acknowledgement form into the sales process. FAIR Canada urges the CSA to consider developing an independent registry like in the UK or the creation of an accredited investor registration number that could be issued by securities regulators or some other independent body. Given widespread problems with unqualified investors being sold exempt market investments through the AI Exemption, some form of certification by an independent third party is necessary.
- 6.4. FAIR Canada recommends that the CSA share its information on the investor experience with risk acknowledgement forms in the exempt market. Have risk acknowledgement forms that are currently in use helped to protect investors by ensuring they understand the risks associated with the exempt market investment? Or have compliance reviews found that these forms were ineffective as the investor was simply told to sign and that they were a formality?<sup>13</sup> Are the forms meeting their intended objectives? FAIR Canada urges the CSA to publish information disclosing the effectiveness of the use of such forms in light of existing complaints, investigations and enforcement proceedings where such forms were used.
- 6.5. FAIR Canada also urges the CSA to conduct investor testing of the proposed risk acknowledgement form on individual investors to see whether it would help investors make better investment decisions. For example:
  - Will investors understand that some protections afforded them under securities laws are unavailable in an exempt purchase? Will they understand the differences in the legal remedies available to them as a result?

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<sup>13</sup> FAIR Canada earlier submission to the CSA dated February 29, 2012 notes some decisions of securities regulators where investors were told to simply sign the forms and that they were a mere formality. See our submission dated February 29, 2012 at paragraph 5.7, and 5.8 at pages 7 to 8, available online at <http://faircanada.ca/wp-content/uploads/2011/01/120229-FAIR-Canada-submission-re-MA-AI-exemptions.pdf>.

- While the registrant or issuer has a duty to ensure that the investor meets the exemption requirements, does the format of the risk acknowledgement form lead the investor to believe it is their obligation to determine that they meet the qualification criteria under the AI Exemption, rather than the registrant's obligation?
- Why does the form not alert the investor to the suitability obligations that are owed to them by a registrant selling them a prospectus-exempt security and to remind registrants of their obligations (especially in light of the evidence that registrants are often unaware of their KYP and KYC obligations)?

6.6. Other observations FAIR Canada has made regarding the risk acknowledgement form are:

- Why does the CSA not also require the salesperson's certification or attesting to the information when the investor initials beside the amount of the fee or commission being paid to the salesperson?
- Why is there no required disclosure regarding the conflicts of interest present in the sale of securities of related or connected issuers?
- Why is there no required disclosure setting out the referral fees that have been paid in the sales process?
- Why is there no warning to the investor that if the sale of the prospectus-exempt security is not made through a registrant who has KYC and KYP obligations, then the investor will need to do their own due diligence on the seller and the investment in order to determine whether it is a legitimate investment or not?
- Why does the form not state clearly what the consequences are if the information is not complete or is inaccurate?
- What is the risk to a non-registered person of falsely signing the risk acknowledgement form? What has happened to the many non-compliant registrants who sold prospectus-exempt securities to unaccredited investors?

6.7. FAIR Canada urges the CSA to recognize that the proposed risk acknowledgement form is unlikely to be sufficient to adequately protect investors. Further steps need to be taken now to protect individual investors who meet the current net asset and net income tests to be accredited investors along with the significant number of individuals who do not meet these criteria but are nonetheless sold exempt market investments in purported reliance on this exemption.

## **7. Statutory Best Interest Standard Required**

- 7.1. FAIR Canada believes that a statutory best interest standard would help to ensure investors are protected from recommendations to purchase securities that are inappropriate, and would provide investors with a better chance for redress in the event of mis-selling.
- 7.2. While there are considerable compliance concerns relating to the exempt market (as noted above), we believe that a best interest standard, if implemented and enforced, would improve investor protection in Canada.

- 7.3. 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. We recognize this would involve considerable changes relating to mis-aligned incentives, conflicts of interest and remuneration structures (high up-front commissions, finder's fees, referral fees etc.), but we believe that such a standard is necessary, and it is what investors expect.

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 Neil Gross at 416-214-3408/[neil.gross@faircanada.ca](mailto:neil.gross@faircanada.ca) or Marian Passmore at 416-214-3441/[marian.passmore@faircanada.ca](mailto:marian.passmore@faircanada.ca).

Sincerely,



Canadian Foundation for Advancement of Investor Rights