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June 18, 2014

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Re: Multilateral CSA Notice of Publication and Request for Comment *Proposed Amendments to National Instrument 45-106 Prospectus and Registration Exemptions Relating to the Offering Memorandum Exemption and in Alberta, New Brunswick and Saskatchewan, Reports of Exempt Distribution*

Dear Sirs/Mesdames,

We are writing in response to the Canadian Securities Administrators' (CSA's) Multilateral CSA Notice of Publication and Request for Comment *Proposed Amendments to National Instrument 45-*

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106 Prospectus and Registration Exemptions Relating to the Offering Memorandum Exemption and in Alberta, New Brunswick and Saskatchewan, Reports of Exempt Distribution (the Proposed Amendments) as published on March 20, 2014.

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EXECUTIVE SUMMARY

Advocis is pleased with the CSA's continued efforts to enhance investor protection while simultaneously improving access to much-needed capital by start-up businesses and small- to medium-sized enterprises. Advocis members support regulation which fosters retail investor participation and protection in the exempt markets.

PART ONE: GENERAL OVERVIEW AND ANALYSIS

The offering memorandum (OM) prospectus exemption is generally used by businesses in pursuit of early stage and small business financing. Issuers distribute the resulting securities through advisors and dealers, primarily exempt market dealers and their dealing representatives. Retail investors and their advisors express frequent interest in OM-exempted securities, since the offering memorandum document is a rich source of investment-related disclosure. These retail investors rely on the eligible investor exemption to purchase OM investment products

At present in the participating jurisdictions (Alberta, Saskatchewan and New Brunswick), a retail investor who qualifies as an eligible investor is a person who in general fulfills one of the two following sets of criteria: (1) net assets, alone or with a spouse, in excess of $400,000, and a net income before tax in excess of $75,000 in each of the two most recent calendar years; or (2) a net income before taxes, alone or with a spouse, in excess of $125,000 in each of the two most recent calendar years.

However, the proposed changes to National Instrument 45-106 *Prospectus and Registration Exemptions* under review here will introduce aggregate annual limits – what is in effect permissible "contribution room" – on how much an individual retail investor can invest each year in an investment product issued pursuant to the OM emption. These limits are:

- $10,000 in respect of all investors who are not eligible investors; and
- $30,000 in respect of individual investors who are not accredited investors and do not qualify as specified family members, close personal friends or close business associates under the friends, family and business associates exemption.

The impact on non-accredited investors in general and on non-eligible investors in particular – that is, on almost all of the retail investors in the participating jurisdictions, will be profound.[1]

Advocis believes the CSA's proposed contribution limits for retail investors under the OM exemption do not augment but in fact undercut the new National Instrument 31-103 regime which was introduced in September 2010. The Know Your Product, Know Your Client, and other suitability obligations now in effect in the participating jurisdictions represent significant enhancements to investor protection.

[1] The criteria for qualifying as an accredited investor are extraordinarily high. Less than 4 per cent of the Canadian population would qualify for accredited investor status. Typically, retail investors who are accredited investors are individuals who, either alone or with a spouse, beneficially own financial assets with a net value of $1,000,000 and have an income before tax in excess of $200,000 in each of the two most recent calendar years, or (2) has net income before tax combined with that of a spouse in excess of $300,000 in each of the two most recent calendar years; or (3) either alone or with a spouse has net assets of at least $5,000,000.

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The purported, though undocumented – basis of the proposed amendments – the need to limit investor exposure to illiquid securities – has struck many stakeholders as scarcely credible. This is in part due to the total lack of evidence and data regarding the alleged consumer harm, and in part to the new compliance standards of NI 31-103, particularly the new licensing requirements for exempt market dealers, improved standards for the ongoing training and education of dealing representatives, and above all the strict guidelines which exempt market dealers and their chief compliance officers must follow before granting approval to a transaction before it can be finalized and processed.

According to the CSA, "there are a few issuer groups raising the majority of the funds under the OM Exemption in Alberta. Some of these large issuers have 'in-house' exempt market dealers selling the securities on their behalf." If this is true, then the rationale for the proposed limits becomes more problematic, as the enforcement of suitability requirements on a few large dealers should be a relatively cost-effective process. In fact, if the regulator is so certain that the problem is the sale of illiquid securities by a few large issuers and dealers, then compliance sweeps of this firms would be the logical first order of business, not a dramatic reduction in access to both liquid and illiquid securities on the part of retail investors. The most obvious next step would be for the regulators to review the transactions of these issuers and dealers to determine compliance. Since provincial securities commissions will receive notification of these transactions in the monthly reports submitted by exempt market dealers, a random review of these transactions is possible, desirable and practicable. If these reviews turn up suggestions of malfeasance, the regulators have the ability to pursue various enforcement actions at that point, as well as the conducting of further audits on the dealers and their salespersons.

The concern over illiquidity is puzzling as almost all investing Canadians understand the concept: for example, a registered retirement savings plan investment comes with illiquidity, as one cannot withdraw money until age 65 without incurring a penalty. As well, many investments available in the public markets, inducing mutual funds, may have a penalty clause for withdrawing money before a certain period of time.

Part Two: Consequences of the CSA's Proposed Amendments

The outcome of the CSA's proposed amendments will be a series of unintended consequences, each of which will lead to increased costs on investors, advisors, and issuers. Advocis does not believe that the overall level of consumer protection will be enhanced; indeed, retail investors may be exposed to more risk as a result of the proposed changes. Moreover, it is not clear that the proposed changes will be easily enforceable, if at all. Strict enforcement will require the tracking and review of the exempt market investments made by retail investors under the OM exemption. The review, whether conducted by the issuer, dealer or regulator (or a self-review by the investor) will have to be conducted at the level of individual dollars and cents in order to ensure the aggregate annual caps are not exceeded.

The impact on non-accredited retail Investors will take the form of a dramatic barrier to entry to exempt market investing, and therefore to the exempt market's lower costs and reduced volatility. The converse is that these retail investors will be exposed to higher volatility and other costs as retail investment capital is forced by the $10,000 and $30,000 caps to migrate to the public markets. This in turn will lead to negative impacts on their portfolios, including increased exposure to volatility and impediments to portfolio performance and diversification.

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As well, current and future exempt market investors will face a series of perverse incentives when forced to undertake certain types of financial planning decisions. This is exemplified in paradox of the successful investment which is completing its exit phase under the aggregate annual caps. For example, after a successful OM-exempt investment of $29,000 (and thus an investment under the proposed cap) concludes its exit phase, the principal and returns will be made available to the investor, often with the option of reinvestment. But both the successful investor and issuer would be barred from fully enjoying their successes: where in the past the investor could reinvest the entirety of the principal and returns back into the company, now they would be prohibited by the annual cap from further and fully benefiting from their initial investment since – in the name of investor protection – they would be allowed to reinvest only the principal and a fraction of the generated returns. The impact on the process of successful capital formation is striking – the regulator is seeking to bar access to investing in a company which has proven itself a success, which is surely the best possible metric of calculating investment risk.

The impact on private issuers and on capital raising will be equally problematic. Issuers and dealers will face increased costs and risks as a potent source of investment capital for OM products is severely diminished (in fact, over 90 per cent of OM-exempt investment product purchases in Alberta are made by individuals). Moreover, the proposed amendments will provide exempt market dealers with the wrong incentives in constructing their compliance systems. The industry will respond to the reduction in retail investment capital with what will amount to a regulator-driven redesign of investment products, but the capital which will in any event be redirected to public markets will lead to a further inhibition on Canadian entrepreneurialism and innovation in the form of increasing undercapitalization of smaller firms and of small- to medium-risk start-ups.

In economic terms, the exempt markets in the participating jurisdictions will experience the imposition of the aggregate annual limits as artificial constraints on investor-led allocation of capital, which will lead to a negative impact on price discovery and price formation for OM-exempt products. The ultimate outcome will be, perversely, to make illiquid investments even more illiquid. Finally, it is inarguable that constrictions on the efficient allocation of capital will force exempt market dealers and salespersons from the industry.

PART THREE: THE PROPOSED AMENDMENTS AND SOUND REGULATORY POLICY

All of this forces one to wonder what sort of scrutiny the CSA subjected the proposed amendments to before releasing its *Request for Comment*. Advocis believes that sound regulatory policy must include a comprehensive, transparent cost-benefit analysis. Given the apparent success of National Instrument 31-101 in the last few years – at least according to the trade media and notable dealers – the absence of such an analysis is particularly conspicuous here, as is the total absence of evidence that consumer harm from OM-exempt products has emerged in the participating jurisdictions since the introduction of the reforms in NI 31-103 in September 2010.

The CSA professes to be addressing a problem of investor losses for investments made pursuant to the OM exemption and distributed by a few large issuers and exempt market dealers; in specific, it says it is seeking to limit investor exposure to illiquid investments. Based on the data available from the Alberta Securities Commission, the proposed amendments seem to be a classic example of regulatory overreach. The truth is that there are already suitable investor protection mechanisms in place which are sufficient for dealing with illiquidity concerns.

In reviewing the aggregate annual caps in light of their impact on existing legislation and regulatory policy, we conclude that they:

- create too large a group of investors to allow for fair and effective regulation and financial planning;
- do not mesh with current suitability requirements and informed financial planning; and
- in the final analysis must be regarded as an undue imposition on individual retail investors, exempt market dealers and issuers.

PART FOUR: ALTERATIVE REGULATORY MEASURES

Accordingly, we would urge the CSA to abandon the proposed amendments in favour of a more targeted, proportionate, and non-arbitrary regulatory response. To this end we suggest a number of alterative regulatory measures, which either (1) amend the current regulatory *status quo* in a limited fashion through minimally disruptive measures which will protect those investors truly in need of regulatory protection, or (2) accept the proposed amendments in some form, but offer limited carve-outs to mitigate the negative effects of rigid aggregate annual caps.

We conclude by reminding the CSA of its mandate to promote investor trust and confidence and urge it to give due consideration to the alternative measures which come forward from stakeholders. In any event, we believe that the first response to concerns over investor losses or purchases of illiquid securities should be informed by facts gathered from the field. The regulator should determine if Know Your Client, Know Your Product and other suitability requirements are being complied with by the group of registrants the CSA has already identified as the source of concern, *before* undertaking actions which will severely diminish the capital allocation opportunities of all investors, issuers and registrants.

It should be recalled that National Instrument 31-103 regime is not even four years old. The CSA should let NI 31-103 continue to be modified in an incremental, measured and proportionate way, one which accords with the “facts on the ground” and is informed by significant samples of objectively gathered data. We believe that the regulator has in fact undervalued the protection afforded by the enhanced suitability requirements for registrants which NI 31-103 mandates.

CONCLUSIONS AND THOUGHTS ON THE CSA’S MANDATE

The proposed $10,000 and $30,000 annual contribution limits for non-accredited investors promise to be unfair to nearly all stakeholders, and they come with a guaranteed promise of regulator-induced market inefficiencies and outright market failures.

Advocis hopes that the CSA will consider alternative regulatory responses and abandon the proposed amendments to limit the investment choices of non-accredited investors. Far from achieving their professed goals, the proposed amendments will adversely affect the vast majority of retail investors and their advisors and exempt market issuers and dealers. If illiquidity really is the final concern of these amendments, then let the CSA focus on ways of addressing the sales of clearly illiquid products with enhanced transparency, disclosure and advice requirements, instead of imposing annual limits on all exempt market products, regardless of their liquidity. Capital markets flourish under constructive, not destructive policy.

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PART ONE: GENERAL COMMENTS AND ANALYSIS

1. Advocis: Who we are

Advocis is the largest and oldest professional membership association of financial advisors and planners in Canada. Through its predecessor associations, Advocis proudly continues over a century of uninterrupted history serving Canadian financial advisors and their clients. Our 11,000 members, organized in 40 chapters across the country, are licensed to sell life and health insurance, mutual funds and other securities, and are primarily owners and operators of their own small businesses who create thousands of jobs across Canada. Advocis members provide comprehensive financial planning and investment advice, retirement and estate planning, risk management, employee benefit plans, disability coverage, and long-term care and critical illness insurance to millions of Canadian households and businesses.

As a voluntary organization, Advocis is committed to professionalism among financial advisors. Advocis members adhere to our published *Code of Professional Conduct*, uphold standards of best practice, participate in ongoing continuing education programs, maintain professional liability insurance, and put their clients' interests first. Across Canada, our members spend countless hours working one-on-one with individual Canadians on financial matters. Advocis advisors are committed to educating clients about financial issues that are directly relevant to them, their families and their future. Our following comments on the CSA's proposal reflect the priorities of Advocis' members and their clients.

2. Overview of the Proposed Amendments

The Alberta Securities Commission (ASC), the Financial and Consumer Affairs Authority of Saskatchewan (FCAA), and the Financial and Consumer Services Commission of New Brunswick (FCNB) (collectively, the participating jurisdictions), have proposed changes to National Instrument 45-106 *Prospectus and Registration Exemptions* primarily relating to the current offering memorandum prospectus exemption (the OM exemption) set out in section 2.9 of NI 45-106 (the proposed amendments). As well, the Ontario Securities Commission (OSC) is concurrently considering a proposal relating to an OM prospectus exemption for Ontario. The OSC and the regulators in the participating jurisdictions have coordinated their efforts in developing their proposals for the OM exemption. The result is a significant degree of alignment among them regarding the OM exemption, but the FCNB and OSC have proposed a somewhat different exemption than the proposed by the ASC and the FCAA. For the purposes of this paper, we are concerned chiefly with amendments forwarded by the ASC and the FCAA. Advocis' views on the unique status of the offering memorandum in Ontario are set out in a separate submission.

In Alberta and Saskatchewan, the proposed amendments seek to limit the risks associated with an investment by a retail investor in illiquid securities through new caps on the aggregate amount that can be sold to any one investor under the OM exemption in a 12 month period:

- $10,000 in respect of all investors who are not eligible investors; and
- $30,000 in respect of individual investors who are not accredited investors and do not qualify as specified family members, close personal friends or close business associates under the friends, family and business associates exemption.

In New Brunswick, the proposed amendments will place caps on the aggregate amount that can be sold to any one individual investor under the OM exemption in a 12 month period:

- $10,000 in respect of individual investors who are not eligible investors; and
- $30,000 in respect of individual investors who are eligible investors but do not meet the definition of an accredited investor.

The major part of this submission focuses on the following proposed changes to the OM exemptions in the participating jurisdictions.

PART TWO: CONSEQUENCES OF THE CSA'S PROPOSED AMENDMENTS

The proposed changes to NI 45-106 discussed below seek to enhance investor protection in the exempt market, mainly by reducing the risk exposure of individual retail investors to illiquid securities. However, we believe that there is a significant likelihood that they will result in a set of unintended consequences which will adversely affect non-accredited investors and start-up businesses and small- to medium-sized enterprises.

1. Overall levels of consumer protection will not be enhanced

Advocis believes that the proposed amendments seem unlikely to yield anything but incremental improvements in exempt market investor protection. Annual investment limits will not protect investors from misleading sales practices or fraudulent issuers or dealers, who will simply find new ways to dupe investors, regardless of annual investment restrictions. While the express intent of the annual investment caps is to reduce the levels of risk exposure experienced by retail investors, the ultimate outcome seems more likely to be an increase in risk exposure. A blanket policy of restricting the amount that all retails who do not qualify for accredited investor status cannot eliminate the perpetual human problems of fraud and incompetence. Punishing nearly all the actors in the retail exempt market is not a solution for the bad actions of the group the CSA has identified as being composed of a few issuers and dealers.

2. How enforceable are the proposed changes?

Investors can easily purchase investment products from an unrestricted number of exempt market dealers. Accordingly, some external form of monitoring and oversight will be necessary. This will entail tracking the investments of a potentially large group of people. In Alberta, over 90 per cent of the investment purchases made under the OM exemption from 2011 and 2012 were by individuals.

a. Retail investors will have to be reviewed at the level of dollars and cents

Enforcement of the proposed amendments will depend on the ability to effectively determine if the exempt market investor has stayed within the $10,000 or $30,000 annual investment limit. Unlike the accredited investor exemption, for which less than four per cent of the population qualifies, thousands of Canadians in the participating jurisdictions will be caught by the annual investment limits. Successful enforcement will depend on monitoring and tracking investors and their annual contribution limits. Exempt market dealers and their salespersons, including dealing representatives, currently have no capability for determining with sufficient accuracy if a client has stayed within his aggregate annual contribution limit for the past 12 months.

The nearest analogue to the proposed amendments may be the contribution limits on registered retirement savings plans. The regulatory apparatus devoted to ensuring Canadians adhere to the contribution limits of their registered plans has been developed and refined over decades. Despite numerous tracking systems, reporting requirements and oversight mechanisms, every year a significant number of Canadians still manage to make excess contributions to their registered plans. There is no reason to expect the proposed amendments will approach the level of compliance associated with RRSPs. With regard to the position of dealers, there is no way for them to determine objectively how much a non-eligible investor has already invested in a given year.

b. Who will monitor the retail investor?

Otherwise, the CSA is placing the burden of enforcement on the registrant-investor relationship, a burden which will tend to inhibit full and frank sharing of information by the investor and force the advisor or dealing representatives to adopt a transaction-based approach, with a special focus on contribution limits – which will further displace suitability as the mainspring of the registrant-investor relationship.

Investors can of course elect to transact business with any exempt market dealer they please. To ensure *ex ante* compliance with the proposed amendments, there are two major options: (1) voluntary compliance on the part of the individual investor; or (2) empowering a third party with the ability to track the investor's total exempt market purchases on something approaching a real time basis. Clearly, the creation of such a monitoring system would not be a useful allocation of regulatory or compliance resources. It will, we submit, be unduly onerous – if not simply impossible

– for exempt market advisors and dealers to monitor their clients to ensure if they have stayed within their permitted aggregate annual limits.

Adding another costly layer of regulation to protect investors from themselves – up to a maximum of $30,000 a year – seems unnecessary. No cost-benefit analysis has been adduced to justify the proposed amendments, nor indicate what they will cost. Ultimately, the investment restrictions will tend to erode public trust and confidence in the idea that the regulators of the capital markets are committed to ensuring middle-class Canadians can access the broadest possible range of investment products.

3. The Impact on Non-Accredited Investors: Unintended Consequences and Increased Costs

Eligible investors who want to assume suitable investment risks in the small- to medium-sized enterprise sector will be limited to a ceiling of $30,000 in exempt market investments per year. Those retail investors who do not meet the criteria for eligible investor status but still want to assume suitable investment risks in the small- to medium-sized enterprise sector will be limited to a ceiling of $10,000 in exempt market investments per year.

a. Understanding the costs to retail investors when they are barred entry to the exempt market

An individual who does not qualify under the eligible investor exemption will effectively be prevented from diversification via the exempt market. In the proposed jurisdictions, many if not a majority of the securities issuances suitable for retail investors made under the OM exemption begin at the $25,000 level. This means individual investors will have fewer opportunities to reduce their levels of risk through portfolio diversification – the outcome the proposed amendments ostensibly seek to prevent. Perhaps the CSA's desired outcome is not to reduce the risk exposure of individual investors *per se*, but a narrower one – to reduce the *exempt market* risk exposure of individual investors. If so, one must then conclude that the CSA wants to reduce access to the exempt market to accredited investors and institutional investors.

At this point, it is useful to look at the exempt markets in conjunction with public markets, to understand what makes the investing in the former a preferred option for so many investors in the participating jurisdictions. Several considerations are at play here. First, clients are becoming increasingly sophisticated in their investment selection, especially for their longer-term, illiquid investments. Years of continuous, real-time reporting on equity markets in a number of media channels has resulted in the average client's worldview underpinned by the fact that the long bull markets of the 1980s and 1990s are probably not coming back any time soon. Second, recent and anticipated levels of interest rate are forcing them and their advisors to consider alternative ways of improving their portfolio's overall performance. Investors in public markets are now expected to

accept nominal returns below, say, six per cent, and for long periods of time – but with increasingly high levels of volatility. Third, retail investors seem to feel that they are not being properly compensated for the volatility of their holdings in public markets. Fourth, based on analyses of equity and income returns in North American equity markets for the past 20 years, many investors are being advised to reduce when appropriate their traditional level of exposure to equities. The result is a reduction in public market asset allocation by retail investors, who are moving capital to the exempt markets.

This is not surprising, since a "flight from equity" in general presents an investor with only a few practicable options, including: (1) parking money in savings accounts or money market funds, which is only acceptable as a short term strategy; (2) investing in bonds and other debt instruments, which brings the risk that modest returns of 2 or 3 per cent percent will turn into negative returns once inflation is factored in and if the asset is not held in a tax-preferred account; and (3) exempt market products, which as private products can come with a set of risk factors unique to them *qua* product.

Despite many product-specific risks which are typically not seen in traditional public market investments, and despite the need in general for a high degree of investment acumen in the exempt market, there are appropriate products for retail investors. There are numerous offerings that will guarantee a part or a whole of the investment principal, have track records of delivering attractive returns, and are structured to ensure significant alignment between management compensation and the delivery of results to investors.

It is well known that public equity markets have demonstrated extremely high volatility for more than two decades, and the trend seems to be accelerating. But since the "re-booting" of the exempt market under National Instrument 31-103, lower-volatility exempt market products, suitable for retail investors, are being offered across a wide swath of asset classes. Some of these products have demonstrated 25 to 50 per cent less volatility than traditional stock indices. Indeed, by its very nature the exempt market as a whole offers less volatility exposure, since its products are not traded on a daily basis. And many alternative asset classes are producing higher absolute returns than retail investments in public market offerings. Lower volatility and higher absolute returns suggests a scenario where investors may access superior levels of risk-adjusted returns.

Since the advent of the reforms under National Instrument 31-103, the exempt market has been functioning well, especially in comparison to the relatively slow growth of mutual fund investing by Canadians. Faced with poor levels of risk-adjusted returns, retail investors are following in the footsteps of Canadian pension funds and diversifying in the exempt market.[2] The main driver

[2] An overview of useful metrics for comparing the exempt market to public equity markets is found in Stephen Johnston, "Why Is the Exempt Market Flourishing?," *Canadian Exempt Market Watch*, Vol.2 (1), January 2012, pp. 6 -7.

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appears to the desire to access lower volatility products which come with higher returns. Liquidity is not a primary concern for these longer-term investors.

In sum, exempt market securities which come with an offering memorandum are a primary source for products with annual reporting and audited financial statements outside of mutual funds, stock exchanges or dark pools. Exempt market products are now being distributed by advisors who are required to be licensed and to operate through an exempt market dealer. And with many alternative asset classes producing higher absolute returns with lower volatility, retail investors are willing to trade liquidity for superior risk-adjusted returns.

The proposed aggregate investment limits of $10,000 and $30,000 will dramatically reduce the ability of retail investors to access products with attractive Sharpe ratios, and force retail capital back to listed equities, with their current levels of less-than-stellar risk-adjusted returns. They will generate a significant decrease in the ability of non-eligible investors to diversify their wealth in the exempt market. Instead they will have to turn to prospectus-based offerings, and bear the higher costs which come with those products.

b. Reduction of investor access to the exempt market's lower costs and reduced volatility

Many exempt market products purchased by retail investors come with lower costs and reduced volatility relative to those on offer on the public markets. Many private equity firms are efficiently run in terms of their management costs than their publicly traded counterparts. It is clear that many investors want stable, low-volatility investments which come with the potential for above-average returns, and that they are willing to accept a high degree of illiquidity to access these products. Among a certain style of investor, trust and confidence in public equity markets is exceptionally low, due to perceptions of exposure to exceptionally high levels of volatility, the predatory tactics employed by certain front-running high frequency traders, the potential for flash crashes, the possibility of falling victim to insider trading schemes, and so on. Whether such concerns are wholly or even partially justified is beside the point: once sufficient suitability requirements and avenues for accessing professional financial advice are in place, investors certainly deserve the right to invest in a manner which they know will best promote their own peace of mind.

c. Increased investor exposure to higher transaction costs

To comply with the investment limits and ensure appropriate risk reduction measures are selected, the exempt market investor will have to make at least two or three exempt market purchases (if not four or five), and come in under the $30,000 cap. This means that issuers will have to issue securities in the $5,000 to $10,000 range – a regulator-mandated product redesign which will make capital raising more time-consuming and expensive for issuers, and ultimately lead to higher costs and lower net returns for investors, all under the aegis of enhanced investor protection.

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To avoid these higher costs and invest surplus capital which cannot be allocated in the exempt market due to the $10,000 and $30,000 annual limits, exempt market investors may consider returning to public equity markets; again, this is an instance of regulation-directed asset allocation. But reducing the amount of retail investment in the exempt market will increase investment in public markets, particularly in mutual funds. This means exposure to higher management expense ratios.

In sum, the proposed amendments will increase administrative and sales-related costs for issuers and exempt market dealers. The amount of work required to issue and sell an exempt market security is largely independent of its price point. The various transactional costs for a single security priced at $5,000 will be, *ceteris paribus*, roughly the same as the costs for a nearly identical security priced at $50,000. But by forcing issuers to create and attempt to sell more securities in order to work around the $10,000 and $30,000 annual limits, the total number of securities to be placed in order to reach a maximum offering under section 2.9 of National Instrument 45-106 will rise substantially – perhaps by a factor of two or three times or more. Over the long term, the increases in these transactional costs will be largely if not totally borne by the investor.

d. Negative impact on portfolio performance and diversification

It almost goes without saying that the ability of retail investors to properly diversify will be negatively affected. Many exempt market issuers will only accept subscriptions beginning at a price of $25,000, due to the costs per investor. The problem immediately suggests itself: how can the advisor properly diversify his client's exempt market portfolio with an annual limit of $30,000 (or $10,000)?

Retail investors who are currently invested in products issued under the OM exemption will be affected and have to redesign their financial plans and buy new products from sources other than the exempt market.

In CSA Staff Notice 31-336 *Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants on the Know-Your-Client, Know-Your-Product and Suitability Obligations*, the CSA states that "Diversification is an important factor to consider when assessing suitability of investments."[3] However, for many clients the proposed aggregate annual contribution limits will impede the process of diversification.

e. Negative impact on client reinvestment following the issuer's exit strategy

The retail investor who is willing to accept illiquidity for the potential of larger gains down the road will have to find a venue other than the exempt markets in the participating jurisdictions – at least if

[3] *Ibid*., *Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants,* p. 14.

his investment is a success. A retail investor who invested $30,000 and years later, upon the product's exit phase, suddenly has $50,000 will be barred from reinvesting his capital in what is likely a very attractive business.

In the exempt market, the "exit strategy" or "harvesting strategy" is how the issuer plans liquidation or divestment of the underlying asset at the "exit stage." The main business stages of a private issuance are the product stage, the development stage, and the exit stage, which should be explicitly set out in the offering memorandum. The exit strategy will either be executed in a series of steps, or in a single phase in which all of the investors exit simultaneously.

Obviously the exit stage is critical to the investor, since the exit strategy sets the timeline for the investment and impacts its potential returns. Further, since the exempt market has a very limited secondary market and most of its securities have limited product redeemability, the exit strategy takes on additional importance. Certain exempt market products, especially ones designed for income-oriented investments, will have a redemption feature in which the fund will return the capital to the investor, either through cash flow, the sale of assets, or through new investment. The aggregate annual caps may very well mean that the investor will not be able to fully reinvest his gains in the proven investment opportunity.

Even more problematic is determining how the proposed amendments work for an investor who is in a prospectus-exempt dividend reinvestment plan and he is pushed over whichever aggregate annual limit applies to him.

f. Re-allocation of investor capital to public market

As noted above, in order to avoid higher transaction costs and invest money which can no longer be used to purchase exempt market securities due to the aggregate annual caps, retail investors will be forced to increase their investment in public markets. This means more than exposure to the higher MERs of many mutual funds. It also means exposure to the risks associated with the possibility that: (1) public equity markets are currently at artificially high levels due to the actions of central banks, and (2) that certain subsectors of the equity markets are trading at higher-than-realistic levels and are prone to excess volatility due to highly active institutional investors.

g. Current exempt market investors will face perverse incentives in their financial planning

The proposed aggregate annual limits will inhibit the flexibility advisors and clients need to build a suitable and properly diversified portfolio.

Individuals exiting successful exempt market investments: Setting aside certain investments such as flow-through shares, the retail investor who invests $30,000 in a one year ultimately expects growth in excess of the value of his initial investment allocation. That growth will take time – hence the

investor's willing assumption of illiquidity risk. The proposed amendments will forbid any re-investing of the initial capital plus the return on investment in what amounts to a proven winner. The investor – and the firm – are now not permitted to fully realize the benefits of their successes.

The inadequacy of the proposed annual contribution room under the proposed amendments is highlighted by the hypothetical instance where an exempt market investor exits his $29,000 investment with $39,000 in proceeds. Suppose he now wishes to reinvest in the company. He is now capped at $10,000 or $30,000, depending on his status, so at least $9,000 will not be returning to the company which has proven itself successful investment in the eyes of the investor. The investor, who on his own or with professional advice, researched the investment and bore the risk, is now effectively being penalized in spite of – or because of – the investment's success.

In the best case scenario, the CSA will restrict this investor to re-investing a maximum of $30,000. In some cases, the investor will in fact be restricted to re-investing an amount less than the original principal investment! This outcome is also highly prejudicial to the successful company which used the invested capital. All of this will be the result of the CSA's effort to "limit the risks associated with an investment by retail investors in illiquid securities."[4]

Investors approaching retirement: The older the investor, the greater the likelihood that they will wish to move assets from public equity markets. In many cases, a $30,000 cap will represent a very small percentage of such an investor's net assets. But the proposals will mean that unless they are accredited investors, they are capped at unrealistically low ceilings in the exempt market. They will have to try to allocate to exempt market securities over several years at $10,000 or $30,000 per annum, and ride out any volatility in the public markets. While these investors are trying to reallocate their money, their pension plan may in fact be investing in the same exempt market products which are now all but closed off to them.

Higher-end investors: These individuals who approach but do not qualify for accredited investor status will be unable to properly diversify if they can only put $10,000 to $30,000 per year into the exempt market. Typically, these are long-term clients who have committed with an advisor to carefully following a retirement plan in order to save a significant amount of capital for their retirement. The proposed caps will impede their ability to use the exempt market to select products of appropriate levels of risk and liquidity as they approach or enter retirement.

[4] Canadian Securities Administrators, *Multilateral CSA Notice of Publication and Request for Comment Proposed Amendments to National Instrument 45-106 Prospectus and Registrant Exemptions Relating to the Offering Memorandum Exemption and in Alberta, New Brunswick and Saskatchewan, Reports of Exempt Distribution* (March 20, 2014), pp. 1-3. Accessible at www.albertasecurities.com/Regulatory%20Instruments/4780093-v1-CSA_Notice_re%20proposed_amendments_to_OM.pdf.

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The rigidity of the ceiling caps is an impediment to flexible planning: the proposed aggregate annual limits do not take into account the fact that many investors invest on a semi-periodic, irregular basis, due to fluctuating market conditions, the disparate times their different investments reach maturity or become less effective for tax reasons, the occurrence of both planned and unforeseen major life changes, and so on. For one twelve-month span the retail investor's total exempt market investments may be considered to be optimal at approximately $45,000; in the subsequent twelve-month span, the optimal sum of investments may be $10,000. Over a two-year span the retail investor has averaged a $27,500 maximum, less than the $30,000 annual limit, but the CSA's rigid commitment to absolute ceiling caps on exempt market investing will deny this investor the flexibility he or she needs.

The inherent rigidity of ceiling caps take on an absurd quality when you consider fact patterns where they may actually increase levels of risk exposure for retail investors. Depending on market conditions at the time, the risk exposure of a retail investor who invests $45,000 and then $10,000 in two consecutive years may in fact be less than the risk exposure of the individual who has to obey ceiling caps and so invests $30,000 and $25,000 in two consecutive years. In both cases, the annual average investment is $27,500, but if year two of the investment period shows deteriorating market conditions, the second investor's risk exposure is much greater. Permitting investors to invest when they deem it best is preferable to a mandating obedience to absolute annual limits.

4. Impact on Private Issuers and Capital Raising

a. Negative impact on capital raising: increased costs and risks for issuers and dealers

Cost-effective and timely access to capital is vital for small- and medium-sized firms to continue to grow and bring to fruition their business goals and vision as set out in the prospectus or offering memorandum. The proposed amendments will further reduce financing for new enterprises. They will hamper the ability of small businesses and entrepreneurial ventures to raise funds.

The OM exemption is often if not primarily used to accomplish early stage and small business financing. Those business enterprises which are funded entirely through offering memoranda typically raise a majority of their capital from individual retail investors.The proposed amendments have the possibility to effective negate the usefulness of the offering memorandum model to raise money from retail investors. The ceiling caps will restrict the OM exemption to a small cohort of Canada's wealthiest retail investors.

b. Regulator-driven redesign of investment products

Obviously the $10,000 and the $30,000 ceilings will make it much more difficult for issuers to raise capital using the price points of their current investment products. To be capable of meeting the diversification needs of investors operating under a $30,000 cap, exempt market securities will have

to be reduced significantly. Unless issuers repackage and re-price their products, the population of potential investors will be dramatically reduced – as will the saleability of their investment products.

To conclude: the proposed amendments will make securing funding start-ups and small businesses very problematic. The CSA would do well to consider the negative economic impact of the proposed amendments.

c. An inhibition to entrepreneurialism and innovation

If start-ups and small- and medium-sized businesses find their exempt market operations no longer capable of meeting their capital requirements, there is no reason to expect that they will find success in raising capital from public equity markets. Ultimately, we should then expect a return to the era when the major banks and investment houses active in public equity markets exercised an unhealthy degree of control over those innovative hot spots of the financial markets which historically have generated so much of Canada's economic growth.

5. Impact on Exempt Market Dealers and Salespersons

It is obvious that the aggregate annual limits will place significant strains on the exempt market dealers and their staff. The time and resources involved in searching for suitable exempt market securities will increase dramatically under a ceiling cap of $30,000 and will prove to be prohibitive under a ceiling cap of $10,000. The standard business model of the retail-focused exempt market dealer will have to be largely rebuilt. Numerous features of this model will need to be recalibrated, due to concerns relating to time allotments for customer-facing activities, the needed restocking of the product shelf, the complexity of retooling yet again in-house compliance systems, and having to identify and insure against new areas of potential liability. Finders and dealing representatives will find their services are no longer needed by many dealers. Dealers themselves will have to approach retail investors under the banner of what in effect will amount to two separate and in fact somewhat conflicting compliance regimes: first, the test of whether the investor qualifies under either of the rigid annual investment caps; and second, the now drastically reduced process of product selection and the application of the suitability requirements.

Suppose that a retail investor is somehow able to properly diversify his exempt market portfolio. A $10,000 or even $30,000 maximum annual allocation, when allocated across multiple products, will make for an unusually small amount of capital raised for each issuer of the portfolio's securities. The threat to the exempt market dealer is obvious.

The restrictions of $10,000 or $30,000 will dramatically impact the amount earned by the exempt market dealer and his registered dealing representatives on each transaction as demand tapers off when investors are forced to abandon exempt market products due to the caps. Many commissions

on exempt products which are suitable for retail investors run in the four to seven per cent range. In many cases, a quarter of the commission earned on an exempt market sale is allocated to the exempt market dealer. This means that under the proposed caps dealers may be making $200 on each transaction. To remain viable going concerns, dealers will have to revisit their business models. Rebuilding products to reflect the new limits may make up for a small portion of the lost revenue, as lower prices will help eligible investors buy several diversified products and come in at the $30,000 mark. But it is likely that many dealers will leave the business, as the ability for most dealers to make a living from servicing only eligible and accredited investors seems difficult.

Broadly put, two main types of dealers operate in the exempt market: (1) the issuer-driven exempt market dealer. Largely or wholly owned by a single product manufacturer, an issuer-driven exempt market dealer has a set product shelf of related products; and (2) the independent exempt market dealer, who is not committed to any one product manufacturer, and whose product shelf contains a diverse group of products. In addition to enhanced product diversity, the independent exempt market dealer conducts its own independent due diligence, so that if a product issuer encounters material difficulties down the road, that product may already have been removed from the independent dealer's shelf and replaced by another one.

It is unfortunate that the independent dealer will be the first to feel the impact of the proposed amendments. The issuer-driven or tied dealer with likely be able to rely on external capital to drive sales, at least for a while.

And as it becomes more difficult for businesses to raise capital through the offering memorandum and therefore for industry dealers, finders and salespeople to earn a living, the pressures on issuers and other persons involved in distributing exempt market products will rise. Competitive pressures will force some of these registrants to try to reduce compliance costs. Undoubtedly some dealers will try to survive by augmenting their decreased revenues through the creation of new fees. This will justifiably attract regulatory action, and further drive away retail investors and their remaining capital.

6. A Negative Impact on Market Microstructure: Liquidity and Price Discovery

It should be kept in mind that exempt market securities are traded in a manner which bears no relation to the textbook version of a frictionless, self-equilibrating market. This means that artificial controls on market liquidity will interfere with proper price discovery in unusual, even paradoxical ways.

In a market as large and dynamic as the exempt markets of the participating jurisdictions, a cardinal assumption is that not every issuer and investor are simultaneously and at all times monitoring the

market. The aggregate annual investment caps will impact liquidity and price discovery for exempt market securities, in particular those securities whose target population of investors will be impacted by the annual caps. This happens for several reasons.

First, the limited number of active market participants will have quite diverse information about the fundamentals of any given exempt market security. The order flow is therefore a complex of accurate information mixed with conjectural "noise." The emergence of a fair and consensual price is a gradual process at the best of times. This process is slowed down considerably when the security is illiquid in nature and it takes longer for the participants to properly interpret the actions of other market participants. Absolute aggregated annual investment caps will slow the evolution of the trading process and paradoxically promote investor or issuer risk, as the security's actual transaction price will in the absence of proper price discovery deviate for longer periods of time from its fundamental value (understood as its price if traded by a fully informed set of investors).

Second, recent empirical research suggests that when price-relevant information reaches the market through trading pressure, rather than through issuer disclosure or some other publicly-made announcement, liquidity in that security suffers.[5]

7. Larger negative impacts on the efficient allocation of capital

If the proposed amendments are passed, investors will have to consider exiting the exempt market. Non-accredited and non-eligible investors who have achieved success in the exempt market beyond the $10,000 threshold will face a perverse regulatory incentive to remove proceeds from the exempt market. In addition, capital raising from retail investors for medium-risk projects will all but disappear. With the annual limits resulting in a loss of cash flow and profits for exempt market dealers, they will be less inclined to undertake to raise capital for investment projects which suggest any real possibility of undercapitalization, since the dealers' ability to raise funds (and make a profit) is already very constrained.

The aggregate annual caps, by the very nature of a bright line standard, will dramatically interfere with the way the market allocates capital. The ongoing process of myriad groups of small investors entering and exiting exempt market investments based on performance or maturity of the investment will be dramatically curtailed. The centuries-old operation of capital accumulation – in which capital that has been invested successfully being reinvested in the same success – will also be curtailed. The resulting harm will impact *all* investors in that issuer. Curtailing success ultimately reduces the flow of information from the market, resulting in less efficient capital allocation, reduced employment and production, and a reduction in tax revenues.

[5] See Thierry Foucault, Marco Pagano and Ailsa Röell, *Market Liquidity: Theory, Evidence, and Policy*. London: Oxford University Press, 2013, p. 14.

PART THREE: THE PROPOSED AMENDMENTS AND SOUND REGULATORY POLICY

1. Absence of a Comprehensive, Transparent Cost-Benefit Analysis

After the introduction of National Instrument 31-103, there does not seem to be any concrete evidence that demonstrates the exempt market is seriously riskier or more volatile than the public equity markets. With the roll-out of National Instrument 31-103, the major concerns with regard to exempt markets are now: (1) problems arising from non-registrants selling prospectus-exempt products, not problems with the prospectus-exempt products themselves; and (2), exempt market dealers not adhering to existing Know Your Client (KYC) and Know Your Product (KYP) requirements.

a. Absence of evidence suggests absence of harm

If the CSA has data-based analysis to prove that the exempt market is now riskier to individual retail investors than the public equity markets, then that data should have been shared with industry stakeholders prior or in conjunction with the publication of the proposed amendments currently under review here. For example, we are unaware of any comprehensive analysis which examined investor complaints about the performance of exempt market securities with that of comparable products in the public markets. One wonders if the regulator, out of an overabundance of caution, is subjecting exempt markets to excessive regulation based on historically informed bias, rather than on recently collected, collated and interpreted facts and data. This latter concern is of course one that applies to all financial products, not merely to prospectus-exempt securities.

Indeed, what we should see from the CSA is a post-National Instrument 31-103 analysis made on the basis of investor complaints regarding products issued under the OM exemption, segmented by industry sector and category and by the nature of the investors' complaints – i.e., was the complaint about illiquidity, poor performance, or suitability and related KYP and KYC obligations.

The proposed amendments will contribute to an erosion of public confidence in the regulation of our securities markets in general and, more particularly, in all exempt market products available to retail investors.

b. Is the consumer harm meant to be remedied in fact illiquidity? Or just disappointment in investment performance?

The CSAs' *Request for Comment* states that "The ASC has received numerous complaints from investors that have invested significant amounts under the OM Exemption and incurred significant losses."[6] But there is no effort to tie the key features of the nature of the consumer harm – investment size and/or concentration, and poor performance – to product liquidity, which is the key

[6] CSA, *Proposed Amendments to National Instrument 45-106 Prospectus and Registrant Exemptions Relating to the Offering Memorandum Exemption*, *Op. cit.,* Annex B, p 2.

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feature of the solution offered by the proposed amendments, which is to "limit the risks associated with an investment by a retail investor in illiquid securities"[7] To go further: there is no affirmation that the consumer harm is related to illiquidity or can be solved by restricting access to illiquid investments. Anyone who invests in an illiquid security will want out of it if it proves to be a bad bet. A performance complaint is natural, if not justifiable. There is no similar aggregate annual cap on retail investors being considered by the CSA for illiquid investments outside the exempt market.

c. Is the problem actually caused by a deficiency within newly-revised National Instrument 31-103?

It must be noted that it is not clear that the complaints which form the basis for the CSA's case are in fact related to product sales made by registrants under National Instrument 31-103. There seems to be no publicly available documentation of registrant malfeasance. For example, the ASC has not produced evidence – much less issued press releases – of widespread enforcement actions taken against dealing representatives or other registrants for the sale of poorly performing illiquid securities after the reforms of National Instrument 31-103. One is forced to conclude that the "numerous complaints" were based transactions made before September 2010 and indeed may have been part of the rationale for implementing National Instrument 31-103. The absence of collated and publicly available evidence post-implementation of 31-103 – whether in the form of qualitative statements or quantitative data – to support the CSA's proposals is problematic. Lacking evidentiary justification, the proposed amendments can only undermine investor and issuer confidence in securities regulation.

d. Who is causing the problem?

According to the CSA, "There are a few issuer groups raising the majority of the funds under the OM Exemption in Alberta. Some of these large issuers have "in-house" exempt market dealers selling the securities on their behalf."[8] If this is true, then the rationale for the proposed limits becomes more problematic, as the enforcement of suitability requirements on a few large dealers should be a relatively cost-effective process.

e. What does the available data say?

Unfortunately, very few provincial or territorial securities commissions collect and publish data on the use of the OM exemption. There is no national database in which this information is stored for those jurisdictions which do gather such data, however irregularly. The regulators say that the proposed amendments are a function of the fact that they have received numerous complaints from investors who have "invested significant amounts under the OM exemption and incurred significant losses." While no data is forthcoming on these losses, or even an indication of the approximate dates on which the investments were made, the data available from the ASC following the advent of

[7] *Ibid.,* p. 3.
[8] *Ibid.,* pp. 2-3.

the reforms of National Instrument 31-103 suggest that the proposed amendments represent a form of regulatory overreach, if not overkill.

In terms of the use by issuer and investors of the OM exemption in Alberta, the ASC data shows the following[9]:

The offering memorandum is widely used: In fact, the offering memorandum is the second-most used capital-raising prospectus exemption in Alberta in terms of frequency of use. In 2012, 41 per cent of distributions made in the province's exempt market were made under offering memoranda. But since the value of the securities distributed was roughly half a billion dollars, or just 3.8 per cent of the provincial total, one sees immediately that the securities are likely intended for retail investors.

Alberta's offering memorandum issuers – domestic firms involved in real estate and mortgage investments: In 2011 and 2012, over 77 per cent of the issuers under the OM exemption were Alberta-based. Of the 287 issuers raising money in Alberta in that time frame, only 64 were based outside of the province. In total, Alberta's 223 domestic offering memorandum issuers raised $824 million. Almost all were non-reporting issuers, 155 of whom (70 per cent) self-reported their industry category as real estate or mortgage-investment corporation. These real estate and mortgage investment issuers were responsible for 76 per cent of the capital raised by Alberta-based issuers under the OM exemption.

The ASC noted that only a few large issuer groups raise the majority of the funds under the OM exemption. Of these, some rely on in-house exempt market dealers to sell the securities on their behalf.

Over 90 per cent of the OM-exempt purchases were made by individuals: Since the 2010 reforms, the vast majority of the purchases were made by individuals, most of whom were eligible investors (if KYC requirements were followed). In 2011 and 2012, 90.5 per cent of the purchasers under the OM exemption were individuals. Of the remainder, 5.9 per cent were corporations, 1.7 per cent were limited partnerships and 1.6 per cent were trusts.

The eligible investor category: those investors most likely to be impacted by the proposed amendments: Roughly 61 per cent of the individual investors made at least one purchase in an amount greater than $10,000, which suggests that they were qualified eligible investors, or accredited investors. What's more, their investments over 2011 and 2102 accounted for

[9] *Ibid.* Note that all figures in this section are from *Annex B Background – Local Experience with OM Exemption*.

approximately 90 per cent of the total value of purchases by individuals. Clearly, this is the group which will be most negatively affected by the proposed amendments.

In the absence of a $30,000 cap, what is the size of the purchases being made by these investors? The ASC states that the average size of an investment by an individual investor who may be assumed to be an “eligible investor” (since the product cost more than $10,000) was approximately $45,700 in 2011 and $47,900 in 2012. The median for these investments was roughly $26,200 and $27,500 respectively.

Of special relevance to the proposed amendments: approximately 24 per cent of eligible investors purchased more than $50,000 and approximately 8 per cent purchased more than $100,000 per year. Overall, under Alberta’s current OM exemption, 2,737 individuals invested $50,000 or more in a single year over 2011 and 2012. These are the retail investors who, under the proposed amendments, would be forced to reduce their exempt market investments by at least $20,000. They break down according to investment size as follows:

- 1773 individuals invested between $50,000 and $99,999;
- 816 individuals invested between $100,000 and $249,999;
- 122 individuals invested between $250,000 and $499,999; and
- 26 individuals invested in excess of $500,000.

The CSA would do better to focus its efforts on the 964 individuals who over a two year period committed between $100,000 to $500,000 to securities under the OM exemption, or on the 24 per cent of retail investors who purchased more than $50,000, and not on the much larger cohort (by several thousand persons) of the retail investors who came in under $50,000.

<u>The non-eligible investor category is currently stable</u>: Around 39 per cent of the individual investors in OM-exempt securities paid amounts equal to or less than $10,000. The vast majority of these individuals are quite likely non-eligible investors. Regarding the retail investors who invested less than $10,000 (many of whom may be non-eligible investors), 10 per cent in 2011 and 17 per cent in 2012 made repeat purchases, resulting in their total investment exceeding $10,000. Typically the total investment was less than $25,000. About 111 investors who invested less than $10,000 per distribution did invest an aggregate annual total ranging from $25,000 to $100,000.

<u>Year-over-year exposure by repeat investors to exempt market risk is low</u>: Just under 69 per cent of retail investors limited themselves to a single investment over 2011 to 2012. In terms of multiple purchases by retail investors, 20 per cent made two purchases, 5.6 per cent made three, and 5.8 per

cent made four or more or more. The individuals making multiple purchases showed increased average and median investments.

2. Suitable Investor Protection Mechanisms Are Already in Effect

The breadth and depth of the current regulatory regime that governs exempt market transactions is remarkable. Under National Instrument 31-103 and its related *Companion Policy*, all issuances of securities pursuant to the OM exemption are to be conducted by registrants, such as an exempt market dealer or its dealing representative, who are registered with the jurisdiction's provincial securities regulator. The registrant must ensure that the applicable KYC, KYP and suitability requirements are fully adhered to. The purchase of the security is then to be subjected to the review of the registrant exempt market dealer's chief compliance officer. The CCO may then approve or reject the sale based on various criteria, including eligible investor status and suitability requirements. If the sale of the investment product is granted approval by the CCO, the issuer can then accept the proceeds of the sale. The issuance of the security is then duly recorded and put on file with the local securities regulator. The regulator, notionally at least, can at this point determine that the issuance was not proper and consider recourse to a number of compliance, disciplinary and other enforcement options.

In general dealers and advisors report that the levels of both investor protection and product quality increased under NI 31-103. Educational and registration requirements for dealing representatives are in force. The sales process requires completion of KYC and KYP forms and confirmation by the dealing representative of the suitability of the investment product for their purchaser. The impact of the new registration, suitability and education requirements extends far beyond the retail investor; the additional scrutiny has removed many poorly designed products and poorly managed investment funds from product shelves, which has made for better asset allocation for investors and issuers.

When an exempt market purchase involves a dealing representative who is registered with a provincial securities commission, and is supervised by a registered exempt market dealer, any effort to place limits on how much may be invested effectively removes the ability to evaluate and plan for concentration risk from the individual and his advisors and places it in the hands of the regulator. This effectively undermines the entire purpose of well-established KYC, KYP and other suitability requirements and obligations which form the bedrock for investor protection in Canadian securities regulation.

3. Impact on Existing Legislation and Regulatory Policy

The proposed amendments represent a dramatic departure from the deeper principles underpinning National Instrument 31-103 in particular and the entire system of registration in

general. By removing from the permitted scope of a registrant's activities the ability to assess concentration risk for a client, the proposed amendments tend to undermine the entire exempt market regulatory enterprise – and, more pointedly, the professional status of exempt market registrants. There can be no doubt that since National Instrument 31-103 was introduced in September 2010, the overall functioning of the exempt market from the point of view of consumer protection and effective allocation of capital has improved substantially. With exempt market registrants having to meet various education criteria, and fulfill KYC and KYP product requirements and execute a number of related forms, consumers are now dealing with registrants who are highly motivated to ensure the suitability of the investment for the client, as well as explain and document that suitability.

The result is a system of enhanced scrutiny and disclosure which tends to remove suspect issuers, poorly constructed products, weak investment managers, and inadequate or unethical dealers and selling agents. The asset misallocation and bad behavior of poorly managed securities issuers, poorly designed products, and incompetent or unethical sellers which characterized portions of exempt market activity from 2005 to 2010 is now no longer present and therefore no longer a justifiable basis for such extreme regulatory intervention in the exempt market. Steps as drastic as the proposed aggregate annual investment restrictions represent, in effect, the CSA saying that National Instrument 31-103 simply does not work and that the average retail investor must not be permitted to invest in the exempt market. We do not believe there is any justification for this tacit or implied position which the CSA seems to be advancing in the guise of these proposals.

4. The Proposed Amendments Provide Exempt Market Dealers with the Wrong Incentives

The proposed amendments will tend to encourage mechanistic "ticking of boxes" behavior by exempt market dealers and their selling agents and shift the primary compliance focus of dealer firms away from client needs and objectives. In its guidance *Notice* to exempt market dealers and other registrants, the CSA has been explicit that a "mechanical 'tick box' approach is not sufficient" for constructing an investor portfolio.[10] Yet under the proposals the dealer and his staff would now begin the investment process with a mechanistic application of a single threshold to all non-accredited retail investors, any two of whom can easily have a gap in income of more than one hundred percent.

5. The Annual Limits Create Too Large a Group of Investors to Allow for Fair and Effective Regulation and Financial Planning

There is a vast amount of difference between any given pair of clients within the eligible investor category. The $10,000 and $30,000 limits will capture such diverse groups of individual investors

[10] CSA, *Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants, op. cit.,* p. 9.

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that fair and effective regulation within the category will be almost impossible. Can such a large and variegated group of investors really be considered in any coherent sense to be equally vulnerable to the risk of suffering (in a more or less similar manner) from the same harm: poor investment performance from illiquid securities?

a. Aggregate annual limits do not mesh with suitability-based regulation and planning

The investors who populate the category of eligible investor are an extremely heterogeneous group. Their needs, objectives and investment suitability requirements vary widely. A 35-year-old IT professional with an income of $100,000 a year has vastly different needs than a retiree who has $45,000 in income but $550,000 in investable assets. They are both eligible investors, but each is ultimately unique in his investor profile. They likely bring different levels of exempt market experience and investment history to the advisor. They bring different needs and objectives, too, so that one individual may need to access sophisticated tax and financial planning resources before the purchase, while the other doesn't. The unique needs of the investor determine how the advisor responds. If the 35-year-old has a self-constructed portfolio, 90% of which is in volatile public markets, the proposed amendments mean it will take years for him to re-balance his portfolio with exempt market purchases. This does not serve the client's needs better than before.

This is how and why suitability assessments *work*, and why they must be given priority by the regulatory over aggregate annual restrictions: they are designed to respond to the different needs of different investors through an individualized or tailored approach. The very nature of an aggregate annual limit means the advisor must begin with a mindset that categorizes individual investors as into groups, subgroups and other cohorts, which strains the advisor—client relationship and which simply does not fit with the purpose or scheme of suitability requirements meant to be customizable to an individual investor's needs. The absolute and inflexible rigidity of this "one size fits all" approach means it is better characterized as a rigid "one size must fit all, or forget it" standard. The aggregate annual caps represent a severe inhibition to proper financial planning.

b. The problem with regulation by categorization

The relatively arbitrary nature of the $10,000 and $30,000 aggregate annual investment caps and their impact on future exempt market investors who would rely on the OM exemption is problematic. Part of the problem arises of necessity from the practical impossibility of treating every investor as a unique and discrete case. In large part, regulators have to execute their mandate on the basis of group categories. But part of the problem arises from the regulators' recent estimation of retail investors when considered *en masse*. The received wisdom on retail investors is that they are less sophisticated and uninformed, engage in random trading, follow simplistic "rules-of-thumb"

and are victim to a variety of psychological biases.[11] Recent research from the United States "challenge[s] the traditional view of households as noise traders, uninformed or insignificant participants in the stock market" and that it "is likely that household investors collectively have information that professional analysts do not have and therefore contribute to price discovery and market efficiency."[12] The views of retail investors reveal a sharp rise in dispersion or disagreement with one another just before the onset of a recession, with a concurrent readjustment of portfolio or trading strategies; this is in contrast to the views of professional and institutional market forecasters, whose views do not diverge until the tail end of a recession.[13]

Admittedly, the study's data comes from U.S. equity markets trading in prospectus-based securities, but we believe that the general insight is one that the CSA should consider– that retail investors, as a diverse group, obtain and process information differently than investment strategists, who are a highly homogenous group. The study indicates that regulators underestimate the investment acuity and overestimate the vulnerability of retail investors as a group.

6. Impact on Individual Investors

The aggregate annual limit represents a drastic curtailment on the freedom of choice of investors to allocate their assets as they deem fit, regardless of whether that decision is undertaken solely on their own or is made based on the advice of a registered professional advisor.

a. The proposed amendments are an undue imposition on individual retail investors

Admittedly, restrictions on an individual's freedom of contract are an inevitable and often justifiable consequence of many investor protection measures. But in this case Advocis believes the proposed amendments simply go too far in abridging those rights in an effort to reduce retail investment in illiquid securities. Investors deserve to be able to make benefit from the risk and reward opportunities of exempt market investing, and they deserve to be able to benefit from the new and revised protections of suitability requirements and enhanced disclosure. Restricting the ability of ordinary Canadians who do not meet the accredited investor exemption requirements is ill-advised and unfair. Limiting Canadians' ability to invest in the same products in which institutional investors such as the Canada Pension Plan and the Ontario Municipal Employees Retirement System routinely invest is unfair.

Indeed, post-National Instrument 31-103, major Canadian public and private pension funds, including the Canada Pension Plan, have been dramatically increasing their involvement in private

[11] Dan Li and Geng Li, "Are Household Investors Noise Traders: Evidence from Belief Dispersion and Stock Trading Volume," Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C. (2014-35), p 1.
[12] *Ibid*., p. 19.
[13] *Ibid*., pp. 3-4 .

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equity investments on the basis of the demonstrated real returns and lower risk volatility that characterize many exempt market investments. Many individual retail investors who are not fortunate enough to be members of these pension plans are restricted from the ability to make use of these valuable investment opportunities.

Current exempt market requirements offer a level of protection a retail investor will not get through an online trading account. Moreover, for most of the long history of Canadian securities markets particularly mutual fund investments, and in the life insurance sector, there has never been an annual aggregate limit on investment size per annum as long as the suitability requirements are met. An investor may sign a leveraged life insurance contract without advisor oversight or regulatory approval being a concern of any regulatory body, but investing $30,001 pursuant to an offering memorandum after having fulfilled various suitability requirements is now unacceptable.

b. The proposed amendments are not consistent with current market principles and protections

It should be recalled that there are no mandatory aggregate annual investment limits for retail investors in the public equity markets. The proposed amendments, when viewed from a macro level, represent an arbitrary interference with the supply of funds and with the demand for exempt market products.

Accordingly, we have concerns about the consistent application of regulatory policy with regard to the individual retail investors raised by the proposed amendments. It cannot be emphasized enough that in the absence of fresh, compelling, and comprehensive cost-benefit analyses, investors deserve as a matter of general public policy to be able to choose which products they believe are suitable for them. As long as an investor – whether on his or her own or in conjunction with a registered professional financial advisor – evaluates the investment in terms of its anticipated risk level, expected return, general characteristics and liquidity features, he or she should be able to invest in it, regardless of whether it is a principal-protected note, an exchange-traded fund, or an investment fund which guarantees a portion of the principal investment.

As in any functioning securities marketplace, the foundational principle is freedom of choice by parties acting with full information. That’s why Advocis believes that informed investors – whether acting in isolation or with regulated advice – should receive and review comprehensive disclosure (here, in the form of an offering memorandum) and then assume the risks entailed – and perhaps execute risk assessment and acknowledgment documentation.

While the offering memorandum is often pejoratively dismissed by some self-styled consumer advocates as nothing more than a "prospectus lite," the truth is that many offering memoranda are in fact as detailed as standard prospectuses when it comes to the specialized product information which investors and advisors or dealers actually need to read, review and come to terms with.

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Moreover, registered dealing agents and exempt markets dealers represent under National Instrument 31-103 an intermediate layer of investor protection and dealer accountability lacking many retail financial investments available in Canada.

Again, the conclusion we reach seems inescapable: the proposed aggregate annual investments are not in the best interests of Canadian retail investors and small- to medium-sized or start-up businesses seeking to raise capital. Among other problems, they do not sit well with basic principles of consumer choice and they will inhibit dramatically the number of actor who will evaluate, interpret and possibly act on market information – here, the offering memorandum.

c. The proposed amendments will result in misincentives and other unintended consequences

An aggregate annual limit of $30,000 a year for exempt market products will simply force investors to divert any amount over $30,000 which they would have otherwise invested into other areas of the securities markets. These may well be areas in which they have less expertise or experience, or at least not understand as well as they or their exempt market dealer understand the current industry sectors and subcategories of the exempt market. At minimum, such a forced re-allocation of capital will cause the investor somewhat reduced level of peace of mind.

d. Forcing investors out of exempt markets and into public ones in effect transfers part of their wealth to third parties

The ability of investors to invest in a properly diversified portfolio of private and publicly available investments is a theoretical cornerstone of regulatory policy in most jurisdictions, but the proposed amendments will reduce the ability of professional advisors to cost-effectively diversify a client's portfolio without making recourse to the more volatile public equity markets. The result is that to properly protect the client from volatility, the client must now bear a sort of tax that comes with prospectus-only investments; this level of this notional tax is uncertain, but it is composed of, among other items: (1) any number of transaction costs, fees and taxes which are paid when moving money out of the exempt market and into the public markets; (2) the less competitive management fees of those public markets, and (3) the costs of increased volatility in those same public markets, and so on. All of these asset allocation costs must be borne by the investor in the name of protecting him through preventing him from investing in illiquid securities!

e. Resources will be allocated to working around the proposed amendments

As well, the proposed amendments will result in a misallocation of resources as stakeholders seek to circumvent the annual investment caps. As with all regulation which seeks to eliminate a popular and widespread activity, the impacted participants – here, exempt market issuers and investors – will devote considerable time and effort to circumvention. In the event the proposed amendments are implemented, this diversion of resources will occur and it will be another unnecessary and unanticipated cost consequence of ill-advised regulation. The CSA would do well to submit fact-

based evidence to cost-benefit analysis before declaring a particular type of investment a form of risk or harm which can only be remedied by rigid aggregated annual investment limitations.

One way in which the proposed amendments will create incentives for investors to bypass the guidance of registered and licensed dealing representatives and registered exempt market dealers, will be to attempt to accomplish portfolio diversification through the use of online trading accounts. This is in stark contrast to the fact that in the exempt market, any investment purchase made under National Instrument 31-103 will be made through a registered advisor or dealer who must complete KYC and KYP forms and fulfill other suitability requirements before the investor can invest in a share issuance made pursuant to the OM exemption.

To reiterate: current exempt market requirements offer a level of protection a retail investor will not get through an online trading account. Moreover, for most of the long history of Canadian securities markets particularly mutual fund investments, and in the life insurance sector, there has never been an annual aggregate limit on investment size per annum as long as the suitability requirements are met. An investor may sign a leveraged life insurance contract without advisor oversight or regulatory approval being a concern of any regulatory body, but investing $30,001 pursuant to an offering memorandum after having fulfilled various suitability requirements is now unacceptable.

7. Are the Proposed Exemptions an Instance of Unjustifiable Regulatory Creep?

It is inevitable that a bright line standard will prevent clearly suitable transactions from taking place, thereby affecting the client's ability to achieve his or her investment objectives. However, this inherent feature of bright line standards is not in itself a compelling argument against their use. But the lack of *justification* for the selected $10,000 and $30,000 levels is such an argument.

a. Providing justification for intrusive regulation

Sound securities regulation functions as both a sword and a shield. It seeks to promote the best outcomes possible in the context of being sure of preventing the worst ones from occurring. To achieve these goals, the means and instruments of law, policy and regulation need not always be palatable or acceptable to the affected stakeholders. But we believe that major regulatory initiatives must at least be capable of being justifiable to a majority of the affected stakeholders. The $10, 000 and $30,000 ceiling caps are lacking in any clearly articulated and substantive justificatory argument. Only the thinnest possible justification has been adduced for them – allegations of consumer harms, with the possibility of more to come.

With respect, it should and must take more than this level of argument to justify such a radical intrusion into the ability of retail issuers and small- to medium-sized enterprises and start-ups to rely

on the OM exemption. We believe that the threshold for altering a newly-established market – here, the exempt markets, post-September 2010, under the newly-amended National Instrument 31-103 – must require clear and unassailable evidence of consumer harm or market failure. We do not believe that this threshold has been met with regard to the aggregate annual investment caps. In fact, for the reasons set out above, we believe that the medicine will kill more than it cures; a blanket policy of reducing the amount that may be allocated to certain relatively illiquid securities punishes all investors for whom those investments are suitable and attractive. It is akin to preventing forest fire from spreading by cutting down the rest of the forest.

The greater the regulatory intrusion into an apparently well-functioning market, the stronger the need for a prudent, public and well-reasoned explanation.

b. Problems inherent with bright line standards

The fundamental question raised by the CSA with regard to National Instrument 45-106 is whether individual exemptions appropriately balance issuers' and investors' interests. The exempt market's "bright line" tests – such as the accredited investor or minimum amount exemptions – allow issuers to raise capital without a prospectus if they are selling to certain investors who meet the criteria set forth in the legislation.

It is well-known that these "bright line" thresholds, based on accreditation or financial means, are imperfect proxies for sophistication. Investing or financial risk sophistication – and hence the ability to dispense with the protection of the disclosure contained in the prospectus prior to investing – is imputed to the investor because he or she can meet one of the thresholds. But by setting the threshold so low – at $10,000 or $30,000 – what is imputed to the barred group of non-eligible investors is a lack of financial sophistication.

What is more, the investor is required to be judged "sophisticated" and willing to invest where there is no prospectus. The establishment of a "means test" or financial thresholds is a mechanism to screen the investor's risk tolerance against their financial suitability to risk their assets.

The OSC noted in *One Step Forward – A Study of the Economic Impact of OSC Rule 45-501 Exempt Distributions* (March 2003) that the purpose of the exempt market was to reduce the regulatory burden surrounding issuances – i.e., the burden on all stakeholders – and make the investor aware of the attendant risks:

> The premise for the prospectus-exempt regime is to reduce the regulatory burden surrounding issuance of securities, under certain conditions. The investor should be aware of the risk associated with the limited protection or recourse available to the investor in a non-

> prospectus environment versus the benefits derived from an issuer's ability to issue under reduced regulatory requirements (i.e. transaction details are reported post-trade).[14]

The authors of *One Step Forward* noted the concerns being expressed over the high thresholds being set for the accredited investor exemption:

> many commentators were concerned with the derivation of the thresholds in forming the Accredited Investor category. They commented that the thresholds for net income or net assets had become overly restrictive, creating a barrier to entry to the investors who could benefit most from this access. The long-term impact cannot be determined at this point.[15]

One can imagine what the reaction would be to the broad barriers to entry being proposed by the low ceilings of the aggregate annual investment caps.

c. Providing proportionate, non-arbitrary regulatory responses

It is arguable from a normative basis if the proposed amendments to aggregated annual investment restrictions should be within the ambit of authority of provincial securities commissions. Should such a large class of actual and potential investors be open to the risk of being deprived of their ability to invest in a particular type of investment, in the absence of clear evidence of an existing harm? From the point of view of investors who have used the OM exemption subsequent to the introduction of NI 31-103, the proposed changes will doubtless seem heavy-handed and arbitrary. What is the justification for the $30,000 cut-off point? Was that dollar amount selected because so many issuances under the OM exemption are made at or around the $25,000 price point? Why should the limit not be set at $50,000 or $75,000?

One thing seems clear: the apparently arbitrary selection of $10,000 and $30,000 as the appropriate figures for the aggregated annual caps will cause exempt market investors and issuers to lose confidence in their regulators' commitment to their mandate – chiefly, their commitment to conducting intensive data-gathering and research on the "facts in the field" as a necessary prelude to the construction of fair, measured and balanced securities regulation.

There is a legitimate concern over the enforceability of the annual investment caps. As noted above, the $30,000 or $10,000 annual investment limits will be difficult to track and monitor. There is also the issue of what seems to exempt market stakeholders as disproportionate regulatory focus on OM investments. After all, retail investors routinely invest in securities with risk levels equal to or in excess of the risk exposure that comes with many offering memorandum investments. And with

[14] Ontario Securities Commission, *One Step Forward – A Study of the Economic Impact of OSC Rule 45-501 Exempt Distributions* (March 2003), p. 6.
[15] *Ibid.,* p. 10.

self-directed investors, the absence of a suitability assessment by a third party means that level of risk can rapidly increase exponentially. Given the investor protections mandated under National Instrument 31-103, is it really fair to continue to reduce the scope of retail investor access to offering memorandum products?

PART FOUR: ALTERATIVE REGULATORY MEASURES

One immediate reform measure would be to remedy the current state of data-gathering in the exempt market. This is an area in which the CSA has recently announced very bold and comprehensive steps. At present, very few provincial or territorial securities commission collect and publish data on the use of the OM exemption. A national database, in which information is stored, including disciplinary information, is critical to producing properly informed regulatory proposals and responsive industry comment.

Advocis' position is that alternative qualification criteria for individual investors could be used to more effectively promote both capital raising and investor choice while still preserving enhanced levels of investor protection.

1. Retain the Current Regulatory Regime for Eligible Investors, but Implement Additional Amendments

The notional and undocumented basis of the proposed amendments – limiting investor exposure to illiquid securities – will strike many stakeholders as scarcely credible, given the new licensing requirements dealing representatives must meet, the ongoing training and education of salespersons, and the strict guidelines for granting approval to a transaction in the part of exempt market dealers and their chief compliance officers before it can be finalized and processed. In fact, if the regulator is so certain that the problems are sales of illiquid securities by a few large issuers and dealers, then it must surely be an easy fix, as the provincial securities commission will receive notification of these transactions in the monthly reports submitted by exempt market dealers. The regulators have the ability to pursue various enforcement actions at that point, as well as further audit the dealers and their salespersons.

For these reasons, Advocis believes that the current eligible investor criteria in the “Alberta model” are working. In fact, our preferred position is that all jurisdictions adopt the Alberta model. In the absence of evidence that the criteria are not working, we would suggest that the CSA direct its attention to the “few large issuers” and “in-house” exempt market dealers” who are apparently responsible for much of the impugned investments. Refining the regulatory architecture on the CSA’s side and the compliance systems on the issuer and dealer side in an effort to further promote the execution of suitable transactions will be much less intrusive to the operation of capital markets

and much more consumer-friendly than the rigid aggregate annual caps. Such refinements could include the following:

a. Continue to focus on suitability requirements and ensure access to good advice

Advocis believes that the most effective safeguard is and always will be to ensure the suitability of the investment for the client. It cannot be reiterated enough that KYC, KYP and other client suitability measures form a comprehensive compliance process which, under National Instrument 31-103, should be allowed to continue to function and evolve, without the introduction of the crippling $10,000 and $30,000 ceiling caps.

If the CSA has credible reason to believe that too many exempt market transactions in illiquid securities are not being subjected to the currently required reviews for KYC, KYP and suitability compliances (perhaps certain transactions are bypassing the ambit of mandatory suitability reviews through poorly supervised referral arrangements), then the CSA should take measures designed to ensure that the clients in those referred transactions in fact obtain professional financial advice prior to purchase of the investment through the established channels, such as registered advisors, exempt market dealers, and registered dealing representatives.

b. Issuer-focused reforms: Enhance existing information production and disclosure requirements

Transparency in the capital markets helps those markets run efficiently and with integrity. Achieving such transparency in the form of disclosure of information to investors is deservedly a high priority goal of Canada's securities regulators. Enhancing ongoing disclosure under the OM exemption is one way to promote investor protection while not forcing retail investors out of the marketplace. The absence of accurate, understandable and meaningful disclosure, as well as lax registration requirements were unfortunate features of the exempt markets prior to the amendments of September 2010. It is clear to industry participants that these registration and disclosure requirements have produced a better informed function exempt market. Before undercutting those amendments in such a draconian fashion, as the proposed amendments surely will, it is incumbent on the CSA to search out and propose more proportional regulatory responses to the alleged consumer harms, and conduct and disseminate the results of cost-benefit analyses.

Again, before imposing rigid and disruptive aggregate annual investment caps, the CSA should confirm that all exempt market issuers are registered with the appropriate provincial securities commission(s). In lieu of the aggregate annual caps, the CSA should consider promulgating more precise and comprehensive rules to improve disclosure, detect fraudsters and so on. Improved background and criminal record checks, and a publicly announced commitment by the CSA that exempt market fraud by issuers will be subjected to disciplinary measures which at least equal those dispensed for fraud in the public markets, would also help. Following such revisions, a clearly

worded guidance notice to issuers and dealers setting out which acts of commission and omission will force the regulator to deny access to the exempt market could then be circulated.

The ASC noted that over 2011 to 2012 it was a few large issuer groups which raised the majority of the capital issued under the OM exemption. Of these issuers, some relied on in-house exempt market dealers to sell the securities on their behalf. A compliance sweep of these particular actors, backed by a range of fines and other disciplinary measures, should help deter issuers are cannot or will bring suitable products to the exempt market.

A reconsideration of the obligations of issuers to produce audited financial statements or undertake quarterly reporting may be desirable. Enforcement of existing or new obligations on issuers using the OM exemption to, for example, disclose audited financial statements, report on a quarterly basis, and report within 10 days all material changes to the business, will foster a climate of increased transparency and flows of information. Perhaps securities issuances under the offering memorandum which seek to raise a certain threshold of capital should be subjected to some form of enhanced ongoing reporting obligations. All of this will likely better serve investor protection than the proposed aggregate annual caps.

c. Exempt market dealer-focused reforms

Another logical step to reforming the existing offering memorandum investment market before radically restructuring it would be introducing incremental increases in the requisite educational standards of exempt market dealers, advisors, and their representatives and salespersons. Specifically, if illiquidity concerns are such a problem that the CSA wants to restrict retail investor access to OM-exempted investments (which runs at over 90% in Alberta), then the CSA may wish to introduce a short and reasonably priced course for EMDS and registered dealing representatives on illiquidity. The threat of barrier of entry through timely and proportionate increases in educational requirements will require an initial investment by the CSA which could be recovered from dealing representatives. Such a course would surely cost less than the overall impact on exempt markets of the proposed amendments.

Another option would be to implement greater due diligence requirements for tied or in-house exempt market dealers; perhaps requiring such single-producer or single-product exempt market dealers to take additional steps to ensure proper corporate governance is in place for the issuer the dealer is contracted with. If not, empower the dealer to hold in escrow the capital raised and only release it to the issuer once the business model set out in the offering memorandum is ready for the funds. Put an obligation on issuers to determine if suitable corporate governance structures are in place for the company seeking capital.

In sum, the CSA should continue the positive steps begun in September 2010 with National Instrument 31-103. The next rational step would appear to be requiring that all exempt market dealers follow the requisite minimum standards, including the use of properly accredited or certified salespersons, and the in-house implementation or observance of policies and processes which will ensure that the investment product being sold is appropriate and suitable for the purchaser.

2. Adopt the Proposed Amendments with Reasonable Restrictions to Limit Their Impact on Capital Raising

Placing reasonable limits on the scope of application of the proposed amendments while limiting their negative impact on capital raising while preserving the investor protection measures where they may be needed. One set of options would be to adopt the proposed amendments, but with an increase in the annual "contribution room."

a. Adjust the proposed aggregate annual limit of $30,000 to $50,000 or $100,000
Consider again the data available on those investors most likely to be impacted by the proposed amendments. Over 2011 and 2012, roughly 11,000 individuals invested in Alberta's exempt market. During a single calendar year, approximately 24 per cent of these investors invested $50,000 or more and roughly 9 per cent invested between $100,000 or more.

If the CSA is determined to make resort to a rigid bright line standard, we believe it would do better to focus its efforts on and not on the much larger cohort (by several thousand persons) of the retail investors who came in under $50,000.

Another set of options would adopt the proposed amendments' aggregate annual limits as the "default position" of the exempt market's regulatory apparatus, but limit their application several clearly-defined exemptions.

b. Apply the proposed amendments to instances characterized by a lack of diversification or over-concentration in a single investment product
One possibility is to only apply the $10,000 and $30,000 limits to certain distribution situations. For example, the issuer-driven exempt market dealer which is largely or entirely owned by one product manufacturer and distributes only that manufacturer's products poses more of a risk of than an independent exempt market dealer. These tied or issuer-driven exempt market dealers, and the "in-house" exempt market dealer who distributes a single proprietary product, bring with them a stronger possibility for over-allocation of retail capital in too few products.

The CSA may wish to consider applying the proposed aggregate annual limits to such distribution models which involve a very narrow product shelf, to help prevent the over-concentration of a retail

investor's money in single product family, or even in a single product, as has happened in the past with single-product exempt market dealers and unlicensed or unregistered promoters. Since independent exempt market dealers usually conduct better due diligence than tied sellers on products and issuers, requiring issuer-driven dealers to conduct or have conducted for them greater due diligence would be another possible option.

c. Introduce the proposed ceilings but offering a carve-out which exempts certain registrants or investors from them

Approaches which focus on the individual investor are much less disruptive than the rigid annual limits. The CSA could amend the current proposals so that there is more limited application of the aggregate annual limits in cases where the possible harm of illiquidity is reduced.

A carve-out for certain retail investors: For example, a carve-out could exempt the retail investors from the annual caps if they sign a risk acknowledgement form and provide proof that they received advice from a registrant who is independent of the entity raising capital, who meets certain minimum exempt market educational and/or experiential requirements, and carries sufficient professional liability insurance.

A carve-out for certain registrants: the "independent" exempt market dealer, who carries a diverse group of products, has no commitment to any one product manufacturer, and conducts independent due diligence, could be exempted from the $30,000 aggregate annual cap. The CSA should avoid impinging on the business model of independent and registered exempt market dealers whose generation of new business depends on their track record of fulfilling suitability and diversification requirements for clients.

d. Introduce the current proposals but allow for additional contribution room to be made on a periodic basis, or offer higher annual ceilings but with biannual exposure to the market

The ASC states that the average size of an investment by an individual eligible investor was approximately $45,700 in 2011 and $47,900 in 2012. We believe that the negative impact of the proposed aggregate annual caps could be reduced by permitting some form of clearly-delineated variance of or periodic holiday from the $30,000 cap. Some possible examples are:

Allow retail investors to invest $60,000 every second year as opposed to $30,000 every year: Given that the average offering memorandum investment by Alberta's retail investors is greater than $30,000 but less than $60,000, and given their apparently low level of consecutive year-over-year investing in product under the OM exemption, it would seem that retail investors would probably prefer to be allowed to invest $60,000 once every two years than the proposed $30,000 every year. Would such a proposal really yield a material increase in risk exposure for retail investors as a whole in comparison to the risk exposure of the proposed amendments?

Allow a single-year enhancement of the annual cap in the amount of $30,000 every five years: To reduce the inherent rigidity of ceiling caps, the CSA should consider allowing a retail investor once every five years to invest an additional $30,000 in a single calendar year. Thus, when an investor sees an opportunity to pursue an investment he believes in, or is rewarded with the opportunity to re-invest the principal and returns from a successful investment back into an issuer's operation, he will be able to do so. This once-every-five-years exemption would remove some of the absurdity of the outcomes that will surely result under an inflexible $30,000 annual limit.

Permitting investors to invest when they deem it best is preferable to a mandating obedience to absolute annual limits.

e. Introduce the current proposals but allow for a "qualified investor" exemption

The notion of an investor exemption which is tied to investment knowledge seems to be a perennial regulatory consideration. The argument is that by virtue of their academic qualifications or work experience, or other forms of "active knowledge" of financial planning, some people do not require protection under the prospectus and disclosure system. Accordingly, it is unfair to deny them access to exempt trades simply because they do not meet certain wealth threshold and do not qualify for the eligible or accredited investor categories.

If the impetus behind the proposed amendments is, as the CSA says, to limit the exposure of retail investors to illiquid securities, then the CSA should recognize that the disruptive nature of the amendments can be ameliorated by exempting those retail investors who do not need the full force of the CSA's proposed annual caps pursuant to the OM exemption. These would be those retail investors who are not accredited investors, but are able to provide some form of objective evidence that demonstrates knowledge and experience with illiquid products in particular and exempt market investing in general.

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

Advocis supports the policy reasoning behind the argument that regulators should require accredited investors to meet a test of "active knowledge" before they can be considered sufficiently sophisticated to participate in the exempt market. However, the administration of such a knowledge-based exemption can be problematic and resource-intensive. One option would be to mandate that the retail investor be independently verified or certified by a dealer or issuer as being a "qualified investor." Another option would be to mandate that investors pass a recognized test on

exempt market issues, including illiquid exempt market products, before they can access an exemption for qualified investors.

Advocis notes that under the European Union's Prospectus Directive of May 30, 2001, which came into force in the United Kingdom on July 1, 2005, distributions to "qualified investors" are exempt from the prospectus requirements. The Directive allows Member States to choose to authorize resident individuals as qualified investors when they expressly ask to be so considered. Such individuals must meet at least two of the following criteria[16]:

- investment experience: the investor has carried out transactions of a significant size (at least 1,000 euros) on securities markets at an average frequency of, at least, ten per quarter over the previous four quarters,
- investment knowledge: the investor works or has worked for at least one year in the financial sector in a professional position which requires knowledge of securities investment, or
- portfolio size: the size of the investor's securities portfolio exceeds 0.5 million euros.

These "qualified investors" are listed in a *Qualified Investor Register*, which is publicly available and delivered electronically to issuers and other distributors of securities.

With regard to the OM exemption, a "qualified investor" exemption from the proposed aggregate annual limits could be based on some combination of:

- investment experience: for example, the investor has carried out or ordered to be carried out transactions relating to the OM exemption and/or illiquid exempt market securities;
- work experience: the investor works or has worked in the financial sector in a professional position which requires knowledge of securities investment; and/or
- education: the investor has completed the Canadian Securities Course, achieved a CFA designation or has received an advanced degree in business or finance; in addition,
- retail investors who hold advanced degrees in business or finance, or have industry licenses or accreditations of direct relevance, such as an Exempt Market Dealer course designation or a CFA designation, could apply for the automatic granting of qualified investor status.

f. Introduce the current proposals, but with an exemption for investors who rely on a registered financial advisor

At present, under National Instrument 45-106, section 1.1 (h), a retail investor may qualify as an eligible investor if he has obtained advice regarding the suitability of the investment and, if the retail

[16] For more information, see the summary in CSA Staff Consultation Note 45-401 – *Review of Minimum Amount and Accredited Investor Exemptions – Public Consultation*.

investor resides in Canada, the advice obtained is from an eligibility advisor. An eligibility advisor is an investment dealer (or an equivalent category of registration), registered under the securities legislation of the retail investor’s jurisdiction, and is authorized to give advice with respect to the type of security being distributed.

If the proposed amendments are brought into place, we would urge the CSA retain and expand this advice provision, so that all-non-accredited investors may avoid the $30,000 cap if they secure and act on professional financial advice from a registrant regarding the purchase of the OM-exempt product.

<u>Why advice from a registrant?</u>: Instead of simply introducing a rigid, bright line standard for determining how much an investor can allocate to OM-exempt products, as set out in the proposed amendments (and which is solely a proxy for the individual’s ability to absorb investment losses), Advocis believes the CSA should consider an exemption from that bright line standard based on a different proxy – a proxy for investment experience and knowledge based on the individual investor's engagement of an intermediary.

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

> We are troubled that a large number of investors are shut out of the private placement market because of the size of their personal fortunes. We recommend that the category of individual regarded as an accredited investor be broadened to include not only those who are wealthy, but also those who rely on a registered adviser in making their decision to invest in the private placement. The financial sophistication of the registered adviser, which comes from his professional training and accreditation, would be transposed onto his client.[17]

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

> 5.52 Appropriate safeguards could be put in place to ensure that both the registered advisor and the investor acknowledge that the investor is relying on the adviser.[18]

Similarly, in their article, "'Canada Steps Up'—Task Force to Modernize Securities Legislation in Canada: Recommendations and Discussion," Paul Halpern and Poonam Puri consider various recommendations to broaden the category of the individual to be regarded as an accredited

[17] *Canada Steps Up - Final Report, October 2006 – The Task Force to Modernize Securities Legislation in Canada*, Commissioned by the Task Force to Modernize Securities Legislation in Canada, (http://www.tfmsl.ca/docs/V2(3)%20Deaves.pdf), pp.96-97.
[18] *Ibid.,* p. 97.

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investor under the private placement exemptions to include those who rely on a registered adviser.[19] An exemption based on investor reliance on a registered provider of financial advice could be constructed with the following safeguards:

1. the issuer must provide annual and quarterly reporting;
2. sales pursuant to the exemption could be limited to a pre-set number of investors (e.g., 250) for any single private placement to contain risk exposure; and
3. sales by the registered advisor of the product would only be permitted to clients with whom the registered advisor had a pre-existing relationship.

What sort of advisor?: As noted, if the proposed amendments are brought into place, we would urge the CSA retain and expand this advice provision, so that all-non-accredited investors may avoid the $30,000 cap if they secure and act on professional financial advice from a registrant regarding the purchase of the OM-exempt product. This registrant should be a member of a professional association which requires that the advisor act in the best interests of the client, meet mandatory ongoing continuing education requirements, and carry sufficient professional liability insurance.

Since the exempt market appears to offer potentially lucrative investment opportunities, a retail investor always needs to be cautious and should ideally seek recourse to a trusted advisor before the purchase of a high-risk and/or illiquid security. Such an advisor, in addition to the criteria outlined above, should offer to make full disclosure of his compensation model to the investor, and engage only with exempt market dealerships which have solid business models and proven product shelves.

4. Abandon the Rigid Bright Line Standard Altogether in Favour of More Flexible Caps

Advocis recognizes the problems associated with alternative criteria, especially in regard to the selection of objective metrics which seek to capture the more subjective concept of investor sophistication. The virtue is that it is an objective standard, and for any given investor it can be determined with a high degree of accuracy and a low degree of cost on which side of the exemption's "bright line" he or she falls. However, these virtues become liabilities when dealing with annual contribution room in the amounts of $10,000 or $30,000, as the party entrusted with tracking and monitoring the investor aggregate annual investments will be required to delve down to the level of individual dollars and cents. The problems with any "bright line" test in terms of its inherent arbitrariness are well known and need not be reviewed here.

[19] Paul Halpern and Poonam Puri, "'Canada Steps Up'—Task Force to Modernize Securities Legislation in Canada: Recommendations and Discussion," *Capital Markets Law Journal*, 2007, Vol. 2, No. 2., p. 20

a. Introduce a cap based on a percentage of net financial assets

Advocis believes a much more flexible way of enhancing investor protection under the OM exemption would be to consider limiting a retail investor's exposure to any single industry category of investment product under the OM exemption to a maximum percentage of the investor's net financial assets. This would ensure investments are being made and using proper suitability assessment. Imagine two individuals who both earn $80,000 per annum. One has $500,000 in net assets, but the other has $800,000 in net assets. All other things being equal, the second person should be afforded greater contribution room in the exempt market. While imperfect, a series of caps based on a percentage of net financial assets is more acceptable on a normative basis and less disruptive to our capital markets in financial terms. A slightly more ambitious version of this option would take into account the individual's marital status, years to retirement, and perhaps other considerations.

b. Introduce a graduated set of aggregated caps based on the size of the investor's portfolio and the relative liquidity of the investment

Recall that at present a retail investor who is an eligible investor is a person who in general fulfills one of the two following sets of criteria: (1) net assets, alone or with a spouse, exceed $400,000, and a net income which before taxes exceeded $75,000 in each of the two most recent calendar years; or (2) a net income before taxes, alone or with a spouse, which exceeded $125,000 in each of the two most recent calendar years.

Advocis believes that it would make more sense from a perspective of fairness to stakeholders and further the interests of proportional investor protection to construct a graduated set of aggregate annual caps, instead of an overly rigid, largely arbitrary and artificial one. For example, a person seeking to qualify under the criteria set out in (2), above, who earns between $125,000 and $149,999 a year, could be permitted to invest $30,000 a year under the OM exemption, while the investor in the next category along the graduated scale, who earns between $150,000 and $199,999 a year, could be permitted to invest $35,000, and the investor earning between $200,000 and $249,999 could be permitted to invest $40,000, and so on.

In sum, we believe that there are literally dozens of possible reform options open to the CSA which can address the still undocumented harm posed by illiquid securities in the post-September 2010 era of the new National Instrument 31-101. The reforming spirit of 31-101 should be allowed to continue to be articulated through incremental amendments, and not stifled by the introduction of the proposed amendments, which amount to wholesale barriers to entry in our capital markets.

Conclusions and Looking Ahead: The CSA's Mandate and Regulatory Policy

Advocis is pleased with the CSA's two ongoing balancing of competing policy objectives: (1) the continued effort to enhance investor protection while simultaneously improving access for start-up

businesses and small- to medium-sized enterprises to much-needed capital; and (2) balancing the need for harmonization across jurisdictions with the need to recognize and craft regulation based on the specific characteristics of each jurisdiction's capital markets issuers and investors.

Moreover, Advocis members support regulation which fosters retail investor participation and protection in the exempt markets. This is not empty rhetoric, nor is it surprising: our members succeed through long-term relationships and positive word-of-mouth, not by selling unsuitable, illiquid securities to retirees or reducing diversification in a client's portfolio. Our *Best Practices Manual* promotes the provision of well-diversified and suitable investment options to our clients.

However, the introduction of such low-ceilings in the annual contribution room for non-accredited investors who purchase exempt market products is unfair to nearly all stakeholders and comes with a guaranteed promise of regulator-induced market inefficiencies and outright market failures. One of the most obvious will be forcing investors to allocate more money to the more volatile public markets, thereby increasing their risk exposure.

1. Refocus on Promoting Investor Trust and Confidence

Let us recall that part of the CSA's mandate is to introduce proportionate regulation which will foster investor trust in the producers of retail investment products, in the intermediaries that distribute them, and in the regulators who create and enforce the rules which govern them. A key part of investor trust is the sense that the financial system is not and does not have to be so tightly regulated that the average retail investor cannot even rely on a registrant to sell them a suitable exempt market product which costs in excess of $31,000.

2. Give Due Consideration to Alternative Regulatory Measures

Advocis hopes that the CSA will consider alternative regulatory responses and abandon the proposed amendments to limit investments by non-accredited investors. If illiquidity really is the final concern of these amendments, then why not focus on ways of addressing clearly illiquid products, instead of annual limits on *all* exempt market products, regardless of their liquidity. Capital markets flourish under constructive, not destructive policy.

Advocis would be pleased to offer further comment or assistance on this matter at any time. To discuss any of the issues that we have raised herein, please contact the undersigned, or email Ed Skwarek at eskwarek@advocis.ca.

Sincerely,

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