

CSA Notice and Request for Comment
Proposed Amendments to
National Instrument 45-106 *Prospectus and Registration Exemptions*
Relating to the Accredited Investor and
Minimum Amount Investment Prospectus Exemptions

February 27, 2014

Introduction

The Canadian Securities Administrators (**CSA** or **we**) are publishing for a 90-day comment period proposed amendments (the **Proposed Amendments**) to National Instrument 45-106 *Prospectus and Registration Exemptions* (**NI 45-106**).

If adopted, the Proposed Amendments would, among other things:

- require persons relying on the accredited investor prospectus exemption in section 2.3 of NI 45-106 and section 73.3 of *Securities Act* (Ontario) (**the AI Exemption**) to obtain a signed risk acknowledgement in Form 45-106F9 *Risk Acknowledgement Form for Individual Accredited Investors* (**Form 45-106F9**) from certain individual accredited investors who are not permitted clients,
- restrict the minimum amount investment prospectus exemption in section 2.10 of NI 45-106 (**the MA Exemption**) to distributions to non-individual investors, and
- amend the definition of accredited investor in Ontario to allow fully managed accounts to purchase investment fund securities using the managed account category of the AI Exemption, as is permitted in other Canadian jurisdictions.

The text of the Proposed Amendments is contained in Annexes A and B of this notice and will also be available on websites of CSA jurisdictions, including:

www.lautorite.qc.ca

www.albertasecurities.com

www.bcsc.bc.ca

www.nssc.gov.ns.ca

www.fcnb.ca

www.osc.gov.on.ca

www.fcaa.gov.sk.ca

www.msc.gov.mb.ca

Substance and Purpose

The Proposed Amendments are intended to address concerns that:

- some individual investors may not understand the risks of investing under the AI Exemption or may not in fact qualify as accredited investors

- the threshold of \$150,000 in the MA Exemption may not be a proxy for sophistication or ability to withstand financial loss for individual investors and may encourage over-concentration in one investment for an individual investor.

We are not proposing to change the dollar thresholds in either the AI Exemption or the MA Exemption because we concluded that this would not address the identified concerns.

Background

The AI Exemption and the MA Exemption have historically been premised on the investor having one or more of

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

The AI Exemption and the MA Exemption provide cost-effective objective measures for issuers to distribute securities to raise capital or for other purposes. However, the thresholds for individuals to qualify as accredited investors were originally set by the Securities and Exchange Commission (**SEC**) in 1982, and subsequently adopted by the CSA in the early 2000s. The current \$150,000 threshold for the MA Exemption was set in 1987. The thresholds have not been changed or adjusted for inflation since.

The CSA conducted a broad review of the AI Exemption and the MA Exemption because of investor protection concerns highlighted by the financial crisis in 2007-2008. On November 10, 2011, the CSA published CSA Staff Consultation Note 45-401 *Review of Minimum Amount and Accredited Investor Exemptions* (the **consultation note**). On June 7, 2012, the CSA published CSA Staff Notice 45-310 *Update on CSA Staff Consultation Note 45-401 Review of Minimum Amount and Accredited Investor Exemptions*.

As part of our broad review, CSA staff reviewed and considered the following information:

- 110 comment letters received on the consultation note
- feedback received during consultation sessions held across Canada
- data relating to the exempt market and the use of the capital raising prospectus exemptions gathered from exempt distribution reports filed in the participating jurisdictions for distributions in 2011
- data compiled from Statistics Canada on Canadian income levels
- input from compliance and enforcement staff about complaints and investigations involving the use of these exemptions
- decisions resulting from enforcement proceedings of securities regulatory authorities involving the exemptions
- guidance issued by CSA members on establishing accredited investor status.

Review of the AI Exemption

As a result of this broad review, the CSA learned the following about the AI Exemption:

- The data we gathered confirmed that the AI Exemption is the most relied on capital raising exemption for all issuers (investment funds and non-investment funds; reporting and non-reporting issuers) both in terms of amount of capital invested under it (\$134 billion or 90% of the total¹ invested in 2011 by Canadians) as well as number of times relied on for distributions to Canadian investors (64%).
- A common theme in the 110 comment letters received on the consultation note was the need to maintain or increase access to capital. Many commenters expressed concern about any changes to the AI Exemption that may limit access to capital, particularly for small and medium sized enterprises. A majority of commenters supported keeping the AI Exemption at its current income and asset thresholds. Approximately one-third of commenters supported decreasing the thresholds to encourage new capital investment.
- Very few Canadians meet the current thresholds to be accredited investors. Approximately 1.1% of Canadians met the net income test in 2011. Increasing the income threshold to \$245,000 to account for inflation since 2001 would reduce that number by almost one-third (only 0.7% of Canadians had income of \$250,000 and over in 2011). (Statistics Canada, Table 111-0008, representing individuals that filed a tax return in Canada).
- Most enforcement hearings involving the AI Exemption focused on whether the investors properly met the accredited investor test. In many cases, the investors were not informed about the details of the tests or the risks of purchasing under a prospectus exemption.

Review of MA Exemption

The CSA learned the following about the **MA Exemption** from our broad review:

- The MA Exemption raises the second highest amount of capital (\$5.6 billion or 3.7% of total¹ invested in 2011 by Canadians), after the AI Exemption. However, when we considered the number of times investors invested under the MA Exemption, we found it was relied on less than 1% of the time for distributions to Canadian investors. This is less frequently than other “capital raising” exemptions, such as the AI Exemption, the family, friends and business associates exemption in section 2.5 of NI 45-106 and the offering memorandum exemption in section 2.9 of NI 45-106.
- Commenters were evenly divided on whether to retain the MA Exemption. Many commenters supported eliminating it because it is philosophically unsound and creates the

¹ A total of \$149.5 billion was invested by Canadian investors in investment funds and non-investment fund issuers under the five main prospectus exemptions used for capital raising: the AI Exemption; the family, friends and business associates exemption in section 2.5 of NI 45-106; the offering memorandum exemption in section 2.9 of NI 45-106; the MA Exemption; and the additional investment in investment funds in section 2.19 of NI 45-106. The amount of capital invested in investment fund issuers likely includes funds investing in other funds and investors redeeming in one fund and moving their capital to another fund – it is not limited to new capital invested. Investment funds are not required to reflect redemptions when reporting distributions.

risk that the investor is over-concentrated in one product. Those that supported retaining it told us that it is an efficient, cost effective alternative when the AI exemption is not available.

- The majority of individuals invest between \$150,000 and \$200,000 when investing under the MA Exemption. When investors can choose how much to invest, they generally invest much less than \$150,000. For example, most individuals invest \$30,000 or less when investing under the AI Exemption.
- Compliance and enforcement staff in some jurisdictions told us the problems they typically see with the MA Exemption include:
 - situations where the investment is clearly not suitable for the investor;
 - individual investors are encouraged to borrow money to meet the terms of the MA Exemption; and
 - individual investors are pressured to invest \$150,000 to participate in an “opportunity” when they would rather invest less.
- While the MA Exemption is not widely used in all jurisdictions or by all industries, it does provide an inexpensive alternative when the investor is not an accredited investor. The exemption works well for certain industries; for example, for the sale of real estate securities such as condominium projects where the condominium unit is valued over \$150,000. During consultation sessions, staff of some jurisdictions heard that certain small and medium-sized enterprises may not be able to invest under the AI Exemption because they do not meet the net asset test that applies to corporations (net assets of \$5 million).
- We reviewed all Canadian purchasers under the MA Exemption in 2011 and categorized them as individuals or non-individuals. Based on this review, we estimated that individuals investing under the MA Exemption represented less than 1% of the total \$149.5 billion invested by Canadians in 2011².

Summary of the Proposed Instrument

Proposed amendments to the AI Exemption

We do not propose to change the income or asset thresholds used in the definition of accredited investor at this time. We will continue to monitor developments in other jurisdictions.

We propose certain amendments to the AI Exemption to address investor protection concerns, particularly that some individual investors may not understand the risks associated with exempt market investments or may not in fact qualify as accredited investors. The following lists all

² Represents the amount invested by Canadian investors in investment funds and non-investment fund issuers under the five main prospectus exemptions used for capital raising: the AI Exemption; the family, friends and business associates exemption in section 2.5 of NI 45-106; the offering memorandum exemption in section 2.9 of NI 45-106; the MA Exemption; and the additional investment in investment funds in section 2.19 of NI 45-106. The amount of capital invested in investment fund issuers likely includes funds investing in other funds and investors redeeming in one fund and moving their capital to another fund – it is not limited to new capital invested. Investment funds are not required to reflect redemptions when reporting distributions.

changes we propose to make to the AI Exemption:

1. Individual accredited investors must complete and sign a new risk acknowledgement form, Form 45-106F9 *Risk Acknowledgement Form for Individual Accredited Investors*. Form 45-106F9 describes, in plain language, the categories of individual accredited investor and the protections an investor is renouncing by purchasing under the exemption. The investor would be required to indicate on the Form 45-106F9 which category of accredited investor they satisfy.
2. The Form 45-106F9 requirement would apply to all existing categories of *individual* accredited investor, namely individuals that:
 - earned net income of \$200,000, or \$300,000 with a spouse, in each of the two most recent calendar years, with a reasonable expectation to exceed that level in the current calendar year,
 - own financial assets (cash and securities – no real estate), alone or with a spouse, in excess of \$1 million, or
 - own net assets of at least \$5 million.
3. Individual accredited investors who meet the permitted client test under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103)* would not be required to complete and sign Form 45-106F9. To be a permitted client, an individual must own financial assets in excess of \$5 million. As a permitted client, these individuals are able to waive suitability under subsection 13.3(4) of NI 31-103.
4. Any salesperson or finder, whether registered or not, involved in the trade to the individual investor would be required to complete and sign Form 45-106F9.
5. We propose additional guidance in the Companion Policy on the steps issuers should take to verify accredited investor status, including explaining the different tests and asking questions to obtain factual information from purchasers about their income or assets before discussing the investment.
6. Issuers would be required to identify the category of accredited investor of each purchaser in the report of exempt distribution (Form 45-106F1 and, in BC, Form 45-106F6). This would assist our compliance and enforcement departments when reviewing adherence to the AI Exemption.
7. The definition of accredited investor would be amended to include family trusts established by an accredited investor for his or her family, provided the majority of trustees of the family trust are accredited investors. We propose this amendment to address comments we have received since adopting NI 45-106 as well as on the consultation note, that it seemed inconsistent that an accredited investor could not purchase securities on behalf of a trust established for the benefit of the accredited investor's family.
8. The Ontario Securities Commission (the OSC) proposes to amend the definition of accredited investor to allow fully managed accounts to purchase investment fund securities in Ontario.

Registered advisers of fully managed accounts have a fiduciary duty to investors. A registered adviser of a fully managed account is an accredited investor under the definition of accredited investor in NI 45-106 and can buy all types of securities for the managed account on an exempt basis except, in Ontario, investment fund securities. A number of investment management industry participants commenting on this carve-out supported its removal, for the following reasons:

- a portfolio manager's proficiency and fiduciary obligation to the investor serve as adequate investor protection,
- managed account clients should have the benefit of the exemption whether investing in securities directly or through an investment fund, and
- it would harmonize the managed account category of the AI Exemption across Canada.

Proposed amendment to the MA Exemption

We propose that the MA Exemption be amended so that it is only available for distributions to non-individuals to address investor protection concerns associated with the use of the exemption to distribute securities to individual investors.

Other proposed amendments

We propose to amend the form of **report of exempt distribution** (Form 45-106F1 and, in BC, Form 45-106F6) to gather additional information, particularly:

- the category of accredited investor for each purchaser
- updated industry categories
- more information on any person being compensated in connection with the distribution, including identifying which purchasers the person was compensated for.

This additional information will assist our compliance and data gathering functions. Having more information about the types of issuers using these exemptions will enable us to more effectively understand and regulate this market.

We are also making **housekeeping changes** resulting from the removal of the dealer registration exemptions (formerly Part 3 of NI 45-106) effective March 27, 2010 to reflect the adoption of NI 31-103. These include changing the title of NI 45-106 from "*Prospectus and Registration Exemptions*" to "*Prospectus Exemptions*" and making consequential amendments to other instruments to recognize the title change.

Impact on Investors

The Proposed Amendments are intended to enhance investor protection.

The amendments to the AI Exemption, except those to the definition of accredited investor in connection with fully managed accounts and family trusts, would help individual investors understand whether they qualify as accredited investors and the risks of investing in the exempt market.

The OSC's proposed amendment to the definition of accredited investor to allow fully managed accounts to purchase investment fund securities in Ontario would permit fully managed accounts

to purchase all securities on an exempt basis, including investment fund securities.

The amendment to the definition of accredited investor to include family trusts would permit an accredited investor to establish a family trust for the benefit of his or her family members.

The amendment to the MA Exemption is intended to reduce the risk of individual investors over-concentrating their investable assets in one investment while retaining the efficiency of the exemption for corporate and institutional investors. It also addresses our concern that the amount invested is not a good proxy for sophistication or the ability to withstand financial loss for individual investors.

The amendments to the report of exempt distribution would provide us with more information about this market, enabling us to better regulate by developing more targeted compliance and investor education programs.

Consequential Amendments

National Amendments

We will consequentially amend the following instruments and companion policies to recognize the change in title of NI 45-106 from “*Prospectus and Registration Exemptions*” to “*Prospectus Exemptions*”:

- Companion Policy 11-102CP *Passport System*
- Multilateral Instrument 13-102 *System Fees for SEDAR and NRD*
- National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*;
- Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations*;
- Multilateral Instrument 32-102 *Registration Exemptions for Non-Resident Investment Fund Managers*
- National Instrument 33-105 *Underwriting Conflicts*;
- National Instrument 41-101 *General Prospectus Requirements*;
- National Instrument 45-102 *Resale of Securities*;
- Companion Policy 45-102CP *Resale of Securities*;
- National Instrument 51-102 *Continuous Disclosure Obligations*;
- Companion Policy 51-105CP *Issuers Quoted in the U.S. Over-the-Counter Markets*
- National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*;
- National Instrument 62-103 *The Early Warning System and Related Take-Over Bid and Insider Reporting Issues*; and
- Multilateral Instrument 62-104 *Take-Over Bids and Issuer Bids*.

Local Matters

Annex C is being published in any local jurisdiction that is making related changes to local securities laws, including local notices or other policy instruments in that jurisdiction. It also includes any additional information that is relevant to that jurisdiction only.

Both the British Columbia Securities Commission (BCSC) and the Ontario Securities Commission (OSC) are proposing local amendments to NI 45-106. In addition, the OSC is proposing local amendments to National Instrument 45-102 *Resale of Securities* (NI 45-102) and OSC Rule 45-501 *Ontario Prospectus and Registration Exemptions* (OSC Rule 45-501).

The BCSC proposes to amend Form 45-106F6 to gather additional information about issuers, purchasers and persons being compensated for distributions under prospectus exemptions. The BCSC also proposes to amend Form 45-106F6 and add a new section 6.7 to NI 45-106 to codify certain exemptions from the requirements in Form 45-106F6 currently in BC Instrument 45-533 *Exemptions from Form 45-106F6 Requirements*.

The OSC proposes to amend NI 45-106, NI 45-102 and OSC Rule 45-501 to reflect the anticipated coming into force of certain amendments to the *Securities Act* (Ontario) (the OSA). These OSA amendments were originally introduced in Bill 162 *An Act respecting the budget measures and other matters* (Bill 162) in 2009 in conjunction with changes to registration requirements made at that time. The proposed OSA amendments were to be implemented in two phases, and the second phase amendments are now expected to be proclaimed into force. In accordance with the provisions of Bill 162, certain prospectus exemptions currently set out in NI 45-106 or OSC Rule 45-501 were replaced with an equivalent list of statutory exemptions. Assuming the remaining provisions of Bill 162 are proclaimed, the following prospectus exemptions (or elements of these exemptions) currently in NI 45-106 will be moved to the OSA:

- the AI Exemption in subsection 2.3(1) of NI 45-106 will be moved to section 73.3 of the OSA, and
- the private issuer exemption in subsection 2.4(2) of NI 45-106 will be moved to section 73.4 of the OSA.

The local amendments proposed by the BCSC and OSC are reflected in the proposed amending instrument and in the blacklined versions of the amended instruments and forms presented in Annex A. A more detailed explanation of the proposed local amendments is provided in Annex C, which is available on the website of each of the BCSC (www.bcsc.bc.ca) and OSC (www.osc.gov.on.ca).

Request for Comments

We welcome all comments on the Proposed Amendments, the companion policy, forms, and consequential amendments.

Please submit your comments in writing on or before May 28, 2014. If you are not sending your comments by email, please send a CD containing the submissions (in Microsoft Word format).

Address your submission to all of the CSA as follows:

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority (Saskatchewan)

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

Deliver your comments **only** to the three addresses below. Your comments will be distributed to the other participating CSA jurisdictions.

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We cannot keep submissions confidential. Please note that all comments received will be posted on the website of the *Autorité des marchés financiers* at www.lautorite.qc.ca and the website of the Ontario Securities Commission at www.osc.gov.on.ca. Therefore, you should not include personal information directly in comments to be published. It is important that you state on whose behalf you are making the submission.

Thank you in advance for your comments.

Contents of Annexes

The following annexes form part of this CSA Notice:

Annex A1	Proposed Amendments to National Instrument 45-106 <i>Prospectus and Registration Exemptions</i>
Annex A2	Proposed Amendments to National Instrument 45-102 <i>Resale of Securities</i> (This amending instrument contains local-only amendments proposed by the OSC.)
Annex A3	Blackline of amended National Instrument 45-106 <i>Prospectus Exemptions</i>
Annex A4	Blackline of amended Form 45-106F1 <i>Report of Exempt Distribution</i>
Annex A5	Blackline of amended Form 45-106F6 <i>British Columbia Report of Exempt Distribution</i>
Annex A6	Proposed Form 45-106F9 <i>Risk Acknowledgement Form for Individual Accredited Investors</i>
Annex B	Proposed Changes to Companion Policy 45-106 <i>Prospectus and Registration Exemptions</i>
Annex C	Local Matters
Annex D1	Overview of Comments Received on CSA Staff Consultation Note 45-401 <i>Review of Minimum Amount and Accredited Investor Exemptions</i>
Annex D2	List of Commenters on CSA Staff Consultation Note 45-401 <i>Review of Minimum Amount and Accredited Investor Exemptions</i>
Annex D3	Summary of Comments on CSA Staff Consultation Note 45-401 <i>Review of Minimum Amount and Accredited Investor Exemptions</i>

Questions

Please refer your questions to any of the following:

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