

COLUMN: BANKING ON CORPORATE

What is a sophisticated investor?

The scope of the private placement exemption, which describes investors that don't need protection, has been the focus of regulatory consideration

SECURITIES LAWS are in many respects consumer protection laws; but in that aspect, they are somewhat unique. For one thing, they are disclosure-oriented. Think of Health Canada as if it focused only on labeling, so food producers could put any poison in food or drink for public sale as long as the ingredients were clearly disclosed. Equally distinctively, securities laws create an elaborate framework to demarcate categories of persons who don't require the consumer protection that it provides: It's as if Health Canada went further and identified classes of cast-iron-stomached people who can digest anything and don't need nutritional regulation at all or much reduced forms of it.

Securities rules are replete with exceptions, where the full machinery of the securities regulatory system is considered unnecessary. There are exceptions and exceptions to those exceptions and still further exceptions, which is probably why it has proved so difficult to set securities laws to music. One of the most common is the set of exceptions (commonly called private placement exemptions) that permits issuers to distribute securities without undergoing the typically costly and time-consuming process of preparing and clearing a prospectus.

In some cases, private placement exemptions are driven by circumstance; for example, core investors in a private company entirely familiar with its business shouldn't need or want a prospectus. In other cases, these exemptions respond to market and

social developments, like the newish, limited exemptions to raise capital via crowdfunding. And then there are exemptions that are based on the characteristics of the purchaser, most notably what is known as the accredited investor exemption, which is the exemption used in the substantial majority of private placements.

The scope of this exemption, which outlines the characteristics of investors that don't need protection, is often the focus of academic and regulatory consideration. Late this summer, the parallel exemption in the U.S. was expanded to add new categories. Earlier in the summer, the Ontario Capital Markets Modernization Taskforce proposed expansions to the concept. The issue is predictably complicated, raising questions as to whether broadly cast private placement exemptions encourage finance activity outside of the traditional public offering system and deny investment access to other segments of the market. But at its core is the idea that certain persons do not require the full protections of the normal rules.

The concept of accredited investors in Canada includes categories that are unsurprising, such as various levels of government, financial institutions, registered securities dealers and advisors and other regulated entities. It also predictably includes entities (such as companies or partnerships) and individuals (alone or with a spouse) that meet certain asset thresholds and individuals who meet prescribed

income or wealth levels. The basic premise, as I had understood it, was that the exemption was intended to include those persons who do not require the protection of securities laws because they are "wealthy, wise or well advised." A common criticism, however, has been that there is undue emphasis on the wealth element, which may speak to the party's ability to withstand an investment loss and its resources to get advice, but which is not a proxy for investment sophistication.

The announced and proposed regulatory initiatives illustrate the challenges in defining accredited investors. The Ontario task force proposed to expand the category to include individuals who have successfully achieved proficiency requirements in order to advise clients on investments, echoing the U.S. reform to include registered investment advisers and individuals with similar certifications. Depending on the jurisdiction, persons who are blessed by securities regulators to provide professional investment advice have either very recently or not yet been considered sufficiently sophisticated to invest for themselves on an exempt basis. The evolution can also lag behind social change; for example, the formal recognition in the U.S. that there are "spousal equivalent" relationships that should inform the assessment of familial income or wealth occurred just this summer.

Oddly, pushes to expand emphasis on the wise and well-advised aspects haven't appeared to result in any impetus to include corporate lawyers as accredited investors. Maybe that is fortuitous, in my own case, because my investing track record (like my nutritional choices) illustrates nothing but that I can use all the regulatory assistance that can be provided. Given my impulsive and emotional investment approach, there may be need of a new category — not for exempt investors but for verklempt investors. **CL**

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