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Legal Economics and the Canadian Accredited Investor Standard: Efficiency as a Proxy for Change

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Abstract

This paper takes a legal-economic approach in assessing the current accredited investor standard that exists as part of Canada's securities laws. An accredited investor is often characterized as an individual that, due to his or her wealth, may participate in certain investment opportunities that would otherwise not be available. Canada's National Instrument 45-106 views accredited investors as those with a unique ability to understand financial markets, and due to this level of understanding, the typical disclosure protections afforded to the public—mainly, the prospectus—are not necessary to these individuals.

A legal-economic approach to the accredited investor standard looks at the system as constant balance between the benefits enjoyed by those in a position to benefit most from the law as constructed, versus those that are harmed by it. The efficient construction of a law is one that benefits everyone and harms no one. While this is entirely unrealistic to achieve in contemporary society, the goal of any regime should be to come as close to realizing the efficient system as possible—greatest benefits to least amount of harms.

This analysis begins by examining the history of the law and its underlying purpose in order to theorize a perfectly efficient 'ideal system'. How does Canada's system compare? The analysis takes issue with the current structure of the law, noting that the benefits-to-harms ratio may not be as efficient as is feasible. A better regulatory approach would consider placing less emphasis on wealth as the sole proxy for accreditation. The analysis ends with a list of proposed amendments aimed at increasing the benefits of the system, while decreasing harms as a push toward a more efficient Canadian securities law regime.

Keywords: Securities law; legal economics; economic efficiency; accredited investor; National Instrument 45-106; *Securities Act.*

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Introduction to a Complex Issue of Law

Ontario's securities regulator, the Ontario Securities Commission (OSC) was formed in 1932. From the beginning, the stated goals of the OSC were and have continued to be based on: (1) the promotion of public confidence in Ontario's markets; (2) the prevention of fraudulent practices; (3) the creation of a fair and efficient capital market; and (4) the reduction of systemic risk of potential market failures.[1] As part of achieving this mandate, section 53(1) of the *Securities Act*[2] articulates a general rule that [*emphasis added*]:

> No person or company shall trade in a security on his, her or its own account or on behalf of any other person or company if the trade would be a distribution of the security, *unless a preliminary prospectus and a prospectus have been filed* and receipts have been issued for them by the Director.[3]

The prospectus is a disclosure document that describes and provides great detail about an investment offering to the public.[4] Assuming the offering company is not already a reporting issuer (a corporation that has issued securities to the public)[5] in a Canadian jurisdiction, a company will be required to file a long-form prospectus to make public offerings. This type of prospectus includes information such as: (1) a brief summary of the company's financial background and financial information; (2) the name of the company; (3) the number of shares; (4) types of securities being offered; (5) name of the underwriting bank or company; and, (6) the offering price.[6] The idea is that the prospectus requirement aids in Ontario's regulation of the securities industry by requiring "full, true and plain

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[1] Ontario Securities Commission, "About us", online: < https://www.osc.ca/en/about-us>.
[2] RSO 1990, c S5 (*Securities Act*).
[3] *Ibid* at s 53(1).
[4] Chris Murphy, "Prospectus" (29 April 2021), *Investopedia*, online: <https://www.investopedia.com/terms/p/prospectus.asp>.
[5] *Securities Act*, *supra* note 2 at s 1(1), "issuer".
[6] National Instrument 41-101 *General Prospectus Requirements*, "Requirements for Filing a Long Form Prospectus" at Part 9.

disclosure of all material facts relating to the [securities] and shall comply with the requirements of Ontario securities law."[7] As can be imagined, the financial resources associated with making full and plain disclosures of an entire company can be great; the financial cost of the process can be upwards of $50,000[8] and can take anywhere from six to nine months, if managed properly.[9]

South of the border, the United States' Securities Exchange Commission (SEC) enacted its own legislation aimed at the regulation of its securities markets, the *Securities Act* of 1933[10]. Similar to the Canadian approach to securities regulation, registration in the US can be seen as a primary tool in achieving the SEC's legislative purposes: the requirement that investors receive financial and other significant information concerning securities being offered for public sale; and, to prohibit deceit, misrepresentations and other fraud in the sale of securities. It is for this reason that the US *Securities Act* has often been referred to as the "truth in securities" law.[11]

While the US *Securities Act* was originally directed at the prevention of fraudulent securities sales, at the same time, Congress understood that there was no practical need for registration where certain criteria were met.[12] This notion spurred the creation of what is known to be the private markets, or private placement offerings. Under US securities laws,

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[7] *Securities Act*, *supra* note 2 at s 56(1).
[8] All currency figures are represented in Canadian Dollars (CAD).
[9] Joel Arberman, "Going Public: How Long Does it Take?", *Streetdirectory* (blog), online: <https://www.streetdirectory.com/travel_guide/18694/corporate_matters/going_public_how_long_does_it_take.html#:~:text=It%20can%20last%20between%20two,is%20coordinated%20and%20managed%20properly.>.
[10] 15 USC § 77a et seq.
[11] U.S. Securities and Exchange Commission, "The Laws That Govern the Securities Industry", *Investor.gov*, online: <https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry#:~:text=Often%20referred%20to%20as%20the,in%20the%20sale%20of%20securities.>.
[12] Felicia Smith, "Madoff Ponzi Scheme Exposes "The Myth of the Sophisticated Investor"" (2010) 40:2 U Balt L Rev 3 (Lexis) at 218.

the investors to which private offerings are directed are exclusively to those deemed to be "sophisticated"[13] due to their financial resources and 'expertise' in assessing market risk. For this reason, according to policymakers, it is not necessary to protect this class of investors under the prospectus regime. Instead, sophisticated investors are considered to have the "… [financial and experiential] wherewithal to 'fend for themselves'[14]."[15]

Created from the American idea of the sophisticated investor and a private placement market, Canadian National Instrument 45-106[16] was drafted soon after to recognize a specific set of criteria that serve as exemptions to the general prospectus requirement. Part 2 of NI 45-106 lists Divisions one through five, each outlining instances in which prospectus requirements could be waived. This paper focuses exclusively on Division 1: Capital Raising Exemptions. More specifically, this paper examines the prospectus exemption that recognizes a set of individuals with whom the Government does not offer the ordinary protections as with public market investors: accredited investors (AIs).[17]

The AI exemption allows companies to raise capital without the financial burden of doing so through the public markets (i.e., prospectus requirements). The exemption was created as a bright-line, objective test that identified classes of individuals that the law would not need to protect. The exact details and official definition of an AI and who may qualify as one are found in section 1.1 of NI 45-106. While there are over 20 situations in which a person or corporation may qualify as an AI, this paper focuses on individual

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[13] Wallis K Finger, "Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition under the 1933 Act" (2009) 86 Wash UL Rev 733 (Lexis).
[14] *Smith*, *supra* note 12.
[15] *SEC v Ralston Purina Co*, 346 US 119 (1953) at 125-27 ("*Ralston*").
[16] National Instrument 45-106 *Prospectus Exemptions* ("NI 45-106"), online: <https://www.bcsc.bc.ca/-/media/PWS/New-Resources/Securities-Law/Instruments-and-Policies/Policy-4/45106-NI-March-11-2021.pdf>.
[17] *Ibid* at Part 2, Division 1, 2.3 "Accredited investor".

investors (an individual person or an individual person plus a spouse) rather than institutional investors (investment funds, municipalities, trusts). With respect to an individual AI's required criteria, the relevant definitions of the exemption include any individual or individuals that fall within one or any of the following classes:

> "accredited investor" means
> …
> (j) an individual who, either alone or with a spouse, beneficially owns financial assets having an aggregate realizable value that, before taxes but net of any related liabilities, exceeds $1,000,000,[18]
> (k) an individual whose net income before taxes exceeded $200,000 in each of the 2 most recent calendar years or whose net incomes before taxes combined with that of a spouse exceeded $300,000 in each of the 2 most recent calendar years…,[19]
> (l) an individual who, either alone or with a spouse, has net assets of at least $5,000,000…[20]

In the 1980s, when the AI exemption was first established in Canadian securities law, the stated purpose of the law was twofold: (1) to promote a more cost-effective method to raise capital; and (2) to protect investors that were unable to sustain losses resulting from the laxed disclosure requirements of the private markets. Scholars and experts as part of the securities law community have near universally expressed disappointment with the law as constructed.

Although the system may have achieved those policy goals when it was first introduced, a lack of continual or even partial updates to the law since its creation has resulted in its economic inefficiency. Contrary to the living tree doctrine—the idea that the law continually evolves based on contextual factors such as timing and perspective—that Canadian law-making is largely based, the criteria for the AI exemption was scripted in the

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[18] *Ibid* at s 1.1, "accredited investor" (j).
[19] *Ibid* at (k).
[20] *Ibid* at (l).

1980s and has since been shelved. This illustrates the central thesis with which this paper is based: that the AI exemption as constructed is economically inefficient. In other words, this paper proposes that the law should be revised, which is consistent with the majority opinion; however, its conclusion is drawn based on a legal-economic approach.

Part of reinforcing a largely held opinion about a particular law is establishing exactly what that opinion is. To establish that the law should be revised based on a legal-economic analysis rather than the standard approach, this paper will first be required to recognize the standard approaches in getting to that conclusion.

Part I of this paper will begin with a summary of standard opinions and literature from experts in the field. This portion of the analysis is imperative in recognizing a universally held idea that the law has, in fact, become inherently flawed. More importantly, this portion of the analysis forms the basis for the paper's originality, which is to use a legal-economic approach in getting to similar conclusions as experts in the field.

Theoretically, a legal-economic analysis should yield the same conclusion, based on an argument of economic efficiency. Part II of the analysis explores this idea. What is a legal-economic analysis? What does it mean to say that a law is or is not economically efficient? According to the legal economist, these questions are imperative in understanding whether a law is adequate in achieving its overall purpose.

Part III of this analysis will build from the legal-economic foundations of Part II as a way of theorizing what a perfectly efficient system might look like. Notwithstanding any obstructions, hurdles or conflicts in how to actually realize the perfectly ideal/efficient system, what might this system look like?

Only after one is able to understand and appreciate what this theoretical system might look like is one able to judge how Canada compares. Doing so requires an assessment of the Canadian AI standard. From a legal-economic perspective, there is a need to highlight the current system's winners and losers. Who benefits from the current regime? Who is harmed by the current regime? This is discussed in Part IV.

Determining whether a system is efficient requires one to compare the benefits versus the harms of that system. The comparison comes from a simple weighing of the benefits and harms of individuals as part of this system. If the winners benefit more than the losers are harmed, then, by legal-economic standards, the system may be considered efficient. If the losers of the current system are harmed more than the winners are benefited, then a reform may be in order. A similar line of reasoning forms when, though the system's benefits may yet outweigh the harms, there is still room to narrow the gap between winners and losers. If, therefore, the hypothetical ratio between winners' benefits relative to losers' harms can be positively adjusted, then a legal-economic argument exists for the purpose of adjusting the system. This is explored under Part V.

If a system is found to be economically inefficient, logically, the next step in an analysis would be to determine whether there is a realistic opportunity to improve efficiency. What sort of changes to the law would have the effect of increasing benefits to the winners, while decreasing the harms to the losers? Any change of the law under the legal-economic approach must demonstrate that doing so would increase efficiency. Part VI proposes several alternatives upon which to execute a positive adjustment to the law for the purpose of increasing economic efficiency.

From this analysis, I must admit that there is no ideal or perfectly efficient system. However, the system that yields the most efficient results, or whichever system generates the most benefit to the winners relative to the harms done to its losers, should prevail. While this analysis proposes that the law is inefficient, it should not be construed as an attack on the AI exemption in its totality. Rather, this paper recognizes the successes of the private market exemptions and suggests improvements to it as a way of benefiting individuals and society as a whole.

Part I. Existing Literature on the Accredited Investor Exemption

The exemption for private offerings to those deemed to be "accredited investors" has established itself as the most widely used exemption for private offerings and has become a major topic of commentary within the securities law realm.[21] Borrowed from the American "accredited investor" proscribed in Rule 501(a) of Regulation D under the Securities Act (SEC),[22] it makes sense that much of the literature surrounding the exemption has come from American authors. Of this commentary, rarely is it the case that the author chooses to endorse the current structure of the AI standard.

Scholars have typically highlighted two primary issues with the law. Firstly, the law is outdated based on the fact that the financial metrics that classify AIs from non-AIs have not been adjusted for inflation since it was scripted back in 1982.[23] For reference, the inflation rate in Canada between 1980 and 2020 was roughly 199%, meaning $100 in 1980 would be the equivalent of $299 in 2020.[24] And while Canadians have become wealthier over that time, the figures that divide AIs from non-AIs have remained 100% the same, thereby including a wider range of individuals within the definition of AIs than was once intended. The second point of contention, according to much of the securities law field, is that the law is designed such that only those with a certain level of financial wealth are able to participate in the private markets. This paper focuses primarily on this idea and the efficiency in which it outputs.

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[21] Thomas M Selman, "Protecting Retail Investors: A New Exemption for Private Securities Offerings" (2020) Va L & Bus Rev 41 (Lexis) at 3.
[22] Jeff Thomas, "Redefining Accredited Investor: That's One Small Step for the SEC, One Giant Leap for Our Economy" (2020) 9 Mich Bus & Entrepreneurial L Rev 175 (Lexis) at 4.
[23] *Ibid* at 13.
[24] Bank of Canada, "Inflation Calculator", online: <https://www.bankofcanada.ca/rates/related/inflation-calculator/>.

In a very abstract sense, the practice of allowing anyone with a certain level of financial means to participate in the private markets is comparable to inviting a newcomer to participate in a game without a full appreciation nor understanding of the rules. Consider this: would it be appropriate for an individual with no knowledge of how to play poker to participate in a high stake's poker tournament, solely based on the fact that he or she has money to play with? Would it be appropriate for any 7-foot tall individual to participate in the NBA solely based on his height? Would it be appropriate for a chihuahua to participate on a dog sledding team based solely on the fact that it is a dog? All of these examples, especially the last, seem extreme in a sense. However, in the abstract, these examples are aimed at highlighting a synonymous flawed set of reasoning: because a person or animal has Trait X, he or she is eligible to participate in Class Y. Employing this reasoning, would it be appropriate for an individual with a certain level of money to participate in private capital markets solely based on the fact that he or she has the money to do so?

Experts and scholars in the field would perhaps agree with the proposition that the law is based on a flawed set of reasoning. These authors employ different methods for the purpose of justifying the similar conclusions: that the law ought to be changed. For instance, Christopher Zimmerman takes a more normative approach in asserting that the purpose of the law is and should be centered on the fight for investor protection and argues that the law has not been constructed (nor enforced) adequately to do so.[25] Syed Haq looks to behavioural economics as a basis for claiming that the rules do not adequately protect investor interests.[26] Wallis Finger chooses to describe each of the most popular revisionary

[25] Christopher R Zimmerman, "Accredited Investors: A Need for Increased Protection in Private Offerings" (2019) 114 Nw UL Rev 507 (Lexis).
[26] Syed Haq, "Revisiting the Accredited Investor Standard" (2016) 5:1 Mich Bus & Entrep L Rev 59.

alternatives to the current AI standard and highlight their respective shortcomings. This serves as a basis for proposing a newer, more refreshing take on the AI exemption.[27] Felicia Smith looks to real world applications of the flawed nature of the AI exemption, which focuses much on the Madoff Ponzi scheme to highlight a need to make the AI exemption more exclusive.[28] Jeff Thomas contends that the AI standard is actually too limited. He notes that entrepreneurs have been and remain to be the driving force of economic upswing. Converting non-AIs into AIs by broadening the definition of the AI exemption would enable more capital to flow within the private markets. Peter Morris, opposite to many, takes a very extremist approach. He contends that the entire market ought to be reconstructed. Perhaps the private markets are inherently flawed and ought not exist.

These authors represent a cohort of individuals that believe in the law's inadequacy or mischaracterization of those that are "sophisticated". Employing each of their own unique methodologies, these authors believe in revising the AI exemption to provide a check on those that are able to invest via this exemption through means supplementary to financial wealth. Theoretically, a legal-economic analysis may yield a similar conclusion: that a revision is necessary for the betterment of society. This paper, however, expresses that conclusion by examining legal-economic factors. So, how does a legal-economic based approach analyze Canada's AI standard?

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[27] *Finger, supra* note 13.
[28] *Smith, supra* note 12.

Part II. Legal Economics: A Briefing

Any society, however primitive or developed, will have some form of legal structure. In a most basic sense, even a 'society' of 10 individuals will have rules. Assuming these 10 individuals intend on conducting themselves democratically, I will assume these rules will be based on some kind of fairness and utilitarianism. I recognize that this assumption is based on Western world societal underpinnings, and that a group of 10 individuals with Eastern world upbringings may develop completely different rules; however, generally speaking, societies, whether 10 people or 10 million people, will develop a set of rules that orient behaviour in certain ways.

The legal-economic perspective for developing these rules can be described using a society of 10 people as a metaphor for a society including any number of individuals. The analysis considers what is most *efficient* as a guideline for establishing the most appropriate set of rules. As mentioned, a society of 10 individuals will likely look to utilitarianism and equality as motivation for its legal framework: what is most fair and what is best for the greatest number of individuals within this society? The legal-economic analysis takes and builds from this idea by considering what is best for the greatest number of individuals, but factors all social and economic outcomes into the equation. With respect to social and economic considerations, what is best for the greatest number of individuals *relative* to the harms done to certain individuals as part of this system?

Theoretically, the design of any legal system can be expressed as a ratio between the benefits a set of laws may bring to some on one side against the harms that same set of laws may bring to those on the opposite side. The legal-economic analysis considers the ratio of 'benefits-to-harms' of a particular set of laws as a benchmark for achieving the best legal system to maximize societal benefits—this is what is called *economic efficiency*. Legal economics concerns itself with the goal of maximizing efficiency. In order to maximize efficiency, it is first necessary to gain a full understanding of what efficiency means within the context of Canadian securities law.

There are many different iterations of efficiency. It is my understanding that a society that is purely efficient is one that rids itself completely of any waste or improper allocation of resources. Though it may be possible, however unlikely, for a society of 10 individuals to allocate its resources such that there is no waste, the reality of contemporary societies is that this idea is purely theoretical—it simply serves as inspiration. Where the *efficient* system rids itself completely of any excess waste or resources, practically speaking, all society can hope to do is to allocate resources in a way that limits waste as much as possible in an effort to continually inch toward the perfectly efficient system. Essentially, the efficient state considers the benefits and the harms of a regime and weighs them relative to each other. The aim of legal economic scholarship, therefore, is the improvement of efficiency, otherwise considered the improvement of the weight of benefits afforded to society relative to the costs of a regime to society.

To simplify this idea, I call upon an analogy I once used in a paper I wrote, *Gambling on Single Event Sports Law*[29]. I analogized the idea of achieving a perfectly efficient system with a simple game of chess.[30] In chess, each player will make a move as an effort to improve one's position with the goal of eventually winning the game. In theory, from a legal-economic perspective, society's goal should be similar. Every move toward the end

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[29] Jeremy White, *Gambling on Single Event Sports Law: Criminal Code Section 207(4)(B) Should Be Amended to Legalize Single Event Sports Gambling: An Economic Assessment of the Law* (2020) [unpublished, archived at Western University Faculty of Law].
[30] *Ibid* at 4.

goal of being perfectly efficient, where the benefits-to-harms ratio improves and waste is limited completely, represents a policy or law that ultimately improves society as a whole. If a law can be structured such that the weight of its benefits outweighs the weight of its harms, then the legal economist would encourage this option as the *efficient* one. If the weight of its harms outweighs the weight of its benefits, then the legal economist would discourage this option as the *inefficient* one. The goal of policymaking, therefore, should be to maximize this ratio, or increase the weight of the benefits relative to its harms.[31] Simply stated, the goal of securities law within the context of the Canadian accredited investor exemption should be to move toward the efficient state, where the weight of the law's benefits is increased relative to the weight of its harms.

[31] Matt Grossman, "Efficiency" in *Encyclopedia Britannica*, online: <https://www.britannica.com/topic/efficiency-economics-and-organizational-analysis#ref1181051>.

Part III. What Might the Perfectly Efficient AI Exemption Standard Look Like?

From a purely macroeconomic perspective, to say that a system is "efficient" is to mean that a maximum level of performance is reached that limits its inputs relative to its eventual output.[32] In general terms, something is efficient if nothing is wasted and all processes are optimized.[33] Much of the motor vehicle industry, for instance, understands the value in zero waste facilities as a method of limiting costs and landfill, while increasing bottom line figures.[34] Under the same umbrella lies the idea of maximizing or optimizing the economic state of people living within society or societies—economic efficiency.[35]

Legal economics considers economic efficiency in terms of optimizing people's livelihood within society as a direct consequence of the laws in place that support that society. So, theoretically, a legally economic efficient system would be designed such that the laws governing that system are able to maximize the benefits of all within it relative to its harms. The efficient legal system, therefore, is one balances the costs and the benefits, the winners and the losers, the weight of the effects on each party involved, and the overall impact it will have on individuals and on society itself. The efficient system is a theoretical concept in which nobody is harmed, and everybody benefits. While this system may be impossible to realize, it is nonetheless imperative that policymakers continually act to come as close to it as possible, such that the benefits of the winners greatly outweigh the minimal harms to the losers. So, what would an ideal system look like within the context of securities law, with a focus on Canada's AI exemption?

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[32] Caroline Banton, "Efficiency Definition" (15 November 2020), *Investopedia*, online: <https://www.investopedia.com/terms/e/efficiency.asp>.
[33] *Ibid.*
[34] For example, Toyota "Zero Waste" Program recycles more than 90% of its materials. See, Toyota Canada, "Toyota and the Environment", online: <https://www.toyota.ca/toyota/en/about/environment>.
[35] *Banton*, *supra* note 32.

To paint a picture of what the ideal system might look like, it is first necessary to discuss the general theories of Canadian securities law. If discussing what the perfect, ideal, or efficient system should look like, there needs to be some discussion on exactly what area of law that this paper is attempting to perfect. With that said, this chapter is devoted to answering four particular and important questions: (1) why do we have securities laws? (2) why does the prospectus requirement exist? (3) why do we have exemptions? and (4) why do we have the AI exemption, specifically? Answers to these questions will help shape exactly what the most efficient system could look like.

1. Why do we have securities laws?

The often advertised answer for this question is that securities laws "protect investors; maintain fair and efficient markets; and facilitate capital formation."[36] While I have no doubt that this may be true, the answer for "why do we have securities laws?" is much deeper. Why are there laws in place that prevent individuals from purchasing any kind of security? Why are there laws in place that prevent insiders from trading on information known only to those with undisclosed information?[37] Why are there laws in place that require offering companies to disclose all relevant information about itself in the form of a prospectus?[38]

The answers to these questions all relate to the idea of influencing behaviour in a certain way. In my view, this idea can be broken down in simplest terms by looking at the ever-classic Locke v Hobbes debate on mankind in its natural state. Both philosophers understood that humans in the state of nature yearn for some level of protection of each

[36] *Securities Act*, *supra* note 2 at s 1.1 "Purposes of Act". See also, Ontario Securities Commission, "Role of the OSC" <https://www.osc.ca/en/about-us/role-osc>.
[37] *Securities Act*, *supra* note 2 at ss 76(1) and 76(2).
[38] *Ibid* at s 53(1).

one's own self-interest. According to Locke, mankind's reason for parting with the freedoms of life without government is due to our belief that, without it, our natural rights of life, liberty and property could never be guaranteed.[39] Hobbes' view, on the other hand, is that humans in a state of nature is a constant war of every man against every man,[40] each one having a "… relentless desire of power after power, that ceaseth only in death."[41] For the purpose of uncovering a theory on why we have securities laws, the distinction between the two viewpoints is irrelevant. The relevancy of their views is that they offer an alibi for having rules to follow. Ultimately, it is related to the idea of protecting the individual from both himself and from others. Within the context of securities laws, this idea presents itself in the form of certain limitations on one's ability to invest freely on the one hand. On the other, a logical justification for allowing corporations to make offerings in a cost-effective way that ultimately does not hold them accountable for the information they choose to share (or lack thereof) within the private markets.

2. Why does the prospectus requirement exist?

As is the case with almost all jurisdictions in Canada, Ontario legislation creates a "closed system"[42] in which all sales that are part of a distribution will require a prospectus to be filed unless a specific exemption exists.[43] Assuming that no exemptions to the general requirement exist, an offering company will be legally obliged to provide "… full, true,

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[39] John Locke, *Second Treatise* in David Wootton, *Modern Political Thought: Readings from Machiavelli to Nietzsche*, 2nd ed (Indianapolis: Hacket, 2008) at 320 (*Wootton*). Locke states, "[T]he great and chief end, therefore, of men's uniting into commonwealths, and putting themselves under government, is the preservation of their property."
[40] Thomas Hobbes, *Leviathan*, in *Wootton* at 159.
[41] *Ibid* at 149.
[42] Richard Lachcik, "Caandian Securities Law" 20 Denv J Intl L & Pol'y 357 (1992) at 376.
[43] *Ibid.* See also, *Securities Act*, *supra* note 2 at s 53(1).

and plain disclosure of all material facts relating to the security proposed to be issued."[44]

This includes items such as,

- financial statements over the last 5 years;
- reports;
- information with respect to the offering price;
- number of shares being offered;
- types of securities being offered;
- name(s) of the company's principals;
- underwriter information;
- material acquisitions an dispositions of shares over the last 2 years;
- pending legal proceedings;
- information on any shares held in escrow;
- any potential conflicts of interest of management or shareholders with more than 10% equity over the last three years;
- any other material facts not covered by the Securities Act.[45]

The general purpose of the prospectus requirement is easy to understand. The Government, through the Securities Commission, requires that offering companies disclose all material facts about itself for the purpose of protecting investors. Metaphorically, the prospectus requirement can be thought of as going through airport security. Before boarding the plane, one must go through security checkpoints designed to ensure the protection of the entire flight. Similarly, the prospectus requirement is designed to ensure that offering corporations are legitimate before being made public. Once public, company information as part of the prospectus is available to anyone for any purpose. The prospectus, in its simplest sense, serves a means to protect those wishing to take part in the public markets.

From a typical investor's point of view, without the prospectus requirement, there would be virtually no way of knowing that company information is relatively accurate, nor would there be any way of knowing anything about a company apart from hearsay

[44] *Securities Act*, *supra* note 2 at s 56(1).
[45] *Securities Act*, *supra* note 2 at Part XV.

information. And as is likely obvious, it would be imprudent to invest in a company that one knows virtually nothing about. Even if one’s only ‘research’ into an offering company is a scroll through Yahoo! Finance[46] or similar news outlets, the information with which these outlets are basing projections and stories is directly tied to their respective abilities to gather public information via the prospectus requirement. It is therefore necessary for the purpose of protecting investors.

3. If the OSC generally requires filing of a prospectus, why do we have exemptions?

Arguably the greatest method of protection against the potential evils of unregulated markets would be to wholly prevent the public from interacting with market altogether. On the contrary and in reality, regulators not only enable the capital markets to exist, but offer certain individuals and companies the opportunity to bypass the prospectus requirement. So, to answer the question directly above, exemptions exist because the protection of investors and the general public is not sole reason for which the OSC and its accompanying laws, including the prospectus requirement, exists.

It can be inferred that the rationale behind prospectus exemptions is twofold. Firstly, exemptions offer certain individuals the opportunity to capitalize on certain investments that would otherwise not be available to the public. A very relevant example of exemptions in practice is the fact that many of the Canadian banks refuse to allow general investors the choice to invest in many crypto-based exchange traded funds unless one is an accredited investor. This is likely due to these assets being considered much more volatile, while offering much less information relevant in making informed investment decisions.

[46] Yahoo! Finance provides financial news, data and commentary. Among other offerings, viewers can find stock quotes, press releases and financial reports of almost any publicly traded company.

Secondly, exemptions exist for the purpose of enabling companies to raise capital without the financial burden of filing a prospectus and its continuing disclosure requirements. Again, if the idea of having laws in the first place was unconditionally aimed at the protection of investors, exemptions would not logically be made available. The existence of exemptions necessarily implies that the law considers factors such as capital formation and economic growth as a basis for having such laws in place.

In visualizing what an ideal or perfectly efficient system might look like, there must be some consideration toward the idea that ensuring investor protection may not encapsulate the entire theory of securities laws. In fact, credence must be afforded to the idea that securities laws may be focused on raising capital and lowering the cost of doing so for corporations; perhaps even more paramount to the theory of securities laws being designed wholly to protect investors.

4. Why do we have the AI exemption, specifically?

Soon after the stock market crash of 1929, US Congress understood the need for more accurate stock pricing.[47] The stock market prior to the crash was flooded with booms and busts in a decade-long phase of volatility.[48] One of the primary drivers of such volatility was that investors would routinely treat the public markets as synonymous with mortgage transactions—investors would "finance" stock purchases, with stockbrokers acting as lenders. This structure enabled investors to buy, let's say, 100 shares of Company X, with only 20% of the price being out of pocket and the rest being financed by the stockbrokerage. Just as mortgagors prior to the 2008 crisis, the ease at which individuals could buy more stock than what they could actually afford drove prices upward. When

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[47] *Haq*, *supra* note 26 at 60.
[48] *Ibid.*

prices fell, investors could not repay their loans, which had a trickle effect across the entire US economy. The US Government responded to the crash with a new regulatory legislation—the Securities Act of 1933.[49]

Congress allowed exemptions from registration and prospectus requirements in certain areas where "there was no practical need for its application or where the public benefits are too remote."[50] In a series of landmark US cases such as *Doran v Petroleum Management Corp*[51] and *Ralston*[52], the AI exemption was defined to include only those that were financially sophisticated and equipped enough to participate in private markets based on their knowledge and experience in evaluating risk.[53] It is thought that these individuals are able to adequately assess market risk, which warrants their ability to invest in securities with less regulatory hurdles.

As mentioned, Canada near copied the US AI standard at the time. Under NI 45-106, AIs may participate in investment opportunities not available to other investors, such as in fast-growing tech companies not yet listed on public markets and certain hedge funds and venture capital funds.[54] I suppose the theory behind the existence of this exemption is that Government does not necessarily have to protect individuals with financial wealth as much as middle class and lower individuals when it comes to securities investments. Hypothetically, the law recognizes that there are certain individuals that are financially and mentally equipped so as to not be misled by volatile offerings—these individuals are better

[49] *Ibid* at 61.
[50] *Ibid* at 61. See also, HR Rep No 73-85 at 5 (1933).
[51] 576 F2nd 91 (5th Cir 1978).
[52] *Supra* note 15.
[53] *Haq*, *supra* note 26 at 61.
[54] Andrew N Vollmer, "Abandon the Concept of Accredited Investors in Private Securities Offerings" (2020) Mercatus Center at George Mason University Working Paper at 3.

equipped to understand the risks and benefits to certain investment opportunities.[55] From this, it can be inferred that the law would not want to hamper this class of individuals from capitalizing on opportunities in the market—they simply do not need a paternalist regulatory body to save them from potentially risky investments—this is one theory.

The other theory for the existence of the AI exemption is that, again, perhaps the Government is not as concerned with investor protection as it is with the goal of reducing capital formation constraints. In 2019, the SEC estimated that roughly $2.7 trillion was raised through the exempt markets, whereas only $1.2 was raised under registered (public) offerings.[56] (Not so) arguably the reason companies prefer the exempt markets for raising capital is that they come with less burdensome rules and regulations for gaining capital. So, from a company's perspective, the AI exemption exists as a method of raising cheaper capital. From the investor's perspective, the AI exemption presents itself as an opportunity to perhaps see greater returns relative to the public markets—these investments may be higher risk, but come with higher reward.[57]

Based on the information above, what might the ideal system look like?

From the investor's perspective, the ideal system is one in which investors are completely protected from fraudulent actors. Perhaps an ideal system is one in which the public can invest in securities without much worry or real possibility of loss. It is one in which offerings are adequately priced, and information on such corporations is free-flowing and lacking any sort of asymmetry. The ideal system also enables any person or

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[55] *Haq*, *supra* note 26 at 60.
[56] Securities and Exchange Commission, "Amending the "Accredited Investor" Definition", Release Nos. 33–10734; 34–87784 (Dec. 18, 2019) [85 FR 2574 (Jan. 15, 2020)] ("Proposing Release"), online: <https://www.sec.gov/rules/final/2020/33-10824.pdf>.
[57] *Ibid.*

corporation, notwithstanding knowledge, capital, sophistication or risk tolerance, to invest without any regulatory hurdles aimed to prevent one from doing so.

From a more holistic or societal perspective, the ideal system is one in which the cost of capital formation is nil or nearly irrelevant. The ideal system is one where companies willingly offer material information to the general public in a comprehensive manner, while keeping costs of doing so at a minimum. The ideal system encourages investment in any company, with confidence that the price of each unit or percentage of equity in the company adequately reflects its true value. The ideal system encourages knowledgeable decision making, based on relevant information of a company's socioeconomic position, which can be freely accessed (again) in a comprehensive form.

Clearly, there are far too many moving parts and considerations. An ideal and efficient system generates far too much conflict. For instance, how can an efficient system be one that completely protects investor interests while allowing them to freely invest in any company they so desire? How would a system be in a position to guarantee that the cost of a company's full disclosure is nearly zero, while ensuring that the disclosure is truly adequate?[58] The answers are not clear. However, the law must be able to reach as close to the efficient state as possible, while attempting to mitigate such inconsistencies as best it can. This relates back to the idea that the efficient system can never truly be realized, yet it should be the goal of any regulatory agency, government or administrative body to come as close to it as possible.

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[58] For instance, "full and plain disclosure" often requires a full audit of the company's financials, which are estimated to cost greater than $10,000. See, Cameron Keng, "How Much Do Financial Audits Cost? At Least $10,000 Dollars, *Forbes*, online: <https://www.forbes.com/sites/cameronkeng/2018/05/31/how-much-do-financial-audits-cost-at-least-10000-dollars/?sh=79768d094262>.

Part IV. Overview of the Canadian AI Exemption Standard – Benefits and Harms

When considering the economic efficiency of any regime, one method of doing so examines the benefits and harms borne from the rules, regulations and laws that dictate everyday life for those moving within and as part of that regime. The goal of this section is to examine the Canadian AI exemption standard as it relates to people living by its prescribed laws. Logically, people living within a society should feel comfortable with the idea that laws are in place for the sake of benefiting rather than harming each member. This portion of the analysis, therefore, looks at the benefits and harms stemming from the AI exemption in Canada as a way to test whether this idea holds true in Canadian society. Only after examining the benefits and harms of the current regime is one able to logically extrapolate its state or level of efficiency. Determining a regime's economic efficiency, as alluded to earlier, requires one to identify the benefits and harms of a system and allocate some kind of weight to each side. If the weight of the winners is less than the weight of the losers, then there is a basic legal-economic argument supporting a change in the law.

1. Benefits of the Current Model

This analysis examines the benefits stemming from the Canadian AI exemption regime by looking at two tiers of each category. The first tier looks at the individual him or herself, which considers how each person is benefitted by the law as constructed. The second looks at society as a whole, which considers how everyone as part of the entire system benefits from society's legal landscape and structure.

Benefits to the individual as a product of the law as constructed are threefold. Firstly, the way in which the law is constructed enables investors to allocate one's capital more freely within the private markets. Secondly, the law creates cost efficiencies by lowering the cost of raising capital through the exemptions. Thirdly, the law is aimed at the protection of the individual him or herself, and is designed in a way that mitigates the potential for what may be seen as poor investments by those without the capital or knowledge to support the risk.

With respect to societal benefits, an examination of the law as constructed requires a more macro approach; the analysis must look at how the law as presently constructed impacts and effects Canadian society as whole. For society, the primary benefit of the law as constructed is related to the idea of a paternalist state—that society as a whole will benefit from the State's prevention of bad investment decisions by those that really should not be investing in that way. But is this something that we, as Canadians, should want?

Freedom of Investment – Individual Benefit

An individual's benefit of being labeled an accredited investor is simple, really. If any weight is given to the idea that part of government's existence ultimately produces limitations on individual freedoms, and non-AIs are entitled to participate solely within the public markets, then any exemption that serves to broaden one's freedom to invest in markets other than (but still including) the public markets must be considered beneficial to the individual. Allow me to rephrase for simplicity's sake: if one is to believe that freedom of choice is beneficial, then the choice to invest in several alternative domains (not just one, public market domain), must necessarily be considered beneficial to the individual who serves to gain from that added set of freedoms.

Cost Efficiency of Raising Capital – Individual/Corporate Benefit

At the root of all general private or public offerings lies a need for the offering corporation to raise capital, likely as an effort to realize its operational objectives.[59] For instance, contestants will approach the Shark Tank[60] in search of a deal for capital in exchange for the business' own securities. This kind of transaction happens every day, be it public or private. The difference between a company approaching the Sharks in search of a private transaction with AIs versus going public comes down to monetary considerations. Rather than simply offering equity in one's company to an AI, a public offering would mandate an entrepreneur to move through the prospectus requirements, the burdens of which have already been discussed. The exemptions, therefore, serve not only the AI him or herself—the exemptions are designed to enhance a corporation's ability to raise capital in a less costly manner.

This is not only recognized by scholars, but also by Government. For instance, in 1980, just as the world was entering into one of its worst economic recessions,[61] Congress and the SEC noticed the impact a lack of public spending prowess had on American commerce.[62] The law required that businesses register for a public offering and prepare the necessary disclosure documents in an effort to raise capital, all of which costing the business at least 6-months of time and the equivalent of $660,000 in today's currency.[63] Congress' response came in the form of loosening restrictions on private capital formation for small businesses by allowing issuers to sell up to $2 million of securities to an unlimited

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[59] *Zimmerman*, *supra* note 25 at 4.
[60] Shark Tank is a show on ABC Television in which contestants pitch a business idea to a panel of investors known as "Sharks" in hopes of striking an investment deal.
[61] M Ayhan Kose, Naotaka Sugawara and Marco E Terrones, "Global Recessions" (March 2020), *World Bank Group*, online: <https://documents1.worldbank.org/curated/en/185391583249079464/pdf/Global-Recessions.pdf>. The World Bank calls this period "The Global Recession of 1982".
[62] *Zimmerman*, *supra* note 25 at 7.
[63] *Ibid.*

number of AIs.[64] Moreover, the definition of the AI was broadened in this context to include those that were ready and able to purchase $100,000 of securities—one of the first mentions of wealth as a standard AI proxy.[65] These offerings do not come with the same disclosure requirements. In fact, the issuer and investor are, for the most part, free to negotiate and define adequate disclosure.[66] A survey conducted by former SEC general counsel Andrew Vollmer concluded that, in general, private transactions involving AIs included, at a minimum, certain due diligence on founders or corporate records, and the maximum amount of disclosure was a placement memorandum resembling a prospectus for a registered offer.[67]

A class that benefits from the AI exemption, therefore, is corporations that wish to save on cost and time with respect to capital formation. The fact that corporations and investors are free to 'choose' the level of disclosure necessary to complete a transaction rather than needing to spend exorbitant amounts to be allowed to make offerings is the true benefit of the regime. It is the flexibility that comes with the exemption that allows the corporation to save, and any cost and time savings must necessarily be considered a benefit to the class that is realizing such savings.

Protection Against Poor Investments – Individual Benefit

In theory, the subject line above makes sense. Those that are deemed not sophisticated enough to be trading more freely than just within the public market realm should not be embarking on these riskier investment paths. The beneficiaries of the law as constructed must therefore be considered those that cannot be classified as *accredited*,

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[64] *Ibid.*
[65] *Ibid.*
[66] *Vollmer*, *supra* note 54 at 16.
[67] *Ibid.*

sophisticated, or *knowledgeable* enough to partake in a market that is said to demand such qualities. It must also be understood to my readers that definitions of such terms are irrelevant for the purpose of determining beneficiaries in this context. That is, irrespective of whether the law chooses to recognize those with $1 or $1 billion of wealth accumulation as "sophisticated", or if the law were to recognize a high school drop-out or a CFA[68] as "sophisticated", anyone that falls below the "sophistication" threshold set by the law would be in a position to benefit from the law's denial of one's possibility of losing money. In theory, if one is not sophisticated enough to make sound and logical investment decisions, then he or she ought to be protected from the dangers of doing so. He or she would therefore benefit from the law's prevention or denial of poor investments being made by those that should not be investing in private offerings.

Protection Against Poor Investments – Societal Benefit

Imagine what might happen if the prospectus requirement did not exist. The commercial landscape would more than likely be flooded with actors attempting to take advantage of those most susceptible. Now, imagine what might happen if the exemptions did not exist. The commercial landscape might well serve to protect investors more than it does today; however, capital formation would be all the more difficult for entrepreneurs and smaller business, then monopolies would begin to form, and class barriers would likely grow even stronger. The system, with all its offering requirements and exemptions, attempts to find some form of middle ground between the two. There are those that are harmed and those that are benefited by the laws related to public and private investment,

[68] "Chartered Financial Analyst".

although one thing is clear: society as a whole stands to gain by virtue of the law's prevention of poor investments.

As stated, the law must be able to have some level of paternalist element so as to prevent fraud and abuse, although at times these measures ought not be present when attempting to bolster the growth of smaller and up-and-coming businesses. The way the law is set up is such that it protects investors from fraud and abuse, then allows exemptions to a specific class of people that, in theory, do not require these protections. All this is to mean that the law is constructed as a method of protecting those within society from destroying the system as a whole. Theoretically, if the laws did not adequately prevent poor investments based on the prospectus requirements and exemptions, enough poor investments might lead to a nationwide or perhaps global recession. What happens when the laws of a nation do not adequately prevent poor investment decisions? One example comes to mind: 2008. The system itself was to blame for its enabling of individuals to mortgage property when they arguably should not have been able to do so, sometimes without any down payment or any credible credit check. While this paper concerns itself with the securities market and not the mortgage market, in the abstract, the idea that the system must protect society as a whole is nonetheless properly grounded. Without the existence of the rules as constructed—that is, rules that prevent poor investment decision making on a nationwide scale—society, or at least the economic constructs as part of that society, collapses.

2. Harms of the Current Model

While the benefits of the system are duly noted, I serve to remind readers that a legal-economic analysis always considers the harms of the system as well. The first harm to consider is the harm done to individuals that are neglected by the law's AI criteria—those that do not qualify as AIs. It may very well be true that often times the law's characterization of "accredited investors" is wholly accurate; however, in reality, there are always certain individuals that arguably *should* qualify, yet do not—they lose as part of this system. A second harm as a result of the law's construction is generated in the potential for private market offerings more easily exposing a certain class of people—the elderly. These individuals have worked a lifetime for capital, thereby qualifying under the AI exemption criteria, yet may often be seen by predators as a class featuring poorer financial literacy.[69]

From a more holistic perspective, the harms of the system as constructed are far more complex. Firstly, the law as constructed begins by making an assumption about wealth as a proxy for financial literacy. Secondly, the law as constructed harms society in part due to its failure to accurately assess one's loss bearing ability. Using proxies such as gross income and net worth, for instance, does not necessarily imply that one is liquid enough to bear losses resulting from poor investment choices.

Limited Freedom of Investment – Individual Harm

Acknowledged earlier was the thought that the law as constructed produces a benefit to certain individuals that are granted more investment freedom—but what about those that do not qualify as AIs? Those refrained from taking advantage and participating within this limited market are harmed based on the idea that any law that prevents a certain activity in which people would want to partake in must be considered harmful or disadvantageous. If there is any merit to this idea, and there are at least some individuals that would want to

[69] *Haq*, *supra* note 26 at 73.

partake in the private markets, then the law as constructed must be considered disadvantageous to those individuals based on the limited and exhaustive AI criteria.

For those not able to invest in the private markets, to me, it takes one sentence to describe their position: *it takes money to make money*—in a sense, the system is paradoxical. The AI exemption is inherently discriminatory to those classified within the low-to-middle classes of wealth. The only way to make money in the private markets is to be granted access to this lucrative market to begin with; and, the only way to be granted access to this lucrative market is to have enough money in the first place. The system operates as if there is a pot of gold at the end of a rainbow, and the only way to get the gold is to prove to the little green leprechaun that you already have a pot of gold. The ones suffering the most harm, therefore, are those without the requisite amount of capital to participate within a market that has the potential to drastically increase one's capital. Hypothetically, even if someone were guaranteed to lose money in the private markets, if there is any legitimacy to the argument that people ought to be able to make their own decisions, then it must be harmful to prevent that person from making the decision to invest in the private markets based on his or her wealth level. The harm, therefore, is that the law does not respect the "liberty interests"[70] of investors.[71]

Potential Exposure of Elderlies – Individual Harm

Canada is getting older, as annual fertility numbers continue its decline since the 1970s and life expectancy continues to rise.[72] As of July 2020, 18% of Canadians were reported as being aged 65 or older, representing the largest population based on age in the

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[70] *Vollmer*, *supra* note 54 at 21.
[71] *Ibid.*
[72] Statistics Canada, "Population estimates on July 1st, by age and sex", online: <https://www150.statcan.gc.ca/n1/pub/91-215-x/91-215-x2020001-eng.htm>.

country, and that number continues and is projected to rise annually.[73] Now, why does this matter?

The issue to extrapolate here is not necessarily the volume of individuals aged 65 and older; rather, the issue has to do with the idea that these individuals are more likely to have accumulated the most wealth compared to any other population group of Canadians.[74] These individuals are therefore more likely to qualify as AIs based on the financial metrics listed under NI 45-106. The fact of the matter is, while there is credence to the idea that age equals wisdom,[75] elderly individuals rank lowest in terms of financial knowledge.[76] This may be a suitable explanation for the idea that financial scammers often target elderly classes.[77]

With respect to this paper, and the AI exemption as a whole, this information may infer that the law's wealth-based approach unnecessarily exposes elderlies to financial predators. These individuals have worked a lifetime for capital, thereby qualifying as AIs. The problem is that elderly individuals may qualify under the exemption but only because they worked their whole lives to get there. But-for the timing of it all, these individuals may not be knowledgeable enough to make the 'right' investment decisions. To me, if the goal of the law is to protect investors by reserving the private markets only to those with the financial wherewithal to succeed within them, why would the law put the least financially savvy individuals within the AI class? The harm of it all, therefore, is that the

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[73] *Ibid.*
[74] *Haq*, *supra* note 26 at 73.
[75] Annamaria Lusardi, "The Importance of Financial Literacy" (June 2009), *National Bureau of Economic Research*, online: <https://www.nber.org/reporter/2009number2/importance-financial-literacy>. In a 2004 study, elderly individuals ranked highest out of any age-based class of individuals in terms of self-assessed knowledge.
[76] *Ibid.*
[77] *Ibid.*

law is designed in a way that exposes the elderly class; a class that, generally, may not have the financial knowledge to successfully engage with a market that provides little investor protection.

Diverse Methods of Wealth Accumulation – Individual Harm

We have already established that the law uses wealth as a proxy for determining one's accreditation as part of the private markets. The system chooses to acknowledge one's financial literacy based on how much wealth one has accumulated or how much is earned annually. Interestingly, there is no reference or appreciation of the method upon which one earned it. Perhaps the stereotypical AI worked tirelessly, understood the market, bought low and sold high. In such cases, perhaps the law is right to recognize the stereotypical AI as a player in the market that has a true understanding of its workings, making him or her equipped to "fend"[78] for oneself.

In the abstract, what the law is doing is drawing an inference about the way in which people attain wealth. That because there are *some* individuals with much capital that also possess a certain high level of financial literacy; therefore, *all* individuals with much capital must also possess the same level of financial literacy. Now, of course, to truly believe this inference as logically sound would be a representation of a poor grasp on modern commercial reality. In reality, there may be no positive correlation at all between one's investment expertise and the investor's accumulated wealth.[79] For instance, one's wealth may be a simple function of circumstance—someone with no financial literacy whatsoever wins the lottery; an individual made millions without engaging with any public securities

[78] *Ralston*, *supra* note 15 at 125.
[79] So-Yeon Lee, "Why the "Accredited Investor" Standard Fails the Average Investor" (2012) 31 Rev Banking & Finance L, 987 at 991.

market; Paris Hilton inherited millions.[80] These examples showcase one's wealth independent of one's financial literacy.

The harm, therefore, flows directly to those that qualify as AIs but do not actually possess any semblance of risk-assessment skills needed to engage with the private markets. Similar to the reasoning forwarded earlier,[81] if a law is supposedly designed to protect people, it would be imprudent for that same law to expose certain individuals. Meaning, assuming there are certain individuals that qualify as AIs but do not possess the requisite financial expertise to succeed in the private markets, these individuals would be at risk of losing as a result of the law's lack of protection toward this class of people. Because an individual has a great amount of money does not necessarily imply that the same individual will not invest all of it unwisely. For instance, Bernie Madoff (Madoff) was sentenced to 150 years for his role in a multinational Ponzi scheme approximating $65 billion, a large number of which was invested and subsequently lost by AIs.[82] And for those individuals, there were and continue to be no laws in place that required Madoff to make adequate disclosure, nor to prevent such individuals from investing in the scheme in the first place.

Failure to Assess One's Loss Bearing Ability – Societal/Individual Harm

With reference to the specific wording of NI 45-106, an AI is defined as an individual whose net financial asset value exceeds $1 million; whose net income (either alone or with a spouse) exceeds $200 thousand in each of the past two years; or, whose net assets exceeds $5 million.[83] What is interesting about these metrics is that each one focuses exclusively

[80] *Finger*, *supra* note 13 at 733.
[81] See, "*Potential Exposure of Elderlies – Individual Harm*".
[82] *Smith*, *supra* note 12.
[83] NI 45-106 at section 1.1, "accredited investor".

on assets or income itself, without mention or consideration of the one's liquidity.[84] In basic accounting terms, one's financial value must always consider the difference between his or her total assets and liabilities. While the law does consider *net financial assets* as well as *net assets*, it is not able to identify how liquid those assets may be. An individual may have a net financial asset value that greatly exceeds the law's requirements; however, those assets may be classified as securities that would be difficult to liquidate immediately at market value. If all else fails, the danger of the law as constructed is that a failure of one's investment may necessitate one's selling of financial assets at less than market value due to the law's inadequacy in appreciating the liquidation of such assets.[85] For this reason, certain individuals with low asset-to-liability ratios may be at risk of significant losses based on one's respective capital structure and the ease at which such assets may be liquidated to offset liabilities.

Similarly, a metric that bases financial literacy on annual income does not consider any kind of expenses that might offset income numbers. On an income statement, for instance, the net income figure at the bottom will represent earned income after tax, depreciation, losses and expenses. The AI standard, contrarily, looks only at what the individual brings in as income before any such deductions to the bottom line. Based on the AI standard in place, situations may arise where an investor has very little income after debts and expenses to cover or absorb a loss from a potentially risky private market investment. For instance, recent graduates in fields such as law or finance will regularly qualify as AIs, although still be faced with paying off student debt.[86] Similarly, mortgagors

[84] *Haq*, *supra* note 26 at 72.
[85] *Ibid.*
[86] *Ibid.*

may qualify as AIs, although still be faced with paying off up to 80% of the balance of the mortgage. A failure in the system to measure or account for these situations presents a clear harm to those that invest in the private markets and eventually realize losses significant enough to exceed one's income. In these cases, it is arguably the fault of a system that attempts to correlate a high degree of financial literacy with increased income levels. The losers, those that are harmed by the system, can therefore be characterized as those that *should have had* the benefit of more stringent laws in place that would prevent (or at least account for) these types of situations from ever occurring.

Part V. Benefits vs Harms: Is the System Efficient?

Now that the primary benefits and harms of the current AI standard have been established, the analysis shifts toward assigning meaning to each one. The goal of employing a legal-economic approach to any given system is to gain an understanding of how exactly each benefit and harm impacts a person or persons living within that system. This is accomplished by assigning weight to each respective benefit and harm.

Before this analysis moves further, it is important to consider what is meant by the term, "weight" within the legal-economic context. As can be imagined, "weight" in this case is not meant to define or characterize an allocation of mass. Instead, "weight" can be defined as the ability of someone or *something*—in this case, the law—to influence decisions or actions of those living within a system.[87] In simplest terms, this portion of the analysis looks at each individual benefit and harm highlighted earlier and discusses the relative impact it may have on those within the system.

This exercise can be thought of as similar to a company's decision on the kind of waste disposal system it wants to employ. If a zero-waste and zero-emission system costs a company $100,000 to employ and another system costs $1,000 to remove the waste, albeit by dumping it into the ocean, a legal-economic analysis would have to consider the weight of each benefit and harm generated by either system. While it may benefit the company greatly by choosing the more wasteful option, the harm of dumping the waste into the ocean might drastically outweigh the company's monetary savings. On the other hand, if the company choosing the more expensive option, perhaps it is no longer able to profit and eventually forces mass lay-offs. Only by assigning a reasonable amount of weight to either

[87] *The Oxford English Dictionary*, 2nd ed, *sub verbo* "weight".

option's respective benefits and harms is one able to understand which option is, from a legal-economic perspective, the more efficient one. The point of this exercise, therefore, is to examine the contextual factors surrounding the AI standard in an effort to understand whether it is efficient. And again, this requires a weighing of the factors highlighted in the prior section of this paper.

1. The Winners – Benefits of the System: How Much Do They Weigh?

Freedom of Investment: large benefit

How much does the individual AI stand to gain or benefit as a result of being able to participate in the public markets? From a purely economic perspective, the answer is: a lot. The US Private Equity Index reported that, over a 20-year period ending in June 2020, the private equity industry produced average annual returns of approximately 10-11%.[88] Over that same period, the S&P 500 returned approximately 5-6% annually,[89] while the S&P/TSX Composite Index[90] averaged roughly 4-5%.[91]

From a more social or psychological perspective, the benefit of participating in a more exclusive market arguably carries its own weight to certain individuals. The private markets are abundant with up-and-coming startup companies in the hopes of acquiring the necessary capital to eventually scale upward. While the smart investor will conduct his or her own due diligence in the company, the fact remains that there is certainly no guarantee of success. In fact, failure rates for startup companies in the US have historically remained

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[88] Mark Jahn, "How Do Returns on Private Equity Compare to Other Investment Returns?" (5 January 2021), *Investopedia*, online: <https://www.investopedia.com/ask/answers/040615/how-do-returns-private-equity-investments-compare-returns-other-types-investments.asp#citation-3>.
[89] *Ibid.*
[90] The S&P/TSX Composite Index tracks approximately 250 of Canada's largest public companies by market capitalization (the total value of the company's outstanding shares).
[91] Stock Performance Guide, "S&P/TSX Composite Index (Canada) Yearly Returns", *1Stock1* (blog), online: <http://www.1stock1.com/1stock1_766.htm>.

at roughly 90%.[92] So, the markets can be likened to a sort-of gamble, where players hope to win big on riskier investments. In the long run and as opposed to literal gambling at a casino, this paper recognizes that one's expected return of investment in the capital markets is still positive. Nevertheless, there is still an argument to be made that the capital markets represents a form of gambling, except with a positive instead of negative expect return. With gambling at a casino, individuals will generally recognize that there is a negative expected return, yet will participate nonetheless. This is arguably due to the pure enjoyment and thrill that comes to individuals when there is money at stake and potential winnings to be had. Irrespective of one's expected return, the feeling of 'gambling' within a casino versus the capital markets may be somewhat similar. Under this line of reasoning, the benefit that comes with being accredited can be understood as being given an opportunity to 'gamble' more freely within the capital markets, and the activity of gambling and investing brings joy to those that choose to do it. The benefit, therefore, is that accredited investors are afforded the opportunity to feel the thrill and excitement asccociated with 'gambling' on companies with the potential for drastic positive returns.

Lowering Cost of Capital: large benefit

The importance of easing capital formation for companies has already been established. The weight of this benefit cannot be underappreciated. The fact of that matter is that, if small businesses are unable to secure the capital necessary to grow, they often times fail. A failure of small business in today's contemporary commercial landscape means fewer jobs; fewer jobs translate to higher unemployment rates; higher

[92] Matt Carrigan, "2019 Small Business Failure Rate: Startup Statistics by Industry" (24 January 2020), *National Business Capital and Services*, online: <https://www.national.biz/2019-small-business-failure-rate-startup-statistics-industry/>.

unemployment rates are often tied to economic recession; and economic recession results in detrimental effects to both individuals and society as a whole. It is for this reason that Ontario's government under Premier Ford has pushed the OSC to consider the fostering of capital formation be added to its mandate.[93]

It must be noted that, though the cost of capital formation is inevitably lowered through private offerings, there are nonetheless certain costs that attach to such transactions. For instance, it is the responsibility of the offering corporation to ensure the identity of the AI with which the company is dealing. This is a matter of determining whether the supposed AI is compliant and qualifies under the AI exemption rules.[94] Nonetheless, as Canada continues to accelerate out from under the current recession, placing heavy weight on lowering cost of capital will be imperative in supporting the economy.

Protection Against Poor Investments (individual): large benefit

Because the legal-economic analysis considers each individual him or herself, the weight of any prevention against making poor investment decisions ought to be large to the individual that would otherwise make such investments. The law is aimed at the protection of the individual him or herself and is designed in a way that mitigates the potential for what may be seen as poor investments by those without the capital or knowledge to support such risk. Implicit in the law's prevention of bad investment decisions is the 'saving' of an individual's money and potentially even one's life. To the individual that is 'saved', the benefit of the law cannot be understated. While there is no

[93] Geoff Zochodne, "Encouraging capital formation should be added to OSC mandate, taskforce recommends" (10 July 2020), *Financial Post*, online: <https://financialpost.com/news/fp-street/encouraging-capital-formation-should-be-added-to-osc-mandate-task-force-recommends>.
[94] *Vollmer*, *supra* note 54 at 21.

way to quantify the number of individuals that are prevented from making poor investment decisions based on the law's preventative structure, nor any method of determining the impact of this prevention itself, these points are irrelevant to the analysis. The relevancy in the law's prevention of poor investments to the individual is that the individual, whomever he or she may be, realizes a benefit by being denied the opportunity to make poor investment decisions. And the fact that the individual is in a better place, be it financially or otherwise, due to his or her inability to make poor investments is proof enough of the value of the law itself.

Protection Against Poor Investments (society): nominal benefit

How much does society itself benefit from the law's prevention of poor investment decisions made by those that the law would consider non-accredited? Another hypothetical question that warrants an answer in the hypothetical.

For society, the primary benefit of the law as constructed is related to the idea of a paternalist state—that society as a whole will benefit from the State's prevention of bad investment decisions by those that really should not be investing in that way. In theory, this is an idea that society should strive to realize. The way the law is constructed, however, does not necessarily guarantee it. The reality is that the markets, both public and private, feature a solid foundation of individuals that are either primed to be taken advantage of or of those ready to make poor investment decisions. At a certain point, the idea that a restrictive set of laws to certain markets likely has no little effect on the eventual formation of these groups. In other words, irrespective of such restrictions, bad investments are going to occur. Sometimes such investments occur on a level that negatively impact the entire world economy (i.e., 2008 financial crisis, Madoff, Enron). In most cases, a massive economic recession can be tied directly to those with enough poorly invested capital. For this reason, the law's protection against poor investment on a macro-societal scale is no doubt imperative, although the method at which the law attempts to do this may be questionable based on the financial metrics with which it uses to assess who is knowledgeable and who is not. Perhaps the law is looking at the wrong class of individuals in need of protection.

The benefit of preventing poor investments is, in theory, greatly beneficial to society. The argument of this section is that poor investment decisions only ever hurt society when they are done on a national scale; and often times the only class of individuals that can negatively impact society based on poor investment choices are the ones that qualify as AIs. Simply stated—these individuals are the ones with enough money to influence the market, be it intentional or not. For instance, if $50,000,000 is invested in a *bad* company (for the purpose of this paper, a *bad* company represents one where it would be poor choice to invest in it) whose market capitalization is only $1 billion, there may be a rush of smaller investments into this company. Eventually, after the stock skyrockets, it comes back down. Those that bought into the 'hype', those that continually invest in AMC circa 2020-2021, will inevitably lose money when the stock falls back to what it is actually worth. In any event, the ones driving the market may often be the ones with the most amount of money. And when those individuals make poor investments, much of the market may react negatively to it and lose out if (and likely when) the *bad* company's stock falls. So, the benefit of preventing individuals considered non-AIs from making poor investment decisions is likely nominal or even irrelevant to society's function.

2. The Losers – Harms of the System: How Much Do They Weigh?

Limited Freedom of Investment: large harm

For those that want to invest in private offerings but do not meet the AI criteria, the law as constructed must be considered harmful. In the abstract, any limitation on one's freedom to act a certain way must be considered harmful to that individual. Within the context of the AI exemption, the limiting nature of the law creates a closed-system where only those that meet a certain level of financial wealth are granted access. But, if knowledge of the financial markets is rooted in the law's purpose, then why would the law solely focus on wealth as a proxy?

In response to this exact concern, the US SEC recently amended the AI exemption standard to acknowledge one's knowledge and experience within the financial sector. In addition to the financial wealth AI criteria, the new standard now recognizes natural persons holding certain credentials to qualify as AIs. For instance, those holding certifications such as a Series 7, Series 65 and Series 82 will qualify. In addition, the SEC acknowledges those that have significant experience in the financial sector as AIs under its definition of "knowledgeable employees," which includes:

(i) executive officers, directors, trustees, general partners, advisory board members or persons serving in a similar capacity of a […] fund, or affiliated persons of the fund who oversee the fund's investments; as well as,
(ii) employees or affiliated persons of the fund (other than employees performing solely clerical, secretarial or administrative functions) who, in connection with the employees' regular functions or duties, have participated in the investment activities of such private fund for at least 12 months.

So, why make these changes? The answer is that the SEC understood the lucrativeness of private offerings in the form of roughly 5% greater investment returns. The harm in the preventative nature of the law prior to such amendments was that it negated some from ever realizing these returns. Therefore, the harm in the Canadian AI standard, which has yet to be amended, is that it prevents individuals with a certain level of knowledge of the financial markets from investing in private offerings when they arguably should be able to. If there is any merit to the idea that negating one's opportunity to make money is significantly harmful, then the AI standard must be considered significantly harmful to those that are prevented from doing so.

Exposure of Elderlies: large harm

The median age of an accredited investor is reported to be between 60 to 64 years old.[95] Data based on surveys collected by the US Federal Reserve suggests that, of all individuals aged 60 and over in the US, approximately 13-16% will qualify as an AI.[96]

In September 2020, the Canadian population stood at 38,005,238. The population of those aged 60 and over stood at 9,396,107, or 24.7% of the Canadian population. Assuming the same 13-16% AI figure as with the US, it is estimated that there are approximately 1.2 to 1.5 million AIs aged 60 and over in in Canada. To put this number into perspective, the number of AIs aged 25 to 59 is estimated to be 1.2 million[97] in Canada.[98]

The figures above confirms that the elderly population, as a whole, is amongst the most well-off classes in both the US and Canada. Mentioned earlier, data suggests that this

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[95] PK, "How Many Accredited Investors Are There by Age?" (7 October 2020), *DQYDJ*, online: <https://dqydj.com/accredited-investors-by-age-in-america/#:~:text=The%20median%20age%20of%20an,60%20and%2064%20years%20old>.

[96] *Ibid.*

[97] According to Statistics Canada, in September 2020, the Canadian population was (in millions): 2.6 (aged 25 to 29), 2.6 (30 to 34), 2.6 (35 to 39), 2.5 (40 to 44), 2.4 (45 to 49), 2.5 (50 to 54), and 2.7 (55 to 59), for a total of 17.9 million. According to data collected by the US Federal Reserve, the percentage of AIs by household with respect to the same age brackets was: 0.52% (aged 25 to 29), 1.23% (30 to 34), 5.18% (35 to 39), 7.58% (40 to 44), 10.21% (45 to 49), 10.24% (50 to 54), and 15.38% (55 to 59). The sum of each population age bracket multiplied by the estimated percentage of AIs per age bracket totals approximately 1.2 million AIs aged 25 to 59. See, <https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1710000501&pickMembers%5B0%5D=1.1&pickMembers%5B1%5D=2.1&cubeTimeFrame.startYear=2020&cubeTimeFrame.endYear=2020&referencePeriods=20200101%2C20200101>.

[98] *Ibid.*

class of individuals is also the one most prone to financial victimization based on their low ranking financial literacy numbers (relative to other age classes).

Now, for those that fall within this age bracket, the AI standard presents a real and legitimate concern. Recognized by the OSC, this concern warranted the creation of a new Seniors Expert Advisory Committee (SEAC). The SEAC's goal is to, "… advise OSC staff on securities-related policy, operational, education and outreach activities of the OSC that are designed to meet the needs of Ontario's older investors."[99] Furthermore, the OSC understood "…the importance of consulting with a multidisciplinary group of experts… [to] better understand the unique needs of older investors."[100]

The harm of the law as constructed, therefore, is that the class of individuals with the most financial wealth generally happens to be the class of individuals with the least knowledge of the financial markets. So, statistically, the harm of making poor and risky investments, and perhaps losing large sums of capital within the private markets, flows directly to elderlies. For elderlies that qualify as AIs who lose money as a result of his or her financial illiteracy, the law has allowed these individuals into a riskier market when it arguably should have prevented it. For this class of individuals, the harm of the law as constructed potentially results in a loss of a significant amount of lifelong savings. In extreme cases, this could also mean even more elderlies for which the workforce must financially support.

Diversity of Wealth Accumulation: moderate harm

[99] "OSC announces Seniors Expert Advisory Committee members for 2021-2022" (2 June 2021), *Ontario Securities Commission*, online: <https://www.osc.ca/en/news-events/news/osc-announces-seniors-expert-advisory-committee-members-2021-2022>.
[100] *Ibid.*

The correlating section above aimed to recognize the ‘losers’ of a system that does not protect individuals that meet the capital requirements of being an AI, yet may not have the financial acumen necessary to succeed in the private sector. A thought behind the law is that, though these individuals may not understand a good investment from a bad one, they understand enough to recognize their lack of knowledge. For that reason, these individuals hire qualified help—wealth advisors, accountants, etc.

But what if someone meets the capital requirements without any relevant investment knowledge and he or she does not appreciate his or her lack of financial literacy? I have no way of uncovering exactly how many people would fall under this category, I can only use my imagination. Prior to this year, I probably would not have considered this to be a huge harm to a significant amount of people, and I probably still feel the same even now. However, the new-aged crypto boom and the volatility of such assets has made this topic more intriguing. It is estimated that there are over 100,000 Bitcoin holders with at least $1 million in holdings. While this number is small in comparison to the 51.8-million millionaires (in USD) in the world today, it certainly represents a new breed of investors that has not yet been market tested. I mean to say that, although these individuals objectively made one great investment decision, it is yet to be seen whether the momentum can be carried forward into the private and public markets. For this reason, while I would still consider this to be a relatively nominal harm to both individuals and society, it is nonetheless a harm with the potential of generating much more loss than ever before if unchecked. The weight of the harm would be felt to those that simply lack a true understanding of one’s knowledge in the private sector, and a real time example of this may show itself in the aftermath of the current economic cycle.

Failure to Assess Loss Bearing Ability: moderate harm

An investor will use liquid assets to cover the cost of investing in a security, irrespective of whether it is a private or public offering. The investor will want to ensure that one has enough capital in reserve to cover one's ongoing capital needs. For instance, if one has a mortgage payment plus any hydro, food, gym, etc. expenses totaling $5,000 per month, the savvy investor would understand that, after all investments, he or she would need to have at least $5,000 in liquid assets to cover such expenses. When the return on the initial investment is positive, the investor will have nothing to worry about within the context of covering ongoing capital demands. However, if the investment fails, the investor may be forced to liquify non-liquid assets (land, real estate, equipment, machinery, jewelry, etc.) to cover ongoing expenses.[101] In this context, the failed investment may lead to the selling of assets at a discount due to the non-liquid nature of such assets—it is simply more difficult to sell these assets at cost because they often depreciate in value.

To the individual that, having met the net financial asset or income tests, fails in his or her private offering investments and is no longer able to cover his or her ongoing costs, the AI standard would have failed in its attempt to protect that individual. The difficulty in allocating any type of weight to this potential harm is acknowledged. There is simply no way of knowing how many individuals qualify as AIs based on the income and/or net worth criteria and who have relatively high liabilities or expenses that may offset or even exceed those figures. While those numbers would certainly help the analysis, the fact is that it is unnecessary to the legal-economic analysis. What is important to consider is that the weight of the harm of the AI standard to an individual whose assets does not adequately support

[101] *Lee*, *supra* note 79 at 993.

his or her expenses and liabilities, and subsequently fails within the private markets must be considered relatively high. To those individuals, the risk of failed investments could, in the worst scenarios, mean insolvency or a complete change in lifestyle. For this reason, while the thought of insolvency looms large for the failed AI, insolvency on an individual level (as opposed to a societal level) is not necessarily impactful. In all likelihood, the failed investment would mean that the AI no longer qualifies under the AI criteria, thereby being protected under the prospectus regime when he or she arguably should have always been in that position. For these reasons, the AI standard's failure to assess one's loss bearing ability may still be very harmful, yet not enough to warrant such high worry over the structure of the law.

3. How does the Canadian AI Exemption Standard compare to the 'Ideal System'?

As a reminder, the ideal system is one in which everyone wins, and nobody loses. It was described as a system where everyone is free to invest however they so choose; where information about any corporation is wholly accurate and accessible; and, where there is virtually no risk of being defrauded or even losing invested money generally. It was also described as a system where capital formation does not cost anything for corporations. Companies can simply calculate the capital needed to succeed and attain it without any costs to disclose information.

Understandably, the Canadian AI system does not even come close to replicating this unrealistic system. The Canadian AI system attempts to balance the above initiatives by creating the private and public markets. Under the prospectus regime, the Canadian system is suited to protect investors as best it likely can. Under the exemption criteria, the Canadian system is suited to increase capital formation initiatives as best it likely can. When considering the prospectus regime plus its accompanying exemptions in the abstract, the Canadian system may not be so far off from the ‘Ideal System’. Shown in Part V, only once there is weight assigned to each of the potential losers and beneficiaries of the system is one able to appreciate that the Canadian system certainly has its shortcomings.

From the analysis above, it is clear that the AI standard is inefficient. To say that a system is inefficient does not necessarily mean that the harms *must* outweigh the benefits. Rather, to say that a system is inefficient, in this context, would mean that the system does not produce the greatest benefit and least ‘amount’ of harm. In other words, the system’s output ratio of benefits-to-harms tips further toward the ‘harms’ side than would be optimal or efficient. In that sense, the system is inefficient in realizing a more legally-economic output of lesser harms and greater benefit. Again, it must be acknowledged that while the perfectly efficient system is never realizable, the system as constructed is inefficient in its attempt to come as close to it as possible. While I admit that the system is well-designed, there is certainly room to inch closer to the ‘Ideal System’. And when there is room to inch closer to the ‘Ideal System’—when it is possible to increase the ratio of benefits-to-harms—there is a true legal-economic argument that the law as constructed is inefficient.

Part VI. A Proposal for Increasing Efficiency: Efforts to Increase the Ratio

The benefits-to-harms ratio can be increased in one of three ways: first, by increasing the benefits without increasing harms; second, by decreasing harms without decreasing benefits; and third, by increasing benefits and decreasing harms. All three scenarios involve the idea of bettering the overall ratio that considers both the individual and society in terms of benefits relative to harms as a product of the law's construction.

1. Can the weight of the benefits be increased?

This analysis identified four primary benefits as a product of the law's structure and allocated weight to each one. As a reminder, the benefits identified were: (1) freedom of investment; (2) lowered cost of capital for companies; (3) protection against poor investments from the individualistic perspective; and (4) protection against poor investments on the societal level. For there to be any merit in making changes to the law, such changes would have to have some positive effect on the benefits identified. So, what changes might increase the weight of such benefits without further compromising or creating any more harm?

Expand the AI Criteria

The often cited method of improving the AI standard is based on the idea to expand the pool of investors able to participate in private offerings.[102] As can be imagined, the pool of capital available to new ventures is limited to the number of individuals that both qualify as AIs and that are willing to invest in the private markets.[103]

In August 2020, the US SEC expanded the AI definition to include those with certain professional certifications, designations or credentials. The SEC also expanded the

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[102] *Thomas*, *supra* note 22 at 3.
[103] *Ibid.*

definition to include those employed by a private fund holding certain positions, including: executives, partners, board members, those that oversee the fund's investments, and employees of the fund (other than those performing clerical, secretarial or administrative duties) that have participated in investment activities for at least 12 months.[104] The aforementioned individuals are considered "knowledgeable employees".[105]

An examination of the AI standard's expansion independently may not significantly increase efficiency. Although, doing so represents a step toward better identifying those that may and may not require the protections under the prospectus/public market regime. Furthermore, an expansion of the AI criteria would serve to increase the amount of capital available to up-and-coming businesses. Logically, a standard that chose to recognize the importance of capital raising initiatives to startup companies would perhaps focus on expanding the pool of investors available. In theory, if the AI standard was broadened to include those with certain certifications and qualifications (similar to the US SEC approach), the value and size of investment opportunity would expand, thereby providing much needed capital to entrepreneurial ventures. This would not only benefit individual investors that newly qualify by enabling more opportunity and freedom to invest, but more importantly, an increased pool of investors would inevitably increase the number of successful ventures, which often correlates to positive economic impact.[106]

Proof of AI Standard Form

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[104] Yvan Larocque and Carson Bell, "Now In Effect: Expanded US Accredited Investor Exemption" (14 December 2020), *Millter Titerle + Company*, online: <https://www.mondaq.com/canada/securities/1016260/now-in-effect-expanded-us-accredited-investor-exemption>.

[105] U.S. Securities and Exchange Commission, "SEC Modernizes the Accredited Investors Definition, online: <https://www.sec.gov/news/press-release/2020-191>.

[106] *Thomas*, *supra* note 22 at 3.

Noted earlier was the onus placed on companies, not individual investors, to prove that the investor him or herself adequately qualifies as an AI under the existing criteria. While this may not be a very capital intense initiative, it can nonetheless improve. Perhaps the introduction of a new standard form that can be filed by companies to the OSC would lower cost of doing so to both the filing company and the OSC itself. The standard form would feature a number of questions and require proof that the supposed AI meets one of the AI criteria, which could then be submitted directly to the OSC. In essence, the standard form act to decreases the cost of a company's effort to prove that an investor is accredited, which is especially beneficial to start-ups and smaller companies.

2. Can the weight of the harms be decreased?

This section is represents the analysis, with respect to improving the existing system. The fact is that the benefits of the system were clearly established. Apart from increasing capital formation initiatives by expanding the AI criteria, which would arguably increase each category of benefits identified earlier, there is not much opportunity to increase the benefits of the system to individuals or society as a whole. To improve efficiency, the system may have to focus more on decreasing the weight of the harm it generates. So, how can the weight of its harm be decreased?

Adjusted Wealth Test

The purpose of the wealth requirement to participate in the private markets is to ensure that individuals assuming the risk associated with private offerings are protected irrespective of the investments they choose to make. Metaphorically, the system acts as a bouncer to a prestigious island nightclub, where only those with a ticket are granted entry and tickets act as currency as part of the experience. Presumably, the wealthiest of individuals within the context of this metaphor will have the most tickets and buying drinks will have virtually no effect on whether he or she can pay the 1-ticket taxi fee off the island. For those with only 1 ticket to spend, he or she may spend it to get to the island in hopes of accumulating more throughout the night in order to get back home. This is risky, however, because often times it is difficult to attain more tickets.

Under this metaphor, the ones with plenty of tickets can be thought of as those with much more liquid assets that are greater in value than his or her liabilities. The sole ticket holder, therefore, can be thought of as the investor that qualifies as an AI, but without the liquid assets necessary to cover his or her relatively high liability figures.

So, if the latter investor technically qualifies as an AI under the existing criteria, would it be wise to assume the risk of participating in such markets? Just as the sole ticketholder may never get home, perhaps the investor fails and the money invested is never recouped. For that investor, the system would have failed to protect against that outcome, and he or she should have never been granted entry. Perhaps the best approach would be to ensure that only those with 2 tickets (one for the ride to the island and one back home) are granted access to the party. Similarly, perhaps the AI standard should be adjusted to ensure that only those with assets liquid enough to cover any outstanding or ongoing liabilities are free to invest in the private markets. This would effectively decrease the risk and magnitude of harm done to the individual that ought not have been granted access to private offerings.

While adjusting the wealth tests may decrease harms of the system, it would inevitably lower the pool of investors available. For this reason, a black-letter adjustment of the law may be overly complex and inefficient. Instead, the efficient system might consider maintaining the income and net value figures as written but limit the value of one's investment based on the difference between an AI's assets-to-liabilities. So, if an AI reports liquid assets of $100,000 in excess of all liabilities, he or she will be limited to invest $100,000 in private offerings.

Should the AI standard be adjusted for inflation?

Though the idea of adjusting for inflation seems logically sound on its surface, this paper chooses to reject the proposal to do so. Simply stated, the goal and clear purpose of the prospectus requirement and its exemptions has been established: to both protect investors, with the added benefit of lowering the cost of capital for companies. It stands to reason that, by adjusting for inflation, the number of AIs becomes much smaller, meaning less opportunity to find those willing to invest. If it is true that the law ought to be designed in part to help bolster capital formation, then tightening the AI standard by heightening the income requirements would be counterproductive to the law's stated purpose. The legal-economic argument, therefore, is that adjusting for inflation would harm companies seeking cheaper capital more than it would benefit those that arguably should not be classified as AIs. For this reason, it would be inefficient to adjust the AI standard for inflation, as doing so would ultimately tip the balance more toward the "harms" side more than it would toward the "benefits" side. And this, according to the legal-economist, represents an inefficient move that drifts further away from the perfectly efficient system.

Proof of Advisory of Experts

The focus of the AI standard should arguably still be on investor sophistication. If the private markets are labelled and identified as the riskiest of the financial markets, then a standard that is able to near-ensure that those with a requisite level of financial literacy and understanding of such markets are truly the ones that are participating. One method of achieving this: mandate that only those with certain expertise, experience and/or certifications are the ones participating (knowledgeable persons), or ensure that these individuals are at least consulted by those without such qualifications. In theory, this approach would decrease the risk of poor investment decisions made by those that do not necessarily understand the market, while having no effect on the benefits already enjoyed by the winners of the current system. All that would be required is evidence that the non-expert AI—those that meet the wealth tests but are not considered "knowledgeable" within the context of private offerings—at least consulted an expert about a particular investment.

Elderly Accredited Investor Renewal Program

Why does the Ontario government require individuals aged 80 and over to renew one's license every two years? Ontario's senior driver's license renewal program is an effort made by the Ministry of Transportation (MTO) to protect those operating vehicles and those surrounding such vehicles.[107] Those 80 and older must therefore prove their abilities to operate vehicles by passing certain tests of vision or other potential health-related impairments.[108]

Just as with the MTO, the OSC should take steps toward designing programs aimed to protect senior investors from financially fatal decision making. At the age of retirement (or any age the OSC deems appropriate), an elderly AI would be required to declare that they are fit to participate in the private markets. There would also be a requirement to make the OSC aware of any diagnosed medical condition that may affect cognitive function.

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[107] Government of Ontario, "Senior driver's license renewal program" (9 December 2020), *Ministry of Transportation*, online: <http://www.mto.gov.on.ca/english/driver/senior-driver-licence-renewal-program.shtml>.
[108] *Ibid.*

Every "*x*" years, the elderly individual would be required to renew their 'license' to participate in the private markets by declaration that he or she is fit to participate.[109] For the purpose of preventing unnecessary burdens on elderly AIs, both financially or otherwise, the license would not need to be overly complex. The goal of the licensing program would be to protect investors that are statistically more at risk of fraud and deceit, as well as to those investors that are statistically less financially inept. All that would be necessary would be a submission by the elderly AI of some assurance that he or she understands and appreciates the risks involved with private offerings. Perhaps the OSC would require that the elderly display proof of consultation of what the OSC deems to be an "expert" in the field. Or, perhaps the OSC mandates an elderly AI's participation in a private offerings portfolio review. If necessary, perhaps the OSC mandates the submission of medical records relevant to cognitive function. In essence, irrespective of the method of choice, these measures would be enacted with the purpose of decreasing the harms associated with the current system by limiting the amount of elderly AIs that may succumb to fraud or that arguably should not be investing, while having virtually no effect on the pool of investors available.

Duty to Report Losses

Mentioned throughout this analysis has been the danger associated with the often cited riskiness involved with private offerings. This risk may be exacerbated in cases where the AI is part of a class of individuals that arguably should not qualify under the existing criteria. For instance, an individual that attained wealth by winning a lottery may not understand nor appreciate the difficulties associated with the private markets. An

[109] "*x*" representing a period of time in which the OSC finds is adequate to achieve its goal to test and therefore protect elderly investors.

individual that has a high asset value and an equally high liabilities value might not appreciate or understand the risks associated with a failed investment in the private markets. An elderly individual, working a lifetime to attain wealth that would qualify under the AI exemption, might not appreciate the risks involved with investing in companies that are not required to disclose certain information. What is arguably even more daunting is the reality that even the richest of people may not understand the risks associated with a market that is so draped in failure. With aspirations of gaining more wealth than ever, AIs will invest in the possibility of cashing in on a winning company. Again, the reality is that these investments will fail more often than not. The peculiarity of the private markets is that there is no mandate for these companies to make adequate disclosure to its investors, which, to certain investors, may seem more akin to gambling at the roulette table than investing in the public markets. It is those investors—the ones that are truly gambling with their money in the private markets without any adequate disclosure being passed to them—that must be targeted and protected by the OSC.

The OSC should mandate a duty placed on AIs to report losses in excess of a certain percentage of one's reported net value. For instance, if one is valued at $10 million, the OSC may find that losses in the range of 25-50% of that figure would be too dangerous to ignore, and the OSC should therefore be made aware of such losses. These figures are arbitrary, of course, although the goal of having some kind of duty to report losses as a percentage of one's reported wealth would be to allow the OSC to monitor dangerous investing habits by those that arguably should not be investing. Having been made aware of such investors, the OSC may review one's private investment portfolio to look for any fraud, deceit or problems with the investor's spending him or herself. From there, the OSC could choose to continue to allow the investor to carry forward, or even choose to suspend the investor if deemed appropriate. In times of market decline, however, many may exceed the thresholds set under this standard. For this reason, it would be the discretion of the OSC to review and/or take action, when necessary, to protect the individual. While this program may have the effect of lowering the pool of investors within the market, it would mean more money being kept by the investor him or herself, meaning less risk to the individual. Under this approach, the system would guarantee some level of protection against very poor investments being made in the future by relying on one's historical investment strategies. In theory, this approach would decrease the potential for harm being done to individuals that arguably should not be investing so frivolously in a market characterized by its high degree of risk.

Part VII. Conclusion

The current Canadian standard for AIs is based on the idea that one's wealth is the sole factor to consider in determining one's financial acumen. Beginning with a brief history of the origins of the AI exemption, it is easy to understand why this would have been the case in 1933. However, the thought of both protecting individuals and increasing capital formation through means of an exemption based solely on individual wealth has become outdated. While the benefits of the system have remained relatively true to form since the law's scripting, the harms generated by the system as constructed seem unnecessary. The proposed amendments serve to recognize the importance of relying less on wealth as the sole benchmark for accreditation as a means to better realize the law's policy objectives. Given that the purpose of the law is twofold in its effort to both protect investors and decrease capital formation restraints, there are clear legal-economic grounds upon which the OSC should amend or at least review the current standard. The OSC should open the AI standard to those that really are sophisticated, irrespective of wealth, which would increase the pool of investors and the ease at which companies may raise capital. The OSC should subsequently look to protect those most vulnerable to lose as part of the private markets. These proposals are based on a legal-economic perception of the law as is scripted, and a basis upon which to realize the greatest output of benefits relative to the harms generated as a result of the law's construction. In essence, this paper serves as a promotion toward a more efficient securities law regime.

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