Protecting Who from What? The Case for Opening Up Private Company Finance to all Canadians

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ABSTRACT

Private companies are becoming increasingly dominant in the Canadian business landscape, yet most Canadians are prohibited from participating in private company investments. The ability to invest in the most promising private companies is primarily limited to the wealthiest cohort of Canadians under the wealth-based "accredited investor" definitions used in Canadian securities regulation. This concept may have once been defensible, but the rapid evolution of our society in ways that increasingly allow middle class Canadians to take unlimited financial risk in several areas has eroded the moral and logical foundation of any wealth-based investment criteria for the private markets. Meanwhile, Canadian private companies operate at a significant disadvantage to their American competitors in capital formation, as U.S. securities regulation has evolved in recent years to expand the ability of middle class individuals to invest in the private markets. This article builds the case that the current Canadian wealth-based accredited investor concept is outdated and proposes an alternative structure to re-democratize private company investment in Canada, placing Canadian private companies in a more competitive posture for early-stage capital formation.

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INTRODUCTION

The private company form has become ubiquitous across the Canadian business landscape. There are currently more than 1.3 million Canadian private companies with active employees and another 3 million Canadian private companies without active employees.[1] This equates to more than one Canadian private company for every 10 Canadians.

Private companies also are playing an increasingly critical role in the Canadian economy, as progressively fewer businesses choose to access the Canadian public markets.[2] The majority of Canada's most innovative and promising start-up and growth-stage corporations now eschew the public markets in perpetuity, choosing to remain private and accessing growth capital exclusively through private market financing opportunities.[3] There are now

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1 As of June 2022, the most recent date for which Statistics Canada has published details on registered corporations. Statistics Canada, "Table 33-10-0569-01 Canadian Business Counts, Without Employees" (June 2022), online:< https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3310056901>. Also Statistics Canada, "Table 33-10-0568-01 Canadian Business Counts, With Employees" (June 2022), online:< https://www150.statcan.gc.ca/t1/tbl1/en/tv. action?pid=3310056801>.

2 The number of Canadian operating companies listed on senior stock exchanges in Canada is currently reaching a multi-generational low each successive month. The phenomenon of operating public company decline, in which an ever-increasing percentage of economic activity is delivered through the use of private companies, has been documented extensively in Canada, the U.S. and Europe. See, for example, Bryce C. Tingle and J. Ari Pandes, "Reversing the Decline of Canadian Public Markets" (April 2021) 14:13 University of Calgary School of Public Policy Publications.

3 The author has written a recent series of academic papers evaluating in depth the current status and trajectory of the Canadian capital markets. These papers trace the increasing unwillingness of Canadian business leaders to take their companies public, and discuss the sources and extent of the shift away from the public markets. See: (i) L. Daniel Wilson, "Assessing the Key Factors Contributing to Canadian Public Decline: An Empirical Analysis (2023) 67(3) Canadian Business Law Journal 341 ("Wilson-Key Factors"); (ii) L. Daniel Wilson, "Canadian Senior Market Health Check: Future Relevancy of the Public Markets at Risk as Operating Public Company Decline Accelerates" (2025) 18:01 University of Calgary School of Public Policy Research Papers ("Wilson-Senior Market"); and (iii) L. Daniel Wilson, "Canadian Junior Market Health Check: Resilience After Poor Investor Returns, But Worrisome Signals Looking Ahead" (2025) 18:02 University

more than 430 active Canadian private companies with employees in existence for every Canadian public company. Yet, the opportunity to invest in Canadian private companies remains severely restricted by the current structure of Canadian securities regulation. Only a small fraction of Canadians are eligible to invest in any given private company financing opportunity.[4]

Meanwhile, it is widely recognized that Canada lags other leading economies in terms of access to early-stage capital to support private company start-ups in knowledge-based industries, particularly in comparison to the U.S.[5] On a per capita basis, Canadian companies secure approximately only one-quarter of the total amount of venture capital funding annually invested in American companies.[6] Despite our start-up funding challenges, a key prescription at the core of Canada's system of securities regulation continues to keep an important potential source of early-stage capital on the sidelines, largely prohibited from participating in the entrepreneurial-stage finance ecosystem.

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of Calgary School of Public Policy Research Papers ("Wilson-Junior Market"). The purpose of those papers is to lay the foundation for a series of papers advocating for meaningful reform in Canadian financial market regulation, to open up new opportunities for Canadian investors, stimulate Canadian innovation and competitiveness, and reinvigorate Canadian junior and senior public markets. This paper is the first paper in the series of the reform-focused papers proposing potential solutions.

[4] More than 95% of the Canadian public is prohibited from investing in a typical private company investment. The nature of the prohibition leading to the exclusion of 95% of Canadian investors is explored later in this paper. It is not intended to suggest that every private company in Canada is seeking investors, as many private companies are set up for other reasons; for example, corporations are frequently established to secure limited liability or for tax advantage. However, the challenges of securing capital faces by Canadian start-up companies are well-documented and discussed elsewhere in this paper.

[5] Martin Croteau, *et al*, "The Lost Generation of Entrepreneurs? The Impact of COVID-19 on the Availability of Risk Capital in Canada" (2021) 13:4 Journal of Entrepreneurship in Emerging Economies" 606 at 608.

[6] Canadian venture capital investment totals taken from: David Kornacki, *et al*, "Canadian Venture Capital Market Overview-2023" (17 May 2024) Canadian Venture Capital Association, online:<https://reports.cvca.ca/books /usuc/#p=1>. American venture capital investment details taken from: Statista Research Department, "Value of Venture Capital Investment in the U.S. 2006-2023" (21 June 2024) Statista.com website.

The underlying theory on which our existing securities regulatory regime prevents most Canadian investors from investing in private companies is a concern that private company investments generally involve significant information asymmetry. While founders possess extensive information on the status and prospects of the business, private company investors do not have the benefit of the detailed disclosure mandated for public company financings. The concern of regulators is that middle class Canadians do not fully appreciate the risks associated with early-stage private company investing based on asymmetrical information, and that they do not possess the financial reserves to absorb losses on their investments. This leads to the belief that the average Canadian needs to be protected from losing money in high-risk and illiquid investments where there exists insufficient disclosure to ensure that investors fully understand the risks of the investment. While this paternalistic approach might have been defensible in past decades, our society has rapidly evolved in terms of the amount of financial risk which we allow middle class Canadian to take in other financial arenas.[7] Indeed, the current securities law restrictions may actually be pushing Canadians into much riskier investments with lower social and economic utility.

Middle class Canadians can now legally participate without any monetary limit or training in online sports wagering, including both single-game wagers and in-game and multi-game parlay bets. Middle class Canadians are also increasingly investing in derivative instruments that have become more easily accessed through online trading platforms, again with the freedom to lose significant capital without any effective investment limits or specialized training in the unique risks associated with these complex and volatile instruments.[8] Moreover, middle class Canadians have, for years,

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7 Throughout this paper, the term "middle class" investor is used describe the class of potential Canadian investors who fall in between an upper and lower limit. This paper *does not* use middle class in a traditional sense as referring to a population based on fitting within a specific percentile of household income. With reference to the lower limit, our definition of the middle class includes any Canadian who has discretionary savings that they wish to invest. With reference to the upper limit, middle class is used to describe all those who do not meet existing accredited investor thresholds.

8 Ron Hochman, "Montreal Exchange: The Rise of Retail Investing in Canadian Derivatives (27 September 2022) EQ Derivatives, online:< https://eqderivatives.com/news/montreal-exchange-the-rise-of-retail-

been investing extensively in a never-ending succession of high-risk crypto-currency assets, as securities regulators seek to catch up with a continuously evolving market.[9] The remaining investment market where middle class Canadians *cannot* directly invest is in the private company finance market, which, ironically, is the only one of the high-risk investment segments discussed in this paragraph where allowing middle class Canadians to invest serves a broader, and clearly beneficial, societal purpose. Unlocking more sources of domestic capital to support start-up company origination and growth benefits all Canadians, offering the prospect of increased job creation and enhanced competitiveness.[10] Also, unlike sports gambling and options trading, private company investing does not require a "loser" in order for a "winner" to make a profit on the other side of a zero-sum equation. When a private Canadian company succeeds, everyone wins.

While the two key reform recommendations of this paper are relatively simple, securing the necessary political and regulatory support to implement these ideas will inevitably be a significant challenge. It requires re-thinking decades of paternalistic intervention by securities regulators in the private finance capital markets. Ultimately, this paper advances a proposal to fundamentally alter the accredited investor definition and thereby re-democratize private company investment in Canada, while also updating the 50 shareholder private company limit. If adopted, these ideas will open up a new source of funding for Canadian entrepreneurs to finance their start-up and growth-stage companies. It also gives middle class investors the opportunity to once again participate in early-stage investment by directly investing in the private entrepreneurial finance space, opening up a key opportunity that has become the exclusive preserve of high net worth and institutional investors in Canada.

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investing-in-canadian-derivatives>.

9 Ryan Clements, "Cryptocurrency: Challenges to Conventional Governance of Financial Transactions" (September 2022) Public Order Emergency Commission, online:< https://publicorderemergencycommission.ca/documents/ policy-papers>. Also, Ryan Clements, "Emerging Canadian Crypto-Asset Jurisdictional Uncertainties and Regulatory Gaps" (2021) 37 Banking and Finance Law Review 25.

10 Pierre Lortie, "Entrepreneurial Finance and Economic Growth: A Canadian Overview" (February 2019) C.D. Howe Institute Commentary No. 536.

I. CRITICAL UNDERLYING POLICY CHALLENGES

Canada faces several key policy challenges:

First, Canada is undeniably undergoing a crisis in economic competitiveness.[11] Rarely a week goes by in which there is not a national headline arising from a new study decrying our continual slide in competitiveness, most glaringly in comparison to the U.S.[12] One of the factors in our declining competitiveness is comparative underinvestment by Canadian business in future growth and productivity.[13] Another key element is inefficient regulation.[14] The

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[11] The issue is alternately framed in the media as being a "competitiveness crisis" or a "productivity crisis". Economic productivity is a key element of competitiveness, which is a broader concept than productivity and encompasses other factors as well. Increased productivity directly enhances overall competitiveness. In this paper, we intentionally use the broader term competitiveness, as ease of access to, and cost of, capital can be considered as a separate element of competitiveness from productivity. However, capital can be deployed to increase productivity, so the two components of competitiveness are certainly intertwined.

[12] See, for example: (i) Competition Bureau of Canada, "Competition Report Finds Canada's Competitive Intensity In Decline" (19 October 2023) Competition Bureau News Release, online:< https://www.canada.ca/en/competition-bureau/news/2023/10/competition-bureau-report-finds-canadas-competitive-intensity-in-decline.html>; (ii) RBC Economics, "Canada's Growth Challenge: Why the Economy is Stuck in Neutral" (4 June 2024) RBC, The Growth Project, online:< https://thoughtleadership.rbc.com/canadas-growth-challenge-why-the-economy-is-stuck-in-neutral>; (iii) David Rosenberg, "Canada Was Once Productive and Competitive, but Not Today" (28 March 2024) Financial Post, online:< https://financialpost.com/news/economy/canada-once-productive-competitive-not-today>; and (iv) Alex Whalen, Milagros Palacios and Lawrence Schembri, "We're Getting Poorer" GDP Per Capital in Canada and the OECD" (23 July 2024) Fraser Research Bulletin, online:< www.fraserinstitute. org/sites/default /files/were-getting-poorer-gdp-per-capita-in-canada-and-oecd-2002-2060.pdf>.

[13] Steve Globerman, "Comparing the Investment Performance of Canada and the United States Over the Past Five Decades" (11 July 2024) Fraser Institute Report, online:< www.fraserinstitute.org/sites/default/files/ comparing-investment-performances-canada-and-us-over-past-five-decades.pdf>.

[14] Deloitte, "Making Regulation a Competitive Advantage" (2022) Deloitte Canada at 175 series, online:< www2.deloitte.com/content/dam/Deloitte/ca/Documents/finance/ca-en-making-regulation-comp-advantage-pov-aoda-v2.pdf>.

simple reforms proposed by this paper seek to unlock additional pools of capital to fund investment in growth and productivity, and also to modernize ineffective and unnecessary regulation stifling economic growth.

Second, the availability of private institutional capital for start-up companies in Canada is geographically concentrated within a few provinces and, even more, within a limited number of cities. It is also less accessible in Canada than in the United States. With respect to concentration, Ontario, Quebec and B.C. cumulatively accounted for 86% of total Canadian venture capital dollars invested in 2023, significantly higher than the 74% of the Canadian population that these provinces represent.[15] Ten Canadian cities alone accounted for 81% of total venture capital investment in 2023.[16] With respect to overall Canadian investment compared to the U.S., Canadian venture capital investment in 2023 amounted to 0.236% of Canadian gross domestic product ("GDP") or approximately $125 USD per person.[17] In comparison, U.S. venture capital investment in 2023 amounted to 0.624% of US gross domestic product or approximately $510 USD per person.[18] Total venture capital dollars invested per capita are, therefore, approximately four times greater in the United States than in Canada. One must also consider that institutional private capital regularly flows northwards across the Canada-U.S. border, absent which the Canadian deficit in early-stage institutional capital would be even more stark compared to the U.S. American institutional investors participated in nearly1/3 of all Canadian venture capital deals in 2023.[19] Problematically, this means that capital gains on U.S.-based investment in Canadian private

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15 David Kornacki *supra* note 6. The concentration of institutional private capital in these three provinces is significantly higher than their contribution to GDP. Statistics Canada, "Gross Domestic Product by Industry, Provinces and Territories" (accessed July 13, 2024), online:<www150.statcan.gc.ca /t1/tbl1/en/tv.action?pid=3610040201>.

16 Kornacki, *supra* note 6.

17 Kornacki, *supra* note 6.

18 Total 2023 American venture capital investment data from Krystal Hu, "US Startup Funding Drops 30% in 2023 Despite AI Frenzy" (11 January 2024) Reuters-Technology, online:< https://www.reuters.com/technology/us-startup-funding-continues-drop-despite-ai-frenzy-2024-01-11/>. Also, from Statista, *supra* note 6. USD converted to CDN at 0.73.

19 Kornacki, *supra* note 6.

business are repatriated back to the U.S. rather than reinvested in Canada.

Third, Canada continues to have a significant wealth distribution issue. Recent statistics demonstrate that Canada is currently dealing with the most unequal distribution of wealth in the past decade, with the middle class being hit particularly hard.[20] TD Bank economist Maria Solovieva argues that wealth accumulation due to financial assets accruing largely to the wealthiest quintile of Canadians is the principal cause of this increasing inequality.[21] Wealth inequality has increased notwithstanding a string of redistribution programs initiated at large cost by the Trudeau federal government, creating large deficits over the past decade. If handing out money through government redistribution has not alleviated wealth distribution challenges, it may be time to focus on policy ideas that encourage middle class wealth creation at the source by expanding middle class access to better quality investment opportunities.

Fourth, and foundational to the reform proposals in this paper, is that the trajectory of securities regulation in Canada, combined with the evolution of the Canadian capital markets in favour of private capital, has largely eliminated the middle class from directly participating in the key entrepreneurial finance market. With the admittedly noble goal of protecting unsophisticated investors from being taken advantage of by unscrupulous promoters, we have effectively removed the opportunity for the Canadian middle class to directly invest in the segment of the market that now offers the best investment opportunities with the highest returns.

The Canadian gap in early-stage financing has traditionally been filled by a robust public junior Canadian capital market operating at a level that competed directly with deals financed by venture capital in the U.S.[22] However, the nature of companies

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20 Pamela Heaven, "Posthaste: Canada's Middle Class is Losing Momentum as Wealth Gap Widens" (23 April 2024) Financial Post, online:< https://financialpost.com/news/canada-middle-class-losing-momentum-wealth-gap-widens>.

21 Maria Solovieva, "Middle-Income Families Are Poised to Take the Wind Out of the Economy's Deflating Sails" (22 April 2024) TD Bank reports, online:< https://economics.td.com/ca-middle-income-families-economys-deflating-sails>.

22 Bryce C. Tingle, J. Ari Pandes and Michael J. Robinson, "The IPO Market

willing and able to seek listings on the Canadian junior public capital markets has changed significantly over the past years. While the junior public capital markets in Canada have always been weighted towards high-risk market segments, investors used to at least have the option to invest in companies in industries with comparatively higher success ratios (such as real estate, oil & gas, consumer/industrial products and utilities/pipelines) that generated positive cash-flow earlier in their business growth cycles and possessed balance sheets comprised primarily of tangible assets. Listings from companies in these particular market segments are rapidly disappearing from the Canadian junior public markets. A comparison of TSX Venture Exchange ("TSXV") listings over a 15-year period shows that companies from the lower-risk segments have dropped by 70% in terms of percentage of overall market capitalization, and 56% in terms of percentage of total listings.

Table 1- Evolution in TSXV Listings from 2008 to 2023[23]

	December 31, 2008				April 30, 2023			
	# Listings	% Total Listings	MktCap (Millions)	% Total MktCap	# Listings	% Total Listings	MktCap (Millions)	% Total MktCap
Consumer Products & Services / Industrial Products & Services	193	9.8%	1,288	7.7%	76	5.2%	1,541	2.2%
Oil & Gas	268	13.6 %	3,209	19.2%	75	5.1%	4,129	5.9%
Real Estate	52	2.6%	319	1.9%	16	1.1%	528	0.7%
Utilities & Pipelines	4	0.2%	19	0.1%	1	0.1%	21	0.0%
		26.2 %		28.9%		11.5 %		8.8%

in Canada: What a Comparison with the United States Tells Us About a Global Problem" (2013) 54 Canadian Business Law Journal 321 at 324.

[23] Data in this table is generated form source listings data originally produced by TMX Market Intelligence Group.

What has taken the place of these listings on the TSXV? An increased concentration of companies listed in higher risk markets segments (mining, technology and life sciences), as evidenced by the table below.

Table 2- Evolution in TSXV Listings 2008-2023

	December 31, 2008				April 30, 2023			
	# Listings	% Total Listings	MktCap (Millions)	% Total MktCap	# Listings	% Total Listings	MktCap (Millions)	% Total MktCap
Life Sciences	51	3.1%	418	3.0%	84	6.6%	1,746	2.9%
Mining	1,070	65.3%	8,732	63.0%	926	72.9%	39,702	67.0%
Technology	198	12.1%	1,193	8.6%	170	13.4%	13,144	22.2%
		66.9%		61.8%		80.9%		77.5%

The actual extent of the evolution of the broader Canadian public junior markets towards the higher-risk market segments over this interval is actually understated in the two tables because the comparative data is limited to the TSXV. During this 15 year interval, the Canadian Securities Exchange ("CSE") has become a significant player, hosting one-third of total operating company listings in Canadian junior markets. Nearly 97% of the CSE25 Index market capitalization, and more than 93% of the CSE Composite Index market capitalization, are attributable to life sciences, mining and technology market segments, with the highest concentration coming from cannabis-related stocks in the life sciences segment.[24]

What are the common threads amongst these three different market segments that have increased their stranglehold in listings on the Canadian junior public markets? Each of the three market segments involves businesses that most frequently do not generate positive cashflow until later in their business growth cycles, and also deal with significant investments or intangible assets which are difficult to redeploy in the case of a market failure. In the cannabis business, the companies make huge investments in bespoke growing and processing facilities that, in the event of business failure, are only of use to other cannabis companies. In an over-

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[24] Data taken from the CSE website, accessed September 12, 2024, online:< https://thecse.com/market-activity/indices>.

supplied market such as currently exists across North America, the realizable value of these facilities is a fraction of their build-out costs. In mining exploration ventures, the entire investment in determining the quality and nature of an ore deposit becomes worthless unless a commercial-grade ore deposit is established.

Why is this evolution of the junior public markets relevant to the private company investment market in Canada? It is because the evolution of the junior public capital markets over the past 15 years has increasingly deprived middle class investors from investing in start-up and growth-stage companies in the market segments that offer a more balanced risk/reward portfolio. Companies in these lower-risk market segments have migrated towards the private institutional capital markets, outside of the reach of the middle class investor.[25] Retail investors are being left not only with a diminishing pool of public companies in which to invest in the senior public markets, but also a pool increasingly concentrated to the highest-risk companies in the junior public markets.

II. HISTORICAL EVOLUTION OF THE PUBLIC / PRIVATE COMPANY DICHOTOMY IN THE CANADIAN CAPITAL MARKETS

A chasm has developed over the past century between the public equity markets and the private entrepreneurial finance markets. The public markets were the original dominant venue for equity financing in the western world. Protecting the viability of public capital markets against the incursion of private capital markets was not a subject that even merited consideration until recently. Securities regulation in the developed western world evolved over much of the past century in an environment in which financing through the public markets was the only realistic option available to raise large-scale equity for business growth or to fund acquisitions.[26] Indeed, it is only in the past few decades that the

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[25] Wilson-Key Factors, *supra* note 1.

[26] Securities regulation in the west is generally traced back to the U.K.'s passage of the infamous *Bubble Act* in 1720. See Ron Harris, "Political Economy, Interest Groups, Legal Institutions and the Repeal of the Bubble Act in 1825" (1997) 50:4 The Economic History Review 675. The history of Canadian securities regulation can be traced back more than a century,

private equity markets have evolved to become a viable large-scale equity fundraising option and a direct competitor to the public markets in Canada.

Until the latter half of the 19th century, the concept of a private company was unknown in corporate law anywhere in the western world. Legal historian Ron Harris states that "neither company legislation, nor jurists, nor economists, envisioned companies to be private or small".[27] The first law recognizing the distinction between private and public companies was passed in Germany in 1892, creating the GmbH designation that survives to this day.[28] Ultimately, the recognition of private companies as a corporate form exempt from prospectus requirements was recognized in the U.K. through amendments to the *Companies Act* in 1907.[29] In Canada, the private company distinction in law was first introduced by Ontario in 1912, with other provinces quickly following suit.[30] The U.S. private company distinction developed even later, arising from the application of the federal securities law statutes enacted during the Great Depression.[31] The American distinction between private and public companies is more complex than the one in Canada or the U.K. The American definition of a private company is not contained in a single regulatory instrument, but rather defined by the non-application of several acts.[32]

Notwithstanding the early 1900's recognition of the private company as a distinct form of enterprise, the public company form continued to dominate the financial arena in Canada, the U.S. and the U.K. for the first eight decades of the 20th century. Private

beginning with Ontario passing the *Directors Liability Act* in 1891and the adoption of blue-sky laws in Manitoba in 1912. See Mark R. Gillen, *Securities Regulation in Canada* (3rd ed.) (Toronto: Thomson Carswell, 2007) at 181 and Chris Nicholls, *Securities Law (3rd Ed.)* (Toronto: Irwin law, 2023) at 39.

27 Ron Harris, "The Private Origins of the Private Company: Britain 1862-1907" (2013) 33:2 Oxford Journal of Legal Studies 339 at 340.

28 Harris, *supra* note 27 at 341.

29 Harris, *supra* note 27 at 342.

30 Peter J. Williamson, *Securities Regulation in Canada* (Toronto: University of Toronto Press, 1960).

31 Rebecca DeFontenay, "The Deregulation of Private Capital and the Decline of the Public Company" (2017) 68 Hastings Law Journal 445 at 453.

32 Robert B. Thompson and Donald C. Langevoort, "Redrawing the Public-Private Boundaries In Entrepreneurial Capital Raising" (2013) 98 Cornell Law Review 1573.

sources of equity capital during this era were primarily limited to high-net-worth individuals. Institutional private capital did not exist in a recognizable form until after World War II. The origin of institutional private capital in the North America is traced back to the establishment of American Research and Development Corporation ("ARD") by Georges Doriot, Dean of Harvard Business School, in 1946.[33] In 1958, the U.S. government created the small business investment company regime ("SBIC"), modelled on ARD, that allowed venture capital companies regulated by the U.S. government to access government loans at a 4:1 ratio of equity capital and thereby apply the benefit of significant financial leverage.[34] The SBIC resulted in the establishment of nearly 600 investment firms up to 1962.[35] A string of pro-investment U.S. federal laws between 1978 and 1981 led to explosive growth of private institutional capital in the 1980's before the stock market collapse of 1987.[36] After a brief retrenchment, the amount of capital invested in venture capital and private equity has continued to grow exponentially since the early 1990's. Although the growth in assets under management for institutional private capital or annual deployment of capital has not been lineal, the downturns have been relative short, and the overall growth rate in private capital has far outpaced the overall growth of the economy.

In the U.S. alone, there is currently an estimated $13.5 trillion USD invested in equity in private institutional capital markets, a 136% increase compared to the $5.7 trillion USD that was invested in private capital equity at the end of 2012.[37] In comparison, gross domestic product has grown by 56% from $16.25 trillion USD to $25.43 trillion USD over the same interval. Average total annual private equity financings in the United States for the past five years were $689 billion USD, with a record $1.27

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33 Andrew Garragher and Darren Kelly, "An Evaluative Comparison of the Canadian and American Private Equity Markets" (1998) 1:3 The Journal of Private Equity 22 at 23.

34 Garragher and Kelly, *ibid* at 24.

35 Garragher and Kelly, *ibid.*

36 Garragher and Kelly, *ibid.*

37 Ryan Burke, "Are You Harnessing the Growth and Resilience of Private Capital?" (4 April 2024) Ernst & Young Insights, online:< https://www.ey.com/en_gl/insights/private-business/are-you-harnessing-the-growth-and-resilience-of-private-capital>.

trillion USD in dry powder held in private equity funds as of December 31, 2023.[38] Average total annual venture capital financings in United States for the past five years were $216 billion USD,[39] with a record $311 billion in dry powder available as of December 31, 2023.[40]

The private capital trajectory in Canada has lagged the American experience both in terms of the timing of growth and the amount of capital invested through the private markets. Institutional private capital first became relevant in Canada in the mid-1980's as a result of federal government legislation encouraging pension funds and other institutions to allocate capital to private equity investments.[41] Average total annual private equity financings in Canada over the past five years were $26.5 billion USD,[42] with average total annual venture capital financings over the past five years at $6.3 billion USD.[43]

Although the availability of venture capital and private equity investment remains materially lower in Canada than in the United States, both in terms of absolute numbers and on a per capita basis, increasing access to private institutional capital has nevertheless become a huge factor in the Canadian entrepreneurial finance market and is undoubtedly one of the major factors conceptually linked to the operating public company decline phenomenon in

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38 White & Case, "Value of private equity (PE) deals worldwide from 2019 to 2023, by target country" [Graph] (March 1, 2024). In Statista. Also, PwC US, "Value of dry powder of private equity companies in the United States from 2018 to 2023" [Graph] (March 1, 2024) In Statista.

39 NVCA. "Value of venture capital investment in the United States from 2006 to 2023" [Graph]. (April 26, 2024). In Statista.

40 George Hammond and Tabby Kinder, "Silicon Valley Investors Build $300 Billion Cash Pile in Start-Up Funding Crunch" (29 January 2024), Financial Times, online:< https://www.ft.com/ content/eb2e085a-ef5a-4e91-8634-747e2a602fbe>.

41 Garragher and Kelly, *supra* note 33 at 25.

42 White & Case, *supra* note 38.

43 CVCA, "Value of venture capital deals in Canada from 1st quarter 2013 to 4th quarter of 2022" [Graph]. (March 29, 2023). In Statista. Canadian private equity and private placement numbers include all financings completed with Canadian-based operating companies, whether through Canadian-based institutional investors or through international-based institutional investors. A significant amount of these financings were completed with American-based institutional investors financing Canadian-based operating companies.

Canada.[44] In fact, the combination of venture capital and private equity financings completed in Canada over the past five years has averaged nearly 80% of the total amount of combined capital raised by companies listed on Canadian junior and senior markets over the same interval.[45] If current trendlines continue, the private institutional financing market will outstrip the public financing market in size in Canada before the end of this decade. In fact, the total of private venture capital invested in Canadian private companies has exceeded the amount of equity raised on all the junior public Canadian markets for each of 2021, 2022 and 2023. Yet, the private institutional finance market remains inaccessible to more than 95% of the Canadian population.[46]

III. Overview of the Regulation of Private Company Fundraising in Canada

Despite the prominence of the private company form, most Canadian entrepreneurs and investors are unaware of the securities regulations applicable to private company capital raising efforts. To the extent that the typical Canadian entrepreneur or investor is even aware that securities regulations exist, they frequently operate under a belief that Canadian securities regulation does not extend to private companies, provided that they remain under 50 shareholders.[47] Indeed, many lawyers who

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44 Wilson-Key Factors, *supra* note 1.

45 Comparison data calculated from total Canadian public markets fundraising data calculated from source documents and included in Wilson, 2024. If the private equity invested in publicly-listed companies were excluded from the calculation, the percentage would be even higher.

46 No detailed current analysis is available as to the percentage of Canadian investors who qualify for the "accredited investor" exemption under National Instrument 45-106. Reference to various earlier analyses indicates that this number is between 3% and 5% of the population. See: Ontario Securities Commission, "Proposed Amendments to Accredited Investor and Minimum Amount Investment Prospect Exemptions" (27 February 2014) 37:9 OSC Bulletin (Supp-2). Also, Adrian Camara, "Anonymous Capital: Managing Shareholder Volume for Equity Crowdfunded Companies in Canada" (2016) 31 Banking and Finance Law Review 259.

47 Securities law in Canada is contained in a myriad of statutes, regulations, rules, instruments, policies, bulletins, and notices. The term "securities regulation" is used in this paper as a catch-all term to encompass the universe of such documents that collectively govern the selling of securities in

do not specialize in securities regulation operate under the same misconception, advising clients that they do not need to worry about running afoul of securities regulation as long as the corporation remains below the magical 50 shareholder limit prescribed for private companies. This widespread misconception is dangerous. Securities regulation in Canada does in fact apply to all issuances of securities, whether by private or public companies. Ironically, the "private issuer" exemption found in section 2.4 of National Instrument 45-106-Prospectus Exemptions ("NI 45-106"), the key provision governing fundraising by Canada's private companies (i.e., the cohort most likely to attempt fundraising without expert advice), is also one of the most challenging securities law provisions to fully comprehend for non-experts.

Providentially, most private company share sales in Canada fit within the requirements of section 2.4 of NI 45-106, which does not require that any filings be made with securities regulators when shares are sold in reliance thereon. This allows many private companies to remain in unwitting compliance with Canadian securities laws despite their lack of awareness of the specific securities exemptions under which they are operating. Yet, the general lack of awareness surrounding Canadian private company financing regulation also results in unintentional, but not infrequent, private company share issuances that are offside prospectus and registration exemptions.[48] The improper use by private companies of NI 45-106 is not the focus of this paper, although the core recommendations of this paper would significantly extend the scope of section 2.4 of NI 45-106 and thereby reduce the incidence of improper use of the exemption.

Canada. Each Canadian province and territory has its own unique securities regulation, as securities is regulated sub-nationally under the division of powers in the *Constitution Act 1867*.

48 There is no data available on the actual number of improper share issuances completed each year in Canada under the private company exemption in NI 45-106. This is because these occurrences only come to the attention of Canadian securities lawyers on a formal complaint basis, and relatively few private company investors are willing to, or even realize that they have a foundation to, make a formal complaint. However, every Canadian securities lawyer who has had significant exposure to private company issuers can give examples of situations where companies improperly used the private company exemption without knowing that they were doing so.

A. *Canadian Securities Regulation and the Closed System of Distribution*

The regulation of securities is complex, and this paper only reviews the key elements relevant to private company capital formation and middle class Canadians.[49] Canada remains the only OECD-member country without a national securities regulator. Securities regulation is within the exclusive constitutional powers of the provinces, leaving Canada with 13 securities regulators (including territorial regulators) in a country with a population of only 40 million people. To provide some degree of national consistency, the Canadian securities regulators often voluntarily collaborate under the auspices of the Canadian Securities Administrators, and much of Canadian securities regulation is harmonized across the country under a series of national and multilateral instruments.

Canadian securities regulation is primarily based on the "closed system" of distribution.[50] In order to issue a treasury security, an issuer must either: (i) qualify a prospectus clearing the distribution; (ii) qualify for an exemption from filing the prospectus; or (iii) apply for a discretionary exemption from a securities commission.[51] With discretionary exemptions limited, companies looking to raise equity are generally faced with the dichotomy of either filing a prospectus or selling under an exemption. Once a company files a prospectus, it automatically

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[49] For the purposes of this analysis, middle class is broadly defined as including anyone with some level of discretionary savings to invest, yet not able to meet the threshold of an "accredited investor" under NI 45-106.

[50] See National Instrument 45-102 "Resale of Securities". Of the 13 Canadian securities jurisdictions, only Manitoba does not have a closed system. In Manitoba, the first trade of securities acquired under the private company exemption in section 2.4 of NI 45-106 does not have a hold period unless the trade constitutes a "primary distribution to the public" under *The Securities Act* (Manitoba). The definition of primary distributions to the public captures transfers from control persons and re-sales that are linked to the original distribution. If the private company share issuance in Manitoba is completed under the separate exemptions that are repeated as headings within the private company exemption, Manitoba Securities Commission Local Rule 45-806 provides for a 12 month hold period, similar to the SEC restrictions on Rule 504 and 506 offerings discussed later in this paper.

[51] Issuance of a "treasury" security refers to the first time that a company creates a security and sells it to a third-party purchaser. Each trade in a security is either a treasury issuance or a re-sale of the security.

becomes a "reporting issuer" and is subject to the full range of continuous disclosure obligations moving forward. Under the closed system, every subsequent trade in a security that is originally sold under an exemption requires a further exemption for re-sale in perpetuity until either: (i) a prospectus is cleared for the securities; or (ii) if the company is a reporting issuer, a seasoning period expires. It is only when one of these two events occurs that the securities leave the closed system and become freely tradeable. Securities that are freely tradeable may yet again get caught back in the closed system if a subsequent trade constitutes a "distribution".

B. *Fundraising Under the Private Company Exemption*

As securities regulations apply to every trade of the securities of every company in Canada, each private company trade requires an appropriate exemption in order to remain in compliance. The most obvious exemption available for private company security treasury issuances and secondary market transfers is the "private issuer" exemption found in section 2.4 of NI 45-106. In order to be properly categorized as a private issuer, a company must not be a reporting issuer or have ever distributed shares to the public. A private issuer must also: (i) have restrictions on share transfer in its constating documents;[52] and (ii) not have more than 50 beneficial shareholders, excluding current or former employees.

Who, then, can buy private issuer shares in Canada? In order to be eligible to purchase shares under the private issuer exemption in section 2.4 of NI 45-106, a purchaser must fall within a list of eligible persons set out therein. Somewhat confusingly, the last item in the list defining eligible investors under section 2.4 appears to be a broad catch-all, allowing investment by a "person that is not the public". The phrase "not the public" is not defined in NI 45-106 or anywhere else in Canadian securities regulation. As such, we are left to the securities law tribunals and courts to define the scope of "not the public". After consideration of the phrase in dozens of tribunal hearings and court cases over decades, the only

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52 The restriction on share transfer is a provision requiring any transfer of shares to be subject to the pre-approval of the Board of Directors. This allows the company to ensure that no shareholders are attempting trades that would amount to distributions or otherwise risking the status of the company as a private issuer without its knowledge and approval.

safe legal position is to conclude that this ostensible catch-all exemption does not add anything to the specific classes of eligible purchasers otherwise enumerated in section 2.4 on NI 45-106.[53]

The specific classes of eligible purchasers under the private company exemption in section 2.4 include two broad categories: (i) those individuals in a pre-existing special relationship with the issuer or its key personnel; and (ii) accredited investors. The category of people in a special relationship can further be broken down into two sub-groups: (i) those who are directly and significantly involved in the company, such that they can be assumed to have sufficient knowledge as to the business and affairs of the company to make a reasoned investment decision (directors, officers, employees, founders and control persons of the issuer); and (ii) those with a close enough relationship to the first sub-group that it can be assumed the individual with direct knowledge of the issuer will watch out for their financial interests (family, close personal friends and close businesses associates).

Courts and regulatory tribunals interpreting the private issuer exemption have repeatedly made it clear that a "friend of my friend" is *not* my friend for the purposes of NI 45-106. The personal connection must be direct. Cases have also repeatedly concluded that, if an issuer uses an intermediary to raise funds and pays compensation for doing so, any investors attracted by the intermediary will be assumed not to have been in a sufficiently close relationship to count as having a sufficiently close personal connection to meet the requirements of the exemption. To reach this conclusion, the courts and regulatory panels reason that, if a sufficiently close relationship exists, why would an issuer need the intermediary at all?

Individual accredited investors in Canada, meanwhile, must meet one of the following financial test thresholds under NI 45-106:[54] (i) own, individually or with a spouse, financial assets (bank accounts, brokerage accounts, GIC's and RRSP's) with a market value of at least $1 million net of related liabilities; (ii) reported a personal pre-tax income of at least $200,000 (or $300,00 combined

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[53] Nicholls, *supra* note 26 at 267.

[54] The definition of "accredited investor" s.1.1 of NI 45-106 also includes a number of defined financial institutions along with registered dealers, limited market dealers and funds. However, this paper is concerned with individual investors who are not funds or industry professionals.

with their spouse) in two of the last three years and expect the income level to continue in the current year; or (iii) own, individually or with a spouse, at least $5 million in net assets. Although the percentage of Canadians who meet the definition of accredited investors has certainly increased due to inflation over the past 30 years, as well as through appreciating residential home values, the accredited investor class is still a small minority of Canadians, estimated at no more than 5% of the total population.[55]

Where does this leave the Canadian private company in terms of raising capital under section 2.4 of NI-45-106? In essence, a Canadian private company can only sell its treasury securities to: (i) investors who are directly involved in the business of the company; (ii) investors who have close personal connections to someone directly involved in the business of the company at a high level; or (iii) high net worth investors who meet the accredited investor definition.

Canadian entrepreneurs search for capital from a vanishingly small list of eligible purchasers other than accredited investors. Any person who has participated extensively in the private company fundraising ecosystem in Canada has likely been exposed to situations in which private company founders have pushed the boundaries of who counts as an eligible investor under section 2.4 of NI 45-106. Moreover, any person fitting within the group of eligible investors who acquires treasury shares in a Canadian private issuer can subsequently only sell their shares to another eligible investor within the closed system. This indefinite restriction on liquidity can be a powerful disincentive to making the initial investment.

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[55] Confusingly, a number of the key components of the private company exemption in section 2.4 of NI 45-106 (including the "accredited investor" definition and the close friends and business associates exemption) are also repeated as stand-alone exemptions under other subsections of NI 45-106. However, if you use the stand-alone version of the exemptions rather than provisions contained with the private company exemption of section 2.4, you must file reports with the applicable securities regulator at the time of the issuance and pay the prescribed filing fees.

C. *History of the Private Company Accredited Investor Exemption in Canada*

The direct antecedent of the accredited investor exemption in Canada was the minimum investment exemption, also known as the "sophisticated investor" exemption. This exemption, which provided an exemption for an individual purchaser on the condition that the purchaser invested at least $97,000 in the offering, was first adopted by the Ontario Securities Commission ("OSC") in 1966.[56] Other provincial securities commissions soon followed. When Ontario raised the minimum purchase exemption threshold to $150,000 in 1987, most other provincial regulators left the exemption at the original $97,000 threshold. The stated rationale of the minimum amount exemption was premised on the investor possessing one or more of: (i) a level of investment sophistication; (ii) the ability to absorb loss of their investment; (iii) financial resources to secure expert investment advice; and (iv) the incentive to carefully evaluate the investment.[57] The obvious defect in the design of the minimum amount exemptions was that it did not stipulate what percentage of an investor's net worth could be represented by the investment. The assumption was that anyone that could get her hands on $97,000 or $150,000 evidenced some of the criteria above, failing to consider the implication of an investor borrowing beyond their means or leveraging the family home to make an investment.

The modern accredited investor exemption was adopted by the OSC in 2001, with other provincial securities commissions adopting the exemption around the same time.[58] The nature of the Canadian accredited investor exemption was based on the American precedent, even using the same income thresholds (although denominated in Canadian dollars). Canadian securities regulators other than Ontario began harmonizing their capital raising exemptions with the adoption of Multilateral Instrument 45-103 "Capital Raising Exemptions" in 2003, with Ontario subsequently joining into a nationally-harmonized system under NI 45-106 in 2005. The 2005 harmonization under NI 45-106 was

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[56] CSA Consultation Note 45-401, "Review of Minimum Amount and Accredited Investor Exemptions" (2011), 34 OSCB 11278.

[57] CSA Consultation Note 45-401, *ibid*, at 2.

[58] CSA Consultation Note 45-401, *ibid*, at 5.

also the occasion on which the accredited investor concept became embedded within the private company exemption across the country. On February 19, 2025, the Canadian Securities Administrators consortium announced amendments to NI 45-106 that will be effective in May 2025, including new risk acknowledgment forms in plain language and providing guidance on steps that issuers must take to verify the status of purchasers acquiring under this exemption. However, the substance of NI 45-106 remains in place.

D. *Additional Early-Stage Financing Exemptions for Private Companies in Canada*

The private issuer exemption set out in section 2.4 of NI 45-106 is admittedly not the only exemption available for private companies in Canada to raise capital. As stated above, there are also stand-alone accredited investor and close friend and business associate exemptions in NI 45-106. However, these stand-alone exemptions require post-financing filings with the applicable securities regulators, so private companies universally avoid the stand-alone exemptions unless the private company exemption is unavailable under section 2.4.

Of greater interest, a few Canadian securities regulators have been evaluating and testing various mechanisms to increase the ability of early-stage companies to access additional pools of investor capital. Alberta has been the jurisdiction most willing to consider new financing options for non-accredited investors, often with the support of Saskatchewan. Ontario has been more cautious, but has on occasion been willing to follow Alberta's lead. These exemptions include the self-certified accredited investor exemption, the offering memorandum exemption, the start-up exemption and the crowd-funding exemption. Because the concept of considering novel ideas to enhance capital formation opportunities is at the core of this paper, the merits and limitations of each of these early-stage capital formation initiatives will be considered briefly.

E. *Offering Memorandum Exemption*

The offering memorandum exemption currently contained in s.2.9 of NI 45-106 has a long history in Canada, essentially allowing issuers who cannot complete their financings without resorting to

a sale to the public to use a "prospectus-lite" offering document that is not substantively reviewed by securities commissions and does not result in the issuer becoming a reporting issuer. Shares issued under an offering memorandum exemption remain within the closed system, and are subject to indefinite hold periods unless the issuer ultimately becomes a reporting issuer. Audited financial statements are also required in conjunction with the offering memorandum. There are maximum purchase limits of $10,000 or $30,000 per investor, depending on whether the investor is an "eligible investor", which is similar to an accredited investor, but with significantly lower thresholds.

The offering memorandum exemption gives rescission rights and issuer liability similar to a prospectus. Once an issuer has accessed the offering memorandum exemption, it can no longer waive the requirement of audited financial statements moving forward. The offering memorandum exemption is, therefore, only useful to companies who are confident that they will become a reporting issuer within a defined time period and therefore is often used as a bridge financing tool in advance of some form of going-public transaction. Use of this exemption has become increasingly less common over the past decade due to the investment caps.

F. *Self-Certified Investor Exemption*

The self-certified investor exemption is a recent innovation in the Canadian markets that has not yet seen widespread adoption, but offers the prospect of being the seed of critical and meaningful reform, as discussed later in this paper. The self-certified investor exemption was pioneered jointly in two provinces, Alberta and Saskatchewan, on March 31, 2021 for a three-year initial trial period. The original version of the exemption under ASC Blanket Order 45-538 required that: (i) the sale to the self-certified investor be carried out in conjunction with the sale to at least one accredited investor on the same terms, and the self-certified investor received the same information as the accredited investor; (ii) the self-certified investor could purchase a maximum of $10,000 from one issuer per year under this exemption, and a cumulative maximum of $30,000 per year from all issuers under this exemption; (iii) the self-certified investor must deliver an acknowledgment to the issuer confirming they understand the limitations of their rights and the nature of the re-sale restrictions; and (iv) the self-certified investor must have a degree of financial

sophistication as a result of having a certification in one of a variety of financial designations, an MBA, an undergraduate finance degree, or be a lawyer with experience in securities law. Effectively, the self-certified investor program allows an investor that is sophisticated, but not yet wealthy enough to be an accredited investor, to piggy-back on the decision-making of an accredited investor with relatively small investments.

Alberta and Saskatchewan recently extended the self-certified investor program indefinitely with terms substantially the same as Blanket Order 45-538.

Ontario adopted its own version of a self-certified investor exemption on October 25, 2022 under Ontario Instrument 45-507 for an 18 month initial trial period. It was recently extended for another 18 month period up to October 25, 2025 by OSC Rule 45-508. The Ontario self-certified investor exemption is nearly identical to the Alberta/Saskatchewan version.

In November 2024, Manitoba also adopted a self-certified investor exemption under Blanket Order 45-505, which also follows the Alberta/Saskatchewan precedent.

The limitations of these existing self-certified investor exemptions are obvious. The restrictions remain numerous, opening up investment opportunities to a further small group of Canadian investors, and the maximum amount of the total investment is low.

G. *Small Business Financing Exemption (a.k.a. the "Start-Up Exemption")*

If the offering memorandum exemption is considered as the "prospectus-lite" exemption, then the small business financing exemption can be regarded in turn as the "offering memorandum-lite" exemption. This is another exemption that has been pioneered only in Alberta and Saskatchewan. The current exemption was adopted on September 1, 2021 for a three-year pilot basis in Alberta under ASC Blanket Order 45-539, and replaced a related earlier Alberta version of the program which previously existed under ASC Rule 45-517. Under this exemption, issuers are allowed to raise up to a lifetime cap of $5,000,000 Cdn. (increased from $1,000,000 in the earlier version under ASC Rule 45-517) with a simplified form of an offering memorandum not requiring

audited financial statements.[59] Although the form and disclosure is simplified, this exemption gives the same rights for misrepresentation as a full offering memorandum. Individual investor limits apply at various levels that are lower than the full offering memorandum (between $2,500 and $20,000 Cdn.).

This is another exemption that contains interesting elements that form the seeds of potentially more robust reform proposals, in particular the ability to use unaudited financial statements in an offering document. The major restrictions that limit the commercial appeal are the indefinite hold periods, the cap on individual investors and the limited amount of the annual and lifetime exemptions.

H. *Crowd-Funding Exemption*

The fourth and final early-stage capital formation exemption recently created in Canada is the crowd-funding exemption. Again, Alberta was amongst the first movers in this space under ASC Blanket Order 45-521, which came into effect on October 2, 2019. B.C., Saskatchewan, Manitoba, Quebec, New Brunswick and Nova Scotia also brought in harmonized exemptions at the same time. This crowd-funding exemption was an attempt to provide a path for regulatory compliance to the equity crowd-funding portals that had sprung up online and which operated outside of the realm of securities compliance. It provided an opportunity for crowd-funding portals to register with the securities commissions. The crowd-funding exemption required a disclosure document similar in form to the one prescribed for the small business financing exemption, and prescribed investor limits of $1500, increasing to $5,000 if the purchaser had obtained suitability advice from a registered dealer.

The original Blanket Orders were ultimately replaced by NI 45-110 on September 21, 2021, which included Ontario's participation. The new instrument operates with substantially similar conditions as the earlier version, with one significant difference being that the previous fundraising limit of $250,000 in a single distribution was replaced with the current annual fundraising cap of $1,500,000.

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59 The audit exemption applies as long as less than $1,500,000 per year is raised under this exemption.

Crowdfunding has found a limited niche amongst private companies in Canada, stagnating over the past decade. Total funds raised annually by private companies across Canadian crowdfunding platforms has remained near the $20 million mark since 2017.[60]

I. *Limitations of Alternative Fundraising Exemptions for Canadian Private Companies*

These individual fundraising exemptions available for private companies beyond the specific private company exemption have met with limited success in their market uptake. Why? There are three contributing factors. First, a private issuer who accesses these alternative exemptions likely loses its private issuer status as a result of the financing. To be eligible to issue securities under the private issuer exemption, a private issuer must never have issued shares to the public. If an issuer sells securities using these other early-stage capital formation exemptions to an individual that is not someone who is in a special relationship with the issuer, or those directly connected to the issuer, that event alone likely constitutes a sale to the public under the interpretation of "public" applied by courts and regulatory panels. Once a private company crosses that particular Rubicon, it can never use the private issuer exemption again. Second, the additional fundraising exemptions require the filing of distribution notices with the applicable securities regulators and payment of associated fees. Entrepreneurs can be reluctant to make those filings and put themselves on the list of private companies using the exemptions for fear that the act of filing will single them out for future compliance verification. Third, the individual investment caps in the alternative early-stage capital formation exemptions mean that a large number of investors need to be identified to make a worthwhile financing. The 50 shareholder limit for private companies does not leave room for a worthwhile distribution under these exemptions while remaining a private issuer. As such, these alternative early-stage Canadian capital formation exemptions are more frequently used by junior public companies that are already reporting issuers and not concerned about losing the private company status.

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60 Statista, "Capital Raised-Crowdfunding" (2024) Statista Market Insights, online:< https://www.statista.com/ outlook/fmo/capital-raising/digital-capital-raising/crowdfunding/canada#capital-raised>.

IV. COMPARISON TO THE U.S. PRIVATE COMPANY FUNDRAISING LANDSCAPE

Under the series of North American free-trade agreements that have been in place over the past 35-plus years, Canadian private companies compete continuously and directly with their American counterparts across most segments of the economy. As has been discussed previously, Canadian companies recently have not been competing as successfully with American companies as in decades past, notwithstanding the natural advantage of favorable exchange rates. There are undoubtedly many contributing factors, but the access of private companies to start-up and growth capital is one element of the equation.

A brief analysis of the current U.S. ecosystem for private company fundraising makes it clear that U.S. private companies enjoy significant advantages over Canadian private companies in equity fundraising. We have already pointed out that American start-up and growth stage companies have access to four times as much institutional early-stage equity capital on a per capita basis. The U.S. system of regulation also gives Americans private companies a significant advantage in accessing non-institutional (i.e., middle class or non-accredited investor) investment.

The U.S. does not operate under a direct equivalent to the Canadian closed registration system, meaning that hold periods on private placement shares expire even if the issuer remains as a private issuer. The starting place in the U.S. private company fundraising analysis is the *Securities Act of 1933*, which contains Section 4(a)(2) providing for exemptions from prospectus requirements for private placements. Section 4(a)(2) requires that, to be eligible for the exemption, the purchaser of a security must be a sophisticated investor, or be able to bear the investment's economic risk, have access to the type of information normally contained in a prospectus, and must covenant not to resell the security to the public.[61] This was considered fairly restrictive and led to uncertainties around the margins of private company fundraising for several decades. The modern structure of the

[61] Securities and Exchange Commission, "Private Placements- Rule 506(b)" (Updated June 29, 2024) SEC Resources for Small Business, online:<ec.gov/resources-small-businesses/exempt-offerings/private-placements-rule-506b>.

private company fundraising landscape in the U.S. can be traced to the adoption by the U.S. Congress of the *Small Business Investment Incentive Act of 1980*.[62] In response, the U.S. Securities and Exchange Commission (the "SEC") adopted Regulation D ("Reg D") in 1982, which provided a number of new exemptions from prospectus registration requirements for American private company issuers.[63] The important provisions for our purposes are Rule 504, Rule 506(b) and Rule 506(c).

A. *Regulation D- Rule 504*

Rule 504 is described by the SEC as the "Seed Capital Exemption".[64] The 1982 version of Rule 504 originally exempted private offerings of up to $500,000 US over a 12-month period, provided that general solicitation and advertising of the offerings was prohibited.[65] In 1992, amendments to Rule 504 extended the exemption for non-reporting issuers relating to offerings up to a cumulative amount of $1 million US over a 12-month period, with general solicitations and advertising of the offerings allowed, and the securities issued under such offerings immediately re-saleable so long as the original purchasers were non-affiliates of the issuer or underwriters.[66] The 1992 amendments also restricted the use of Rule 504 to non-reporting issuers and companies with operating businesses.[67] Abuse of this more permissive version of Rule 504 by micro-cap issuers traded over-the-counter led to the SEC tightening the Rule 504 exemption in 1999, adding in a 12-month hold period on Rule 504 distributions and reinstating the prohibition on general solicitations. General solicitations are defined by the

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62 *Small Business Investment Incentive Act of 1980*, Pub. L. No. 96-477, 944 Stat. 2275.

63 17 C.F.R. §230.501 et seq.

64 Securities and Exchange Commission, "Revision of Rule 405 of Regulation D, the Seed Capital Exemption" (25 February 1999) SEC Rule, Release 33-7644.

65 SEC, *ibid*.

66 SEC, *ibid*. In its discussion of the 1999 amendments, the SEC notes that the Rule 405 issuances remain subject to compliance with state securities laws.

67 The specific exclusions in Rule 504 include investment companies and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies (which includes Special Purchase Acquisition Companies).

SEC as a communication intended to increase the market appetite for securities and includes print and broadcast advertisements along with marketing on public websites.[68]

In 2016, the SEC amended Rule 504 again, this time increasing the total amount of funds that can be raised over 12-month period under the Rule 144 exemption to $5 million US.[69] The 2016 amendment also adopted a "bad actor" disqualification that previously applied only to Rule 506, which eliminates the ability of an issuer to use the exemption if the issuer, its directors, officers, promoters, major shareholders or agents have been subject to a list of disqualifying securities violations, criminal convictions, professional disciplinary orders or criminal convictions.[70]

In 2020, the SEC once again amended Rule 504, this time increasing the 12-month fundraising limit to $10 million US.[71] The 2020 amendment modified the prohibition of general solicitation and advertising, allowing issuers to test the waters on exempt securities offerings and also to issue communications in conjunction with a "demo day" or seminar affiliated with a variety of non-for-profit institutions such as universities or local governments, as well as angel networks or accelerators.

While most securities issued under the current form of Rule 504 are restricted for 12 months, there are also provisions in Rule

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68 Securities and Exchange Commission, "General Solicitation" (Updated August 30, 2024) SEC Resources for Small Business, online:< https://www.sec.gov/resources-small-businesses/capital-raising-building-blocks/general-solicitation>.

69 Securities and Exchange Commission, "Exemptions to Facilitate Intrastate and Regional Securities Offerings (26 October 2016) SEC Rule, Release 33-10238.

70 Securities and Exchange Commission, "Rule 504 of Regulation D: A Small Entity Compliance Guide for Issuers" (Original 19 January 2017; Updated as of April 2024) SEC Website:< https://www.sec.gov/resources-small-businesses/small-business-compliance-guides/rule-504-regulation-d-small-entity-compliance-guide-issuers>.

71 The 2020 amendment was through a rule titled "Facilitating Capital Formation and Expanding Investment Opportunities by Improving access to Capital in Private Markets". See Andrew Lom and Rachael Hamshall, "US SEC Amends Rules to Simplify and Expand the Exempt Offering Framework" (November 2020) Norton Rose Fullbright Knowledge Publications, online:<www.nortonrosefulbright.com/en-us/knowledge/publications/ 1ad307f7/us-sec-amends-rules-to-simplify-and-expand-the-exempt-offering-framework>.

504 that also allow issuers to issue unrestricted securities and to use advertising and general solicitation in their offerings as long as the sales are made only to accredited investors and in compliance with applicable state legislation.

In summary, therefore, the current version of Rule 504 allows private companies in the U.S. to raise up to $10 million US per year from non-accredited individual investors, without any limitation as to minimum investment amounts per investor or the maximum number of investors that can purchase securities. No disclosure documents are mandated at the time of the offerings, nor are any continuous disclosure requirements mandated thereafter for the private issuers. The issuer must file a notice of the terms of the offering on Form D with the SEC after each distribution under Rule 504, but there is no fee for the filing. Rule 504 offerings may not normally be advertised or use general solicitations, subject to the demo day exception. Private issuers relying on Rule 504 will still be liable for the accuracy of any written material that is voluntarily distributed to purchasers under the general anti-fraud provisions of U.S. securities legislation, which continue to apply to all exempt financings.

B. *Regulation D- Rule 506(b) and Rule 506 (c)*

Rule 506(b) allows an issuer to raise an unlimited amount of money and sell securities to an unlimited number of accredited investors. However, Rule 506(b) also can be used to sell to up to 35 non-accredited investors in a single offering. Accredited investor qualification for Rule 506(b) is determined by self-certification. To qualify under Rule 506(b), the offering must not include a general solicitation or advertisement. Also each non-accredited investor must have sufficient knowledge and expertise in financial and business matters, either directly or through the support of an advisor, to be capable of evaluating the merits and risk of the particular investment.[72]

Up until 2021, private placements under Rule 506(b) that included any non-accredited investors attracted the filing of a mandatory disclosure document, the completion of which added significant cost to the deal. As such, non-accredited investors were usually excluded from Rule 506(b) offerings to eliminate the

72 SEC, *supra* note 61.

disclosure requirement. However, 2021 amendments to Rule 506(b) eliminated the requirement that an issuer provide specific disclosure documents (other than financial statements) to either accredited or non-accredited investors under Rule 506(b) if the offering is under $20 million US.[73] This has made the use of Rule 506(b) more accessible for non-accredited investors. Under current rules, private placements less than $2 million US require only that the balance sheet need be audited. For placements between $2 million and $7.5 million US, only the balance sheet need be audited if attaining an audit of the full financial statements causes unreasonable expense or effort.[74]

Under Rule 506(b), the issuer must also make itself available to answer questions to non-accredited investors in Rule 506(b) offerings. Also, any non-accredited purchaser under a Rule 506(b) offering must receive whatever disclosure document the issuer voluntarily gives to accredited investors in the same offering. Rule 506(b) can be used for a string of separate private placements, with the 35 non-accredited investor limit applicable to each separate offering.

Turning briefly to Rule 506(c), this exemption allows private companies to raise an unlimited amount of money without any disclosure document. The advantage of Rule 506(c) is that companies can broadly solicit and generally advertise the offering.[75] Offerings under Rule 506(c) are restricted to accredited investors, and the issuer must take reasonable steps to verify the purchasers' eligibility as an accredited investor.

Neither Rule 506(b) or 506(c) have dollar limits associated with the exemption. The ultimate fundraising limit under Rule 506(b) and Rule 506(c) is instead linked to the number of total shareholders of the private company. A private company is only able to use Rule 506(b) or Rule 506(c) up to the point where it has accumulated 2000 total registered shareholders, or up to a

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73 Elizabeth Whitman, "Changes to Disclosure Requirements for Rule 506(b) and Regulation A Offerings" (15 March 2021) JD Supra, online:< https://www.jdsupra.com/legalnews/changes-to-disclosure-requirements-for-8134841>.

74 Whitman, *ibid*.

75 Securities and Exchange Commission, "General Solicitation- Rule 506(c)" (Updated 28, 2024) SEC Resources for Small Business, online:<www.sec.gov/resources-small-businesses/exempt-offerings/general-solicitation-rule-506>.

maximum of 500 registered non-accredited investors. Private companies using Rule 506(b) issue securities with a 12-month hold period and the same bad actor disqualification as was discussed in Rule 504 also applies.

C. *The Accredited Investor Exemption in the U.S.*

The first adoption of the accredited investor concept in the U.S. federal law occurred in 1978. The SEC stated that the accredited investor concept was "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the *Securities Act*'s registration process unnecessary."[76] It was formalized in its modern form as part of the Regulation D reforms in 1982, where it was incorporated in Rule 510(a).[77] The 1982 version of the accredited investor definition included individual investors with $200,000 US in annual net income or $1 million in net worth. It also included an alternative minimum purchase component of $150,000, provided that the purchase did not exceed 20% of the investor's net worth.[78] The SEC amended the definition in 1988, adding the $300,000 minimum joint income combined with a spouse, while dropping the $150,000 minimum investment criteria. In 2011, the SEC further amended the accredited investor definition to exclude the value of the investor's primary residence, thereby decreasing the number of eligible participants. Most recently, in 2020 the SEC updated the definition to allow individuals to qualify as accredited investors based on registration as brokers or on the basis of professional certifications or educational credentials.[79]

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[76] Securities and Exchange Commission, "Regulation D Revisions; Exemption for Certain Employee Benefit Plans: Regulation D Revisions; Exemption for Certain Employee Benefit Plans" (16 January 1987) SEC Release No. 33-6683 at 301.

[77] Securities and Exchange Commission, "Review of the "Accredited Investor Definition under the Dodd-Frank Act" (14 December 2023) SEC Report, online:< https://www.sec.gov/files/review-definition-accredited-investor-2023.pdf> at 8.

[78] SEC, *ibid* at 14.

[79] Securities and Exchange Commission, "SEC Modernizes the Accredited Investor Definition" (26 August 2020) SEC Press Release, online:< https://www.sec.gov/newsroom/press-releases/2020-191>.

The 2011 American modification is similar to the self-certified accredited investor exemptions recently adopted in Alberta, Saskatchewan and, on an interim basis, Ontario. Comparing the rest of the accredited investor definitions in Canada and the U.S., it is apparent that the same thresholds are used for annual net income tests in both countries, although the difference in currency values make the U.S. version comparatively more restrictive. However, the asset tests in the Canadian version are more restrictive than the American version, since the $1 million net worth test in the U.S. excludes only principal residences, whereas the $1 million net worth test in Canada is restricted only to financial assets. If an individual owns a couple of rental properties, the equity value of those assets is excluded from the Canadian test and included in the American test. The $5 million net asset test in Canada that does include the value of principal residences does not have an analog in the U.S.

The Dodd-Frank Act, implemented in the aftermath of the global financial crisis, requires the SEC to conduct a substantive review of the accredited investor definition at least every five years to determine whether the thresholds remained appropriate.[80] These reviews have now been completed in 2010, 2019 and 2023. The SEC's own analysis of the percentage of American households who qualified as accredited investors under the definition in place at the relevant time is as follows: 1983-1.8%; 1989-3.0%; and 2022-18.5%.[81] Clearly, the wealth of American households has increased significantly over the timespan while the accredited investor thresholds have remained flat. Also, the accredited investor thresholds have not been adjusted to account for inflation, which has also added to the increasing percentage of accredited investors.

D. *U.S. Private Company Fundraising Advantages Compared to Canada*

Based on the preceding discussion, the advantages that U.S. private companies currently enjoy over Canadian private companies with respect to capital raising are both significant and obvious:

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80 *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111-203, § 929-Z, 124 Stat

81 This is at approximately four times the percentage of Canadian households who qualify under our accredited investor definitions.

- Although the shares issued under Rule 504, Rule 506(b) and Rule 506(c) carry12-month trade restrictions, they do not carry an indefinite hold period like shares acquired under the closed Canadian systems.
- American private company shareholders who have held their shares for 12 months do not have to ensure that they are selling to a purchaser who is qualified to buy under a further securities exemption. This opens the door to more optionality for American private companies and their shareholders that seek to provide some degree of liquidity without going public.
- A number of private company markets exist in the U.S. where private company shareholders can sell their shares with the participation and support of the private company, including the Nasdaq Private Market. This makes it more attractive for American private company investors to buy private company stock than it is for Canadian investors.
- U.S. private companies have the opportunity to raise $10 million US annually under Rule 504 from non-accredited investors, in addition to an unlimited amount from up to 35 non-accredited investors purchasers per offering under Rule 506(b). This provides a significant opportunity for American middle class investors to participate in the private company market that is not present in Canada.
- The American accredited investor definition includes a significantly higher percentage of the American population than the Canadian accredited investor definition.
- The clear direction provided by the SEC around the demo day advertising and marketing opportunities provide American companies with greater latitude in seeking potential investors outside the existing social network of company founders than the current Canadian restrictions on soliciting the public.

Yet, even in the U.S., the current wealth-based accredited investor regime has been under attack as being elitist and

representing an illogical basis to determine which investors have preferred access to private company investments.[82]

V. PROTECTING WHOM FROM WHAT? THE DEGRADATION OF MORAL AUTHORITY UNDERPINNING OUR CURRENT SYSTEM OF ENTREPRENEURIAL FINANCE SECURITIES REGULATION

Securities regulators in the western world operate under a dual mandate, the two competing elements of which often create an internal conflict. First, securities regulators are tasked with fostering the development of fair and efficient capital markets. Second, securities regulators are tasked with protecting individual investors from improper, misleading or fraudulent practices. Securities regulators in particular seek to protect unsophisticated investors in the market. The tension between the two elements of the mandate arises because every piece of securities regulations imposes an additional cost on issuers. Hence, striking the appropriate balance between promoting market efficiency and protecting investors is perpetual regulatory challenge.

As discussed earlier, the massive gulf in the regulatory burden between private issuers and public companies is not something that was envisioned by regulators in establishing the foundations of our modern securities regulation. Until the past few decades, the public company was unchallenged king of the market for fundraising at any significant scale, and it was assumed that would remain the case in perpetuity. At the time of the adoption of the SBIC program in the U.S. in the 1950's, nobody foresaw a future in which the private markets cannibalized the public markets to the point where the continued relevancy of the public markets was at serious risk. There is no question that the growth of the private

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82 See, for example, Jennifer J. Schulp, "Sophistication or Discrimination? How the Accredited Investor Definition Unfairly Limits Investment Access for the Non-Wealthy and the Need for Reform" (8 February 2023), text of testimony to the Subcommittee on Capital Markets, Committee of Financial Services, United States House of Representatives, online:< https://www.cato.org/testimony/sophistication-or-discrimination-how-accredited-investor-definition-unfairly-limits#investors-should-be-given-more-opportunities-to-access-private-market-investments>.

markets over the past four decades has occurred as a direct result of the relatively light regulatory burden borne by the private issuers compared to their public market counterparts. However, the issue of public company decline is multi-factorial and highly complex.[83] Regulatory arbitrage is certainly *one* key element behind the ascendancy of the private equity markets, but it is not the *only* significant contributing factor.[84]

The recognition that there is something inherently distasteful about preventing individuals who fail to meet the financial threshold from participating in private company investments is certainly not new. The message to the non-accredited investor in Canada is inescapably that they *cannot afford* to lose in their investments, and do not have the agency to make risky investment decisions in private entities. Moreover, we imply that the middle class investor lacks sophistication to properly assess the risk associated with investing in private company opportunities with inevitable information asymmetry, so the regulators must remove the risk of bad investment decisions by eliminating them from directly investing in the private markets.[85]

While the prohibition on non-accredited investors participating in private issuer financings has always been problematic, it was more palatable in the eras when most of the best start-up and growth-stage companies ultimately ended up on the public markets. That is no longer the case, as discussed earlier. The opportunity to invest in the best companies at the critical inflection points, where significant value accretion is likely to occur, is increasingly rare for today's middle class (ie., unaccredited) investor. This results in a Catch-22 conundrum. Do you wish to invest directly in private companies to increase your opportunity for investment returns? Get rich first, so that you can qualify as an accredited investor.

This sea change in the nature of our capital markets begs the following question: do the traditional rationales underpinning the hierarchical system in which direct access to the private capital

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[83] Wilson-Key Factors, *supra* note 1.

[84] Wilson-Key Factors, *supra* note 1.

[85] Unless, of course, the particular middle class investor is fortunate enough to be a relative or good friend of someone directly involved in the company, who the regulators are comfortable assuming will protect their interests on behalf of society.

markets is determined by pre-existing wealth and sophistication remain defensible? It is submitted that the answer is clearly "no". What was once a coherent and intellectually defensible (albeit paternalistic) regulatory paradigm in past decades now stands out as idiosyncratic and hypocritical in the modern environment. Why? The status quo has been undermined by three specific developments.

A. *The Crypto Conundrum*

First, unlimited access to the internet, and the impossibility of securities regulators staying ahead of the light-speed development of crypto-asset platforms over the past decade, has led to millions of unsophisticated Canadians investing in all manner of unvetted crypto-assets with no inherent underlying source of value. This is in no way intended to be a criticism of our securities regulators, it is simply a function of the unwieldy impediments to effective regulation created by the pace of technology adoption in our modern society and the jurisdictional enforcement challenges created by crypto-asset platforms domiciled outside of Canada.

Crypto-asset asset issuers and exchanges in Canada and abroad leapt ahead of regulators in the past decade by: (i) not caring about the obvious unanswered securities regulation issues associated with their business models before launching their marketing efforts; (ii) taking the questionable position that crypto-assets are not "securities" and therefore fall outside the traditional purview of securities regulation;[86] or (iii) locating servers and assets in international locations outside the reach of domestic regulators. Given the history and nature of crypto-assets, along with the jurisdictional difficulties in regulating issuers in a space that is inherently virtual and has limited physical presence, it is likely that securities regulators in Canada and abroad will perpetually struggle enforcing securities regulation against a rapidly-changing international business offering high levels of anonymity to promoters. As stated by one senior financial-sector analyst, "the crypto community has transitioned from a grassroots community focused on disruptive utilization of blockchain to a speculation-

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86 Ryan Clements and Virginia Torrie, "Crypto Asset Regulation in Canada: Developments and Governance Considerations" (2023) 39:3 Banking & Finance Law Review 345.

centric community that encourages the belief in, and evangelization of, memes".[87]

What is fascinating to consider here when comparing the crypto-asset market to the traditional equities market is the difference in the demographic make-up of the typical investor in these two areas. A number of recent academic studies have considered this topic. One study famously concluded that crypto-asset investors have a significantly lower level of "objective financial knowledge", and a significantly higher level of "subjective financial knowledge", than non-crypto investors.[88] Objective knowledge is determined by the actual knowledge of the investors based on the answers provided to specific questions on financial questions. Subjective knowledge represents the degree of confidence of the individual in their level of financial knowledge. The same study demonstrated that crypto-asset investors have lower average incomes than non-crypto investors.[89]

Moreover, a recent correlation study from the psychology department at the University of Western Australia determined that, on a statistically significant basis: (i) individuals with a higher level of financial sophistication were more favorable than the typical person towards investment in stocks, but there was no positive correlation to the view of more financially-sophisticated people towards investing in crypto-assets; (ii) individuals with a higher level of intelligence were *less* favorably disposed to investing in crypto-assets than the typical individual; and (iii) individuals exhibiting a higher level of narcissistic admiration were more favorably disposed to investing in crypto-assets than the typical person, but there was no significant positive correlation with the narcissists' disposition towards buying stocks.[90]

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[87] Alex Pickard, "Cryptocurrencies: The Power of Memes" (May 2022) Research Affiliates, online: <https://www.researchaffiliates.com/publications/articles/913-cryptocurrencies-the-power-of-memes>.

[88] Haidong Zhao and Lini Zhang, "Financial Literacy or investment experience: which is more influential in cryptocurrency investment" (2021) 39:7 International Journal of Bank Marketing 1208 at 1213.

[89] Zhao and Zhang, *ibid* at 1215.

[90] The study defined narcissistic admiration as "an overly inflated sense of self and abilities, an excessive sense of entitlement, and an intense need to be the centre of attention". Gilles Gignac, *et al*, "Predicting Attitudes Toward Cryptocurrencies and Stocks: the Divergent Role of Narcissism, Intelligence

Studies like these paint a concerning portrait of the typical crypto-asset investor from a regulatory perspective. They demonstrate that the typical crypto-asset investor is, from a foundational securities regulation policy perspective, in greater need of protection than an unaccredited investor seeking to invest in the traditional private entrepreneurial finance market. Yet, we have been largely ineffectual in protecting the crypto-asset investor to date and there is no assurance that the regulators are ever going to have the resources to fully regulate the crypto-asset market in the future. Consequently, it becomes increasingly difficult to defend the historical rationale in Canada for preventing non-accredited investors from directly accessing private market share investments, when the research repeatedly shows that those individuals are more financially sophisticated, wealthier and less prone to narcissistic admiration than crypto-asset investors.

B. *The Gambling Paradox*

Whereas the crypto-asset argument above was based on a pragmatic analysis comparing the differences in regulation and enforcement between crypto-assets and corporate securities, the sports gambling paradox is based on an even more direct analysis. Sports gambling in Canada has recently evolved from its traditional position of being largely illegal to now being both legal and ubiquitous. The federal government amended Canadian criminal law in August 2021 to allow single game sports betting for the first time.[91] Anybody in Canada who watches any form of sports is now inundated with a never-ending stream of glossy advertisements for sports betting sites extolling the virtues of how sports betting materially enhances your enjoyment of the sport fandom experience.

Until the 2021 criminal law amendments, sports betting was only available through parlay wagering products operated directly by provincial lottery commissions or through a myriad of illegal sites.[92] Sports gambling is now regulated at the provincial level.

and Financial Literacy" (2023) 215 Personality and Individual Difference 112382.

[91] James T. Holden and Joanna Wall Tweedie, "Sports Betting in Canada: Legal Perspectives from Two Years of Legal Single-Game Wagering" (11 April 2024) 11 Current Addiction Reports 419.

[92] Holden & Tweedie, *ibid*. Holden & Tweedie refer to the illegal gambling

Ironically, the same Canadian province that has been amongst the most restrictive in terms of opening up the private investment markets for non-accredited investors (ie., Ontario), is the only province that has opened up single-game sports betting to competition from for-profit enterprises. Moreover, Ontario decided to let former gray-market gambling site operators participate in the legal commercial gambling market without any repercussions for their past misdeeds. In the first year of operations, licensed gambling operators in Ontario opened 1.65 million player accounts with an average per-month spend of $70 per account. In the second year of operations, total player accounts dopped to 943,000 player accounts as operators consolidated, but with an increased average monthly spend of $191.[93]

The purpose of this analysis is not to criticize Canada's underlying legalization of single-sport gambling at a federal level. The enforcement of Canadian criminal law provisions prohibiting single-sport gambling was effectively impossible once the U.S legalized the practice after a 2018 Supreme Court decision striking down American anti-gambling legislation.[94] If the activity was already widely occurring despite its illegality, the policy basis for both regulating it and taxing it is clear. However, the provincial governments did not see the need to place significant limits on advertising by private operators for an activity that is universally recognized as being highly addictive. In fact, a recent analysis by University of Bristol and the Canadian Broadcasting Corporation calculated that Canadian sports fans spent up to 20% of every game watching some form of gambling advertisement on a selection of NHL hockey and NBA basketball games.[95] Notably, the provincial governments also did not impose any restrictions on income, net worth, or gambling sophistication as a condition for

sites as "grey market" sites. However, grey market sites were simply sites using the geographic enforcement challenge associated with online enterprises to operate illegally by selling to Canadian bettors.

[93] Holden and Tweedie, *ibid*.

[94] Murphy, Governor of New Jersey, *et al*, v. National Collegiate Athletic Association, et al., (2018) 584 United States 2018.

[95] Dexter McMillan, *et al*, "Hey Sports Fans: You Spend Up to 20% of Every Game Watching Gambling Advertising" (22 January 2024) CBC News Marketplace, online:< https://www .cbc.ca/news/marketplace/sports-betting-gambling-advertisements-1.7086400>.

participation in sports gambling. Further, they also did not establish any single-game, monthly or cumulative investment limits on gambling, even for known problem gamblers. The regulators simply mandated the inclusion of help lines and websites for gamblers who recognize their own addictions and choose to access those support services.

The one truism about gambling is that the "house always wins". Successful gambling companies are not in the business of taking risk. Rather, they are in the business of posting and updating odds that evenly split the betting action on different outcomes, assuring their profit on the house's assured numerical edge in any gambling activity. The public *will* lose in every game, its simply a matter of which members of the public win and which will lose today.

Nobody has ever made a compelling case that gambling creates any form of social good. The best that gambling advocates can come up with is the defense that gambling is a long-standing form of recreation and entertainment, and allowing legalized gambling provides people the freedom to do what they wish with their own money. They also argue that, since ordinary people are going to gamble regardless of legality, it is preferable to not make criminals out of ordinary people. While that may be true, there can be no question gambling deprives some of the most vulnerable segments of our population of critical financial resources. Those with gambling addictions are not limited to people from high net-worth backgrounds spending discretionary funds.[96] More than half of Canadians falling within the lowest 20% of household income reported that they gambled in the past year.[97]

Sports gambling could have been regulated in a much more limiting way by the Canadian provinces, but they chose not to. The provinces could have easily required minimum participation conditions and betting limits in their gambling regulations, and did not. This leniency has been extended to an industry that, by its

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96 Scott R. Baker, *et al*, "Gambling Away Stability: Sports Betting's Impact on Vulnerable Households" SSRN (30 June 2024), online:< https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4881086>.

97 Michelle Rotermann and Heather Gilmour, "Who Gambles and Experiences Gambling Problems in Canada" Statistics Canada, Insights on Canadian Society (2 August 2022), online:< https://www150.statcan.gc.ca/n1/pub/75-006-x/2022001/article/00006-eng.htm>.

very nature, is assured to generate more losses than wins for the public without generating any net gains for the economy. Betting redistributes money amongst winners and losers, with the gambling operators serving as the intermediaries for a fee.

Perhaps our new approach to gambling regulation represents the best policy outcomes within the range of available alternatives and the constraints under which the provinces were operating. However, there is no longer any rational basis on which to continue to assert that Canadian non-accredited investors should be prevented from investing in entrepreneurial-stage private company investments when we give the same individuals unlimited latitude to gamble.

In comparison, there is no question that allowing middle class investors to invest in private companies offers the prospect of actually increasing society's total wealth by growing the economy. Unlike gambling, there is no numerical certainty that one side of an investment transaction must lose in order for the other side to win; rather, in a successful investment, all parties to the investment emerge wealthier, and society as a whole benefits through increased employment, productivity gains, and increased taxes to fund social development. If I am allowed to borrow from all my friends and family to gather every dollar possible in my hands, and then to wager all of that money on a proposition bet, what logical or moral basis is there to prevent me from investing in my neighbor's start-up company?

C. *Risk and Retail Investors in the Public Market*

The third and final basis on which to attack the status quo of regulation is the long-standing assumption that the public market remains a significantly less risky alternative than the private market for middle class investors. This long-standing assumption is based on the fact that public market issuers are subject to ongoing continuous disclosure requirements that eliminate information asymmetry between buyers and sellers of securities in the public market. It has long been the default position of most securities regulators to address a host of market problems by creating an ever-increasing list of mandatory disclosures for public companies. Yet, there is a large body of empirical studies that consistently demonstrate that the amount and complexity of continuing disclosure currently foisted on public companies has already progressed to the point where few individuals outside the

company, including external securities analysts following a company, can truly separate the wheat from the chaff and make proper assessments as to future trajectory.[98] If professional analysts are being overwhelmed by disclosure overload, what chance does the typical retail investor have to sift through the volumes of disclosure and reach fully-informed investment decisions?

Moreover, the continuing migration of Canadian public retail investors away from full-service brokerages into order-execution-only ("OEO") trading platforms has been the subject of intensive study without regulators making any move to reverse the trend.[99] These retail investors using OEO platforms are competing head-on in the public market, without the benefit of the sophisticated analyst coverage that remains behind the pay-walls of the full-service brokerages. On the other side of the trades are professional money managers, hedge-fund traders, short-sellers, arbitragers, short-term day-traders and high-volume automated trading systems. Why do regulators allow this unequal trading to continue? Because it reflects the choice of the retail investor. Instead of trading through a discount brokerage without access to high quality analyst reports, retail investors could instead choose to pay for a full-service broker with analyst access, or to have their investments professionally managed in a mutual fund. Yet we continue to respect their choice to invest directly through OEO platforms, even though it is obvious that the self-directed retail investor is trading at a material disadvantage to the professionals.

Finally, the Canadian public markets continue to evolve in terms of increased participation by unsophisticated retail investors

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[98] See, for example: Joost Impink, Mari Paananen and Annelies Renders, "Regulation-Induced Disclosures: Evidence of Overload?" (2022) 58:3 Abacus-A Journal of Accounting, Finance and Business Studies 432. The analysis of Impink, Paananen and Renders found a u-shaped curve in which an increasing volume of disclosure reduced both the timeliness and predictive accuracy. For a summary of recent literature on this topic, see: A.L.V. Regina and M.A.T.R. Munasinghe, "The Concept of Information Overload: A Review of Literature from the Field of Accounting and Finance" (2023) 13th International Conference on Business & Information ICBI, University of Kelaniya, Sri Lanka. ISSN 2465-639, at 104.

[99] Ontario Securities Commission, "Quick Rise of Do-It-Yourself Investing Explored by OSC Study" (21 April 2021) OSC Press Release, online:< https://www.osc.ca/en/news-events/news/quick-rise-do-it-yourself-investing-explored-osc-study>.

in futures, options and other derivative instruments.[100] These instruments are notoriously volatile in value. It is possible to lose the entire amount of one's investment in a derivative with only small movements in the value on the underlying asset. Derivatives can be appropriately used as a risk mitigation strategy for businesses with over-exposure to a commodity or financial claim, but are typically used by retail investors as a high-risk investment strategy seeking high returns. Like traditional gambling, derivative contracts represent zero-sum games in which one party must lose for the other party to win. Yet, we do not require any formal training in the complex nuances of derivatives or the proper use of derivative instruments as a pre-condition to allowing Canadian retail investors to participate in this space. Once again, we defend this position by accepting that it is the personal choice of these Canadian retail investors to invest in this inherently risky undertaking.

VI. A NEW PARADIGM OF THE ACCREDITED INVESTOR

There are a host of possible alternatives to our existing rationally indefensible regime. Our proposals represent the simplest of all the alternatives.

While this paper has attacked the foundations of the wealth-based definitions, it does not suggest that the concept of an accredited investor be removed from Canadian securities regulation. To do so would initiate a cascade of resulting incongruities in regulation requiring far-reaching reform. Rather, Canadian regulators should adopt a version of the accredited investor exemption that is more rationally connected to legitimate goals of the regulators, while simultaneously opening up the private company investment market to all Canadians. Wealth is no longer defensible as the metric for determining who gets to invest. The assumption of a direct connection between wealth and investment sophistication is tenuous, particularly in an era when such a high proportion of household wealth is linked to intergenerational transfer or the sheer luck of owning a principal residence in an urban centre that has increased in value several-fold over the past two decades.

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[100] Hochman, *supra* note 8.

Instead, the appropriate formulation of an accredited investor should be linked to ensuring that eligible investors understand the key principles of private company (ie., high risk and information assymetrical) investing. Most importantly, an investor should never invest a dollar that they cannot afford to (or are not prepared to) lose. Even the most astute private company investor will make investments that, for reasons that are unforeseeable at the time the investment is made, result in a total loss of their investment. Market change, new technology, competitive landscape alteration, death or incapacity of key executives, government policy changes, and trade protectionism are just some of the external conditions that can overwhelm a promising investment. Losses are a function of investment, and every private company investor must be prepared to absorb the entire loss of their investments. At the absolute maximum, the only wealth element that should be required of a potential investor is a liquidity acknowledgment, namely that they will be continue be able to pay their debts when due if the value of their investment goes to zero. In other words, it is reasonable to require a confirmation that the investment is being made out of discretionary funds, not by redirecting essential funds required to repay existing debts or fund the necessities of life. However, we submit that this should be the *only* precondition for categorization as an accredited investor beyond the risk acknowledgment.

The self-certified accredited investor exemptions established under ASC Blanket Order 45-538 and Ontario Instrument 45-507, as previously discussed, provide an obvious precedent. This paper's proposal would extend and materially simplify the existing self-certified accredited investor definitions to include any individual who certifies that they understand the risk of a complete loss of the investment, are willing to accept the complete loss of the investment, and can financially bear the complete loss of the investment. The investment value limits of the existing self-certified accredited investor exemptions should be removed. Again, how can limits on productive investments in private companies be defended that do not exist for other financial risk-taking activities open to all Canadians? It is simply the ability and willingness to bear the loss of one's investment that should be at issue, not whether anyone else might consider the size of the investment wise in relation to size of the investor's investment portfolio.

One additional key item must be considered simultaneously with the adoption of a new self-certified accredited investor concept, namely revisiting the 50 shareholder limitation currently contained in section 2.4 of NI 45-106. The 50 shareholder limit has been in place for Canadian private companies for over 100 years. The evolution of our society has also made the 50 shareholder limit unnecessary and counter-productive in the modern environment. When the 50 shareholder limit was originally created in Canada, the accredited investor concept did not exist. All shareholders of the private companies of those eras had to have a direct personal connection to the corporation or its key personnel. Also, the means of communication with shareholders were limited and slow, and shareholder meetings needed to occur in person or else by written unanimous resolution. All of these practical limitations dictated that there were a limited number of investors that a private company could effectively deal with on an operational basis.

The evolution of communication technology now allows us to instantaneously communicate with an unlimited number of shareholders through multiple mechanisms, including email, websites and social media. Also, the corporate law rules surrounding shareholder democracy have evolved to allow online shareholder meetings and, in some provinces, electronic signatures and resolutions signed by a super-majority of shareholders in lieu of meetings.[101] The combination of these factors means that the 50 shareholder limit has also become arbitrary and indefensible in the modern environment.

This paper has developed the case as to how adopting a new concept of accredited investor for Canadian private company investment will re-democratize our private company investment ecosystem. For this new accredited investor class to become a meaningful source of prospective finance for Canadian private companies, which is one of the key outcomes we are seeking to achieve in the reform process, it is essential that the 50 shareholder private company limit be updated as well. How far should this be extended? This paper has previously discussed that Rule 506 in the U.S. allows private companies to have 500 non-accredited investors

[101] For example, Ontario and Alberta have both made significant revisions to their *Business Corporations Act* to reflect the new requirements of shareholder democracy in the current technology-enable environment.

and up to 2,000 total shareholders. Any new limitation we impose on private company shareholder maximums is going to be somewhat arbitrary. However, a new limit of at least 1,000 shareholders for Canadian private companies would be in order, thereby giving private companies the opportunity to raise meaningful amounts of start-up and growth capital from self-certified accredited investors under the new regime.

The adoption of a new self-certified accredited investor regime could be implemented on a time-limited trial basis, as Ontario has done with Ontario Instrument 45-507. However, the removal of the 50 shareholder limit does not lend itself as easily to a trial implementation. At the very least, private companies who exceeded the 50 shareholder limit would need to be grandfathered from more restrictive securities compliance if the exemption were subsequently reversed after a trial period.

As a final key element for consideration in the adoption of a new concept of self-certified accredited investor, the securities commissions should provide clear guidance on three related items. First, what constitutes the "public" in relation to marketing by a private company of a prospective financing? As discussed, the SEC has given clear guidance in the U.S. around the use of demo days and related communications as a means for marketing private financings. Canadian securities regulators should also give clear guidance on precisely how a private company may seek to identify and communicate with prospective investors without being deemed to have sold shares to the public under section 2.4 of NI 45-106. We would suggest that there is room to allow even more latitude in the promotion of private company offerings than the SEC currently allows.

Second, Canadian securities regulators should clearly state what ability private companies have to use intermediaries to assist in fund-raising and making contact with potential investors, including restriction on compensation and disclosure to potential investors of compensation paid to the intermediaries. If we extend the ability for private companies to sell to self-certified accredited investors, it is essential that we establish clear riverbanks for how companies identify and market to the new class of eligible investors.

Third, Canadian securities regulators should provide greater flexibility and a higher consistency on the ability of private companies to give private investors access to existing business

documentation other than prescribed offering documents as part of the due diligence process. Information asymmetry remains one of the critical concerns in private company investing, yet there is significant lack of clarity as to when a private company is allowed to give a prospective investor a copy of a business plan prepared for internal use by the management of the company without risking allegation that the business plan constitutes a non-compliant offering document.

In particular, the existing Ontario rules provide that any document provided to a potential investor in conjunction with the issuance of securities constitutes an offering memorandum and must comply with the prescribed from. This includes pre-existing documents prepared by the company for its own purposes that are unrelated to the investment and contain potentially valuable information regarding the company, such as technology evaluations, engineering reports and business plans. The rules in other provinces also leave a grey area that creates uncertainty with respect to the dissemination of pre-existing documents in relation to private company financings. Private companies are forced to either withhold this information (thereby preserving maximum information asymmetry) or risk being deemed to have delivered a non-complying offering memorandum.

Reducing information asymmetry should be take priority over mandating the form of disclosure for all private company documents. These rules should be clarified and amended such dissemination of pre-existing documents is allowed. Additional layers of securities regulation are not always required to supplement common law remedies. If a business plan or engineering report contains an actionable misrepresentation, then the law of contracts and torts provides clear recourse to an investor who relies on the representation as an inducement to contract. For private company financings using exemptions unrelated to offering memorandums, the advantages of reduced asymmetry through allowing pre-existing business descriptive documents to be circulated to prospective investors in the due diligence process more offset the associated risks of allowing access to unregulated documents.

VII. CONCLUSION

Society evolves. Our understanding of risk evolves, and what risk it is appropriate to allow the public to take with their own finances evolves. The evolution of our understanding as to what degree of financial risk is appropriate for a typical member of society has evolved dramatically in less than a decade.

This paper has adopted a brick-by-brick analysis to support the following conclusions: (i) Canadian private companies have less access to critical institutional start-up and growth-stage capital than our American neighbors; (ii) Canadian middle class investors continue to face investment restrictions in Canadian private companies that have been removed for American middle class investors; (iii) Canadian companies are becoming increasingly less competitive compared to American companies, and one of the important remedies is to find new sources of capital to finance growth and innovation; (iv) the Canadian middle class is falling behind financially, with one of the reasons being the comparative lack of opportunity to secure returns on financial investments; (v) several high-growth segments of our economy are disappearing from the public markets, moving predominantly into the private sphere as our public markets continue to atrophy in terms of operating company listings; (vi) the diminishing number of companies that do continue to seek to access Canadian public venture markets are more highly concentrated in high-risk all-or-nothing ventures; (vii) our economy and society have evolved over the past decades such that middle class Canadians have a plethora of risky investment opportunities accessible to them without monetary restriction, including legalized gambling, cryptocurrencies and derivative instruments; and (viii) these new risk options for middle class Canadians do not serve any productive societal purpose, unlike private company investment which is the foundation of future innovation and economic growth.

In conclusion, there theoretical foundations of the existing Canadian regime that determines private company investment access according to wealth-based criteria have been undermined by

the evolution of modern society's view of acceptable risk and now represent an anachronism that fails to serve the public good. The proposals outlined in this paper give all Canadians the opportunity to directly invest in earliest stages of the highest-growth opportunities, taking an opportunity that has become effectively the private domain of the wealthiest Canadians over the past few decades and once again making it available to all Canadians.

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