



THE KEMBALL GROUP

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John Stevenson

Secretary,

Ontario Securities Commission

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Page | 1

RESPONSE TO EXEMPT MARKET REVIEW OSC CONSULTATION PAPER 45 710: CONSIDERATIONS FOR NEW CAPITAL RAISING PROSPECTUS EXEMPTION

Dear Mr. Stevenson:

Based upon the material released in December 2012 our appreciation of the situation confronting the OSC is that it recognizes the imperative for growth capital for high potential early stage firms. But based on decades of experience finds the primary mechanism for doing so, exemption from prospectus requirements, a morass of misaligned incentives which ill serves investors and by extension the capital markets writ large.

As we read the Consultation Paper it acknowledges:

1. the demand for new capital by young firms at the early stages intrinsically is for small transaction dollar values. Thus prospectus costs are prohibitive. Therefore it is essential that they not be imposed on such insurers. In the absence of exemptions allocations of capital required to renew economies could not occur using traditional forms of equity;
2. the existence of very large variability in the nature of the demand for capital within the exempt market, making cost-effective regulation difficult;
3. that the lack of alignment of incentives amongst the participants in the prospectus exempt marketplace where most of this type of fund raising has occurred has resulted in outcomes that fail to provide adequate investor protection causing organizations such as FAIR to take the position that the exempt market be eliminated. (Communication with FAIR).





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4. that equity crowd funding will suffer from this same lack of alignment of incentives amongst the parties if the typical exemption approach is followed.
5. that the need to get such capital to entrepreneurs is more pressing than ever from the Province's economic renewal and continued development perspective, and
6. that technological changes make it feasible to raise growth capital in a variety of ways which do not involve the sale of securities but are close substitutes for doing so, e.g. working capital support such as order financing, e.g., the introduction of the Pebble watch and from third parties who also provide funds but choose to obtain their returns via royalties on sales.

Page | 2

We believe from the perspective of securities legislation capital availability to high potential firms such as crowd funding is much ado about nothing but form.

The ruckus raised by the entrepreneurial community seeking access to growth capital and its supporters such as CATA is somewhat misguided. Our perception that securities must be issued is rooted in the widespread choice of financing devices which are corporate securities, as illustrated by set out in the Consultation Paper. To date accommodations to this demand for capital have been formulated from a longstanding transaction mindset which created specific exemptions for securities, e.g. accredited investor and minimum transaction amounts. In our opinion such exemptions and those used in the past but now discarded, unduly restrict wise investment choices, a point raised in the Consultation Paper.

The Kemball Group suggests that it is possible to satisfy the needs for growth capital contemplated by current activities in the exempt market which are typically met by the issuance of equity and convertible debt, as well as proposed ones including crowd funding without issuing securities. A simple contractual arrangement agreement to pay those providing funds their return in in the form of a royalty stream is viable and in our view advantageous. Doing so does not constitute issuance of a corporate security and has not been seen to do so during its long history predominantly in the resource sector. The immediate result would be the same, cash in the till to pursue growth. In our view, royalties permit a better alignment of incentives.





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Based upon our knowledge of the USA experience in introducing the JOBS legislation we believe securities regulators in North America also share this same challenge and like the OSC, are troubled by the exempt market. The essence of the trouble with exemptions was pithily expressed decades ago by an astute observer of regulated financial markets, "Where are the customers' (investors) yachts?" It applies with particular veracity to transactions in the exempt market.

Page | 3

Conclusion

We draw one critical conclusion from our experiences and the research described in the Appendix: investor protection in this market place cannot be provided cost effectively by the type of exemptions that have been used to date.

The Consultation paper contains much material which we read as supportive of this viewpoint. Beyond that we have seen evidence that more than 95% of people who when offered something that is too good to be true do not let greed overcome fear, even in a low interest rate environment with its incentives to chase yield.

So what can be done by the OSC to resolve the dilemma we face as a society, a society by and large populated by reasonable people who are honest but not saints and who thus respond to the incentives they perceive.

Despite our view of much ado about nothing, our proposal is offered on the assumption that the OSC does not want to restrict the types of financial instruments investors could use to fund early stage high potential firms. Absent this assumption, were the OSC to simply be clear that if issuers use royalties they are not issuing securities a significant improvement in access to capital should ensue. The way to test our assertion is simple, issue a statement that royalties are beyond the purview of the Act.

Response & Rationale

The thrust of our response is to focus on one consultation question, are there proposal concepts not included in the Consultation Paper. The detailed basis for our rationale is included in the Appendix.





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PROPOSAL CONCEPT: VOLUNTARY EXEMPTION BY INDIVIDUALS

Our experience with individuals investing their own capital has been that they eschew deals where commissions were paid, a key feature of the exempt market. They sought out deals directly or indirectly using mechanisms suitable to them. Latterly such individuals have become widely known as angel investors.

Page | 4

They pushed to ensure that they were given the information they wanted not, what just what the issuer wanted to tell them. Often they clubbed together to ensure that they asked the right questions. It is a market place where the incentives between issuer and investor can be well aligned, better in fact than is the case between institutionalized private equity such as venture capital and issuers.

Our proposal also builds on a number of items contained in the consultation paper and we hope that you share our view that it is but a logical extension of The Consultation Paper.

Proposal Specifics.

The Kemball Group proposes that the OSC allow individual “angel” investors and others working with early stage firms to exempt themselves from all securities legislation. In effect the OSC would allow individuals to assert that like BDC, chartered banks and pension funds they choose to be presumed to be competent to make their own decisions with their own capital. The amount to invest in any one transaction and the mechanisms used to obtain return of capital and a return on capital would thus be established by the issuer and the investor.

To become an “angel investor” an individual would simply provide written notification to the OSC and the CSA in which they acknowledge that they could lose all the capital in such situations and could not avail themselves of remedies under securities legislation. Angels could revoke this exempt status upon written notification to the OSC.

The OSC would maintain a data base of all such investors for the purpose of allowing issuers to confirm with the OSC that the angel had self-exempted from the act. Issuers would have to obtain confirmation of such status from the OSC before accepting funds from angels or the





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transaction would be deemed not to have occurred and not doing so would constitute fraud.

Benefits. We believe that the presence of a group of individuals who have exempted themselves from the protection offered by securities legislation would:

Page | 5

(a) would provide significantly increased availability of capital to high potential SME's, in part by an increase the numbers of investors who could invest, in part by not setting specific amounts in any one situation;

(b) have relatively low administrative costs and no enforcement costs for the OSC; and

(c) contain the seeds of the possibility to significantly reduce financing activity in the exempt markets, if not eliminate it, by withdrawal of the style of exemptions which have proved such fertile grounds for purveying inappropriate products to investors.

In our view, "angels" would become the preferred sources of capital for issuers wishing to use crowd funding to raise capital. We see this as a logical extension of the private equity portion of the capital markets labeled the angel market, as its "democratization". Currently institutions such as pension funds or accredited individual investors or those providing more than the minimum amount can access high potential early stage opportunities as limited partners but have modest exposure to any one deal.

Marketplace Organization Possibilities.

The Kemball Group suggests that the self-exempt angel concept would in large part organize itself over the years to supply capital to small firms particularly those with high potential in ways best suited to individual opportunities. The concept allows the OSC to both increase access to capital while not requiring immediate action in respect of existing exemptions.

With this in mind, The OSC might wish to consider the following ideas on the future functioning of Ontario's and Canada's capital markets.

1. Confine all issuer and broker dealings with individual investors in the current exempt market to those who have opted out. We





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believe this would be of interest to FAIR based upon an initial discussion and are currently seeking clarification.

2. Facilitation of a Canada wide market by joint listing of the individuals with the CAS and individual securities commissions.
3. Conduct a vigorous continuing fact based awareness campaign including monitoring probes as has been done by CAS with its too good to be true email campaign.

Page | 6

CONCLUSION

Securities regulators face great challenges in their second century in re-balancing the need to protect investors and ensure that in doing so they do not kill the hand full of geese capable of laying wealth creating golden eggs our society needs to thrive. No other entity is able to replace the opportunities that will inevitably be destroyed in the gales of creative destruction now occurring as entrepreneurs around the world strive in hundreds of thousands of ways to make the world a better place. Most will fail: but to hobble their efforts by inhibiting the supply of capital is self-defeating.

For securities regulators, the one predictable outcome of this gale will be increasing variety in the financing needs and mechanisms, signs of which were clearly visible to the authors of The Consultation Paper . We believe that it will prove impossible for regulators to use traditional approaches to cope effectively with this variety and provide investors adequate protection. Does not creation of a risk capital market place whose investors are composed of individuals who have exempted themselves remove ninety percent of the conflict inherent in the OSC's twin mandate?





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APPENDIX

OSC CONSULTATION PAPER

Page | 7

DETAILS OF RATIONALE FOR THE KEMBALL GROUPS RESPONSE

Our rationale arises from experiences financing hundreds of Canadian SME's including \$200,000,000 of working capital over the past half a century. Our founder has held memberships in the CAVCC, NACO – Founding Member -, Ottawa Angel Alliance and The Capital Angel Network – Founding Board Member – the Revenue Capital Association, the International Factors Association, and for periods ITAC and CATA. These organization have helped provide a unique perspective on the capital markets for Canadian SME's.

Key facts shaping our views and recommendations are set out in the following paragraphs.

1. The needs of most SME's are fully satisfied by bank lending: the estimated ten percent of firms led by high aspiration founders are not.
2. The majority of these high aspiration firms do not create sufficient wealth to warrant issuance of securities. But, those that might do so are key to development even though more likely than not they will fail.
3. Nonetheless effectively meeting the needs of this relatively small group of successful high aspiration entrepreneurs is critical to the Canadian economy. From this group and only from it spring the firms that create jobs continuously being lost in the process of "creative destruction".
4. The founder of AngelList in a recent speech stated that his reason for doing so was, "Let's make sure the best companies get funded on their merits, not just on who they know." His experience is that more than two but less than three percent of those listing should not be denied access to capital simply because they don't have the right names in their Rolodex.





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5. The variety of financing requirements amongst the one third who are the high potential members of the high aspiration group requires that any individual financing be custom tailored and for the most promising linked to prior and future rounds of financing. In a word, this is a *bespoke* financing world with high transaction cost per dollar raised.
6. It is a world of risk, some fraud but mostly error and sometimes just bad luck. Most investors avoid it.
7. All but a very small percentage of Canadian investors fail to grasp that if it is too good to be true then that is really the case. Greed seldom trumps fear in part because as human beings, we fear loss twice as much as we seek gains.

Page | 8

Risk. The latest analysis of USA angel investments showed that 60% of the deals lose all capital.

Fraud. Our experience is that there is recourse to the police and the courts and we have availed our self of them. It is a form of amelioration. However prevention is much the better way to manage risk and avoid fraud. Restoration of capital by recovery of funds is usually but not always impossible. If the entrepreneurs involved are fundamentally honest and a bit lucky, capital can be recovered plus costs of dealing with the situation. If the courts are resorted to as the means of getting funds back, the previous comment is far less likely to be accurate.

Error. Beyond bad luck, the real risk to investors in early stage firms is that the entrepreneurs do not have the wit to use capital to create wealth. Some angel investors have repeatedly made accurate judgments about entrepreneurial capacity. Some learn but many find it a real struggle.

Research. Only one percent of the general population possesses the basic level of capacity required to run a high growth rate business of any size. Put another way, the capability to deal with the complexity of P&L responsibility in a high growth rate setting is a scarce resource. Many of this select group will not acquire the required skills and knowledge over their work history. Not a few will lack the personal skills needed to lead and manage an organization. Few, particularly very few founders, will prove able to manage a global organization. Of





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the one percent, many will chose to apply their capacity outside the world of business, in particular entrepreneurial business.

In our view the lack of human capacity is the scarcest resource in the high aspiration early stage financial marketplace. We have often heard angel investors lament the lack of good deals. The research summarized above lends credence to their lament. Nonetheless, it is accurate to say that some angels feel that amongst the good deals their personal decisions often result in any one opportunity being underfunded which increases risk to all.

