

March 7, 2013

Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, ON M5H 3S8

Dear Sirs and Mesdames:

Re: OSC Staff Consultation Paper 45-710 – Considerations for New Capital Raising Prospectus Exemptions

Introduction

The Walton Group of Companies (**Walton**) welcomes the opportunity to comment on OSC Staff Consultation Paper 45-710 – *Considerations for New Capital Raising Prospectus Exemptions (SCP 45-710)*. Walton is an issuer of exempt market investment products and Walton Capital Management Inc. (**WCMI**) is an exempt market dealer that is registered in all Canadian provinces. The exempt market plays an important role in capital raising in Canada and Walton supports an efficient and effective regulatory regime for the exempt market that provides adequate protection to investors.

The slow growth of the economy in Canada and around the world has led governments to find ways of sparking growth and investment. In particular, governments are focusing much of their efforts on promoting investments in businesses and economic activity. While banks and large investment houses play a significant role in the Canadian economy, they may have less interest in funding small and medium sized enterprises (**SMEs**). As a result many companies must seek alternative means to raise capital. The exempt market is integral to these businesses in order to meet their capital requirements. The Canadian Securities Administrators (**CSA**) estimated the exempt market to be over \$150 billion in 2011, compared to the public market, at over \$60 billion.

Awareness of the exempt market has led policy makers to look at ways to increase access to it by issuers and investors. Crowdfunding is one method that is currently generating headlines in the United States and is also being considered by the OSC. However, other existing means of raising capital in the Canadian exempt market should also be examined and where possible, streamlined and harmonized with exemptions in use in other Canadian jurisdictions.

In February 2012, Walton submitted a comment letter in response to the CSA review of the Accredited Investor and Minimum Amount prospectus exemptions, in which Walton proposed the adoption in Ontario of an offering memorandum (**OM**) exemption based on the Alberta OM exemption and Eligible Investor model to provide a harmonized disclosure-based prospectus exemption across Canada. We

submit that the OSC should consider the Alberta OM exemption in the context of a proposed OM exemption in Ontario.

In this letter we will discuss four of the proposed exemptions put forward by the OSC in SCP 45-710 with a focus on the proposed Ontario OM exemption (**Proposed Ontario OM Exemption**). We will also examine investor protection issues, the capital raising options in Ontario and the benefits of a proposed national dealer and OM exemption. Specifically, Walton recommends a new harmonized OM exemption based on the OM exemption and Eligible Investor model utilized in Alberta, Manitoba, Northwest Territories, Nunavut, Prince Edward Island, Quebec, Saskatchewan and Yukon (**Alberta OM Exemption**) combined with the mandated use of a dealer to conduct the trade (**Proposed OM Exemption**). The Alberta OM Exemption has an established regulatory framework and provides efficient and cost-effective capital raising by issuers and an opportunity for diversification by investors in the Canadian exempt market. The Proposed OM Exemption will also address investor protection concerns through dealer involvement. In addition, Walton recommends that a mandatory, publicly accessible, central repository for OMs distributed under the Proposed OM Exemption be established, to improve issuer transparency and provide investors with access to more comprehensive information pertaining to offerings in the exempt market.

Proposed exemptions

General comments

In the background to SCP 45-710, the OSC identified two main themes raised in comment letters and consultation sessions with respect to the Accredited Investor and Minimum Amount exemptions: (a) providing greater access to the exempt market for issuers and investors, and (b) the desire for harmonization of the exemptions across Canadian jurisdictions. Currently, there are approximately 40 prospectus exemptions found in NI 45-106; however, certain key exemptions are not available across Canada. The OSC has the opportunity to take a holistic approach to NI 45-106 and streamline the exemptions through harmonization and regulatory reform.

SCP 45-710 outlines that the objectives of the OSC's policy review are to determine how to best regulate the exempt market in a manner that (a) enhances its role in raising capital for businesses with a focus on SMEs, (b) provides retail investors with greater access to investment opportunities without compromising investor protection, and (c) better aligns the interests of issuers and investors.

The OSC further states that it is guided by the principle that business and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought.

Walton will discuss the proposed exemptions in SCP 45-710 in light of these principles.

Crowdfunding Exemption

Crowdfunding is a concept that has recently received significant media attention and as a result has become a focus of politicians and by extension, regulators. By and large, crowdfunding has been used to raise funds for charities and to sponsor Olympic athletes; there has not been a great deal of crowdfunding to raise equity for businesses in Canada or the United States.

Under the crowdfunding exemption discussed in SCP 45-710, an issuer could not raise more than \$1.5 million in any 12-month period and investors can only invest \$2,500 per instance or \$10,000 in the aggregate in any calendar year. Further, the exemption is only applicable to an offering of shares of a company, and an issuer is not permitted to advertise the offering.

This exemption would only be useful for micro-financing for very small issuers. In fact, if a company received a successful start through crowdfunding, it would likely need to access capital through more traditional prospectus exemptions for its next tranche of financing, due to the limitations on the size of the offerings allowed under the crowdfunding exemption.

This proposed exemption could not be used by many issuers including SMEs. There are too many limitations, from the amount of capital that can be raised and invested, to the types of securities that can be traded, to make this a meaningful exemption to increase access to capital for issuers. In addition, given the small investment size per investor annually, crowdfunding would only minimally achieve the goal of allowing additional access to the exempt capital market for investors.

Exemption Based on Investment Knowledge

SCP 45-710 proposes adding a new exemption that would allow the distribution of securities to "sophisticated" investors who do not qualify as Accredited Investors, but who have sufficient investment knowledge such that they do not require the protections afforded by a prospectus offering.

Creating an additional exemption for another class of investor will create further disparity with the rules in place in other provinces and additional confusion among dealers and investors, without significantly increasing access to capital for issuers. We also note that the definition of Accredited Investor already encompasses registrants and former registrants, who have the proficiency to understand the characteristics of the investment and concurrent risks. This proposed exemption, if implemented, is unlikely to increase investor or issuer access to the exempt capital markets in any material way.

Exemption Based on Registrant Advice

This exemption is described as an extension of the managed account definition of an Accredited Investor to include investment dealers granted a portfolio management designation by IIROC. This exemption is also unlikely to increase the size of the exempt market in any meaningful manner.

Proposed Ontario OM Exemption

In SCP 45-710, the OSC takes the unique view that crowdfunding and the OM exemption should be on the same continuum. The OM exemptions currently in use in the Canadian provinces other than Ontario and in Australia bear no resemblance to the crowdfunding exemption proposed in Ontario and little resemblance to the Proposed Ontario OM Exemption. The Proposed Ontario OM Exemption has the same constraints as crowdfunding, but without the use of a portal and with a disclosure document. It cannot be considered a distinct and meaningful OM exemption.

We submit that the Proposed Ontario OM Exemption will have limited utility to issuers requiring infusion of material amounts of capital. In particular, it is unlikely that the Proposed Ontario OM Exemption would be a meaningful capital raising tool for SMEs. It contains the same restrictions on the amount of capital that can be raised and the maximum size of the investment per investor as the proposed crowdfunding exemption. These limitations, combined with restrictions on advertising, will not allow issuers to pursue capital raising on their own. An issuer will need to find 600 investors, without the ability to advertise, in order to raise the maximum offering amount of \$1.5 million. This is not a realistically attainable goal. In addition, the cost to an issuer of preparing an OM, issuing securities, maintaining records and communicating with 600 investors is prohibitive, when only a maximum of \$1.5 million may be raised. This is not in line with the principle that business and regulatory costs should be proportionate to the benefits to the issuer.

The result is that issuers would be forced to use a dealer to attract the number of investors needed to raise capital using this exemption. Customary compensation for dealers in the exempt market is a commission of approximately 10%; however, with investments limited to \$2,500 it is unlikely that many dealers will

find the opportunity worthwhile. Given the numerous investors to contact and trades to be executed to achieve the maximum capital raise, combined with the amount of time involved in KYP, KYC and suitability requirements, and the number of investors that they would have to contact and complete trades for, many dealers would focus on offerings where larger investments are possible, resulting in greater compensation to them. Moreover, the commissions paid to dealers would further reduce the proceeds to the issuer. The small offering size coupled with the difficulty and expense of finding enough investors to fill the offering make this proposed exemption of limited use to issuers.

In addition, we note that the Proposed Ontario OM Exemption does not apply to limited partnerships and other non-share investment vehicles, such as income trusts, that are often used to raise money for specific projects. The restrictions on the type of securities that can be sold under the Proposed Ontario OM Exemption prohibits capital raising for these types of projects and will force issuers to choose other investment vehicles that may not be as tax efficient.

For the investor, the Proposed Ontario OM Exemption significantly limits the amount that can be invested and the investment choices, thereby limiting investor access to the exempt capital market.

Ultimately, the Proposed Ontario OM Exemption falls short of the goal of increasing access to capital markets while maintaining investor protection.

Investor protection

Exempt market dealers

In SCP 45-710, the OSC states that it has found numerous compliance deficiencies in its reviews of exempt market dealers (**EMDs**) and is concerned that increasing the scope of the exempt market could increase these issues. The exempt market dealer category is relatively new, as it only came into effect nationwide on September 28, 2009, and was implemented over various transitional periods. In addition, the issuance of blanket orders creating the “Northwest Exemption” from registration has created further confusion.

Some difficulties are to be expected as dealers adapt to the new and more stringent requirements. With additional guidance from securities regulators, compliance field reviews and enforcement action when necessary, the level of compliance among EMDs should increase. Indeed, securities commissions grappled with similar issues when new regulations relating to mutual fund dealers were introduced in the early 2000s. Many of the mutual fund dealers' compliance issues related to KYC and suitability. After a period of transition to the new rules and regulations combined with compliance field reviews and enforcement actions, these compliance concerns diminished.

We submit that the solution for addressing these issues is to focus on compliance and enforcement as opposed to creating new rules limiting the ability of EMDs to make use of the new exemptions.

Risk management

The OSC has restated its concerns from 2004 about a lack of investor protection for those who invest under the Alberta OM Exemption and the other OM exemptions available in the other provinces, but has not identified its concerns in detail. Rather than mandating disclosure for issuers, the OSC has taken the approach that use of the Accredited Investor exemption offers better investor protection than the Alberta OM Exemption. As the OSC and most other observers will attest, being an Accredited Investor (in the top 4% of the Canadian population based on income or assets) does not make a person a more sophisticated investor.

SCP 45-710 notes that there appears to be a lack of understanding of the exempt market by Ontario investors despite the fact that they must be Accredited Investors. While there is a temptation to protect

investors from their own poor judgment, regulating investors is not the mandate of securities regulators in Canada. Regulators are to create an environment that permits investors to make an informed decision. As noted by the International Organization of Securities Commissions in its principles of regulation, regulation should not be expected to remove risk from the capital markets, but it should ensure proper management of that risk.

Risk management and mitigation in the exempt capital market can be achieved as it is in the public capital markets, through mandated disclosure of the key features and risks of the investment, requiring an investment professional to determine that the investment is suitable for investors in light of their risk tolerance, investment objectives, time horizon and personal circumstances, and increased transparency of issuer offerings. We have included these features in our Proposed OM Exemption below.

Capital raising by issuers in Ontario

The OSC notes that in carrying out this policy review it is important to consider the whole of the capital raising regime. There is currently a gap in the proposed Ontario capital raising regime that should be addressed by permitting further investment in the exempt market. If made available, an issuer may obtain seed financing through crowdfunding or through the other applicable prospectus exemptions currently available in Ontario such as the founder, control person and family exemption. However, after a period of successful operations, the issuer may want to expand and will require additional financing. The issuer needs more than \$1.5 million in capital, which must be available in a short period of time. The issuer may be too small or may not have the necessary experience to become a public entity listed on a stock exchange or simply may not wish to become a public entity, and must therefore look to the exempt market. Based on the current and proposed regime in Ontario discussed in SCP 45-710, the issuer only has the options set out in the table below:

<u>Capital Raising Method</u>	<u>Issuer Type</u>	<u>Investor Base</u>	<u>Comment</u>
Crowdfunding	Very small to small	All investors	Funding limit of \$1.5 million; investment limit of \$2,500 per investor
Exemption based on Investor Knowledge	All issuers	"Sophisticated" investors	No limits on funding but limited potential use due to number of investors who may qualify; overlaps with the Accredited Investor exemption
Registrant Advice Exemption	All issuers	All investors who use a registered adviser to manage investments	Extension of portfolio manager concept; overlaps with the Accredited Investor exemption
Proposed Ontario OM Exemption	Very small to small	All investors	Funding limit of \$1.5 million; investment limit of \$2,500 per investor
Accredited Investor Exemption	All issuers	Fewer than 4% of investors	No limits on funding or investment size but

Minimum Amount Exemption	All issuers	All investors	investor must meet high financial threshold to qualify Limited use because investor must invest \$150,000 or more
Prospectus Offering	Medium to large	All investors	High cost of capital raising and continuous disclosure and other public entity requirements; requires a sponsoring dealer; many issuers do not want to be public entities

The current and proposed regime in Ontario does not provide a suitable means of access to capital for SMEs or other entities that are seeking to raise greater than \$1.5 million in capital per year. Other than the \$1.5 million annual limit that is allowed under both the crowdfunding exemption and the Proposed Ontario OM Exemption, the only other available fundraising options would be to sell securities to (i) "sophisticated" investors, (ii) to sell to investors who rely on registrant advice, (iii) to sell to investors utilizing the Accredited Investor exemption, (iv) to sell to investors utilizing the Minimum Amount exemption, or (v) to complete an initial public offering, which may not be the best option or a realistic or desired alternative for the issuer. On the other hand, under the Alberta OM Exemption, the issuer would have access to 12% of investors (based on the Eligible Investor definition under the Alberta OM Exemption) in all other provinces and territories in Canada compared to only 1.8% to 3.6% of Ontario investors under the Accredited Investor exemption. Although the OSC is hoping to improve the ability of SMEs to raise capital in the exempt market, the proposed exemptions in SCP 45-710 are not likely to achieve this objective.

An Alternative OM Exemption

The Alberta OM Exemption and OM exemption available in British Columbia, New Brunswick, Nova Scotia and Newfoundland and Labrador (**BC OM Exemption** and together with the Alberta OM Exemption (the **Current OM Exemptions**)) are important capital raising exemptions for Walton and WCMI and many other issuers throughout Canada. The percentage of trades and sales WCMI completed under the Current OM Exemptions have increased as WCMI rolled out its sales operations across all provinces. In 2011, 90% of trades outside Ontario, which accounted for 84% of total sales, were made using the Current OM Exemptions. On a national basis, 67% of WCMI trades, which accounted for 54% of sales, were made under the Current OM Exemptions. We expect our use of the Current OM Exemptions will increase as our operations in other provinces become more established.

An obvious way to manage the risk in the exempt market is to include the features used to manage risk in the public market, namely, mandated issuer disclosure, the use of a registered dealer and greater transparency for issuers. We recommend that the OSC work with the other CSA members to establish a national harmonized exemption with mandated issuer disclosure, similar to the Alberta OM Exemption and based on the disclosure requirements as set out in the Current OM Exemptions. We also recommend the Proposed OM Exemption include the requirement that trades must be made by a registrant, including EMDs, to ensure that the securities are suitable for the investor. Lastly, we recommend the establishment of a mandatory, publicly accessible, central electronic repository for OMs distributed under the Proposed OM Exemption, similar to SEDAR, to permit investors to search, review and compare OM disclosure,

which will further enhance investor protection by providing investors access to information in the exempt market and improve transparency of issuer offerings.

Under the Alberta OM Exemption model, Eligible Investors are able to invest in exempt market securities without any limitation on the size of the investment. Eligible Investors represent approximately 12% of Canadians based on income, according to Statistics Canada information from 2010. Non-Eligible Investors can also invest in exempt securities under the Alberta OM Exemption, but are limited to a maximum investment of \$10,000 in a single security. The Proposed OM Exemption, if implemented in Ontario, would bridge the capital raising gap that currently exists in the capital market in Ontario, including the gap that exists for issuers that wish to expand their business but do not want to become public entities.

Consistent with the experience in Alberta and British Columbia, this type of exemption would likely become the most common method of raising capital in the exempt market in Ontario. Investment in the exempt market in Ontario, which was approximately \$86.5 billion in 2011 and is restricted under existing rules to less than 4% of investors, could expand to greater than 12%, significantly increasing the level of investment in Ontario. Given the limitations on offering size, investment amount and types of securities included in SCP 45-710, this same increase in investment could not be achieved through the proposed new exemptions.

We understand that OSC Staff may have reservations about the adequacy of the current mandated disclosure rules under the Alberta OM Exemption and may point to the failures of issuers in the last several years as evidence. Regulators in the other jurisdictions have heightened their scrutiny of the OMs filed with them, have issued an increasing number of cease trade orders and have provided guidance to issuers in CSA Staff Notice 45-309 with respect to improving OM disclosure in accordance with NI 45-106. With the increasing regulatory scrutiny, progress is being made on OM disclosure, and it is possible that the existing rules are adequate. Moreover, a central repository for these OMs, similar to SEDAR, will increase transparency and, as precedents become publicly available, the quality of OMs produced by issuers will improve. A harmonized approach would also lead to improved disclosure, as issuers gain experience with a single set of OM requirements and benefit from CSA guidance that includes the OSC.

Assuming funds were raised with the Proposed OM Exemption, Ontario investors relying on the Accredited Investor exemption and the Minimum Amount exemption would have the same opportunity to receive and review the OM disclosure as would investors purchasing under the Proposed OM Exemption, even if they were not directly relying on that exemption. This would allow investors a choice to use the most appropriate exemption available to them, and benefit from the statutory protections provided under the Alberta OM Exemption rules. For example, the Alberta OM Exemption provides protection to investors in the form of cooling off periods and remedies in the case of a misrepresentation by an issuer in the OM, similar to those protections provided by the prospectus rules. Currently, issuers relying on the Accredited Investor exemption and the Minimum Amount exemption have no requirement to provide any disclosure to investors before they make an investment decision.

The other tool used to protect investors in the public market is the mandated use of a dealer. The implementation of National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* introduced the exempt market dealer category of registration. Just like dealers in publicly-traded securities, EMDs are required to conduct due diligence on the client and on the product, to assess the suitability of the investment for the specific purchaser and to deal with clients honestly, fairly and in good faith.

Walton recommends the mandated use of a dealer to conduct a trade as part of the Proposed OM Exemption. The combination of mandated disclosure and use of a registered dealer manages the risks of the exempt market in a manner that is similar to risk management in the public market and adequately

addresses the risks of exempt market including any conflicts of interests. The Proposed OM Exemption would ensure that investors receive relevant issuer information and benefit from the professional judgment of a dealing representative to ensure the investment is suitable before an investment decision is made.

Walton submits that the Proposed OM Exemption meets the stated goals of the OSC in its policy review in SCP 45-710. Given the feedback from the consultations and comment letters in 2012 in relation to the Accredited Investor and Minimum Amount exemptions, harmonization of the prospectus exemptions should also be considered an objective as part of the regulatory goal of fostering fair and efficient capital markets and confidence in the capital markets. Harmonization of the OM exemption reduces investor confusion and increases confidence and capital market efficiency. The Proposed OM Exemption enhances capital raising opportunities for SMEs in a cost effective manner and increases the number of investors that qualify to invest in exempt market securities, which fosters fair and efficient capital markets while appropriately addressing investor protection concerns.

Conclusion

NI 45-106 is important to exempt market participants, as it delineates the marketplace in which exempt securities may be offered. However, there are approximately 40 different prospectus exemptions identified in NI 45-106. The fact that frequently used and important exemptions are not available in all jurisdictions is an indication of the disharmony in the exempt market, which leads to inefficiency and confusion. We submit that the solution is not to add new exemptions that may only be used in Ontario and only apply to certain types of securities, but rather to focus on making the current exemptions available and harmonized across jurisdictions, and to address compliance and enforcement to better protect investors.

Walton does not recommend reducing the size of the marketplace for exempt securities, but it does question whether the current regulatory framework in Ontario meets the needs of investors and issuers and appropriately manages the risks. The disparities in the rules in various jurisdictions create confusion, erode investor confidence and decrease efficiency of the capital markets. Many investors also oppose the disparity of investment opportunities and plead for "democratization" of the exempt market, so that they have the same investment choices as other Canadian investors.

The proposals put forward in SCP 45-710, will not materially increase access to the exempt market for issuers and investors. In particular, the Proposed Ontario OM Exemption will impose additional regulatory burden that outweighs the benefits of the new proposed exemptions.

We would be happy to discuss our comments with you. Please do not hesitate to contact us if you have any questions.

Yours truly,

WALTON INTERNATIONAL GROUP INC.

"Mark McKenna"

Mark McKenna
President

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