NAO-Ontario Responses to OSC Staff Consultation Paper 45-710
(Exemption Market Review)

March 8th, 2013

To: **Mr. John Stevenson**
Ontario Securities Commission
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On behalf of the board of the Network of Angel Organizations - Ontario ("NAO-Ontario") please find our commentary in response to your consultation paper. We support the goals of protecting investors from unfair, improper or fraudulent practices and fostering fair and efficient capital markets as well as confidence in those markets. Moreover, individual angel groups or networks from various parts of the province may be responding to your consultation paper as well.

We are pleased to see that the OSC appreciates that it has an important role in fostering capital formation in small and medium sized businesses ("SMEs") that generate much new employment in Canada. Guidelines for increased access to investment opportunities for retail investors (who might otherwise seek out of country opportunities) are welcome as is the recognition that many successful business people and professionals are competent to analyze investment opportunities for themselves.

We also commend the OSC for providing more information on the exempt market, on the activities in some other jurisdictions and on investor demographics.

Our comments on questions in your paper cover only select issues, as follows:

1. **Is the 50 security holder limit under the private issuer exemption too restrictive? If so, what limit would be appropriate? Please explain:**

Yes, it is too restrictive to fund significant growth and so small as to be inadvertently violated, for example if a single shareholder divorces or dies and leaves his or her shares to more than one heir. The reality is that high potential high-growth companies need regular infusions of capital as they scale and that building scale before an IPO enhances value for both the company and for its shareholders – think Amazon, Google and Facebook, none which could have scaled in Canada. Many Canadian companies prematurely have an IPO due to prospectus exemption and private issuer restrictions currently in place. These companies and their shareholders might be better served by keeping management's focus on building the business.

Premature disclosure as to business model and metrics by being public frequently can enable larger companies to outcompete an innovative new entrant – creating additional risks for high growth companies and their investors. To require a company to always go back to the same shareholders for growth or change capital during this phase does not reflect the reality of a business environment that is now global, can limit access to crucial capital or induce individuals to have more of their wealth invested in a single private entity than may be prudent. As a company's business grows or changes it may also need new management whose commitment will require a meaningful stake in the business.

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The US is our most comparable jurisdiction in as much as it is in geographic proximity and is one of the largest capital markets in the world. Companies in Canada are increasingly being created with exchangeable shares to facilitate an eventual move to the US. Section 12(g) of the JOBS Act in the US exempts from reporting companies with fewer than 2000 accredited investor or 500 non-accredited investor shareholders and currently does not look through single purpose entities to the ultimate holders (though the SEC appears to be seeking the ability to do so).

2. **Should the OSC consider re-introducing the closely held issuer exemption in addition, or as an alternative, to the private issuer exemption? If yes, should the conditions be changed?**

We believe an expanded private issuer exemption is preferable to a closely held issuer exemption. In a world of collaboration by people with different skills and a rapidly changing global business environment, we need to depart from a view of SMEs as largely family businesses or rules that restrict companies from adding new talent as shareholders.

3. **Should the OSC consider adopting a family exemption, which would allow for securities to be issued to an unlimited number of family members of the directors, executive officers or control persons of the issuer or its affiliates?**

We see this as similar to a closely held exemption and think that Ontario should just adopt section 2.5 (1), possibly with limits on the total numbers of accredited and non-accredited investor similar to that of the private issuer exemption if it so desires.

4. **Are there other changes that should be made to the current Ontario exemptions referred to above?**

Non-founder employees should be allowed to be shareholders under the private issuer exemption provided that such distributions should not be coercive and apply practical ways to ensure non-coercion. This makes it easier to hire new talent or keep/reward existing talent who may not be a current executive officer, a founder or relative of a founder.

5. **Would a crowdfunding exemption be useful for issuers, particularly SMEs in raising capital?**

NAO-Ontario has no specific recommendations on crowdfunding as angel investors in our networks are all accredited or sophisticated investors and are not "retail" in the sense of the general public needing protection. Accredited investors who become “angel” investors frequently do so because they wish to “give back” to their communities by supporting local entrepreneurs and companies.

6. **Have we recognized the potential benefits of this exemption for investors?**

Please see comment number 5, above.

7. **What would motivate an investor to make an investment through crowd-funding?**

Please see comment number 5, above.

8. **Can investor protection concerns associated with crowdfunding be addressed and, if so, how?**

Please see comment number 5, above.

9. **What measure, if any, would be most effective at reducing the risk of potential abuse and fraud?**

Criminal background checks, guidelines as to prudent portfolio allocation, requiring names and/or brief CVs to be posted for senior officers to decrease the economic incentives that anonymity can provide, prescribing disclosure and possibly adopting the concept of a Nominated Advisor may help reduced abuse and fraud.

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Lists of risks are a standard, but largely ineffective tool in shielding investors. They currently do more to shield management from liability than to protect or inform investors. However, the active use of risk acknowledgement statements may be helpful to alert investors that they are assuming risks.

Directors and officers insurance would help protect investors; so too would additional penalties in addition to prosecution, such as prohibiting people from being a director or officer or from trading in securities for a prescribed time.

10. **Are there concerns with retail investors making investments that are illiquid with very limited options for monetizing those investments?**

Please see comment number 5, above.

11. **Are there concerns with SMEs that are not reporting issuers having a large number of security holders?**

The burden of numbers is not hard to overcome in this day and age. The ability to communicate to shareholders by electronic means mitigates some concerns, as password-protected sites have been created to post communication information.

12. **If we determine that crowdfunding may be appropriate for our market, should we consider introducing it on a trial or limited basis? For example, should we consider introducing it for a particular industry sector, for a limited time period or through a specified portal?**

Please see comment number 5, above.

Issuer Restrictions

13. **Should there be a limit on the amount of capital that can be raised under this exemption? If so, what should the limit be?**

$2 million for the first year and $6 million in total are appropriate limits, keeping in mind the cost of distribution, and the increased cost of communication for a larger number of shareholders.

14. **Should issuers be required to spend the proceeds raised in Canada?**

Subject to certain provisos, we would not object to a requirement that 30 - 40% should be spent in Canada. For example, the proviso that the purchase of equipment installed in Canada that remains in Canada for 1 year should be considered *spent in Canada*, even if purchased from a foreign supplier. However, the possibility exists that we might have companies that can attract foreign capital via such portals and there should be no such restrictions on that capital.

We need to encourage companies to purchase equipment that provides the most value and that can often means purchasing directly from foreign manufacturers. Canada is a small market and leads in few industries. Much automation equipment is imported generally and foreign sourced equipment can also be more cost competitive. Innovative companies often seek innovative new entrants that may not yet have Canadian distributors. Much innovation occurs outside of Canada. We must take care that our rules do not keep Canadian companies from accessing such innovation to build their businesses.

Additionally, the most successful companies are global at an early stage so at least 50% should be allowed to be spent to access global markets via trade shows, representation, foreign offices or employees or components that can only be sourced from abroad on a competitive basis.

Investor protection measures

15. **Should there be limits on the amount that an investor can invest under this exemption? If so, what should the limits be?**

The proposed limits represent a reasonable balance for a trial period.

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16. **What information should be provided to investors at the time of sale as a condition of this exemption? Should that information be certified and by whom?**

Angel investors in our networks are all accredited or sophisticated investors and are not "retail" in the sense of the general public needing investor protection.

17. **Should issuers that rely on this exemption be required to provide ongoing disclosure to investors? If so, what form should this disclosure take?**

Issuers should provide semi-annual financial statements and should communicate information on material events.

18. **Should the issuer be required to provide audited financial statements to investors at the time of the sale or on an ongoing basis? Is the proposed threshold of $500,000 for requiring audited financial statements (in the case of a non-reporting issuer) appropriate?**

Review engagement financial statements by an independent third-party CA/CPA and signed by the directors are appropriate at the initial offering provided that the format has extensive note disclosure and otherwise complies with GAAP, if some of our other recommendations are adopted. Audited financial statements may not be necessary, as the burden may outweigh the benefit for many early-stage situations.

19. **Should rights and protections, such as anti-dilution protection, tag-along rights and pre-emptive rights, be provided to shareholders?**

These features seem overly complex for this market. It is probably easiest to require that existing shareholders should be included in new offering solicitations. We do not understand why convertible preferred shares are an excluded class of shares.

Funding portals and other registrants

20. **Should we allow investments through a funding portal (similar to the funding portals contemplated by the crowd funding exemption in the JOBS Act)? If so:**

Possibly, but NAO-Ontario has not had sufficient time to research this matter or consult with angel groups in Ontario.

21. **What obligations should a funding portal have?**

NAO-Ontario has not had sufficient time to research this matter or consult with angel groups in Ontario.

22. **Should funding portals be exempt from certain registration requirements? If so, what requirements should they be exempted from?**

Please see answer to 21 above.

23. **Should a registrant other than the funding portal be involved in this type of distribution? If so, what category of registrant? Should additional obligations be imposed on the registrant?**

Please see answer to 21 above.

24. **Should an OM exemption be adopted in Ontario? If so, why?**

Yes. There should be more consistency across Canada and this would be a viable financing option for many companies seeking growth capital and/or to transition a business via a model that includes new management.

25. **Should there be any monetary limits on this exemption? If so, should those limits be in addition to any limits imposed under any crowdfunding exemption?**

The existing monetary limit proposed for individual investors is sufficiently low. Regarding overall capital that can be raised by a single OM, $10 million would seem to be a reasonable number given the fact that the directors and officers are attesting to the lack of misrepresentation.

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26. Should a purchaser be required to receive investment advice from an adviser in order to rely on this exemption?

Not if the purchaser is a sophisticated/accredited investor as discussed.

27. Should there be mandatory disclosure required in an OM? If so, what level of disclosure should be required?

Yes.

28. Should we require registrant involvement as a condition of this exemption? If so, what category of registration should be required?

Please see answer to 21 above.

General questions on considerations for prospectus exemptions based on sophistication and advice

29. Would this exemption be useful for issuers, particularly SMEs, in raising capital?

Yes – it would be especially useful. Investors that understand an industry and the opportunity are the most likely, in the absence of fraud or abuse, to invest wisely and to be positions to assist the investee.

30. Are there sufficient investor protections built into this exemption?

In evaluating this, one has to balance the risks of highly trained people being mistaken against depriving those people of good investment opportunities and companies of knowledgeable capital.

One also has to realize that investment industry experience provides no technical insight into whether an innovation is likely to be successful, such that the risk of being mistaken is already an acceptable risk

We think an overly protective stance limits Ontario's innovation and economic potential and that there is a danger of the compliance burden outweighing any benefit.

Questions on the specific terms of the concept idea

31. Should we require an investor to satisfy both a relevant work experience condition and an educational qualification condition or would one suffice?

Not always. There can be many categories of professional qualification, industry experience or education that should suffice.

32. How should we define the relevant work experience criteria?

We do not believe that a professional who has demonstrated proficiency in his or her field and regularly evaluates new technology should additionally be required interrupt a career to gain specific work experience in the investment industry, when much knowledge regarding portfolio management, diversification, investing at different lifestyle stages, the practices of the investment industry and financial planning can be acquired by taking and passing the Canadian Securities Course.

33. What educational qualifications should be met? Should we broaden the relevant educational qualifications?

We have made suggestions in this regard in our answers to question 30 - 32.

34. **Are there other proxies for sophistication that we should consider?**

Please see our answers to questions 30 - 32.

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Consultation questions on a prospectus exemption based on registrant advice.

35. Should we consider a new prospectus exemption that is based on advice provided by a registrant? If so:

No. We believe that the focus in these exemptions should be capital funding for SMEs, not for registrants to sell more funds and financial products with less disclosure than currently mandated. Registrants can be eligibility advisors under an OM exemption. In the case of angel investors and angel networks, the investors make their own investment decisions and invest directly in companies.

36. Do you agree with limiting this exemption to a situation where the registrant has a fiduciary duty to act in the best interests of the client?

No specific comment, other than 35 above.

37. Do you agree that this type of exemption should be limited to certain types of registrants (e.g., investment dealers) or should this exemption be available for another type of registrant (e.g., an EMD)?

NAO-Ontario has not had sufficient time to research this matter or consult with angel groups in Ontario.

38. Should this type of exemption be available for registrants that sell securities of "related issuers" or "connected issuers" (which would raise conflict of interest concerns, as explained in National Instrument 33-105 *Underwriting Conflicts* and Part 13 of NI 31-103)? If so, would this be consistent with the registrant being subject to a fiduciary duty to the client?

No.

39. Would exempting the issuer from a disclosure obligation have implications for a registrant's ability to conduct a meaningful KYP and suitability review?

NAO-Ontario has not had sufficient time to research this matter or consult with angel groups in Ontario.

40. **Do you agree that a registrant should be required to have an ongoing relationship with the client?**

NAO-Ontario has not had sufficient time to research this matter or consult with angel groups in Ontario.

41. Should there be any restrictions on the type of security that could be purchased? For example, should this exemption be available for purchases of securities of investment funds and/or complex products (including securitized products and derivatives)?

NAO-Ontario has not had sufficient time to research this matter or consult with angel groups in Ontario.

42. Should the existing managed account exemption described above be expanded in Ontario to permit purchases of securities of investment funds?

No, as individuals who are active investors, we tend not to believe in managed accounts for lightly regulated investments.

Thank you for this opportunity to respond to your questions. As angel investors who are accredited investors making direct investment decisions, we believe that any areas of uncertainty around the exempt activities or need for regulation of angel groups should be clarified in the short term, rather than awaiting other changes around crowdfunding, etc.

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NAO-Ontario administers Ontario's Angel Network Program which provides grants to incorporated non-profit “angel groups” of accredited investors for administration and events to create forums for accredited investors to meet innovative companies seeking capital. These members make their own investment decisions and invest individually as principals. They perform their own due diligence. Grants are awarded on a competitive basis for eligible expenses defined in a contract with the Government of Ontario (chiefly salaries and meeting costs) and audited annually. NAO-Ontario collects information on the number of members in these groups, the number of active members, amounts invested by group members, amounts invested at the same time by accredited investors that are not group members (co-investors), government funding received by investees and. We occasionally ask whether the investees are still in business. We request, but cannot require, information on new employment created by investee companies. We do not collect information on investment performance.

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