NACO | National Angel Capital Organization

March 08, 2013

To: John Stevenson
Ontario Securities Commission
20 Queen Street West, Suite 1903
Toronto ON M5H 3S8

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

Dear Mr. Stevenson:

This comment letter is in response to the OSC Staff Consultation Paper 45-710, Considerations for New Capital Raising Prospectus Exemptions and in part to the OSC Staff Notice 33-738. It is being submitted by the National Capital Angel Organization (NACO), a federally registered not-for-profit organization dedicated to supporting Angel investors as they foster the growth of the next generation of innovative Canadian companies.

NACO recognizes the importance of identifying and providing access to capital in support of the development of Canadian small and medium enterprises (SMEs) and specifically high potential early-stage companies. The OSC has done a commendable job in identifying the concerns that have been raised by issuers and investors regarding the appropriateness of available existing prospectus exemptions, and in reaching out in this manner towards finding positive solutions. Through balancing the need for improving capital raising options and the need to protect investors we will better unleash the potential of Canadian entrepreneurs while providing a broader swath of Canadian investors with access to the resulting investment opportunities.

While we are very encouraged by the forward-looking approach being adopted by the OSC on these matters, we would like to point out a few issues that are of immediate concern to Angel investors. In anticipation of the substantial number of responses likely to be generated by both this proposal as well as the subsequent public consultations, we would like to keep our remarks confined to providing a brief overview of the critical role that Angel investors play in both fostering and then mentoring the early-stage companies that will ultimately become the backbone of the growth of the Canadian economy, as well as a few key observations on the consultation paper.

About the National Angel Capital Organization

The National Angel Capital Organization (NACO) is Canada's industry association representing Angel capital in Canada, an asset class that invests an estimated $1-billion annually in Canada's growth-oriented companies.

NACO incorporated as a non-profit in 2002 to promote and help create a vibrant Angel community and culture in Canada by providing Angel investors with a secure environment to network and learn from their peers, and provide a collective voice on national issues.

We are the Canadian industry association for Angel investors, groups, networks, funds and others with an active interest in building competitive seed and early-stage Canadian companies.

Our vision is simple: to bring the Canadian Angel investor community together. Our mission is to support Angels as they foster the growth of the next generation of innovative Canadian companies.

It is through our activities –education, communication, events and public policy development – that we achieve this vision and mission.

Throughout the year, we provide high-value events to promote knowledge exchange and network building with angel investors, venture capitalists, government partners and industry partners. Through our professional development and co-investment events and activities, we provide the resources Angels need in order to make informed investment decisions.

Our research collects data from across the country, providing up-to-date, relevant information to our members and the stakeholders that support them. Lastly, NACO's economic impact activities highlight the role of Angel capital in Canada, and raise awareness of the importance of Angel investing in the Canadian economy.

About Angel Investing in Canada

Angel investors play a fundamental role in the Canadian entrepreneurship ecosystem. Angel investors are often experienced, well-educated, high-net-worth individuals, who invest personal funds in the businesses of unrelated individuals. Typically, they provide private equity or second-round funding to startups that need money to continue to grow. Angel investors are frequently former entrepreneurs or business professionals who have much to offer to new businesses in terms of financing, networks and mentorship.

In Canada, there are approximately 500,000 accredited investors, as defined by NI 45-106. However, only a fraction of these investors choose to actively invest in early-stage companies. Angel investors often invest alone, but increasingly we are seeing investors joining Angel groups, where they can find investment opportunities and leverage the knowledge and experience of other Angels in that network.

In Canada, there are more than 30 Angel groups/networks. Angel organizations in Canada come in a range of structures that reflect their local investment climate. They often differ not only in their legal structure and best practices, but also in the services they provide to Angel investors. As the Canadian Angel investor industry association, NACO works to build connections between Angels and Angel organizations across the country and internationally, including places such as the United States, Europe and as far away as Australia. Through these efforts, we support the development of standardized best practices, standardized educational materials and co-investment between individuals and groups.

Angel investing is a relatively new phenomenon in Canada and one that is making a significant contribution to supporting the Canadian startup ecosystem. Many models exist for Angel organizations in Canada, but they can typically be grouped into four categories: formal non-profit Angel investor networks, informal Angel investor clubs, Angel investor funds and family offices. These organizations differ significantly in terms of legal structure, management structure, membership policies, services provided and level of involvement in the investment process. However, it is important to note that only accredited investors are accepted into these organizations.

The dominant model by far in Ontario is that of formally constituted, non-profit Angel investor networks that facilitate networking and co-investment between investors in a region. These are lean organizations typically run by volunteers and member investors, with financial support from the provincial and federal government.

Angel Investing and Risk

Angel investing is by definition is a high-risk activity that supports the development of high potential Canadian companies, who would otherwise lack access to sufficient capital. Angel investors invest their own capital into companies, often as individuals, but increasingly in groups that allow them to share information, resources and diversify their portfolio risk with other investors. In addition to their capital investment, Angel investors often provide investee companies with advice, mentorship and access to networks that support the development of the investee companies. This value added is often the result of past investment or work experience with similar companies or companies in related industries.

Angel investment is not appropriate for investors seeking stable returns, preservation of capital or income. Angel investors accept the risks associated with their investments and recognize the high degree of probability that they will lose their investment. A 2007 report by the US Angel Resource Institute has shown that as many as 50 per cent of Angel investments did not return invested capital to the investor. However, Angel investors are only partially motivated by the expectation of returns and are significantly influenced by other altruistic motivations, such as the desire to give back to the community and support local entrepreneurs.

In more established jurisdictions, Angel investment has been credited with developing not only companies, but also supporting the development of entire entrepreneurial ecosystems. However, the Canadian industry continues to develop and new models are constantly emerging.

Given this background information, NACO's response to the New Capital Raising Prospectus Exemptions are as follows:

Existing and Proposed Prospectus Exemptions

Use of Accredited Investor Prospectus Exemption
The existence of a minimal regulatory environment, as provided under the accredited investor exemption is essential to the continuance and growth of the Angel investor class. Angel investors are by definition sophisticated investors who, as a minimum, meet the income, financial assets, or net assets criteria identified in the existing accredited investors exemption found in section 2.3 of NI 45-106.

This exemption is used extensively by Angels, who as individual investors are responsible for their own due diligence and independently selecting the companies in which they invest. Even when Angels participate in voluntary groups or networks that help them share information, deal flow and share the work of performing due diligence, they are still responsible for their own due diligence and for deciding individually when to invest.

Proposed Changes to the Definition of Accredited Investor
While NACO understands the concern that financial wherewithal is not a proxy for sophistication, it is important that efforts to protect unsophisticated "retail investors" do not unnecessarily impact the activities of more sophisticated Angel investors. Changes that seek to narrow the definition of an accredited investor could negatively impact Angel investing. A broad definition of an accredited investor is important to investor success.

Creation of Education or Experience Based Exemptions
Post-secondary education or professional designation based exemptions are an interesting approach for determining investor sophistication. However, as it relates to the investor's understanding of the complexities of early stage investment, a more effective way of identifying investor sophistication may be to measure their investment experience. Another more effective and focused solution would be to have prospective investors attend accredited courses on Angel investing, where the courses are being offered by a qualified group, such as NACO, who develop and deliver investor specific educational materials related to early-stage investment. Example topics could include: understanding the risks of investing in early-stage companies; understanding the definition of an accredited investor; company valuation and follow-on investment; due diligence best practices; term sheet best practices, et al.

Crowd Funding Concept Idea

While NACO supports efforts to develop crowd funding options for SMEs, it is important that it is done properly to avoid future problems for issuers or investors. Crowd funding is expected to create situations where hundreds of investors may provide small capital to a company raising up to $1.5 million. The following issues should be considered in any regulatory regime:

Issuer Reporting Requirements

The number of investors could create a significant reporting burden to the issuer, which in many cases will be unsophisticated young entrepreneurs that may not have the resources or wherewithal to comply with regulatory requirements. No experienced investor would suggest saddling an early stage company with such an unworkable governance structure. The ability to respond to urgent developments or to effectively deal with additional funding would be greatly hampered unless the participation of crowd funders is structured in an appropriate manner.

Options could include the appointment of a trustee to act on behalf of crowd funded investors; or the limitation of crowd funding equity rights similar to that of non-voting preferred shares, subject to the perfunctory piggy-back, drag-along and preemptive rights contained in a standard Unanimous Shareholder Agreement.

Combining Sophisticated and crowd funding Investors.

Thought might be given to increasing the maximum amount available under the crowd funding initiative where there are accredited investors who are also investing and who have conducted their own due diligence. For example, perhaps the maximum for crowd funders could be increased by an amount equal to such parallel accredited investments. In this example, should accredited investors invest $1 million in conjunction with the crowd funders, then the latter's maximum might be increased to $2.5 million, thereby providing the company with a more meaningful $3.5 million while at the same time ensuring that there has been adequate review and assessment of the investment opportunity by those with their own money directly at stake.

Response to OSC Staff Notice 33-738

While Angel investors historically have invested on their own or with a small group of friends or associates, both the Federal and many Provincial governments have recently realized the benefits of encouraging them to co-ordinate as groups in order to foster best practices, increase the scope of their due diligence and provide deeper funding pools for early stage companies. However, Angel groups are typically sparsely resourced and volunteer or investor driven. The recent OSC Staff Notice 33-738 has lead to concerns from a number of investors and group managers who do not see their organizations as being in the business of dealing and are concerned that being regulated as Exempt Market Dealers may force them to disband, given their limited resources.

It is important that Angel groups not be considered registrants where they are non profit entities consisting of only accredited investors, and where the investors are required to do their own due diligence, and where the group does not provide investment advice or handle client funds, and is governed by best practices that protect the interests of their members. Full exemption from registration should be applicable where the activities and processes of an Angel group are conducted so that there would be no reasonable expectation from an investor that material reliance could be made on the actions or reviews conducted by the group and where it is clear that the investor is both fully expected to conduct thorough due diligence on their own and is sophisticated enough to fully appreciate this dynamic. Where the structure or activities of a particular group might not fit all, or a majority of the above, criteria, then there should be a customized form of registration reflecting the unique and valuable role that angel groups provide. NACO would welcome the opportunity to work closely with the OSC towards refining any such exemptions or customized registrations.

Any changes that push Angel investors to work independently, would be counterproductive to the goal of reducing investor risk and improving investor education through networking, professional development and co-investment; objectives that have recently received significant support and attention from both federal and provincial governments.

Conclusion

Angel investing is a relatively new phenomenon in Canada and one that is making a significant contribution to supporting the Canadian startup ecosystem. Crowd funding has the potential to provide early stage companies with additional sources of capital. However, it is important that regulatory changes being made to allow for new funding options do not have unintended repercussions on the activities of more sophisticated investors. We commend the OSC for their efforts to seek input from the investment community on these initiatives and look forward to continuing our dialogue on this and many other issues in the coming months.

Sincerely,

Michelle Scarborough
Board Chair
National Angel Capital Organization