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John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, M5H 3S8

Dear Mr. Stevenson: ***Re: Comment on Policy 45-501***

This is my comment on OSC Proposed Rule 45-501 regarding exempt distributions. The ideas are taken from my LL.M. thesis, submitted to Osgoode Hall in August 2000, and reviewed by Professor Jeffrey G. Macintosh of the University of Toronto. Attached is a disk with this letter in Wordperfect.

Additional Exemption:

In my view, the proposed accredited investor exemption favours the wealthy. Why should middle class investors not have the same opportunities? Currently, the middle class can only invest in start-up enterprises under the private company exemption if there is a prior association, or under the Seed Capital or Government Incentive Security exemptions. Under the proposals, only a small number of middle class investors could participate, and once the company reached 35 investors, the middle class would essentially be "locked out" until a public distribution.

I suggest a new exemption based on the percentage of an investor's aggregate SME investments to his or her total equity. For example, if the percentage were set at 5%, an investor with an equity of $100,000 could invest $5,000 in SMEs, and an investor with an equity of $2.5 million could invest $150,000 without a prospectus.

The Securities Commission, of course, is concerned with investor protection. Middle class investors don't have the same "due diligence" resources as the wealthy. However, the safeguard under this proposal is the ability to withstand total loss rather than sophistication or the ability to afford due diligence. This is in keeping with a variety of Ontario statutes, where a "prudent" investor is allowed to invest a small percentage of total assets in potentially high-growth, risky securities. For example, the Ontario *Trustee Act* was recently amended to give a trustee authority to "invest in any form of property in which a prudent investor might invest" (section 27). The manager of a mutual fund can invest up to 10% of its assets in "restricted", "illiquid" securities (National Policy 39, section 2).

An offering memorandum with prospectus-equivalent disclosure should be required because middle class investors do not have the same bargaining power or due diligence resources as the wealthy. Advertising should be restricted to "tombstone-equivalent" statements. The issuer should be able to rely on an investor's representation that he or she qualifies for the investment.

Continuous disclosure proposal:

In my view, just as a spectrum of exemptions exist in the pre-IPO market, so too should a sliding scale of regulations exist in the post-IPO market. A balance should be struck, at each point on the scale, between the market's need for fast, relevant and accurate information, and the issuer's need for workable rules which don't drain too much of its resources.

I suggest three continuous disclosure regimes for Ontario companies: (1) The lowest level would be for private issuers or "closely-held" corporations. They would have no public disclosure requirements. (2) The next level would be for "semi-public" corporations. They would have the current disclosure requirements for small issuers, including an annual audit and material change reports but not an Annual Information Form. As under the current rules, they could sell to an unlimited number of investors, but if the distribution was not pursuant to a prospectus, the securities would be subject to a hold-period. (3) The highest level would be "fully-public" corporations. They would have enhanced continuous disclosure requirements, certified by management and periodically reviewed by an independent auditor. The issuer could access the market at any time by a simplified prospectus incorporating by reference the public record - in the style of a term sheet, with the risk factors listed. No hold-periods would apply.

Already, there are significant differences imposed on small and large Ontario issuers. Policy 5.10, which mandates an Annual Information Form ("AIF"), applies only to larger issuers with either a shareholders' equity or revenues greater than $10 million. (Proposed Rule 51-501 would also make the policy apply to an issuer with a market capitalization of $75 million or more). For these larger issuers, the AIF contains an annual description of the business, a management discussion and analysis of the current financial situation and future prospects, and other information designed to supplement the issuer's periodic filings.

Presumably, Policy 5.10 doesn't apply to smaller issuers because the costs associated with filing an AIF outweigh the anticipated benefits to investors. However, in the past few years, British Columbia and Alberta have provided small issuers with an incentive to file an AIF. A small public issuer who files an AIF in B.C. or Alberta can issue shares to the exempt market without a prospectus, subject to a shortened hold period of only four months (rather than the usual twelve month hold in those provinces). In a sense, the western Commissions are obtaining better disclosure from small issuers by "using a carrot rather than a stick". This enlightened approach, combined with more liberal exemptions for "sophisticated purchasers", could presage a shift of junior deals from Ontario to the west.

At the same time, Ontario is moving towards a more rigorous regime by "using a stick rather than a carrot". For example, Ontario Proposed Rule 52-501 would tighten annual and interim financial reporting for all issuers - not just the larger ones. The proposed Rule would require all issuers, no matter their size or float, to file (i) an interim balance sheet, (ii) an interim statement of retained earnings, (iii) an income statement and cash flow statement for each three-month period of its financial year, other than the last three-month period of the year, (iv) notes to the interim financial statements, and (v) include certain line items in their annual and interim balance sheets. In addition, the OSC is considering a requirement that an external auditor review all of an issuer's interim statements prior to filing. Failure to comply with the Rule, once it comes into effect, would expose the issuer to default proceedings and possibly a cease trade order - "the stick".

The policy reasons given by the OSC for Proposed Rule 52-501 are twofold: (1) "Securityholders will benefit from the financial disclosure mandated by the proposed Rule"; and (2) "the proposed Rule will result in greater harmonization with International Accounting Standards and with standards in the U.S."

Regarding the first reason, surveys should be done to determine how useful the additional interim

statements would actually be to SME investors. I suspect that it depends on the size and activity of the issuer. There are many semi-dormant issuers in Ontario with few material changes each quarter. Provided these issuers file timely material change reports, the additional quarterly financial reports may be unnecessary.

As to the costs, the OSC passingly mentioned "some nominal additional costs on issuers", but the business executives I spoke to are not quite so confident. Although interim balance sheets and retained earnings statements may be easy to generate with today's computerized accounting packages, the required notes to the statements and certain line items often require complex judgment calls. Furthermore, if an external auditor is required to comment on interim statements, costs will appreciate materially.

Currently, under Ontario Policy 2.6, the OSC can exempt an issuer from filing interim financial statements where "the issuer demonstrates that the preparation and distribution of such statements would not be of significant benefit to investors and would represent a material financial burden to the issuer". In my view, however, rather than requiring an issuer to make special application for relief (the cost of which application drains the very funds the issuer is trying to save), there ought to be different reporting regimes for different sized issuers.

Regarding the apparent need for increased harmonization with the U.S., consideration ought to be given to the Task Force's observation that the SME market is local.

> "We are also of the view that notwithstanding the ever-increasing globalization of securities markets, SMEs are frequently financed on a local or regional basis, and there are material differences between the equity marketplaces in different regions in Canada relating to different investment landscapes and cultures, and to differences in industry base, economy size and nature of market participants, among other things. Consequently, harmonization of the securities regulatory regime which impacts SME financing, while desirable, is less critical."

I agree with the OSC that small business rules should be harmonized across Canada, but I do not believe it is necessary to harmonize with the U.S. Regarding Canadian harmonization, the CDNX Western exchange has become a national exchange focussing on junior companies via computer links across the country. It is as easy to invest or list on the CDNX from Toronto as it is from Calgary or Vancouver. Ontario's over-the-counter market (now the "CDN") has upgraded its regulations and

reporting requirements and will soon merge with the CDNX. Regarding U.S. harmonization, I doubt there is any need at this time since few Americans invest directly in small Canadian firms. Those that do should be prepared to retain a Canadian advisor.

All of which is respectfully submitted.

Yours truly,

John P. Allen