

## **Northern Securities Inc.**

### **Submission to the Ontario Securities Commission**

*December 8, 2000*

#### **Northern Securities**

Northern Securities Inc. (“Northern Securities” or “Northern”) is a Toronto-based full service brokerage firm that is a member of the Investment Dealers Association, a Participating Organization with the Toronto Stock Exchange and a member of the Canadian Venture Exchange.

Northern is an Internet investment bank that caters to the needs of small cap companies in Canada. In 2000 Northern raised capital in 20 financings for small cap companies. Northern raises capital in the traditional manner and on the Internet through its online public offering site. Northern is completing its online private placement site.

#### **Comparison with the United States is the Key**

In this submission Northern compares the private placement rules in the United States with the current rules in Canada and those suggested in Proposed OSC Rule 45-501 (the “Proposed Rule”). We believe this to be the key comparison. An issuer of securities may have a choice between raising capital in Canada and the United States and we need to develop a regulatory environment from a securities and tax point of view to give Canada a chance at keeping the issuer in Canada, a chance at the issuer listing its shares in Canada, and a chance at the business being located in Canada.

In comparison to Canada, the United States will offer substantial advantages to issuers given the more developed marketplace, the broader base of investors, a single securities regulator, the more advantageous tax environment, and the ability to generate more perceived or real appreciation in equity value. Canada must seize any opportunity it can to create an environment that is at least comparable to the competitive position in the United States – the private placement rules is one such opportunity.

#### **The Current Private Placement Rules Compared to the United States**

It is important to start with the current private placement rules to see the current competitive position between Canada and the U.S. This analysis should show how much we have to catch up to the U.S. This is followed by an analysis of where we end up competitively under the Proposed Rule. All dollar amounts are in Canadian dollars unless otherwise indicated.

<b>CURRENT RULES</b>	
<b>Canada</b>	<b>United States</b>
<ul style="list-style-type: none"> <li>• need \$150,000 to be a qualified investor</li> <li>• can raise \$ in a seed offering from 25 non-qualified investors – in practice limited to about \$1.25 million</li> <li>• can raise \$ in private company offerings – no practical impact</li> <li>• can raise any amount from any number of qualified investors (\$150,000 per investor) but no funds from non-qualified investors</li> <li>• can raise any amount from any number of qualified investors (\$150,000 per investor) but no funds from non-qualified investors</li> </ul>	<ul style="list-style-type: none"> <li>• need US\$1 million net worth or US\$200,000 annual income or US\$300,000 with spouse to be qualified investor</li> <li>• can raise US\$1 million from any investors, whether qualified or not</li> <li>• can raise US\$1 million from any investors, whether qualified or not</li> <li>• can raise US\$5 million from qualified investors and 35 non-qualified investors</li> <li>• can raise any amount from qualified investors and 35 non-qualified investors who are qualified by knowledge or experience</li> </ul>

Competitively the U.S. is substantially ahead of Canada in the rules for private capital raising.

The key advantages for the U.S. are clear:

1. An issuer can raise US\$ 1.0 million from any number of investors, whether qualified or non-qualified (a Rule 504 offering).

Most importantly, there is no prohibition against general advertising or a general solicitation.

Compare this substantial flexibility in the U.S. with a Canadian-style seed capital offering which is the closest equivalent. There is a maximum of 25 purchasers, 50 offerees, and a prohibition against a general solicitation. Since Canada's version of the qualified investor test in the U.S. is a person with \$150,000, the seed capital exemption is clearly targeted to investments of less than \$150,000. In practice the average seed capital investment is \$50,000 or \$1.25 million maximum.

The U.S. Rule 504 offering can raise US\$1,000 from each of 1,000 investors or US\$1.0 million – or US\$10,000 from 100 investors – or US\$20,000 from 50 investors and so on.

With a cap on the number of investors, the Ontario seed capital offering is not competitive:

- 25 investors at \$1,000 each is \$25,000
  - 25 investors at \$10,000 each is \$250,000, and so on.
2. The different categories of qualified investors in Canada and the U.S. provides for an interesting comparison. In Ontario, a qualified investor is someone who invests \$150,000. In the U.S. a qualified investor is someone who has a net worth of US \$1 million or annual income of US\$200,000 or, with his spouse, US\$300,000. These U.S. qualified investors can invest any amount once qualified.

In the qualification of investors, Ontario is quite behind the competitive road. Logically there would be more US qualified investors than Ontario qualified investors (leaving aside population differences).

Typically, there would be a number of Ontario investors who “have” \$150,000 but who would not “invest” \$150,000.

Ontario investors who have much more than \$150,000, say \$1.0 million to \$2.0 million in financial assets, may be prepared to invest only \$10,000 or \$20,000 or \$50,000 in a single investment opportunity. There are many high net worth investors who want to limit their downside risk by investing less than \$150,000.

The number of persons who have \$1.0 million to \$2.0 million in financial assets who would invest \$150,000 is far less than the number of Americans who have either US\$1.0 million in net worth or US\$200,000 in annual income and are able to invest any amount.

There is therefore a major difference in qualifying investors between Ontario and the United States. In Ontario you are qualified by how much you can bring to the table – at least \$150,000. In the United States you are first qualified in net worth or income terms, and then you can bring any amount to the table, however small.

3. In the U.S., in Rule 505, a maximum of US\$5 million can be raised from any number of qualified investors and a maximum of 35 non-qualified investors. There is a prohibition against a general solicitation or general advertising.

Most importantly, the SEC has recognized that previously qualified investors may access a password-restricted web page containing information about private offerings (IPONET No Action Letter July 23, 1996).

In Rule 506 there is no limit on the amount of capital that can be raised in a private offering in the U.S. from qualified investors and 35 non-qualified investors who in fact must be qualified on the basis of knowledge or experience rather than net worth or income.

In Ontario an issuer can raise as much capital as possible in an offering from qualified investors. General advertising is permitted as long as an offering memorandum is available.

There is a finite number of Ontario investors who will invest \$150,000 in any given investment. There would be a much more expanded pool of investors if they were qualified on the basis of some quantitative measure such as net worth, financial assets or income, and once qualified were permitted to invest any amount of funds, however small.

On a competitive comparison, the pool of qualified investors in the U.S. is greater than in Ontario (leaving population differences aside).

The pool of investors is greater in the U.S. because 35 non-qualified investors can participate in a maximum US\$5 million offering. This is a big advantage in the U.S.

In Ontario, there is no such equivalent concept of a non-qualified investors participating in an offering.

It is pretty clear that we are quite far behind the United States in the private placement rules. Now the question is whether we will catch up in the Proposed Rule.

## Proposed Private Placement Rules in Ontario.

The following table compares Proposed OSC Rule 45-501 with the private placement rules in the U.S.

<b>PROPOSED OSC RULE 45-501</b>	
<b>Canada</b>	<b>United States</b>
<ul style="list-style-type: none"> <li>• need financial assets alone or with spouse in excess of \$1.0 million, or net income of \$200,000 or joint net income with spouse of \$300,000 to be qualified investor</li> <li>• can raise \$3.0 million for closely-held issuers from up to 35 non-qualified investors (excluding qualified investors, employee shareholders who buy shares under a compensation plan and certain family members) and can raise any amount of money from qualified investors</li> <li>• can raise any amount of money from certain family members</li> <li>• can raise any amount of money from qualified investors and up to \$3 million for closely-held issuers from 35 non-qualified investors</li> <li>• can raise any amount of money from qualified investors and up to \$3 million for closely-held issuers from 35 investors who need not be qualified by knowledge or experience</li> </ul>	<ul style="list-style-type: none"> <li>• need US\$1 million net worth or US\$200,000 annual income or US\$300,000 with spouse to be qualified investor</li> <li>• can raise US\$1 million from any investors, whether qualified or not</li> <li>• can raise US\$5 million from qualified investors and 35 non-qualified investors</li> <li>• can raise any amount from qualified investors and 35 non-qualified investors who are qualified by knowledge or experience</li> <li>• can raise US\$1 million from any investors, whether qualified or not</li> <li>• can raise US\$5 million from qualified investors and 35 non-qualified investors</li> <li>• can raise any amount from qualified investors and 35 non-qualified investors who are qualified by knowledge or experience</li> </ul>

1. The U.S. is ahead with a less significant requirement of US\$1.0 million in net worth to qualify private placement investors compared with \$1.0 million in financial assets in the Ontario test. This is a big difference. There are many qualified investors in the United States who have US\$1.0 million in net worth. Being required to have \$1.0 million in financial assets in Canada is too high a threshold. We suggest that the level of financial assets be \$200,000 but that the investor be limited to investing a maximum of 20% of his financial assets in a private placement.

2. Companies in the United States can raise US\$1.0 million by advertising, general solicitation and the use of a brokerage firm. Under the Proposed Rule in Ontario companies cannot advertise, solicit or use a brokerage firm in raising \$3.0 million for closely held companies from up to 35 non-qualified investors. This is a serious disadvantage and competitive impediment.

3. From the Comments set out in Appendix A to the Proposed Rule, it is assumed that the Internet cannot be used in connection with a closely-held issuer financing. There is no sensible reason to prohibit a brokerage firm from helping an issuer in a financing through the Internet even a closely-held issuer.

A brokerage firm should be allowed to raise capital on the Internet for an issuer if a password-protected website is in place to pre-qualify qualified investors. Let's open up the capital markets but in a proper, measured and careful way.

The fact that there is a limitation of 35 non-qualified investors is itself a proper restriction that in some cases will limit the investors to those who are closely connected to the issuer. But why in other cases should there be such a limit. What is wrong with persons who are not closely connected with an issuer from investing in the issuer. Either there should be a requirement that only persons closely connected with the investor can invest in the issuer or there should be no such requirement. Our recommendation is to drop the concept of a closely held issuer to put us on a more competitive footing with the U.S.

4. The U.S ability to raise US\$5 million from 35 non-qualified investors is an advantage over the proposed ability in Canada to raise \$3.0 million from 35 non-qualified investors. The gap is \$4.5 million, which is a huge gap. This is a big advantage to the U.S. The \$3.0 million limit should be increased to \$5.0 million so that \$5.0 million can be raised from non-qualified investors.

5. When qualified investors are taken into account, the advantage moves to Canada since an unlimited amount can be raised from qualified investors in Ontario in contrast to the limit of US\$5 million for both qualified investors and non-qualified investors. This is a good competitive edge for Canada.

## **Recommended Changes**

We therefore recommend the following changes in order to improve Canada's competitive position against the U.S:

1. The level of financial assets be reduced to \$200,000 in order to qualify an individual as an accredited investor. The investor should be limited to investing a maximum of 20% of his financial assets in a private placement.
2. A closely-held issuer should be allowed to use a brokerage firm to raise capital in a private placement.
3. A closely-held issuer should be allowed to raise capital through a password protected website on the Internet where investors are pre-qualified as qualified investors.
4. An issuer should be allowed to raise \$5 million from a maximum of 35 non-qualified investors.

## **Northern Securities Inc.**

By: \_\_\_\_\_

**Vic Alboini**  
**Chairman and Chief Executive Officer**