Prospectus Exemptions Review Submission
February 29, 2012

To: British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

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NAO-Ontario administers Ontario's Angel Network Program, and also maintains a list of Angel groups for the Federal Development Agency of Southern Ontario's Investing in Business Innovation Program. The latter program provides loans to businesses based on the amount invested by 'Angels' and venture capitalists (VCs). Activities related to these programs include the collection and aggregation of information on investments in Ontario businesses by accredited investors (AIs) who are members of Angel groups. These members make their own investment decisions and invest as principals. They perform their own due diligence, including engaging technical expertise when needed.

We support the goals of 1) protecting investors from unfair, improper or fraudulent practices and 2) fostering fair and efficient capital markets and confidence in those markets and appreciate the inherent difficulty in balancing activities and rules designed to support each goal. We also support the principles that a) regulatory measures must address identified risks to investors and markets and b) benefits must be proportionate to the costs and the restrictions borne by market participants.

In particular, we hold the view that the impact of proposed changes on capital markets for private small and medium sized enterprises ('SMEs') must be carefully considered. As a large number of private sector workers are employed by entities with fewer than 100 workers[i], and as SMEs create the largest number of new jobs, adequacy of capital to this market is vital to economic growth. We are convinced that the other prospectus exemptions and financing mechanisms in 45-106 are insufficient to compensate for changes to the minimum amount and particularly to the tests for qualifying individuals as AIs.

Unfortunately, the changes implied by the questions posed seem unlikely to achieve the desired objectives and do not appear to adhere to the principles espoused. A focus on addressing and preventing unfair, improper and fraudulent practices would seem to be more conductive to fostering public market confidence than decreasing the efficiency of or eliminating early stage capital markets by overly broad restrictions on individuals. Please find below our responses to the questions posed by the members of the Canadian Securities Administrators (CSA):

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1. What is the appropriate basis for the minimum amount exemption and the AI exemption?

Determining an appropriate basis for the exemptions is dependent on circumstances and the degree to which problems are actually occurring. For these reasons, we would first inquire if there is any analysis from Form 45-106F1 filings and complaints or prosecutions that can be made available to answer the following questions:

- What types of entities receive investor capital via these exemptions (e.g. investment funds, operating businesses, financial institutions) and what securities or products are these entities selling?
- What is the dollar value for each of the above and type of sale and how many investors are involved in each category?
- Which sectors, sub-sectors or products are generating the most problems?
- What is the respective nature of these problems, how many investors and what total dollar value is affected by these problems in relation to the above analysis?
- What is the analysis of problems by dollar value among types of issuers dealing directly with investors as opposed to resellers or placement agents?
- What evidence is there that the identified problems are due to investor naiveté versus lack of disclosure, misrepresentation, overselling or conflicts of interest?
- Do those alleging problems have supporting data that would cast light on the magnitude of a problem or any conflicts of interest - e.g. such as proposing changes that would increase profits via decreased competition or preferential access to or control of transactions?

In the absence of data, media reports lead us to believe that the biggest problems, measured both by dollar value and by the number of investors affected, are associated with high-fee complex products and investment funds, and that these are sold by registrants or insurance agents as well as non-registrants. If true, we believe the regulatory focus should be on sellers of these products and on disclosure, not on individuals investors.

With respect to individuals, the size of an investment in relation to total net worth is the most relevant criteria for determining whether a loss will cause irreparable or undue hardship, given no change in earning power. It is frequently recommended that no more than 5 to 10% of net worth be invested into private or alternative products and that individuals need to recognize these investments are long-term, illiquid and risky.

The second most important criteria is pertinent education and work experience. However, the only education and experience implied in the current definition of AI is financial industry education and experience. One might argue that anyone who successfully completes the Canadian Securities Course has demonstrated the same financial education as a current or former broker registrant, irrespective of income or assets. The additional education qualifying brokers for registration is generally about the ethics of selling to others and regulatory requirements for the profession.

Certified Financial Advisors, Personal Financial Planners, corporate lawyers, and professional accountants all have financial education and experience relevant to evaluating risk with respect to asset allocation and often for evaluating early-stage businesses. Financial and legal education obviously contribute to the ability to do one's own due diligence and also helps clarify when external expertise is required. This training is widely available and its value is recognized by the Offering Memorandum rules (in jurisdictions outside of Ontario) which require that 'eligible investors' receive advice from 'eligibility advisors' who are independent lawyers and accountants receiving no remuneration from an issuer.

We submit that <u>other</u> education and work experience can be equally relevant and sometime more so. Examples include:

- patent agents when businesses' value and trajectory depends on intellectual property,
- doctors and dentists evaluating companies developing human health products, and
- computer sciences training or experience in the software industry for such businesses.

Most professionals already have relationships with accountants and lawyers, and should be presumed to be able to know when to seek additional technical expertise.

Most relevant, however, to investment in early-stage companies and SMEs is previous industry experience and success. A large amount of evidence is accumulating that the most successful businesses are founded by people with industry experience. People with industry experience are arguably better able to evaluate businesses and management in the industries they know than anyone else, whether a restaurant or an IT firm, barring

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misrepresentation. Such investors also bring more than capital; they share advice and contacts that can mean the difference between success and failure to a company.

The average 'Angel' investor is 57, a successful businessperson and frequently even a serial entrepreneur - a US study found that Angels had founded 2.9 companies on average[ii]. He or she generally makes use of the AI exemption to invest as a principal in early- stage companies. Angel groups are of value to these investors for sharing of best practices, due diligence and expertise across industries and for exposure to a greater selection of quality investment opportunities.

More importantly, many angels find the groups most valuable for learning why a knowledgeable investor with industry experience would not him/herself invest in a particular company. Reasons for not investing might include, inter alia, another company that has first mover advantage, barring or not novel IP, a concept that has previously failed, an addressable market much smaller than the purported target market, competing technology with more advantages and fewer problems or because the product or service is mis-targeted or overpriced. Angels recognize that companies seeking investment will present themselves in the most favorable light.

Our groups provide a forum for companies to present to accredited investors but no one actually makes an investment recommendation, rather it is emphasized that investors must make their own decisions. Conflict of interest policies exist to prevent undisclosed financial relationships and codes of conduct are increasingly being adopted (see www.nao-ontario.ca for an examples). The National Angel Capital Organization is working with international angel investor organizations to develop educational modules and standards to help Canadian angel groups to continue to operate effectively and appropriately.

Angel groups help make early-stage and SME capital markets more efficient for potential high-growth companies by making it easier for them to reach a larger number of potential investors than by referral or introduction, particularly when they are too small for an Offering Memorandum mechanism or when it is unavailable to them (as in Ontario).

We suggest that in seeking to protect unsophisticated investors, broad mechanisms that exclude competent individuals be avoided in favour of evidence-based, focused mechanisms that target specific problems at the root. In seeking to protect investors from unfair, improper or fraudulent practices, we think the focus should be upon the practitioner or seller rather than the investors.

2. Does the involvement in the distribution of a registrant who has an obligation to recommend only suitable investments to the purchaser address any concerns?

We do not believe this would address our concerns. Securitized products that have engendered public distrust were usually sold by registrants and financial institutions. Fraudulent schemes in the financial industry are frequently viewed by the public as a failure to adequately monitor, investigate and enforce existing regulations.

The inherent conflict of interest when registrants and financial institutions are being remunerated by both the seller and the buyer deserves note. There is always a risk that the interests of the largest profit source (generally the issuer) will be favoured and that the need to move "product" will lead to overselling. Analyst and rating agency bias described in past and current media reports are just different aspects of this same problem.

There are also inherent conflicts when financial institutions and registrants acting as sellers are privy to material adverse information that is not made public, such as internal views of the quality of the issue, discordant valuations, determinations as to creditworthiness, undisclosed related-party transactions, etc.

The requirement that investments only be 'suitable' is inadequate in the case of conflicts of interest, especially when coupled with inadequate disclosure or failure to engage in appropriate due diligence when investors could reasonably be expected to rely upon diligence being performed. In these circumstances a fiduciary requirement might be more appropriate and the 'suitable' requirement should only be applicable to independent advisors not being compensated by issuers or their intermediaries.

Regarding confidence in capital markets and perceptions that they are fair, there is significant public concern that the financial industry allocates the best investments to themselves and that financial industry returns and fees are excessive in relation to the return to individual investors. This can be seen in the movement of investors to Exchange Traded Funds and discount brokerages and out of markets entirely. Indeed, in the United States, such sentiment is embodied in the title of the recently introduced House legislation *Democratizing Access to Capital Act S. 1791.*

Public support for democratization is evidenced by ordinary people providing capital for projects and business opportunities on websites such as Kickstarter and Kiva, the latter largely involving microloans to individuals in foreign jurisdictions. There appears to be little evidence that these individuals are entering bankruptcy or facing undue hardship at higher rates as the result of such activity. This would support an argument the majority of

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people at all levels of income and financial assets can make effective risk decisions. If so, an overly protective approach to investors is unnecessary, although some regulation is warranted.

The *Entrepreneur Access to Capital Act (HR 2930)* in the US, for example, caps company offering size at $1 million or $2 million if audited financial statements (with amounts adjusted for inflation). The Securities and Exchange Commission (SEC) be informed of the offering and its completion and must be provided with information on the issuer and any intermediary. Additional investor protection includes requiring issuers to outsource cash management to an independent custodian and to maintain books and records deemed appropriate by the SEC. Intermediaries to do background checks on an issuer's principals and are also required to provide a communications interface for investors and issuers. Investors answer a questionnaire, receive specific warnings (including with respect to fraud), and are limited to investing the lesser of $10,000 or 10% of net income. Similar bills include the *Democratizing Access to Capital Act* and the *Small Company Capital Formation Act.* These all recognize the vital importance of access to capital, but limit the size of an issue in aggregate or annually. There financial tests on investors are limited, but they are generally protected by limits on the amount they can invest as well as additional measures. These types of bills appear to balance an economy's need for early-stage capital with reasonable protections for investors more constructively than would broadly excluding individuals from being accredited investors.

However, our primary concern is that requiring the involvement of financial industry professionals, when individual investors (accredited and non) may very well perceive such involvement as unnecessary and unwarranted, would only serve to **decrease** confidence that markets are fair and efficient rather than increase it. In other words, it may be counterproductive as investors and SMEs could perceive such a move as adding to costs without adding value, and possibly as increasing control by an industry that has lost trust without materially affecting the practices that led to the mistrust.

An effective cost-benefit analysis would call for quantitative estimates of such additional actual and opportunity costs to individuals, SMEs and the economy to be compared to quantitative estimates of the benefits of changes.

Minimum amount exemption

3. Do you have comments on the 4 issues outlined by the CSA with respect to the minimum amount exemption?

The minimum amount exemption implies that a person investing this amount has at least the financial resources to withstand the loss, but there is no actual declaration based test of financial resources, education or experience that presage an understanding of business or investment risk. It only requires that someone raise the amount, by unspecified means. Accordingly, we recognize that it is the exemption that could be most susceptible to being used inappropriately by individual investors and most prone to misuse by parties seeking to raise capital.

- **Assurance of sophistication:**

Please see our answers to questions 1 and 2. Many individuals have adequate education, business and investment experience to evaluate investments in companies - indeed, as much or more relevant experience than registrants, due to greater technical education or industry experience. Barring misrepresentation, many also know what additional questions to ask, what constitutes a red flag and when to seek additional advice or technical experience. This is particularly true of the more than 400 members of Ontario's Angel groups. They also form smaller groupings to share the investigation of particular investment opportunities, as well as to share expertise and expenses and often find learning why a colleague with particularly relevant background would not invest in an individual company of particular interest.

We think that all minimum amount investors would benefit from a required statement by an issuer that: ***This investment is considered an "alternative investment" because it is long-term, illiquid and high-risk. Most people should invest no more than 5 to 10% of net worth in this type of investment.***

We think that many people can make effective risk decisions if provided with asset allocation guidelines and appropriate disclosure, barring unfair practices (include the minimizing of risk or over-promising returns).

In the absence of data that members of the CSA might furnish, our view is that a lack of sophistication is more of a problem in the case of sales of investment funds, complex products, high-yield loans and possibly franchises. We also think that entrusting others to manage your money is riskier than doing it yourself if the manager does not have the same risk of loss and if there are conflicts of interest as described above. A recent Globe and Mail opinion piece seemed to indicate that clients of independent registrants had better returns than those who were not independent.

If the data supports our media informed impressions of where problems lie, the most effective regulatory focus might be on those issuers and products. Requiring disclosing of the same sort of criteria, history and sensitivity

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analysis on which a person in the industry would make an informed view could be salutary. For example, many municipalities would not have invested in complex currency or interest swaps if disclosure had been made of the possible consequences of changes in rates or currencies via a sensitivity analysis that included historical extremes and 35% to 50% volatility.

- **Current threshold for the minimum investment:**

We do not believe that this threshold should be increased without more data being released to identify how it is being used. Similarly we would be better able to respond if there were data characterize and quantifying problems, and research as to mechanisms most likely to remedy the causes of those problems. We believe that publication of such data by the CRA would increase transparency, which generally enhances public confidence - especially when subsequent changes are seen as responsive to circumstances.

We believe that regulatory mechanisms should focus on addressing the roots of problems rather than on broad changes that protect the very few while unnecessarily restricting the many who do not need such protection and hurting companies that will no longer have access to capital. The ability of people to make appropriate decisions when well-informed should be respected. This would include, in our view, what a reasonable asset allocation would be to a particular type of investment.

We would also first call for data to indicate the effect such a change would have on capital markets and how regulators will ensure continued access to capital by SMEs, who already have less access to capital than their US peers (see question 24 for how we reach this conclusion). We are of a view that other exemptions and capital raising mechanisms in NI 45-106 are inadequate for vibrant early stage markets.

- **Impact of a minimum amount concept on investment decisions:**

Prior to predicating changes on anecdotal evidence that investors **may** be using this exemption inappropriately, data is needed on the magnitude of this problem. This might better answer whether issues arising are truly the responsibility of individual investors or whether such investors are being induced to over-commit. What is the role of investor misjudgement versus inadequate disclosure, representations that risk is minimal or promises of unrealistic returns?

Raising the thresholds does nothing to protect investors from unfair, deceptive, improper and fraudulent practices, though it may reduce the pool of targets. If the problems are due to these practices or to material lack of disclosure by issuer/seller of the type of information that they would use to make their own decisions, we think that regulatory focus should be on these practices and parties.

As Ontario's Angel investors, whether organized or not, always sign AI declarations when reviewing opportunities and when making their investments, the incentive to boost one's investment to the level of the minimum amount exemption is non-existent.

- **Use of the exemption to raise capital:**

Raising the threshold may have an adverse impact on early-stage capital markets and may well preclude knowledgeable investors from making good investments, depriving companies of their capital and acumen. We believe that CSA members have better data than respondents that would allow them to estimate the dollar value of the impact versus the dollar value of the problems addressed.

In performing a cost-benefit analysis we believe that regulators should also analyze whether other provisions for access to capital are adequate. We strongly believe that they are not.

4. Do you have any other issues with respect to the minimum amount exemption?

Maintaining this exemption becomes critical for early-stage capital if financial tests qualifying individuals to be accredited investors are raised and/or individuals can no longer be accredited investors. We think that other available exemptions are currently inadequate to support vibrant early-stage or SME capital markets, and suggest that regulators should also perform a quantitative analysis of whether other provisions for access to capital are adequate to compensate for changes.

5. Do you agree with maintaining the minimum amount exemption in its current form?

We recommend retaining the amount or reducing it. Adding declaration based tests, issuer disclosure requirements or limitations could also be added, but should be based an analysis of where there are problems and what changes, additional requirements or limitations would best solve those problems.

We think that declarations can be useful, but statements of net worth or declarations of actual amounts are intrusive, and might make investors even easier prey for the unscrupulous. Such information is protected by privacy laws, and so should only be required on an absolute need-to-know basis, not to address a problem of unknown scope. We believe that given adequate information about an investment, guidelines regarding prudent asset allocations to risk capital, and unbiased advice, that investors can make reasonable decisions.

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In our experience there is far less concern when knowledgeable individuals are investing in businesses as principals, rather than in financial products or investment funds, and excluding them on an undifferentiated basis would be inappropriate. We are not opposed to excluding complex products if the data supports such exclusion.

Capital flows to the regions with the best opportunities and most favorable treatment. While the US has eliminated its minimum amount exemption it has many less restrictive options for raising capital for early and mid-stage companies than Canada does and its legislative bodies are contemplating even more.

6. How much should the minimum investment threshold be increased?

Again, without data to identify, characterize and quantify problems, nor an analysis of the causes and research as to mechanisms most likely to remedy those problems, we do not believe that it should be increased. We would instead recommend more specific and evidence-based measures.

No data provided yet indicates the effect such a change would have on capital markets and how regulators would ensure continued access to capital by SMEs, who already have less access than their US peers.

We strongly believe that any threshold increase or exemption elimination should be accompanied by changes to other exemptions or limitations that would ensure both continued access to capital for SMEs, and access to investment opportunities for competent investors and those with access to independent accounting and legal advice.

7. Should the $150,000 threshold be periodically indexed to inflation?

We think that inflation mostly tracks households' cost of living which has little impact on financial assets. A better choice might be the national rate of increases in household financial assets or the national rate of net increase in household income or some ratio of financial assets to average household financial assets.

As noted above, we favour data-supported analysis and changes or limitations, designed to address targeted problems, while respecting the ability of competent people to make effective decisions based on their individual circumstances. In the absence of data to the contrary, we favour more disclosure and other mechanisms targeting issuers and sellers.

Another alternative to consider is to drop the amount to $25,000 - such is an amount similar to the minimums that investment funds typically impose on accredited investors, for example. This could be coupled with disclosure requirements and limits on how much capital can be raised for issuers by this mechanism. Requiring declarations that the amount represents no more than 10% of net worth or net income would largely address the concerns regarding over-commitment and provide increased investor protection.

8. If we changed the $150,000 threshold what would the impact be on capital raising?

CSA members probably have more data than respondents to quantitatively estimate the dollar value of the effect on capital markets from the 45-106F filings they receive. Respondents and the public would likely find information on how much is invested in various types of investments and by type of issuer extremely informative, especially if accompanied by a similar matrix of problems, complaints or losses.

As the briefing document clearly states that the exemption is widely used to raise capital, the obvious implication is that eliminating it or raising its threshold would have a restrictive impact on capital markets. Without knowing how it is used, we cannot estimate the effect on early stage capital markets as most of the members of our groups qualify under the accredited investor exemption.

9. Should individuals be able to acquire securities under the minimum amount exemption?

Yes, in the absence of data supporting the need for change.

Would your answer to this question change depending on whether:

- **Any disclosure is provided to investors, including risk factor disclosure?**

We think that all minimum amount investors would benefit from a required statement by an issuer that: *This investment is considered an "alternative investment" because it is long-term, illiquid and high-risk. Most people should invest no more than 5 to 10% of net worth in this type of investment.*

Risk factor disclosure, accompanied by the same sort of criteria, history and sensitivity analysis on which a person in the industry would make an informed view would have a positive effect on good decisions. For example, in the case of investment funds, the performance of an investment manager's previous funds would be relevant.

- **The security is novel or complex?**

Disclosure standards should be both higher and more rigorous for sellers of these products. Risk factor disclosure, accompanied by the same sort of criteria, history and sensitivity analysis on which a person in the industry would make an informed view would have a positive effect on good decisions. However, we focus on

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investment in companies operating businesses, not complex financial products, so would not oppose excluding the latter if the data supports it. Complex products might be one area in which registrant involvement might be useful, **if** the registrant has no conflicts.

- **The issuer of the security is a reporting issuer?**

Disclosure standards should be higher and enforcement more rigorous. Full disclosure of all fees and returns before and after fees and sensitivity analyses showing the result of changes in interest rates or stock market values (including extreme volatilities) could be useful for some products.

- **A registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?**

For competent investors investing in operating businesses as principals and for SMEs fund recipients, the involvement of a registrant is often unnecessary or unwarranted and often would result in additional costs without bringing any value. Most investors and SMEs would rather see funds productively employed in businesses rather than unnecessarily paid to registrants. An obligation to recommend only 'suitable' investments is inadequate protection for investors in case of conflicts of interest, especially if coupled with inadequate disclosure or lack of due diligence. See question 2 for further comments.

10. If individuals are able to acquire securities under the minimum amount exemption, should there be any limitations?

We recommend retaining the amount or lowering it to $25,000 (provided that the AI exemption is not limited) but adding issuer disclosure requirements or other declaration based tests or limitations predicated by an analysis of data to determine where there are problems and what changes, additional requirements or limitations would best solve demonstrated problems.

A focus on disclosure and selling practices of sellers/resellers and/or additional issuer filings might have the most effect on the stated purpose of protecting investors from unfair, improper or fraudulent practices and enhancing confidence in markets.

11. If we limited the use of the exemption to persons who are not individuals, what would the impact be on capital raising?

It would have an adverse impact. Please see question 8 for additional comments.

12. Are there alternative qualification criteria for the minimum amount exemption?

An appropriate combination of income and/or net worth on the one hand, and technical, industry or other professional experience relevant to the issuer's business or industry would make sense, or financial or legal education or experience or access to independent accountants, lawyers or industry experts. Please see question 1 for additional comments.

13. Are there other limitations that should be imposed on the use of the minimum amount exemption?

NAO-Ontario submits no additional limitations criteria for the minimum amount exemption at this time, unless data were to be made available to suggest what limitations might be warranted and in what circumstances.

14. Should the minimum amount exemption be repealed? Would your answer to this question change depending on whether:

- **Any disclosure is provided to investors, including risk factor disclosure?**
- **The purchaser is an individual, instead of an institutional investor?**
- **The security is novel or complex?**
- **The issuer of the security is a reporting issuer?**
- **A registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?**

The minimum amount exemption should not be repealed unless other changes are made to current exemption or new exemptions are created that will accommodate people who want to make investments not structured by the financial industry in the case of early-stage and small companies, and also accommodate those companies which can only source capital from individuals.

Access to capital is inadequate for companies in Canada (see question 24 for information) and early-stage capital markets, in our view, are currently not efficient. Regulatory support for solutions to these problems would be very useful, as SMEs employ millions of Canadians and small and medium sized companies contribute disproportionately to new job creation. Excluding individuals from investing in SMEs would be disastrous for Canada's economy. Canada's funding gap is largely in the space after friends, family and close businesses associates - the only real exemptions that we have to address that gap currently are the minimum amount and the AI exemptions as the Offering Memorandum is frequently too expensive or too burdensome in relation to the

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amount of money likely to be raised for such seed stage companies and isn't available in Ontario. We would like to see exemptions that would enable companies like Facebook or Groupon to be able to not only be founded in Canada but to grow and thrive here. The majority of our current prospectus exemptions seem designed purposefully to keep companies small and weak or to push them prematurely into the public markets.

Please see also our answers to question 3.

15 If the minimum amount exemption was repealed:

- **Would that materially affect issuers' ability to raise capital?**

Yes, as CSA has advised that this exemption is widely used, it would clearly have an adverse impact. See also our answer to question 14.

- **Is the AI exemption (in its current or modified form) an adequate alternative to the minimum amount exemption?**

Our Angel investor members generally invest via the AI exemption, so it is an adequate alternative for them, in its current form.

16. Are there other options for modifying the minimum amount exemption that we should consider?

Regulators may wish to consider alternatives similar to the Offering Memorandum mechanism for 'eligible investors', modernized and calibrated for amount and declaration based asset or income tests on a sliding scale. Modernizing other prospectus exemptions, as suggested in our answer to question 31, also would be beneficial.

Alternatively, regulators should also consider adding new mechanisms similar to the *Entrepreneur Access to Capital Act*, the *Democratizing Access to Capital Act* and the *Small Company Capital Formation Act* being discussed and acted upon in the US. These Acts recognize that many companies, especially in the tech sector, have much lower start-up capital requirements and costs of distribution than in the past and respect an individual's ability to make effective risk decisions without imposing onerous income or asset tests. Investors are protected by caps on investment and by issuer limitations and filing requirements. The Entrepreneur Access to Capital Act, for example, has a $10,000 limit on individual investment - the same limit our Offering Memorandum rules impose on households with a net worth of more than $400,000. The Offering Memorandum mechanism also has more onerous disclosure and representation requirements than many US exemptions - this make it expensive for small companies and may account for the fact that it seems to be underutilized. It also isn't available in Ontario - we don't understand why.

Regulators also need to consider the effect on Canada's capital markets and the competitive position of our companies if even more favorable US legislation for raising capital by US located companies becomes law. Innovative companies would then prefer the American early-stage capital market over the Canadian. Many new companies are currently created with exchangeable shares to facilitate possible changes in domicile - expect this trend to accelerate if Canada does not modernize.

Another alternative is to drop the minimum amount to $25,000 or $50,000 accompanied by warnings, increased issuer requirements and limitations and a declaration that this amount is no more than 10% of net worth - this would address most concerns regarding over-commitment as long as the AI exemption remains for other individuals.

AI exemption

17. Do you have any comments on the AI exemption as per the background and issues described?

Current thresholds for income and assets:

The position of NAO-Ontario and its stakeholders is that an increase in the threshold of the AI exemption will certainly exclude sophisticated investors who do not need the protections provided by a prospectus offering and this will have a dramatic adverse effect on early-stage capital markets and SMEs.

The current Canadian asset threshold continues to be more restrictive than the recently changed US SEC exemption. While both countries use $1,000,000 as the threshold amount and the US now also excludes the principal residence (unless there is negative equity), the US test is based on net worth rather than the more restrictive financial assets test in Canada.

Capital tends to flow to jurisdictions with the best investment opportunities and the most favorable treatment. Being competitive with the US would suggest that our test should be a $1,000,000 net worth test exclusive of the principal residence rather than a financial asset test. It is also important to note that many US states and foreign jurisdictions (e.g. UK) are implementing tax rebates to encourage early stage investment - these rebates reduce the investment risks to Angels qualifying for them and encourage incremental investment by foreigners. All other opportunities being equal, jurisdictions with such programs may find favor with investors, especially those who can invest alongside local Angels. The need to have a competitive environment for capital, as well as the need to

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make capital raising competitive for Canadian high-potential companies trying to compete globally would support thresholds actually being lowered. The Federal Development Agency of Southern Ontario's Investing in Business Innovation program that provides loans to Ontario companies based on investments by VCs and Angels has served to attract foreign Angels to southern Ontario Angel groups, for example. This program enhances the competitive ability of Ontario investees and helps de-risk an Angel's investment in companies receiving such loans.

Qualification criteria:

Many Angel investors who meet the requirements of the current AI exemption definition and thresholds and who have successfully founded and grown businesses, will not meet an increased financial asset threshold requirement. Angels often invest in asset classes beyond cash, securities and insurance contracts so a net worth test seems more appropriate to us and we believe such tests should be competitive with those of other countries as capital flows to locations with the best opportunities and the most favorable treatment given similar investor protections.

The average angel is 57, a successful businesses person, who has been a founder or seed investor in 2.9 businesses. Industry experience is the most pertinent criteria for investing in SMEs. In the context of Angel investing, which is recognized by all levels of government in their policies and programs as a crucial element of economic development, the assurance of sophistication is provided by successful investors and businesspeople directly participation in the due diligence investigation process. Multiple angels investigating the same opportunity act as a form of peer review that helps one not omit due diligence steps. Angels sharing the due diligence process also share diverse expertise and experience and can easily hire accounting, legal and technical expertise as required. For many angels, the value of participating in the group is learning why other independent or particularly knowledgeable investors would not themselves invest in a particular company. Conflict of interest and, increasingly, code of conduct policies assist in helping to prevent undisclosed financial relationships.

Please see our answer to question 1 regarding other qualification criteria, which should be broader, in our view, than those currently in place. Being a professional could be incorporated in certain exemptions in certain circumstances.

- **Use of the exemption to raise capital:**

The position of NAO-Ontario and its stakeholders is that an increase in the threshold of the AI exemption will certainly and significantly reduce the amount of Angel investment capital available to start-up, early-stage companies as well as SMEs as a whole. Eliminating the exemption for individuals will largely mean that it would be difficult for Canada to ever see a company such as Facebook grow and thrive here.

- **Compliance with qualification criteria:**

All Angel investor group members sign declarations expressing their compliance with the AI exemption qualification criteria. SMEs and experienced Angel investors have every incentive to ascertain compliance in the current scheme of things. Our angel groups with more than 400 members have not reported any problems.

In the absence of actual evidence of non-compliance, an assertion that some individuals **may** not be compliant seems akin to hearsay from unknown sources - usually a poor foundation for change. A fundamental principle of a democratic society usually includes a presumption of innocence until guilt is proven. A corollary of such societies would generally be that citizens expect regulators to presume that the majority are honest in making declarations. While every activity has bad actors and some will seek recompense even for losses due to chance, bad timing or poor judgement - legal remedies also exist for redress and abandoning the presumption that the majority of individual accredited investors are honest in filing declarations is unlikely to inspire confidence among accredited investors or the public. Without evidence of non-compliance and clearly associated harm, restricting the compliant majority to protect some hypothetical few from themselves would seem to be a high cost, low benefit outcome.

18. Are there any other issues you may have with the AI exemption?

NAO-Ontario submits no additional issues regarding the AI exemption at this time.

19. Do you agree with retaining the AI exemption and the definition of "accredited investor" in their current form?

Given:

- The economically significant amount of capital annually sought and obtained by start-up, early stage and other companies under the current form of the exemption and definition;
- the considerable importance of these companies to the Canadian economy as recognized by all levels of government in their policies and their programs, and
- the lack of significant issues to date with our Angel declarations,

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NAO-Ontario does not support restricting individuals from the AI exemption or making financial tests more restrictive. There is merit to recognizing additional education, professional designations and industry experience as are additionally explained in our answer to question 1.

20. What should the income and asset thresholds be?

NAO-Ontario recommends retaining the income and asset thresholds at their current levels, and/or at levels competitive with neighbouring jurisdictions which are actively seeking to increase the capital available to innovative, early stage companies. To be consistent with the US, the test should be based on net worth. Given incentives to investment in other jurisdictions and the lower cost to establish and grow many businesses than in the past, an argument can be made that the levels should be lowered by 30% (the value of some investment rebates).

The SEC recently reaffirmed the AI exemption for individuals at US $ 1 million and also now excludes a principal residence, but uses a less restrictive net worth test as compared to Canada's financial asset test. If Canada raises the levels, many current Canadian AIs will probably co-invest with US Angels in US companies. We would prefer to see investment in high-potential Canadian companies enabled rather than restricted.

Would your answer to this question change depending on whether:

- **Any disclosure is provided to investors, including risk factor disclosure?**

Our experience is that Angel investors have significant acumen and ability to investigate opportunities to invest in businesses as principals, particularly if they have industry experience and that membership in an angel group can help them avoid bad investments as much or more than it can assist them in making good ones thru education in valuation techniques and by learning why some sophisticated investors would not themselves invest in some companies. Angels meeting the current accredited investor tests usually have existing relationships with lawyers and accountants and have the resources to hire expertise as needed. Moreover, when multiple angel investors are asking for the same information, companies are more likely to comply. Therefore, while we do not think it is necessary, we would not object to requiring issuers to make the following statement: *This investment is considered an "alternative investment" because it is long-term, illiquid and high-risk. Most people should invest no more than 5 to 10% of net worth in this type of investment.*

Risk factor disclosure is helpful but can become something of a "bucket list" without much value. Disclosure of the same sort of criteria, history and sensitivity analysis on which a person in the industry would make an informed decision would have a positive effect on decision quality.

- **The security is novel or complex?**

Disclosure standards should be both higher and more rigorous for sellers of these products. Risk factor disclosure, accompanied by the same sort of criteria, history and sensitivity analysis on which a person in the industry would make an informed view would have a positive effect on good decisions. However, we focus on investment in operating businesses, not complex financial products, so would not oppose excluding them if the data support such action. There may be some benefit to registrant involvement in the case of sale of complex financial products, **if** the registrant has no conflicts.

- **The issuer of the security is a reporting issuer?**

Disclosure standards should be higher and enforcement more rigorous. A full disclosure of all fees and returns before and after fees presented in sensitivity analysis form showing the result of changes in interest rates change or markets stay the same, rise or fall would be valuable, for example. Reporting issuers should be held to a high standard because AIs and the public think believe that the reporting process confers some protection. Alternatively there should be extensive disclosure by issuers that investors have no protection.

- **A registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?**

Again, for competent investors investing in operating businesses as principals and for SMEs, the involvement of a registrant is often unnecessary or unwarranted and may be perceived to result in additional costs that reduces the productive employment of capital in the business without bringing additional value. Registrants frequently have no special technical insight or industry exposure and the current "bucket" listing of risks may be seen by some as permissive - i.e. requiring them to do little to no due diligence.

Registrants seeking to maximize financial return from their time may find it insufficiently profitable to work with companies growing beyond the friends and family investor stage exacerbating a market gap that will make early stage capital markets even less efficient. See questions 1 and 2 for further comments regarding why registrant experience may be less relevant than that of AIs and why imposing them as gatekeepers may **decrease**, rather than increase public trust in capital markets being fair and efficient.

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We find some US bills that require intermediaries to do background checks on an issuer's principals and to provide a forum for investors to interact with management potentially useful as well as additional requirements or limitations on users..

21. Should the income and asset thresholds be periodically indexed to inflation?

Given the consistently decreasing capital requirements of many start-up and early stage companies as a result of technological change reducing the costs of market entry, indexing to inflation is not recommended by NAO-Ontario. Investments in start-up and early-stage companies, especially in the Information and Communication Technology industries, have remained within the capacity of typical Angel investors in Canada, acting under the current threshold levels of the AI exemption, throughout the period under consideration.

Moreover, it is unclear that financial asset levels of Canadian households have even returned to pre-"Great Recession" levels. The Angel Capital Association (US) found that the number of millionaires dropped 28% in 2009 and while stock markets have lately recovered, many investors have continued to avoid equity markets with the result that the growth in average household financial assets on both sides of the border is unlikely to have mirrored the inflation rate

As noted above, people meeting the current income and asset tests frequently have the competence to make prudent investment decisions, and/or have access to accountants, legal advisors and additional expertise if required. Data quantifying the challenge currently posed by lack of sophistication would be welcome. As previously noted, we are in favour of targeted solutions to quantified problems that address root causes of such, rather than broad exclusionary mechanisms that protect a hypothetical few at the expense of the competent many.

As noted with respect to the minimum amount exemptions, raising financial thresholds does little to address unfair, improper or fraudulent practices - it only serves to reduce the potential number of targets of such practices. If an analysis of the data supports anecdotal evidence that the biggest problems relate to investment funds, complex products, and associated lack of disclosure, the focus should be upon conflicts of interest and selling practices. Indeed, publicizing such an analysis would be useful to the investing public as a whole, and especially to AIs with net worth, as they are likely to be particularly targeted by the unscrupulous.

The public likely considers the current tests as already restricted to the wealthy; restricting them further when democratization of access to opportunities and support for entrepreneurship is seen as vital for our future, would be unwise. Moreover, most people meeting the current income and asset tests would consider themselves, working with their chosen accountants and lawyers to be able to make effective risk decisions given adequate disclosure. Our view is that regulatory focus should be on those engaging in unfair, improper and fraudulent practices and measures to prevent them rather than merely excluding potential victims, when exclusion doesn't address those practices and makes markets less efficient. In our view, such a focus on bad actors would enhance public confidence in markets as would wider promulgation of warnings to investors by regulators. Perhaps regulators could work with investors to better develop materials for ordinary and accredited investors to better recognize potential fraud.

22. If we changed the income and asset thresholds, what would the impact be on capital raising?

Those Angel investors that meet the current requirements of the AI exemption definition and its threshold often will not meet an increased threshold requirement. Accordingly, the position of NAO-Ontario and its stakeholders is that an increase in the threshold of the AI exemption will certainly and significantly reduce the amount of Angel investment capital available to start-up, early-stage and other SMEs. This will adversely affect the ability of our hi-potential companies to compete globally and may encourage many to re-domicile in more supportive jurisdictions.

According to the most recent study available from Allan Riding of the University of Ottawa (2008) there were approximately 15,800 Angel investors across Canada investing $1.9 billion per annum in start-up and early stage companies[iii]. NAO-Ontario estimates that most of these individuals keep financial assets just greater than the current threshold for the AI exemption, invest in other assets such as real estate, reinvest and are intimately involved with the development of start-ups and early-stage companies as founders, operating officers or advisors. Many entrepreneurs, founders and early employees of successful companies "cash-out" at just over $1 million and become Angels. Losing them as investors in and advisors to new companies would be undesirable if it were to occur due to an indiscriminate change in amount. Entrepreneurs raising capital to start and grow businesses from individuals and business owners reinvesting in new companies is a large component of a successful capitalist economy.

The Government of Canada's Financing Innovative Small & Medium Sized Enterprises 2009 Working Paper found that innovative companies have a greater need for financing, apply for debt financing to a greater degree than less innovative firms, but are less likely to receive it. After debt, leasing, supplier credit and other forms of financing, equity is sought. 32% seek Angel funding; 19% seek VC funding.

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We commend to the CSA and incorporate by reference the recently published Organisation for Economic Co-operation and Development (OECD) report *Financing High Growth Companies: the Role of Angel Investors* which examines and compares Angel investing in many countries, including Canada, and describes the programs being instituted by governments to stimulate Angel investing. We also commend the book Blueprint to a Billion which shows that most companies that eventually reach $1 billion in sales, grow relatively slowly for their first 5 to 10 years before taking off. Oracle and Google's early years are an anomaly; Apple almost became bankrupt before achieving its recent growth.

North American and OECD data appear to indicate that Angel investors invest, in aggregate, similar amounts to VCs, but invest in 20 times the number of deals (US's Angel Capital Association presentation). Canadian VCs invested $941 million in 323 transactions in 2009 and $1.031 billion in 382 transactions in the first 3 quarters of 2011. On this basis, Angels of all sorts (including friends & family, businesses) would likely have invested ~$1.2 billion in 8,000 companies in 2011. Our angel groups, which track only a relatively few Angel AIs, reported that direct, co-investment and follow-on investment of $76 million in 55 Ontario companies from 2007 through 2011 created more than 900 jobs. Without Angel funding these companies would be smaller or possibly not exist. The US Angel Capital Association indicates that only 5% of Angels are affiliated with formal Angel groups; Canadian affiliation levels are likely lower as formal angel groups are a newer phenomenon in here, so our numbers may be conservative.

We estimate therefore that the proposed changes could have impacted some 8,000 companies in 2011, and reduced or eliminated and made less efficient a capital market of ~$1.2 billion. Information from reports on the Government of Canada's SME Financing Data Initiative website (www.sme-fdi.gc.ca) indicate that the informal financing market was ~$3.5 billion in 2000, so there is a long way to go to recover to previous levels, or our figures are conservative. In Q3 2011 VCs financed only 29 seed and start-up businesses in Canada (Industry Canada's VC Monitor) and follow-on funding to existing portfolio companies remained high as compared to investments in new companies. With such VC trends and access to credit again being restricted, Angel investors continue to be the most important source of equity for most private companies.

In as much as early stage capital markets are fragmented, removing the vast majority of investors from those markets by restricting individuals would not serve the stated goal of fostering efficient markets. Angel investing would largely cease in Canada, though some investors would join US or UK groups - further challenging our undercapitalized small, but high potential, companies seeking to access growth capital and possibly encouraging them to relocate to more favorable jurisdictions.

23. What qualification criteria should be used in the AI exemption for individual investors?

Investment experience, portfolio size, financial industry work experience and financial education are all relevant but not exclusively so. One might argue that anyone who successfully completes the Canadian Securities Course has demonstrated the same financial education as a current or former broker registrant, irrespective of income or assets. MBAs, CFAs, PFPs, corporate lawyers, and professional accountants all have experience relevant to evaluating risks and financial investment. NI 45-106 recognizes the relevance of lawyer and accountant training and experience in the concept of 'eligibility advisors'. Graduate degrees in other fields and other professional designations can be equally relevant to particular investments (see question 1 for examples).

As outlined in our answer to question 1 above, previous industry experience and success frequently is **the** most relevant background for evaluations (especially negative ones) of investment in early stage companies or SMEs, whether a restaurant or a software company. A large amount of evidence is accumulating that the most successful businesses are founded by people with industry experience. Indeed we are frequently surprised by the number of registrants who won't invest in private companies personally because they don't know the industry or lack technical expertise. If registrants recognize the value of industry experience and technical expertise, formal recognition in exemptions would seem to be appropriate. An investor with industry experience frequently brings more than capital - insights, tested processes and contacts that can help a business succeed. As noted above, learning why a sophisticated investor with industry experience would not invest him/herself can be a particularly useful educational experience for many AIs.

In our experience Angels are prudent investors. Most limit initial investments in proportion to assets or income, especially if they do not know the management or industry or other investors. Most reserve capital for a follow-on round, based on an issuer's achievement of milestones and further need for capital. Our angel groups have both conflict of interest and code of conduct policies to mitigate problems that might be associated with non-disclosure and the community is sufficiently small that an angel found to have an undisclosed interest would be ostracized. Those that wish to diversify investment beyond their particular industry experience can find it particularly useful to co-invest with another Angel who has the experience they lack and this can be especially helpful if something happens to existing management such that investors have to become more actively involved in the business to protect capital invested.

Would your answer to this question change depending on whether:

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- **Any disclosure is provided to investors, including risk factor disclosure?**
- **The security is novel or complex?**
- **The issuer of the security is a reporting issuer?**
- **A registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?**

Please see our answer to question 20.

24. If we changed the qualification criteria, what would the impact be on capital raising?

As noted in our answer to 22, the effect could be to decrease or eliminate knowledgeable investors from a $1 - 2 billion market and adversely impact the ability of ~8,000 companies to raise capital for their businesses. Restricting investment by those best able to contribute to Canada's economic future seems at odds with policy initiatives to foster entrepreneurship and entrepreneurial endeavours. Restrictions on investors will not address unfair, improper or fraudulent practices and will make early stage capital markets even less efficient than they currently are and will unduly restrict the sophisticated individual investor.

Canadian SMEs already are less able to access capital than their US peers, and we think this is primarily the result of overly limited early-stage financing mechanisms and prospectus exemptions and, within these, overly restrictive conditions. The average US VC investment round from 2005 to 2010 was ~US $6 million (www.ssti.org); we refer you to the Canadian Venture Capital Associations website and to Industry Canada's Venture Monitor for information that will allow calculation of the lower Canadian figures (less than $1 million per round in recent years according to our calculations). The average angel round of financing shown by the US's Angel Capital Association's presentation at the 2011 National Angel Capital Organization's Ottawa Conference was 1/3 to 1/2 higher than the round levels our groups have reported in recent years.

These figures would indicate some combination of problems, e.g. 1) much less attractive Canadian investment opportunities 2) less capital available for investment in Canada despite markets now being global 3) inadequate mechanisms for raising capital in Canada or 4)smaller and less efficient early stage capital markets in Canada.

If qualifications were broadened to include those often of greater relevance to evaluating investment in an early stage business than just financial industry experience and to recognize other professions certifications and designations, there might be a positive effect on SMEs and early-stage capital markets. Lower financial thresholds could also be appropriate with declaration based investment limitations for investors and additional requirements for issuers. This would be consistent with existing exemptions in the US and initiatives and other US initiatives such as *Entrepreneur Access to Capital Act*, *Democratizing Access to Capital Act* and *Small Company Capital Formation Act*.

The OECD report referenced in question 22 shows the importance of Angel investment to high-growth companies. Furthermore, our data (albeit a very small sample) shows that companies receiving Angel investment do better and last longer than the average start-up/early stage company. This is confirmed by a Harvard study published April 2010.[iv]

25. Should individuals be able to acquire securities under the AI exemption?

Yes, in the absence of overwhelming evidence to the contrary. If individuals were unable to acquire securities under the AI exemption, Angel investment in Canada would end - largely eliminating the early stage and SME capital markets in Canada and resulting in widespread perceptions that regulators lack an understanding of these markets.

Prudent Angels almost always limit initial investments to smaller amounts than would be required under the current minimum amount and reserve capital for another financing round. Other exemptions and mechanisms are insufficient to accommodate many Angels. Without the AI exemption, a Facebook, Groupon or Linkedin would likely never have the potential to grow rapidly in Canada and even our vibrant early stage resource markets would be adversely affected.

The Offering Memorandum financing mechanisms aren't available to Ontario Angels, and the maximum amounts that can be invested are too low in relation to the net worth test. The 'close' requirement is too restrictive for family, friends and business associations and ignore the fact that in many 2 career households, spouses and their friends know a founder's business and are professionals capable of assessing risk. The private issuer number of shareholders is too small as is the number of participants in a private investment club if efficient early stage capital markets are to be promoted. Private investment clubs also should be able to foster differing participations by members in different investment opportunities and within clubs, smaller groups should be able to hire independent accountants, lawyers and other technical or industry experts to provide due diligence services without those individuals possibly being seen as improperly facilitating a trade as long as investors manifestly make their own decisions.

Would your answer to this question change depending on whether:

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- **Any disclosure is provided to investors, including risk factor disclosure?**
- **The security is novel or complex?**
- **The issuer of the security is a reporting issuer?**
- **A registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?**

Again, please allow us to refer you to our answers to 9 and 20 above.

26. Should an investment limit be imposed on accredited investors who are individuals?

We are of the view that most AIs are capable of making prudent decisions within the current limit and are better able to evaluate their own experience and circumstances than regulators. Limitations should be based on an analysis of data and evidence to suggest that they will solve a particular problem and not exclude those who don't need such limits.

If a limit is appropriate, what should the limit be?

We see the requirement of a cautionary statement by an issuer that the investment is long-term, illiquid and risky and that no more than 10% of net worth should be allocated to all such investments as possibly of benefit and of no harm.

We do not believe that limitations should be imposed prior to analysis of data to identify, characterize and quantify problems, coupled with an analysis of the causes and research as to mechanisms most likely to remedy those problems. We are of the view that knowledgeable investors, together with their chosen advisors, are best able to judge investments levels than regulatory bodies that cannot take individual household circumstances and experience into account. We also believe that the ability of investors to make appropriate risk decisions should be respected. We also believe that people making declarations as to meeting threshold tests should be presumed to be acting honestly.

We think that evidence based, targeted mechanisms that address the roots of problems are generally better than broad exclusionary mechanisms that presume that successful businesspeople and their chosen advisors cannot make effective decisions or excessively broad limitations.

Would your answer to these questions change depending on whether:

- **Any disclosure is provided to investors, including risk factor disclosure?**
- **The security is novel or complex?**
- **The issuer of the security is a reporting issuer?**
- **A registrant is involved in the distribution who has an obligation to recommend only suitable investments to the purchaser?**

Please see our answers to similar questions 9 and 20. We favour more effective/additional disclosure by issuers and sellers (especially if they are reporting issuers) and think that prudent asset allocation statements would do no harm. We believe that other advisors may have education equivalent to many registrants and see the imposition of registrant involvement in the sale of novel or complex products as beneficial if they are independent, have no conflicts and/or have a fiduciary duty but unnecessary in the case of Angels investing in operating businesses as principals.

27. If investment limitations for individuals were imposed, what would the impact be on capital raising?

Enforcement of an investment limitation that would require a disclosure of actual net worth by Angel investors would reduce or eliminate Angel investment in Canada, and/or cause it to relocate to neighbouring jurisdictions without such requirements. Most Angel investors will only make an AI declaration, and that only to the issuer or qualifying bodies such as the government. They generally won't participate in programs that require them to disclose the precise amount of their net worth or provided net worth statements to anyone.

We would be in favour of new financing mechanisms similar to those already available in other jurisdictions and the previously referenced *Entrepreneur Access to Capital* and *Democratizing Access to Capital Acts* that are at various stages of discussion and approval in the US and that include additional requirements and limitations on issuers and intermediaries. We would only be in favor of declaration based affirmations of eligibility. We also favour modernization and expansion of our Offering Memorandum, private issuer and other prospectus exemptions.

28. Should certification of compliance with the criteria by a third party be considered in a review of the AI exemption?

No. We believe that regulatory bodies should generally presume that investors making declarations are truthful, rather than that they are not. This is especially true in the absence of evidence to the contrary and to maintain

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public confidence by consistent support of the democratic principle that the majority of citizens are fundamentally honest.

A requirement of disclosure of actual net worth by Angel investors, to anyone other than their chosen and trusted accountants and lawyers, would certainly reduce Angel investment in Canada, given the long-standing and oft-expressed privacy concerns of Angel investors, which includes concerns that databases could be hacked that could make identity and other theft easier or that employees of such organizations could inappropriately access their information or be tempted to share such information with inappropriate parties. Media reports of such problems continue to be published.

Such a requirement has already reduced co-investment by Angel investors alongside entities that have to provide such information to qualify for some government programs. Declaration that a person meets the current tests have not been a problem in our groups and most of our angels are well educated, successful businesspeople with a great deal of experience both in managing and growing businesses and in investing.

29. Do you agree with imposing such a requirement?

NAO-Ontario does not agree with imposing such a requirement.

30. Are there alternatives that we should consider?

However, more important than net worth, in assessing the capacity of Angel investors to assume risk and make valid judgments, is the experience, knowledge and connectivity these investors can bring to bear on such decisions and the value of due diligence by a group of co-investing Angels with differing experience. Entrepreneurial and industry experience as noted frequently herein, are especially valuable in assessing a business opportunity. Administration of a generic questionnaire unrelated to any specific investment offering, which ascertains such capacities among potential investors, is an alternative that could assess experience and education if additional investor protection is sought.

31. Are there other options we should consider for revising the AI exemption or for substituting an alternative exemption?

Examples of beneficial alternatives if changes are made include raising the NI 45-106 private issuer restriction of only 50 shareholders to a higher level. The friends, family, and business associates' exemptions should drop the "close" adjective and include friends, family and business associates of spouses of these individuals, given the rise of 2 career families.

The Offering Memorandum mechanism which defines an 'eligible investor' has the potential to compensate for some changes, but is overly paternal if one considers that an asset allocation of 5 to 10% of net worth to alternative investments could be considered appropriate for many. Capping investments at $10,000 for households with a net worth of more than $400,000 is excessively restrictive. Based on a 10% guideline for alternative investments, a $10,000 cap is more appropriate to $100,000 in net worth or income level. Modernizing the mechanism by introducing a sliding scale based on a 10% prudent test level evidenced by declarations would seem to be a useful principle. Examples of how the US imposes other requirements on issuers and provides additional protections for investors in the Entrepreneur Access to Capital Act is described in our answer to question 2 and merit consideration. Our understanding is that the Offering Memorandum mechanism is underutilized, possibly because its restrictions are excessive and because it is unavailable in Ontario. It can be expensive in relation to the small amounts of capital that are often raised by early stage businesses as initial financing rounds can be in the range of $250,000. Requiring only balance sheet audits and having regulators specify the basis on which financial statements need to be prepared might be appropriate modifications. Format creation similar to the Small Company Offering Registration forms in the US could also be helpful.

In addition to an AI exemption, the US has an Intrastate Exemption for small businesses as well as regulation A and D Exemptions that require disclosure and a filing in conjunction with the offering, but limit subsequent filings.

Regulation A allows offerings not exceeding $5 million per year, requires an offering circular similar to a prospectus, does not restrict the securities and does not require audited statements. There are no subsequent SEC reporting requirements unless after the offering there are more than $10 million in total assets and more than 500 shareholders. There are 3 possible formats including a simplified question and answer format. Shareholders can also use Regulation A to resell up to $1.5 million of securities.

Regulation D has 3 rule based offering exemptions. Rule 504 requires registration in a state with disclosure requirements (though sales can be outside that state if the same disclosure is provided), is for sales of up to $1 million in securities per year, doesn't permit advertising to the public (though some states permit advertising to accredited investors) and issues 'restricted stock'. Disclosure must be free of false or misleading statements. Regulators and the American Bar Association collaborated on the creation of a Small Company Offering Registration or SCOR to facilitate such offerings that is recognized by 45 states (SEC website). SCOR forms can also be used for Regulation A financings. Rule 505 is for sales of up to $5 million per year, issues restricted stock, is generally for accredited investors and requires certified, but not always audited financial statements.

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Rule 506 safe harbour for a Private Offering Exemption permits an unlimited number of accredited investors and 35 other investors with no limit on the capital that can be raised. Disclosure must not violate anti-fraud provisions.

Arguably, it is the AI mechanism that has contributed to Canada's vibrant and effective early stage capital markets for resource companies and for investor interest in them, along with a pool of experienced entrepreneurs and managers. The other prospectus exemptions available in Canada cannot compensate for the AI exemption.

While admitting our bias, we see an alternative to changing the limits as either requiring the advice of a person similar to an "eligibility advisor" (in the case of non-professionals or those without industry experience) or membership in a not-for-profit Angel investor group that does not recommend specific investments and that re-administers the AI declaration, a questionnaire, conflict of interest and code of conduct affirmations on an annual basis.

However, as noted throughout, other exemptions and financial mechanisms in NI 45-106 need to be modernized as they are currently inadequate and new ones should be considered. Angel groups are similar to investment clubs, where members share investing experiences and learn to be more effective investors. The activities that angel groups engage in and a possible size of at least 200 members should be able to be formally accommodated - within the private investment club exemption or otherwise.

In addition, we recommend that regulators considering that even small investors participate in new financing mechanisms such as Kickstarter and Kiva and that initiatives in other jurisdictions may better balance investor protection with the need to improve access to capital for small businesses than our approaches. The afore mentioned *Entrepreneur Access to Capital Act*, *Democratizing Access to Capital Act* and the *Small Company Capital Formation Act* are all US initiatives that legitimize what the public is already doing, but also enhance protections. These initiatives seem to focus on more reasonable investor and issuer limitations and requirements rather than on excessively limiting the activity of the majority of accredited investors or suggesting that they need third parties to certify that their declarations are honest.

We continue to believe that a focus on addressing and preventing unfair, improper and fraudulent practices and activities that educate the public about such practices would be more conducive to fostering public confidence than decreasing the efficiency of or eliminating early stage capital markets by overly broad restrictions on individuals.

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[i] Statistics Canada, Employment by enterprise size, 2010, All industries shows total employment of 14.374million. Excluding public sector, educational, healthcare and social assistance provides a private sector estimate of 10.54 million. Further excluding enterprises with employment greater or equal to 100 gives a figure of 4.97 million, 47% of estimated private sector employment. However, this series of tables excludes 2.67 million of employees in unclassified industries (compare Statistics Canada's employment by industry table, year 2010). If the excluded employees are in small businesses, the adjusted figure is 7.64 million and the adjusted percentage is 58%.

[ii] Degennaro, Ramon P. (2010) Angel Investors: Who They Are and What They Do; Can I Be One, Too? Journal of Wealth Management, Vol. 13 Issue 2, p55-60.

[iii] Riding, Allan L. (2008) 'Business angels and love money investors: segments of the informal market for risk capital', Venture Capital, 10:4,366

[iv] Kerr, W.R., Lerner, J. &; Schoar, A. (2010) 'The Consequences of Entrepreneurial Finance: A Regression Discontinuity Analysis', Harvard University http://www.hbs.edu/research/pdf/10-086.pdf

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