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THE EXEMPT MARKET IN CANADA: EMPIRICS, OBSERVATIONS AND RECOMMENDATIONS†

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SUMMARY

There is a massive and vital capital market at work in Canada — possibly bigger than rough estimates have so far suggested — and it is one for which several market regulators are preparing new rules. Yet the remarkable thing is how little we know about it. Data about the so-called exempt market are so lacking that were regulators in Ontario and the other provinces contemplating new exempt-market regulations to proceed, they would be creating policies based on anecdotal, incomplete and, potentially, incorrect evidence.

Even estimating the size of the Canadian exempt market has been an inexact science, given the incomplete data, but we can estimate that it provides in excess of $100 billion in gross capital flow every year, and that amount continues to grow. While it may be natural to assume that the exempt market is used primarily by small and medium-sized enterprises, it seems it is primarily used by the financial services industry. These institutions appear to rely on the exempt market to raise potentially short-term debt capital relatively free of particularly burdensome information-disclosure requirements. Unfortunately, we are forced to rely here again on deductions based on limited evidence: So incomplete are the data about the exempt market that we lack even complete information on the type of issuers, investors and securities, or the volume and duration of the securities and the level of redemptions.

The exempt market exists for important reasons: it is a way out of the regulatory conundrum, wherein the regulator's mandate to protect investors, through significant requirements for information disclosure, can put too large a burden on certain issuers.

That is why it is essential that any new regulations are developed using a thorough understanding of how it operates. Yet the reality is that it is impossible to evaluate how individual investors and small firms are using the exempt market, or their experience in it. This is disconcerting, given that the very logic behind regulating this market is to allow the cost-effective and efficient matchmaking of sophisticated, higher-risk capital to firms unable to access capital through other means. If minimal or no data are available for analysis (as is currently the case), there is no way to tell whether this is in fact happening.

This should be rectified before new regulations are imposed. Provincial jurisdictions and major market participants should co-operate to form an "exempt market data repository" to collect structured data, funded through a small fee, based on the size and type of issue. This repository should allow for segmentation by industry, size of issuer, and by whether it is a reporting issuer or not, and it should provide detail on the size of each issue, the types of security, the intended use of the capital, and the liquidity and duration of the security, as well as requiring notification of redemptions. Reporting the costs of intermediation should be mandatory and the accumulated data should indicate the type of investor (segmented by categories such as "accredited" or "eligible") as well as the investment size and type.

Of course, none of this should become so costly as to render the exempt market prohibitive to the issuers who rely on it. Nor should it necessarily lead to more onerous regulations. Indeed, another important priority must be a broader debate over the very role of a securities regulator when it comes to regulating capital flows between investors and issuers. But at a very minimum, regulators should be able to make available to investors useful information about how a market operates. Unfortunately, when it comes to the exempt market, that responsibility is the very area where Canadian regulators have so far proved to be remiss.

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INTRODUCTION

Even before Christopher Columbus asked Spain's King Ferdinand and Queen Isabella to fund his highly risky expedition to find a western route to the Orient, entrepreneurs and investors have struggled to raise capital in ways that satisfy both parties' risk-return thresholds.[1] The advent of stock exchanges in the 17th century, following the East India Company offering, allowed investors to have access to information provided by the companies at the time of issuance and then on an ongoing basis.[2] Since investors required credible and timely information and full transparency, regulations and regulatory bodies were formed to ensure that this was made mandatory for companies accessing capital in the public marketplace, powers that were then extended to most capital flows (public or private) to try to ensure that investors receive adequate and timely information. This information may also lead to improved governance practices and management accountability.

So long as regulators are able to ensure that sufficient and timely information is made available to investors, that the costs of providing and receiving this information is "reasonable" and that the penalties for providing knowingly false or late information are "sufficiently large," we could be assured of an informationally efficient capital market where investors can invest in risky securities and expect to earn risk-adjusted returns that, on average, equate if not exceed their opportunity costs. This would be true for both publicly listed and private companies raising capital from external investors. As noted below, the applicability and the impact of information availability and disclosure is important when one discusses the role of the "exempt" market in Canada. As will be seen, the exempt market is different than publicly listed markets since investors that are allowed to invest in the securities in this market are qualified using rules and classifications.[3]

The main purpose of this paper is to review the current state of the exempt market in Canada, its role in matching investors with those who require capital, and the optimal role for regulation of information disclosure in order for this matching to take place. As described below, the exempt market can be considered as one situated between no disclosure and full disclosure and it is restricted to investors that meet specific criteria. It should also be noted that it may be better to use the term "private placement" or "private capital" to describe this market rather than the "exempt" market. The term "exempt market" may lead to a conclusion that the market is exempt from regulation or disclosure but, as will be seen below, that is not the case.

Accordingly, the main objectives of this paper are threefold: First, the paper situates the exempt market within the context of the various avenues for raising risk capital and associated information-disclosure regimes, and compares and contrasts the nature of some other mechanisms. It also briefly addresses alternative ways of raising capital resulting from the advances in Internet communication, such as crowdfunding and the JOBS Act (or the Jumpstart Our Business Startups Act) in the U.S.[4] Second, this paper documents the scale and scope of the exempt market. Third, this paper provides observations and some recommendations that may assist in improving the current exempt-market regime by ensuring a

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1 It took Columbus seven years and multiple attempts to get the proper funding. He even had to find "private equity" to fund his quests and agree on a revenue-sharing formula.

2 Although the East India Company received a royal charter from Queen Elizabeth in 1600, the Dutch East India Company was the first company to issue stock and is considered to have been the first truly multi-national company.

3 The exempt market, or more specifically the "exempt securities market" in Canada, relates to that portion of the capital markets for which, under provincial securities legislation, certain exemptions are provided from the full requirements of prospectus-level disclosure as well as from the full requirements for registered dealers in conducting sales.

4 The Jumpstart Our Business Startups Act came into law in April 2012. While only certain provisions under the JOBS Act became effective immediately upon enactment, those involving Title III (i.e., crowdfunding) have yet to be implemented. The United States Securities and Exchange Commission (the SEC) and the United States Financial Industry Regulatory Authority (FINRA) published proposed crowdfunding rules in October 2013, with the comment period ending in early 2014. However, there has been no further publication as the industry awaits the final rules or further changes to the proposed rules.

balance between the "naïve" investor (as viewed by the regulators) and the perfectly informed investor (as viewed by some capital market participants). The analysis presented in this paper shows that the current state of data and information available on the exempt market is inadequate for informing any significant policy debate or for imposing new regulations. This paper does not provide data or conclusions on the costs and benefits of the current regulatory regime in the exempt market, nor does it comment on whether or not the current or new regulations are appropriate from the perspective of investors and issuers. As a backdrop, it must also be noted that the recent experience in the public markets has shown that no amount of disclosure may reduce the imbalance between investors (large or small) and issuers/firms and that no market is immune to significant information asymmetry between issuers and investors and corresponding losses or gains from their investments.

CAPITAL MARKETS AND THE ROLE OF SECURITIES REGULATORS[5]

Since this paper is about the "exempt market," it is important to provide some context for the role of a securities regulator in the exchange of capital between the saver (investor) and the user (firm). In addition, it is important to discuss this role in the context of the size of the firm/issuer and that of an investor, since large firms and large (wealthy, knowledgeable and/or institutional) investors have different information requirements than those of small firms and small investors. The same is true depending on whether the amount raised is small or large and whether it is in the form of debt or equity.

Similar to Columbus, the typical journey of an entrepreneur begins with financing a business idea through sweat equity and personal resources and then, as the idea outgrows the ability for self-financing, to seek equity funding from external sources. In that stage of the journey, capital providers are mostly family and friends (so-called "love" or "faith" money) and business associates who may not have any expectations of earning a rate of return on their investment. The investment amount is typically small and investors trust the entrepreneur due to their personal familiarity. There is no real need for extensive disclosure of information between the two parties since there exists a form of trust between the parties as a result of the relationship. The next stage requires the entrepreneur to formally seek higher amounts of external capital through "angel" investors who have expectations of earning a reasonable rate of return given the obvious risk and illiquidity associated with their investment. At that stage, the onus is on the entrepreneur/firm to provide the information required by these arm's-length investors who would demand information that is relevant to them prior to making an investment decision. This would happen irrespective of any regulation as a matter of expected commercial practice. If the entrepreneur passes through this stage and requires additional external capital, the next step would be the raising of additional risk capital from venture capital or private equity firms, which would also have their own information requirements. If more financing is required and it is not available from private markets, the firm may initiate an initial public offering (IPO) and possible stock-exchange listing with all its required regulatory disclosures, and ultimately raising further capital from the additional issuance of securities (secondary equity offerings or SEOs) as a reporting issuer (public company).[6]

It is clear that as this journey from self-finance to secondary public offering continues, the need for credible information disclosure and associated costs increases due to an obvious information asymmetry between the entrepreneur/firm and investors. In some cases, investors do not have the personal knowledge, ability, time or desire to seek information directly from the entrepreneur or analyze its veracity. The role for this information transmission falls on the stock exchanges (in case of

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5 In this paper we focus mainly on "risky" equity capital and not on the less risky debt-capital requirements of governments and large firms.

6 This traditional model of using an IPO as the only market vehicle to raise risk capital is now being substituted by accessing capital from institutional investors or private strategic- or merchant-banking buyers. In the U.S., there have been over 400 such transactions worth at least US$50 million each from January 2011 to June 2014.

stock-exchange transactions), and the corresponding securities regulators impose rules for information disclosure and disclosure frequency.[7] The information disclosure regulation typically requires that the information be readily available, accessible and timely, and its intent is to provide sufficient information for an investor to assess his or her investment risk without imposing excessive costs on the issuer. The firm (its directors and officers) are held accountable for providing correct and truthful information, ensuring that no one gains special access to knowledge that could provide an investment advantage.

The regulation and the environment for information exchange have changed considerably since the 17th century. There is a recognition that since the creation, provision, and analysis of information has costs, there has to be a proper cost-benefit balance to determine the optimal level of information provision.[8] Moreover, other participants in the market place, such as financial analysts and large institutional investors, can analyze various disclosures made by firms and provide insights to individual investors who may not have the expertise or the time required to conduct credible analysis; especially for firms listed on a stock exchange. Moreover, there may be some investors who may not need any such regulations about information disclosure or analysis. These investors have analytical capabilities and the degree of disclosure to them should not matter to regulators if these investors are the only ones investing in that security without any participation by other, less sophisticated investors.[9] One could also argue that if firms want to raise capital at a reasonable rate of return, they can and would voluntarily provide additional information and undertake costly signals so as to minimize the standard moral-hazard/adverse-selection problem independent of any regulation.[10]

Since disclosure of information and analysis of the disclosed information impose costs on the provider and the recipient respectively, it is also clear that there are economies of scale at play. Large firms can afford the disclosure costs and large institutional investors can afford to analyze the received information. Moreover, if large investors can influence the valuation of a firm, then it is incumbent on the firms to provide good and timely information as required since it would be in their best interest to do so. The failure to do so may increase the firm's cost of capital and restrain its growth. In this scenario, one could even say that the role of the securities regulator is minimal since it is in the self-interest of both the firm and the investor to ensure that there is adequate information. As noted later in greater detail, this may be one of the reasons for exempting issuers from extensive disclosure for accredited investors and investors who can invest a minimum amount of at least $150,000.

Conversely, the information disclosure environment for small investors is different. These small investors may not have an independent way to ensure that the level, timeliness, and truthfulness of information provided to them is adequate to make the right risk-return tradeoff decisions, and this is where the role of the regulator becomes crucial.[11] If a regulator makes the information-provision and -reporting requirements too onerous, then the issuing firm may decide not to raise capital due to associated costs, which would likely negatively impact its growth and, on an aggregate basis, our economy. At a macro level, similar actions by many firms would decrease GDP growth and limit the

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7 Canada does not have a national securities regulator such as the SEC in the United States. So various provincial and territorial regulatory bodies have jurisdiction on the rules surrounding the raising of capital by entrepreneurs/firms in their respective jurisdiction. However, Canadian securities regulators often work together and publish national or multilateral instruments where some or all Canadian jurisdictions adopt harmonized or quasi-harmonized rules that they have negotiated among themselves.

8 For a condensed view on economics of information, see Jack M. Mintz and Finn Poschmann, "Investor Confidence and the Market for Good Corporate Governance," *C.D. Howe Institute Backgrounder* 1 (August 2002).

9 This exclusion of unsophisticated investors in specific transaction is important since one set of investors may have access to information that may give them a competitive advantage in valuing the underlying security.

10 Costly signals may include: a higher ownership in the firm, paying out a large fraction of earnings as dividends, and the hiring of reputed and expensive audit firms, among other mechanisms. These signals are termed as "costly" since these signals need to be undertaken to convince outsiders about the credibility of insiders and for no other reason.

11 In this discussion, we focus on small investors; investors such as venture capital firms have their own requirements and do not need to depend on the regulator for such information.

number of investment vehicles and opportunities for diversification for investors.[12] It should be also noted that there is an inherent assumption in this line of reasoning. It assumes that small investors have the ability to digest the information being provided and analyze it to understand the merits of the issue from a risk-return perspective. In contrast, if a securities regulator makes the disclosure too lenient, there is a potential for bad-quality firms to crowd out good-quality firms, which could result in low or negative rates of return for investors and their eventual unwillingness to provide capital in such a risky environment. This would reduce GDP growth at the macro level and investors may not have adequate investment vehicles for their savings. In addition, since these firms and the size of the transactions are small, there is less incentive for "information intermediaries" to analyze the available information and provide independent advice to investors, since the cost associated with conducting such analysis may far outweigh the benefits. This situation can be described as the "regulator's conundrum," in which the regulator wants to ensure the right level of information disclosure but has to be cognizant of the costs of providing and validating such information.

Thus, one could argue that there are three specific situations in which the role of a securities regulator is less critical. First, if only large investors participate in the market, they may have a scale advantage in demanding and analyzing information; this would automatically impose discipline on the firm to provide the right information. However, if the penalty is small for providing less-than-adequate information or material misrepresentation, then some firms may still try to provide false information (or will be less diligent in providing accurate information, which may result in providing less-than-accurate information) hoping that investors would find it difficult to separate false information from genuine optimism about a firm's future.[13] Second, one may argue that the cost of receiving and acting on bad information may be small if investors invest relatively low amounts of their capital in individual firms and, consequently, diversification benefits may limit overall risk — i.e., some investments would do well and others would not. In this case, the securities regulator may simply impose an absolute as well as a relative limit on the amount that can be invested by an investor (i.e., investor caps) in individual issuers or issues and no other regulation may be required, meaning once a low limit is set on both parties, diversification would be at play.[14] However, one may argue that even in this case, there is a real possibility that bad-quality firms will crowd out good-quality firms and eventually markets would fail.[15] Third, it is possible that independent-analyst firms would be formed with the specific purpose of providing unbiased and independent advice to investors for a fee, which then would allow investors to

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[12] This point is also made with respect to the Canadian IPO market in Bryce C. Tingle, J. Arie Pandes and Michael J. Robinson, "The IPO market in Canada: What a comparison with the United States tells us about a global problem," *Canadian Business Law Journal* 54 (2013): 321-367.

[13] It should be noted that, on an ex-post basis, it is hard to decide whether the firm provided knowingly false information or if it was just optimistic about its future. This issue is evident in regulations that allow stock-exchange-listed firms in Canada to voluntarily provide information of future earnings during the initial public offering process. See: Vijay Jog and Bruce McConomy, "Voluntary disclosure of management earnings forecasts in IPO prospectuses," *Journal of Business Finance and Accounting* 30, 1 & 2 (2003): 125-167. This is especially the case if the firm a) believes that it is a "one-period" game and it may not need to raise any additional capital; and b) if the firm is controlled by a majority shareholder who is therefore immune to the takeover market for corporate control. One would also argue that since very few individuals were prosecuted about various seemingly illegal acts during the 2009 financial markets crisis, the penalty for inadequate or bad information is limited.

[14] That does not mean that the regulator should impose such quantitative limits; these limits may actually reduce the amount and increase the cost of capital available for a small firm, as it would have to seek a much larger number of investors to meet its capital needs.

[15] This is well explained in the seminal article by G. Akerlof, "The Market for Lemons: Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84, 3 (1970): 488-500. This is an example where, due to adverse selection, buyers do not know the quality of sellers and it can cause a market not to exist or can penalize "good" sellers.

make the right selection.[16] However, even in this case, investors may face moral-hazard and adverse-selection issues as they will have to ensure the authenticity of these advisory firms and these firms may be interested in providing analysis only for large transactions.

Based on the above, one may concede that the role of a securities regulator is to ensure an optimum level of regulation so that small investors are reasonably assured that the information provided to them is relevant, accurate and timely and that the penalty for providing false and late information is significant; this may be especially true in the case of small and unknown firms and if the issues are unsecured (e.g., equity). On the other hand, if large firms/issuers are raising capital from large and financial knowledgeable investors, the disclosure requirements could be much less stringent or even non-existent.

It is therefore obvious that the role of the securities regulator is not straightforward even in the private capital markets. This becomes even more obvious if firms bypass the traditional process of going through an intermediary firm (which itself has to abide by the regulations) and instead appeal directly to a large number of individual investors for relatively small amounts of money through a "non-brokered" private placement. One proposed new way to access "retail investors" is through what is called "equity crowdfunding."[17]

In equity crowdfunding, the entrepreneur connects with potential investors via a website or portal and provides information about his or her idea to seek funding from individual investors. Capital raised in this way typically comes in very small amounts,[18] with investors leveraging mobile-payment facilities such as PayPal. Naturally, there is a potential for exposing investors to ideas that may have limited or zero possibility of earning a positive rate of return or that are fraudulent. However, this new way of raising capital has low costs, and higher-risk capital can be raised in a relatively short period of time compared to a similar process under traditional funding methods. This mechanism allows small and entrepreneurial firms to access relatively small amounts of capital, increase jobs, and contribute to the overall growth of the economy. However, the total amount raised through crowdfunding would be modest at best and therefore would have a particularly limited macroeconomic impact.[19]

Even with such modest contribution to the overall flow of capital and small amounts raised from individual investors, the regulatory response to such alternative mechanisms of raising capital has been swift, yet the actual implementation of new rules has been slow. In the U.S., President Barack Obama signed the JOBS Act into law in April 2012; however Title III, involving equity crowdfunding, has yet to become effective. The new law stipulates that entrepreneurs will be able to raise money from any and all types of U.S. investors; however, start-ups are limited to raising $1 million per year, and can only do so through portals approved by the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA). The legislation increased the 500-shareholder rule, which put a limit on the number of shareholders a company was allowed to have before registering with the SEC (and going public) to a 2,000-shareholder rule.[20] Similar reaction was seen in Canada from certain provincial

[16] These types of independent advisory firms do exist, with the role of providing pure advice on the merits of information provided by firms. However, these firms limit themselves to only publicly listed large firms. It is not clear as to whether they have any specific expertise in this activity. See: Jeffery F. Jaffe and James M. Mahoney, "The Performance of Investment Newsletters," *Journal of Financial Economics* 53 (1999): 289-307.

[17] Equity crowdfunding is different than non-equity crowdfunding, which involves donation, pre-paid/pre-purchase and rewards-based campaigns (not offerings), since in the latter type a "contributor" does not obtain a financial or equity interest in a firm.

[18] Since the total amount raised is typically small, these investments do not draw any interest from the typical venture capital or private equity firm.

[19] See Jeffrey MacIntosh, "Extraordinary Popular Delusions and the Madness of Crowdfunding," *National Post*, July 31, 2013.

[20] The growth in the approved portals in the U.S. has been considerable, with over 500 portals already approved and a large number in the pipeline waiting to be approved. However, that does not mean these are equity-funding portals; many of these may be just charity or donation-oriented portals. Additional information can be found on www.crowdsourcing.org. Also note that the SEC has not yet made final decisions regarding crowdfunding regulations.

securities commissions, but just like the JOBS Act, they too have been slow in implementation. For example, the Ontario Securities Commission (OSC) and the regulators of five other provinces have proposed that a firm can raise a maximum of $1.5 million in equity in any 12-month period and that individuals are allowed to invest no more than $2,500 in a single offering, up to a maximum of $10,000 per year. The British Columbia Securities Commission (BCSC) and the regulators of five other provinces are looking at a proposed crowdfunding start-up exemption, where a firm can raise $150,000 per offering, twice a year (i.e., $300,000 per year), with individuals allowed to invest no more than $1,500 in a single offering without any annual maximum. The start-up exemption is currently legal in Saskatchewan only. In addition, securities regulators have also proposed that crowdfunding websites and portals be required to register with securities commissions, that they comply with the minimum capital and insurance requirements, and that they adhere to various reporting rules and requirements for conducting due diligence on companies and directors and officers using their website or portal. The portal under the start-up exemption would not have to be registered.

THE EXEMPT MARKET

One of the origins of the exempt market can be considered as the regulator's response to the regulatory conundrum as it relates to information disclosure and investor protection. A trade-off is achieved by allowing certain exemptions to issuers from the full requirements of prospectus disclosure, while imposing certain classification rules to determine which investors are allowed to provide capital to these issuers. Thus, the exempt market is where capital can be raised under an exemption from the detailed prospectus-disclosure and -delivery requirements.

Although there has been a considerable movement to create a nationalized and harmonized prospectus-exemptions regulation regime, requirements vary across provinces and territories.[21] It is not the intent of this paper to describe specific differences between provincial/territorial securities regulations of the exempt market, since these are readily available elsewhere.[22] Instead the focus of this paper is on those aspects that provide the context for understanding the scale and scope of the exempt market and the degree of information available to researchers and other interested parties to analyze the state and the efficacy of this market.

In essence, there are three parties involved in the exempt market: the issuer or firm that needs access to capital and sells either equity or debt securities to investors; the investor who is willing to provide the funding; and, when required, an intermediary that facilitates the matchmaking between the issuer and the investor. One example of a matchmaker is an "exempt-market dealer" (EMD). A typical EMD is engaged in the business of trading and matchmaking between issuers and qualified eligible investors under existing prospectus exemptions, where it typically charges a fee as a percentage of the transaction value of the offering. An EMD may also participate in the promotion, distribution and trading (i.e., buying and selling) of exempt securities, as either a principal or agent. All EMDs are subject to extensive dealer-registration and -compliance requirements and are directly regulated by the provincial and territorial securities commissions.[23] EMDs are required to meet substantial dealer obligations that include: educational proficiency, capital and solvency rules, insurance, audited financial statements,

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21 This can be seen by analyzing various national policies such as NI 45-106, OSC SCP 45-710, and NI 31- 103.

22 A very recent and excellent summary of the regulations can be found in Jack Mintz, "Muddling up the market: New exempt market regulations may do more harm than good to the integrity of markets," *The School of Public Policy Research Papers* 7, 30 (University of Calgary, November 2014).

23 More specifically, EMDs are required to meet standard dealer obligations, which include: educational proficiency, capital and solvency rules, insurance, audited financial statements, know-your-client rules, know-your-product rules, trade suitability, compliance systems, record keeping, client statements, trade confirmations, disclosure of conflicts of interest and referral arrangements, etc. The EMD category of registration exists in all provinces and territories of Canada subject to certain exemptions from registration.

"know-your-client" (KYC) rules, "know-your-product" (KYP) rules, trade suitability rules, compliance systems, record-keeping rules, client statements, trade confirmations, disclosure of conflicts of interest and referral arrangements, and more.[24] The EMD category of registration exists in all provinces and territories of Canada and is subject to certain exemptions for registration.

With respect to the issuer and investor, the essence of the exempt-market regulation is simple: provide a minimum level of information that an investor who is considered as qualified (either by sophistication, relationship with the issuer, wealth or income) would require for making an informed investment decision. Certain provinces and territories may also exclude specific types of securities that can be issued in this market under prospectus exemptions.[25]

Currently, if securities are sold to retail investors, investors are provided an offering document that contains information such as the intended use of proceeds, nature of business, capital structure, names of directors and principal holders, long-term objectives, identities of related parties and financial statements. In fact, under the offering-memorandum exemption,[26] audited financial statements are legally required to be included in the offering memorandum and interim financial statements, subject to an exemption in certain jurisdictions if the amount being raised is less than $500,000.[27] The other commonly used exemptions — i.e., accredited investors and friends or family — do not require any disclosure, however some disclosure is typically provided as a matter of commercial practice.

In addition, some corporate issuers in certain circumstances may be required to provide certain information including audited financial statements, changes to capital structure, nature of business, directors and management, and acquisition and perhaps disposal of assets.[28]. Not all provinces and territories require similar annual disclosure; some are satisfied with the provision of financial statements according to corporate law. Although the level of information disclosure may sound onerous, it can be much lower than the disclosure required in a prospectus of an initial public offering, and by lowering the disclosure requirements; higher-risk capital can flow more easily and at a reduced cost.

This overall lower level of disclosure is counterbalanced by the restriction on the investor who, under the "accredited-investor exemption," is considered an "accredited investor" by the virtue of investment sophistication — as measured by wealth or annual income or both — before he or she can invest in these "exempt" securities. Under NI 45-106, an accredited investor includes:

- an individual who has net assets, alone or with a spouse, of at least $5 million;

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[24] In western provinces there is also a so-called "north west" exemption.

[25] As can be seen, securities issued in the exempt market are materially different from securities that can be traded easily on the public stock exchanges (i.e., liquid securities). Exempt-market securities are illiquid and there are certain restrictions on resale (i.e., it must rely on an exemption, such as accredited investor). The securities themselves aren't different; it's how the market is regulated that makes them different. Some types of securities are also subject to disclosure rules that apply not only at the time of sale but also on an annual basis.

[26] See section 2.9 of National Instrument 45-106 *Prospectus and Registration Exemptions* (NI 45-106).

[27] On Dec. 20, 2012, members of the Canadian Securities Administrators (CSA) — excluding those from British Columbia and Ontario — published Multilateral CSA Notice 45-311: "Exemptions from Certain Financial Statement-Related Requirements in the Offering-Memorandum Exemption to Facilitate Access to Capital by Small Businesses." Each CSA member (other than British Columbia and Ontario) issued a harmonized interim local order that provides an exemption from certain financial requirements set out in the offering-memorandum exemption. The order remains in force until Dec. 14, 2014. The order provides relief from the audited-financial-statement requirement and the requirement for issuers to prepare financial statements using Canadian GAAP applicable to publicly accountable enterprises, provided that: (a) the issuer and related issuers raise no more than $500,000; (b) no investor invests more than $2,000 in any 12-month period; (c) the issuer is not a reporting issuer, investment fund, mortgage-investment entity or real estate issuer; (d) the issuer does not distribute complex securities; and (e) the offering memorandum contains a bold warning on the front page.

[28] Ontario has proposed disclosure under the proposed offering-memorandum exemption; other provinces require that the financial statements, as determined by corporate law, are provided.

- an individual whose net income before taxes exceeded $200,000 in each of the two most recent calendar years or whose net income before taxes combined with that of a spouse exceeded $300,000 in each of the two most recent calendar years and who, in either case, reasonably expects to exceed that net income in the calendar year; or
- an individual who, either alone or with a spouse, beneficially owns financial assets having an aggregate realizable value that, before taxes but net of any related liabilities, exceeds $1,000,000.

There is another category of investor called an "eligible investor" that may invest in exempt-market securities pursuant to the offering-memorandum exemption. The offering-memorandum exemption requires, among other things, that a prescribed form of offering memorandum is provided to an investor along with a risk-acknowledgement form and, under the Alberta model[29] of the offering-memorandum exemption, an investor can invest more than $10,000 if he or she is purchasing as principal and is an "eligible investor," which includes:

a) a person whose

   (i) net assets, alone or with a spouse, exceed $400,000;

   (ii) net income before taxes exceeded $75,000 in each of the two most recent calendar years and who reasonably expects to exceed that income level in the current calendar year; or

   (iii) net income before taxes, alone or with a spouse, exceeded $125,000 in each of the two most recent calendar years and who reasonably expects to exceed that income level in the current calendar year.

b) a corporation in which a majority of the voting securities are beneficially owned by eligible investors or a majority of the directors are eligible investors;

c) a general partnership, of which all of the partners are eligible investors;

d) a limited partnership, of which the majority of the general partners are eligible investors;

e) a trust or estate, in which all of the beneficiaries or a majority of the trustees or executors are eligible investors;

f) an accredited investor;

g) a person described in section 2.5 (family, friends and business associates);

h) a person that has obtained advice regarding the suitability of the investment and, if the person is resident in a jurisdiction of Canada, that advice has been obtained from an eligibility adviser.

Under the Alberta model of the offering-memorandum exemption, a non-eligible investor can purchase only amounts less than $10,000.[30]

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[29] There are two models of the offering-memorandum exemption in Canada; the "British Columbia model" and the "Alberta model." The British Columbia model is followed by the provinces of British Columbia, New Brunswick, Nova Scotia and Newfoundland and Labrador. The Alberta model is followed by Alberta, Manitoba, Prince Edward Island, Quebec, Saskatchewan, the Northwest Territories, Nunavut and Yukon. Ontario has not adopted the offering-memorandum exemption, although it is presently considering it under proposed amendments to National Instrument 45-106: *Prospectus and Registration Exemptions*.

[30] For those jurisdictions that follow the British Columbia model of the offering-memorandum exemption, the offering memorandum is available to any investor in any amount. There are no investor qualifications or investor or issuer investment limits. The CSA has recently proposed eliminating the minimum-amount exemption for individuals but not for institutions.

While one may argue whether or not annual income or wealth conditions automatically lead to an individual being a financially sophisticated investor, the intent of the eligibility requirements is clear:[31] These individuals should understand (or seek advice from those who understand) the inherent risk-return trade-off of the proposed investment with information that is not as detailed as that which is provided in a prospectus.[32] It is also interesting to note that the regulation does not propose any testing of the investor for financial literacy.[33]

Another important point about exempt markets is that these markets can be used by small and medium-sized enterprises (or SMEs) that wish to raise risk capital from investors as an alternative to initial public offerings, which are becoming even more costly due to the disclosure requirements for a publicly traded company under applicable securities regulations. However, the exempt market is not just for SMEs and is being used by larger firms and large investors, as can be seen in the empirical section of the paper.[34]

In essence, the exemptions from full disclosure are based on the following premises:

- an investor has the ability withstand a financial loss;
- an investor has the ability to obtain the relevant information from the issuer (for example, the various exemptions for major institutional investors);
- an investor has sufficient knowledge of company principals to invest (e.g., close family, friends and business associates);
- an investor has sufficient information about an issuer (e.g., an exemption as a director, officer or employee);
- a security is subject to another regulatory scheme (certain co-operatives or real estate products);
- a security is simple to understand and low risk (e.g., government debt).

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[31] Historically, the minimum-amount exemption under Section 2.10 of National Instrument 45-106: *Prospectus and Registration Exemptions*, was called the "sophisticated-investor exemption." Currently, there are two types of exemptions, one for accredited investors and one that relates to the minimum-amount exemption.

[32] While the focus here is on the individual, it should be noted that an accredited-investor status is automatically bestowed on institutions, such as: Canadian financial institutions and Schedule III banks, the Business Development Bank of Canada, basically every government or Crown corporation, pension funds, and even registered charities. This automatic qualification has implications for the size of the exempt markets as described in the section on scale and scope of the exempt markets.

[33] For example, Canadian Securities Administrators' National Instrument 52-110: *Audit Committees* (NI 52-110), requires all members of the audit committee of the board of directors to be financially literate. According to NI 52-110, a director is financially literate if he or she has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are reasonably comparable to the breadth and complexity of the issues that can be expected to be raised by the issuer's financial statements. Many firms even provide a financial literacy self-test tool kit. See for example, http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/USEng/Documents/Audit%20Committee/Audit%20Committee%20Resource%20Guide/financial%20literacy%20self%20assessment%20tool.pdf.
A similar tool kit can be provided for those investors who may want to know what knowledge is required to be considered a "sophisticated" investor. In this regard, the OSC was proposing that to qualify as a "sophisticated" investor, the investor would have to satisfy two conditions. The first would be relevant work experience: the investor must have worked in the investment industry for at least one year in a position that requires knowledge of securities investments. The second condition would be meeting a relevant educational qualification: the investor must have earned or received either a Chartered Financial Analyst designation, a Chartered Investment Manager designation, or a Master in Business Administration (MBA) degree from an accredited university. This, however, would have excluded wealthy investors/entrepreneurs who pursued wealth and job creation without formal education and have acquired considerable financial judgment through that experience. Moreover there is no guarantee that an individual specializing in human resource management in an MBA program may have better knowledge than a person from hard-knocks business background. In its August 2013 progress report, the OSC stated that it was no longer considering an investor sophistication exemption.

[34] For an excellent and updated summary of data and issues, please see Tingle, Pandes and Robinson, "The IPO."

THE SCALE AND SCOPE OF THE EXEMPT MARKET IN CANADA

Given the extent of the legislation, the regulators' desire to deter and detect fraud and to ensure that the exempt market functions as intended, one would expect that the information about the overall scale and scope of this market would be readily available to researchers and other capital market participants so as to enable the evaluation of both the efficiency and the effectiveness of this market mechanism. However, this is not the case.[35] There are no specific and regular publications from provincial regulators that provide the level of depth required for analysis and there seems to be no systematic approach for collecting and reporting the volume of the transactions by types of issuers, types of investors or types of securities.[36] There are also no data on the redemptions of securities that were issued to investors, so all reported numbers are on a "gross" basis and there is no information on the duration of securities (i.e., the length of time a particular redeemable or a normal debt security remains issued and outstanding prior to redemption or its rollover by an issuer). The information about redemptions and duration is important for understanding the true size of the exempt market since it is claimed that a larger number of financial institutions use exempt markets to raise short-term money. If that is indeed the case, then it inflates the importance of the exempt market based on aggregated data using overall gross numbers that are reported by the media.[37] The currently available data are not comprehensive, nor is there a readily available database that has all the attributes required for a fact-based independent analysis of the exempt market. It is not even clear whether the data are being collected at the level of granularity required and, if they are being collected, if the respective securities commissions have a budget, or co-operative desire, to analyze this data in a collaborative way so that a national picture of the Canadian exempt market is made available to researchers, policy-makers and other interested parties.

On the face of it, one may think that one of the main reasons the exempt market came into being was the need for SMEs to seek equity (and, at times, debt) capital from individual investors on an efficient and less costly basis.[38] This would potentially respond to the hypothesis that SMEs face an equity gap: they need equity capital, but in amounts too small to interest institutional investors, so the exempt market can facilitate easier access to sophisticated investors. However, given the current state of available data, it is not possible to segregate out the capital raised by SMEs (both equity and debt) in the overall capital flow through the exempt market from accredited but individual investors, making it impossible to evaluate both whether individual investors and small firms are utilizing the exempt market, and their experience from these investments. After all, the reason for the regulation and creation of the exempt market is to allow this matchmaking for higher-risk capital in a cost-effective and efficient manner and to protect investors; however, if minimal or no data are available for analysis, then there is no way to tell whether this is in fact happening.

Another concern is in regards to the potential duplication in interpreting the available data. For example, many companies on the TSX Venture Exchange (TSX-V) use the exempt market as a vehicle to raise additional equity capital in private placements, but since available data do not require the identification

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[35] This need for better data on the nature and the size of the exempt market is recognized by the OSC, which in June 2012 launched an electronic version of the report (the E-form) which could be filed through the OSC's website on a voluntary basis; it became mandatory as of February 2014. The BCSC also has an electronic filing system. Further information is available in OSC Staff Notice 45-708 Introduction of Electronic Report of Exempt Distribution on Form 45-106F1 (June 21, 2012). http://www.osc.gov.on.ca/en/SecuritiesLaw_issuer_forms-45106f1-45501f1_index.htm.

[36] This is not to say that the aggregate data are not available; the challenge is that it is not available in the granularity that may be required for fact-based analysis.

[37] For example, an article by Jeff Gray in *The Globe and Mail* on July 31, 2012 stated that "The exempt market has grown enormously, with $86.5-billion raised in Ontario alone in 2011, up from $78.6-billion the year before, with observers blaming the tightening of the credit markets for pushing small companies to seek other sources of funding."

[38] This, of course, is not the only reason for the existence of the exempt market. It can be used for securities that are very safe — for example, Government of Canada bonds — or it can be used by investors that do not require detailed information, or those who already have the required knowledge about the issuer either because they are the family or friends of an issuer seeking seed funding.

of an issuer as an exchange-listed issuer (meaning whether or not the company is listed on an exchange like the TSX-V), there may be overlap in the reported amount raised through the exempt market and on Canada's public markets.[39] In addition, there are no data on the ex-post performance of the exempt securities, especially those that were issued as equity instruments. One may argue that it is not the role of the securities regulators to prevent losses from investments or to track performance once the security is purchased by investors. However, if such data were available, investors would have better information about the risk/return trade-offs associated with exempt-market securities, and the data could provide information to help assess the efficacy of disclosure rules.[40] Moreover, since there are no such readily available data, a single investment gone bad gets undue attention and leads to calls for increasing scrutiny and additional rules.[41] Therefore, it is imperative that minimum levels of data are considered necessary from a public policy perspective so that a fact-based debate can ensue on the efficacy and the extent of the exempt market.[42]

There is another fundamental weakness in the currently available data. There are only limited data available on the cost of the transaction (since in some cases intermediaries may be involved) and on the degree of illiquidity (for example, liquidity can be ascertained in the case of public markets through the bid-ask spread, but this is obviously not applicable for private securities). This is especially so for equity-type securities issued by SMEs and invested by individual accredited or eligible investors.[43] It is well known that markets become transactionally efficient when transaction costs are known to the market. But the current state of information about the exempt market is not robust enough in this regard. With these caveats about the nature of the information on the exempt market, the next section provides an analysis on available data.

SCALE AND SCOPE OF THE EXEMPT MARKET

The source of data for this paper is multifold: it comes from websites of provincial securities regulatory commissions as well as from private correspondence and requests to the commissions.[44] Most of the data were received in aggregated and non-interlinked tables and not all data were amenable to analysis at the individual sub-category level or were consistent across all provincial jurisdictions. As noted earlier, the data are on a "gross amount"-raised basis. Since it is possible that a large percentage of securities issued by financial institutions may be of redeemable or rollover debt securities, and the amount excludes redemptions, gross amounts may also overstate the importance of the exempt market as a source of

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[39] The total amount raised via seasoned equity offerings by TSX-V listed companies averaged $1 billion annually in 2011 through 2013.

[40] This data may not be easy to track since there are trading restrictions on these securities. However, it is the same situation with venture capital and investments made by private equity firms; that data are now being collected and are being made available for analysis.

[41] For example, The Canadian Foundation for Advancement of Investor Rights (FAIR Canada) has claimed: "Widespread non-compliance with the laws and regulations governing the loosely-regulated exempt market coupled with a high level of fraud and weak oversight harms investors and weakens confidence in the Canadian capital markets."

[42] If securities commissions in Canada lack the budget, they can release the data free of charge to academic and other interested researchers, opening up exempt markets to fact-based analysis. There are no issues with respect to privacy since the identity of individual investors is not required. All that is required is information on the type of investor. If the identity of the firm needs to be protected, only the data regarding the type of firm and issue (private versus publicly listed; firm size; size of the issue; industry; type of security; etc.) can be released.

[43] For example, F1 and F6 filings in British Columbia include fees and expenses but are not reported as a matter of course. Such data are readily available for initial public offerings and seasoned equity offerings of publicly listed firms. See, for example, Vijay M. Jog, "The Climate for Canadian Initial Public Offerings," in *Financing Growth in Canada*, ed. P. Halpern (Calgary: University of Calgary Press, 1997), 357-401; as well as Tingle, Pandes and Robinson, "The IPO."

[44] We asked for, but did not receive, any information from the Autorité des marchés financiers (AMF).

permanent capital.[45] In addition, Ontario only counts the funds raised within Ontario, whereas all other provinces report funds raised from within the province (inside) and outside the province, including from outside of Canada. So aggregating across provinces may also result in duplication.

There were various sources of data for this paper. For British Columbia, the data for 2009–2013 were received from the BCSC. The source of the data is from the exempt-distributions report based on form 45-106F1. The BCSC tracks data on debt versus equity and information about individual versus non-individual investors, and they are available upon special request; the data provided were whatever were readily available at the time of request. The BCSC does not keep data on the size of company or the duration of debt securities.

The data for Alberta came from the analysis of the annual reports entitled *The Alberta Capital Market: A Comparative Overview*. Additional data for Alberta came from the Alberta Securities Commission website, which provides summary data by issuer. However, the two sources provide inconsistent information, so I used the annual reports as my source for the analysis shown below. Similar to British Columbia, it is not possible to segment the data by size of the issuer, the type of security or the type of investor.

The data for Ontario come from Appendix C of "OSC Exempt Market Review, OSC Staff Consultation Paper 45-712 – Considerations for new Capital Raising Prospectus Exemptions," published in December 2012, as well as underlying data provided by the OSC upon special request. Here again, the data do not allow for insights on the size of the issuer, the type of security (except for in 2012) or the type of investor. The data for New Brunswick come from the various issues of the *Capital Markets Report* published annually by the Financial and Consumer Services Commission of New Brunswick.[46] In contrast to all other jurisdictions, the data do provide segmentation by type of security, but not by size of the issuer nor type of investor. No jurisdiction provides any data on costs of transaction or post-issuance performance of securities. There is also no way to find out the role and the extent of intermediaries in these transactions and whether or not there is double counting. Also note that we do not have data from the province of Quebec.

Given such disparity in data and different breakdowns used by individual provincial commissions, I provide data at the aggregate level (where such aggregation is possible) followed by data by each province where additional information was available and could be documented. Wherever necessary, I make reasonable assumptions, which are reported in this paper. As such, tables 1 through 7 provide aggregated data for the years 2010–2012 as these are the three years where data were available for all the jurisdictions and required a minimum number of assumptions. Since Ontario plays a large part in the exempt market, this paper provides specific tables related to Ontario to allow for better insight about the exempt-market characteristics.

Table 1 provides data by exemption type as per Section 2 – Division 1 of the National Instrument 45-106 *Prospectus and Registration Exemptions*, September 18, 2009 Volume 32, Issue 38 (Supp-5) where Section 2.3 refers to an accredited investor, Section 2.5 is the category for family, friends and business associates and Section 2.9 is the category for offering memorandum.[47] It should be noted that OSC does not yet have an offering-memorandum exemption, so most of the funds raised in Ontario are under Section 2.3, the accredited investor category. The total includes funds raised by investment funds and other finance companies and is a simple aggregate of data received from various sources listed above. It should be noted that it is possible that there may be some double counting here since all provinces

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[45] Financial institutions normally raise short-term financing via the short-term debt exemption. There are currently no reporting requirements for this and hence it is not captured as part of the exempt-market data set in any jurisdiction.

[46] Due to time and effort limitations, I did not track the data for any other province.

[47] The categories are: 2.1 Rights Offering; 2.2 Reinvestment Plan; 2.3 Accredited Investor; 2.4 Private Issuer; 2.5 Family, Friends and Business Associates; 2.6 Family, Friends and Business Associates – Saskatchewan; 2.7 Founder, Control Person and Family – Ontario; 2.8 Affiliates; 2.9 Offering Memorandum; 2.10 Minimum Amount Investment.

except Ontario include both capital raised inside the province and outside by issuers. Some or all of that outside capital raised may also be captured in Ontario's numbers, depending on how the OSC captures and reports these numbers, since its totals include capital raised within ("inside") the province regardless of issuer's domicile. If one assumes that most of the "outside of province" funding in B.C. and Alberta comes from Ontario, these amount to $14.95 billion in 2012 (see Table 3).

TABLE 1 EXEMPT MARKET BY "CAPITAL RAISING EXEMPTIONS" ($BILLIONS)

	2.3 - Accredited Investor	2.5 - Family, friends and business associates	2.9 - Offering Memorandum	Other	Unknown	Total
2012	121.76	0.59	0.97	9.38	6.21	138.90
2011	86.93	0.35	0.55	6.69	28.30	122.83
2010	84.51	0.38	0.65	6.10	24.09	115.73
Total	293.20	1.32	2.17	22.17	58.60	377.45

These numbers indicate that the exempt market facilitates over $100 billion each year of capital flow between borrowers and investors, including all types of securities, and that it is growing. The total amount is for all four provinces and it shows that the largest category of investors (77 per cent) is the "accredited investor" category; money raised from family, friends, business associates and the offering-memorandum exemption is almost negligible.[48] Other categories represent approximately 21 per cent of the total. Needless to say, the exempt market plays a significant role in Canadian capital markets.

Of the total amount raised, Ontario constitutes a significant percentage, as shown below in Table 2. The dominance of investment funds is also obvious – these constitute almost 65 per cent of the total funds raised in Ontario.[49] This also leads to a potential for double counting since the gross amount that flowed into investment funds likely includes funds investing in other funds and investors redeeming in one fund and moving their capital to another fund; it is not limited to new capital invested.

TABLE 2 EXEMPT-MARKET CAPITAL FLOW – ONTARIO

Ontario — Capital Raised by Investment Funds vs. Other ($billions)				
Year	Investment Fund	Non-investment Fund	Total	% of national total
2012	67.24	37.13	104.37	75.14%
2011	59.01	27.54	86.55	70.46%
2010	52.74	25.83	78.58	67.90%
2009	54.95	14.74	69.69	N/A
2008	71.92	20.24	92.16	N/A

The next table shows the breakdown by source of financing by province where "inside" denotes investors from within the province and "outside" represents the rest.

48 Since Ontario has not yet adopted those exemptions, in Ontario issuers must use the accredited-investor exemption.

49 As noted by one reviewer, this is a very heterogeneous group. This category may include trust companies investing the comingled funds of trusts and estates under their control, private investment clubs or reinvestments by investment funds. It may also include the sale of securities to persons who have already purchased $150,000 or more of the particular fund. Thus, the aggregate figure, while interesting for its size, does not necessarily provide improved insights about the ultimate recipient of these funds.

TABLE 3 EXEMPT MARKET BY GEOGRAPHY

Investment Sources by Province (for all issuers) — $billions								
	AB		ON		BC		NB	
	Inside	Outside	Inside	Outside	Inside	Outside	Inside	Outside
2012	4.8	8.5	N/A	N/A	13.86	6.45	0.01	0.29
2011	9.6	9.7	N/A	N/A	11.86	5.64	0.01	0.015
2010	8.5	8.4	N/A	N/A	11.88	7.76	0.01	0.17

Investment Sources by Province (for all issuers) — per cent								
	AB		ON		BC		NB	
	Inside	Outside	Inside	Outside	Inside	Outside	Inside	Outside
2012	36.1%	63.9%	N/A	N/A	68.2%	31.8%	3.3%	96.7%
2011	49.7%	50.3%	N/A	N/A	67.8%	32.2%	40.0%	60.0%
2010	50.3%	49.7%	N/A	N/A	60.5%	39.5%	6.8%	93.2%

Table 3 shows that the exempt market is a national market and that investors have invested throughout the provinces. Although not shown here, a much higher percentage in New Brunswick and British Columbia has come from U.S. investors. This table also indicates that all provincial securities commissions should continue to harmonize all criteria for defining the issuers and accredited investors to ensure continued cross-provincial investments. As also noted earlier, OSC totals include capital raised within ("inside") the province regardless of the issuer's domicile. One may also conjecture that funds under the "outside" category are investments made by institutional investors in public or large private companies in that province.

Next, I show the breakdowns by issuer type. The reporting issuers are public companies that are already providing disclosure to investors and non-reporting issuers are issuers that are not public companies and therefore would have minimal (or at least less) information at the time of the issuance.[50] As can be seen below, the exempt market is allowing non-reporting issuers to raise significant amounts of capital through the exempt market and investors are willing to invest in these issuers even with the limited amount of information available to them.[51] The data are not robust for 2010, but there is an increase in the percentage raised by non-reporting issuers in 2012 compared to 2011. It should also be noted that non-reporting issuers are not necessarily small issuers; it simply means these issuers are not reporting issuers (e.g., public companies listed on a stock exchange).

[50] A reporting issuer includes any issuer that has: filed a prospectus and obtained a receipt for it from a Canadian securities regulatory authority; merged with a reporting issuer by a business combination or takeover bid; previously had its securities listed on a stock exchange; or received an order from the commission designating it a reporting issuer.

[51] As noted by one reviewer, it would be useful to know how much of the non-reporting category is investment funds and how much of it is large private companies (i.e., non-reporting issuers) as opposed to SMEs; whether there is an industry concentration among the non-reporting issuers; and whether there is a particular kind of offering (by type of security) by non-reporting issuers.

TABLE 4 EXEMPT MARKET BY REPORTING AND NON-REPORTING ISSUERS

Capital Raised by Reporting Status ($billions)				
Canada				
	Reporting	Non-Reporting	Unknown	Total
2012	27.73	98.05	12.51	138.29
2011	18.68	76.14	28.35	123.17
2010	13.81	31.65	69.83	115.30
Capital Raised by Reporting Status (per cent)				
	Reporting	Non-Reporting	Unknown	Total
2012	20.05%	70.90%	9.05%	100.00%
2011	15.17%	61.81%	23.02%	100.00%
2010	11.98%	27.46%	60.57%	100.00%

Next, we turn our attention to the type of securities offered through the exempt market, since one of the intentions behind creating an exempt market was to allow for the raising of higher-risk capital. Unfortunately, this data by security type are available only for 2012 and only for Ontario (non-investment funds only) and New Brunswick (a much smaller market than Ontario's) and thus there is a large percentage under the "unknown" category. However, what is somewhat surprising among the available data is that the equity raised through the exempt market is only five per cent of the total amount raised, but is still large in absolute terms.

TABLE 5 CAPITAL RAISED BY SECURITY TYPE, 2012

Capital Raised By Security Type – Non-investment Funds					
	Debt	**Equity**	**Other**	**Unknown**	**Total**
2012 $billions	27.38	7.05	2.61	33.61	70.65
2012 percentage	38.75%	9.99%	3.69%	47.57%	100.00%

As can be seen above, the amounts raised through equity instruments in the exempt market were $7.05 billion in 2012. This can be compared with $4.8 billion and $1.2 billion raised on the TSX under initial public offerings in 2010 and 2011 respectively; $1.5 billion each raised by venture capital in 2010 and 2011; and $24 billion raised by TSX-listed companies through subsequent equity offerings in the same two years.[52] Needless to say, the exempt market plays a significant role in Canadian equity markets, but most financing occurs through debt instruments.

Table 6 below segments the data by industry sectors. Due to internal inconsistencies, the aggregate numbers do not match exactly and some adjustments had to be made due to lack of data in certain cases for 2012. However, the numbers and the percentages are directionally correct. The most surprising part is that a significant percentage (65 per cent) of capital raised through the exempt market is either via investment funds or other financial-sector firms. It should also be noted that distributions of investment-fund securities reflect distributions to both individual and institutional investors and distributions of both public and private investments. I also note that these data reflect purchases, but do not account for redemptions of securities. As such, there is no way to know the ultimate "resting place and the security types" for the amounts raised by these investment funds, nor the "net" amount, since some of these funds could have been redeemed in a very short period of time or rolled over to finance the

[52] The data on IPOs come from Tingle, Pandes and Robinson, "The IPO," Table 1; the rest come from a compilation from various sources including annual reports from the TSX and sources such as Capital IQ. We did not compile data for other types of securities such as debt and preferred shares. Note that there is a potential for double counting here as well since the venture capital market is part of the exempt market.

redemption of an earlier issue. In addition, these data are limited because they are based on reports of exempt distributions filed with the OSC only. Also, only the specified prospectus exemptions trigger a requirement to file a report. As a result, these data do not capture all exempt-market activity.[53]

TABLE 6 CAPITAL RAISED BY INDUSTRY SECTOR

Capital Raised by Industry — Canada ($billions)							
	Oil and Gas	Others	Financials (includes funds)	Real Estate	Other Industries*	Unknown Industry	Total
2012	9.22	3.61	12.60	2.36	4.72	106.30	138.81
2011	11.68	3.61	14.22	4.25	5.87	83.19	122.82
2010	11.58	2.88	14.94	2.54	7.12	76.66	115.72

Capital Raised by Industry — Canada (per cent)							
	Oil and Gas	Others	Financials (includes funds)	Real Estate	Other Industries*	Unknown Industry	Total
2012	6.6%	2.6%	9.1%	1.7%	3.4%	76.6%	100.0%
2011	9.5%	2.9%	11.6%	3.5%	4.8%	67.7%	100.0%
2010	10.0%	2.5%	12.9%	2.2%	6.2%	66.2%	100.0%

** *Other industries include: biotech, forestry, high-tech, industrial, mining exploration/development, mining production, and utilities.*

Since we have more detailed data from Ontario with respect to various industries excluding investment funds, they are shown below:

TABLE 7 INDUSTRY SECTOR COMPOSITION IN ONTARIO'S EXEMPT MARKET

Capital Raised by Industry — Ontario, non-investment funds only ($millions)				
	2008	2009	2010	2011
Financial Services	4,664	1,065	4,651	6,339
Mining	3,172	2,868	4,856	3,791
Oil and Gas	2,735	1,903	2,952	2,953
Real Estate	742	1,256	1,395	2,154
High-Tech	449	319	607	1,099
Utilities	4,440	616	301	846
Industrial	384	1,269	1,109	517
Biotech	1,017	130	109	243
Forestry	381	24	152	54
Other	2,254	5,290	9,699	9,542
Total	**20,238**	**14,740**	**25,831**	**27,538**

[53] For more details on data limitations, please see OSC, "Exempt Market Review: OSC Staff Consultation Paper 45-710 – Considerations for new Capital Raising Prospectus Exemptions" (2012), 18, footnotes 2 and 3.

Capital Raised by Industry — Ontario, non-investment funds only (percentage)				
	2008	2009	2010	2011
Financial Services	23.0%	7.2%	18.0%	23.0%
Mining	15.7%	19.5%	18.8%	13.8%
Oil and Gas	13.5%	12.9%	11.4%	10.7%
Real Estate	3.7%	8.5%	5.4%	7.8%
High-Tech	2.2%	2.2%	2.3%	4.0%
Utilities	21.9%	4.2%	1.2%	3.1%
Industrial	1.9%	8.6%	4.3%	1.9%
Biotech	5.0%	0.9%	0.4%	0.9%
Forestry	1.9%	0.2%	0.6%	0.2%
Other	11.1%	35.9%	37.5%	34.7%
Total	100.0%	100.0%	100.0%	100.0%

The four most important sectors that use the exempt market are financial services, mining, oil and gas, and real estate. Although not shown here for the sake of brevity, the percentage represented by the oil and gas sector is significantly higher in Alberta. If one combines insights from tables 6 and 7, it may lead to the conclusion that the biggest users of the exempt market continue to be financial institutions that can raise potentially short-term debt capital relatively free of securities regulation, and the growth in the exempt market has not been just because of the (equity) capital needs of SMEs.

The overall conclusion from this section is that the status of the data and the ability to analyze these data in any shape or form for informed decision-making is limited. The data collected are inconsistent and available in tabular form with no ability to link across various tables or across provincial commissions. There is a high potential for double counting and an inability to net out the amounts related to "redemptions or rollover" of debt securities from the aggregated reported amounts. Since the accredited-investor exemption includes not only wealthy individuals but also institutions, it provides no insight about the participation of individuals in the exempt market and the type of securities in which they invest. The exempt market is dominated by investment funds, but very little information is available on them or about their ultimate investment vehicles.

Notwithstanding the fact that many securities issued under the exempt market are illiquid, there is also no information on the performance of these securities (especially equity securities by small firms invested by individual investors). This lack of information is lamentable since this type of information is necessary to investigate the efficacy of this market in matching borrowers and investors by showing the range of realized rates of return. These data, if they were to be available, might lead to regulatory changes with respect to the degree and quality of information and they can provide another signal for investors about this market.

OBSERVATIONS AND RECOMMENDATIONS

The main objective of this paper was to identify and summarize empirical evidence on the state of the Canadian exempt market given its obvious importance in facilitating capital flows between investors and firms. The intent was to use this evidence to make some firm observations and then propose some policy alternatives, if any, for potential improvements to the current state of information about this market.

As noted, the current state of data availability that is necessary for such robust analysis and informed observations is severely lacking. For a market that provides in excess of $100 billion annually of gross capital flow, this lack of data availability is unacceptable and requires a significant and immediate improvement. In the absence of improved information, policies would be made based on anecdotal, incomplete and, potentially, incorrect evidence and selected data and thus would be sub-optimal at best.

As a result of my analysis presented above, I propose that all provincial jurisdictions and major market participants convene and form an "exempt market data repository" to which each and every jurisdiction and all key market participants (e.g., the exempt-market dealers) would contribute structured data. It could be funded through a small fee levied on each issuer based on the issue size and type. As a first step towards this, all contributors should agree on the granularity of the data that must be collected at the origination stage and then on an ongoing basis, as well as their own roles and responsibilities. Since there are three participants at the origination stage, the data required should be specific to each participant.[54]

As a start, the issuer categorization should allow for segmentation on industry, size of the issuer, domicile of the issuer, and whether it is a reporting issuer or not. Next, the granularity at the issue level would be the size of the issue, security type (e.g., debt or equity), the main reason for the funds being raised (e.g., capital expansion, working capital, redemption or rollover of another security, etc.), duration of the security (important for debt securities, because the exempt market is being used for overnight or very short-term capital), and the restrictions on trading (to allow for identifying the liquidity risk). As noted in the main body of the paper, the current data are restricted only to issuances and there are no data about redemptions. To alleviate this deficiency, each issuer must notify the redemption of a specific issue; this would allow for understanding the gross and the net capital flows through the exempt market. Next, if intermediaries are involved in raising capital, it must be made mandatory that the costs of the intermediation be revealed.[55] The information is especially important since the role of investment funds in the exempt market has increased. This is not an unusual requirement and is currently imposed on the initial-public-offering issues. Moreover, it is imperative that these investment funds are subjected to a similar level of reporting about their own investment portfolio.[56] This information on the cost of intermediation would allow for improved understanding of the transaction efficiency of the exempt market.

Another key deficiency of the current data is a complete lack of systematic information about the investor along the lines of the specific exemption type as per Section 2 – Division 1 of the National Instrument 45-106 *Prospectus and Registration Exemptions,* September 18, 2009 Volume 32, Issue 38 (Supp-5). The most important part of this disclosure would be to further separate category-type 2.3 — "accredited investor" — into individual-investor and institutional-investor types, and then by size and type of investment. This is critical since two of the objectives of the exempt market are to increase the flow of higher-risk capital to SMEs and to expand the opportunity set for individual investors.

While the above requirements are focused on information to be assembled at the origination time, there is also a dire need for systematic data on the duration and performance of these securities, especially securities issued by non-reporting issuers, and even more importantly, equity issues issued to individual investors. One of the important characteristics of efficient capital markets is the availability of information on the performance of securities so that investors are able to assess the risk-return trade-offs and are able to make informed decisions about their future investments in similar types of securities.

[54] They are: the issuer/borrower, investor, and an intermediary (e.g., exempt-market dealer).

[55] This is not an unusual thing to ask. The proposed Client-Relationship Model 2 (CRM2) is designed to provide such information from the mutual fund industry.

[56] This will also be the case for mutual funds. Starting in July 2016, all securities commissions will require registered firms to disclose all charges incurred by the client and all other compensation received by the registered firm that relates to the client's account.

This information would also allow regulators to evaluate the required level of regulation. As such, it is imperative that such data should be forwarded by the issuer on at least an annual basis. Given that many, if not all, investments may be illiquid, these data might be quite problematic to get, since there is no market price and returns are not known until there is an exit — which may be many years after the investment is made. If no exit has taken place, this can be alleviated by requiring that the information simply say that no returns can be calculated until exit.[57]

I am aware that the provision, collection, and analysis of data all impose costs on the system and the higher the degree of detail required, the higher the cost. At the extreme, if the demand for information becomes high and costly, both parties may simply stop using that particular avenue to raise capital.[58] This is not my intent with these recommendations. I believe that if the exempt market is to claim its legitimate place in the overall capital-markets environment in Canada, it cannot do so unless all parties involved in this market, including the securities commissions and key intermediaries, come together and systematically act on providing, collecting, analyzing and reporting the required information to all participants in a way that does not impose significant new requirements for disclosure and increased costs. The data would allow for robust analysis and informed policy decisions. I am aware of the recent initiative of the Ontario Securities Commission to require issuers to provide such data and I believe that this initiative by the OSC should be welcomed; it captures many of the data points required for enriching our understanding about the exempt market.[59] I also note that the offering memorandum under the offering-memorandum exemption already provides some part of this information, so provision of this information may not be considered as extra or costly. However, I believe that there is a lot that can be done if all provincial and territorial securities commissions and key exempt-market participants collectively tackle this challenge.

Lastly, there needs to be a broader debate about the role of a securities regulator when it comes to regulating capital flows between investors and issuers. First, the regulator needs to create a clear definition of accredited, eligible or sophisticated investor; investors classified under these definitions would be expected to seek whatever information they deem necessary and would be capable of analyzing the received information prior to making an investment decision. Under this scenario, there may not be any role for a securities regulator in terms of the extent and the frequency of the information disclosure. However, the securities regulator may ask from the issuer information on the amount of funds raised, the type of security, and the rates of return, and regularly publish the results based on the analysis of the

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[57] Similar challenges exist in determining the performance of venture-capital and hedge-fund investments; however, these data are being collected and reported. In the U.S., VentureOne collects information on financing rounds that include at least one venture capital firm with US$20 million or more in assets under management. For analysis of returns, see Bruce Booth, Data Insight: Venture Capital returns and loss rates, Forbes.com, November 7, 2012, http://www.forbes.com/sites/brucebooth/2012/11/07/data-insight-venture-capital-returns-and-loss-rates/. Similarly, the TSX Private Markets platform (www.tsxprivatemarkets.com) allows approved participants on the platform to access the detailed company information, including term sheets, offering memoranda, available offerings, secondary-market quotes, and other associated documentation posted by the company. Individual registered investors and companies can access limited company information and would be notified if a posted company has a capital formation and/or secondary trading offering available, but will not be able to directly view details of those offerings. The point is that third-party groups can be asked to participate in the collection of structured data.

[58] Some have argued that in the post-Sarbanes-Oxley era, the cost of disclosure for publicly listed companies is now so high that micro-cap firms are delisting themselves from the stock exchanges and private firms are finding alternative exit avenues other than a listing on the stock exchanges.

[59] See, OSC Staff Notice 45-708, *Introduction of Electronic Report of Exempt Distribution on Form 45-106F1* (June 21, 2012). More specifically, in June 2012, the OSC launched an electronic version of the report (or "e-form") that can be filed through the OSC's website. It stated that the goal in providing an e-form is to both make it easier for filers to prepare and file the report and also to facilitate the OSC's ability to review the data contained in the report. The information required to be included in the report did not change and no new reporting requirements were added at that time. Issuers and underwriters that are required to prepare and file a report may now choose to prepare and file the report using the e-form, instead of in paper format. The electronic filing of the report became mandatory in February 2014, although it is not clear, based on the OSC's internal budget constraints, who would have access to the electronic information beyond the reports the OSC creates and distributes. Also see the March 20, 2014 OSC publication proposing new "Reports of Exempt Distribution" forms, as mentioned in Section 6 of the notice or Appendix E.

data.[60] If the results indicate that the rates of return on specific types of investments and firm types are not appropriate, investors would adjust their information requirements, conduct more due diligence, or withhold capital from these types of firms. Moreover, if investors are institutional and issuer firms are large and considered as "reporting" issuers, then the securities regulator may not impose any additional information-disclosure rules, since a considerable degree of information is already available. However, the current state of data on exempt-market transactions or experience reveals very little about what direction regulators should take while facing this "regulatory conundrum." Evidence-based regulation is critical and important not only for investors but for securities regulators, hence the greater need for useful, transparent and readily available data about the exempt market.

[60] British Columbia Securities Commission (BCSC) has implemented an automated exempt-distribution-report risk model that reviews and assesses all exempt-distribution reports for a number of high-risk factors.

About the Author

Vijay Jog is the Chancellor Professor at the Sprott School of Business at Carleton University and a leading authority in corporate finance and performance. He consults extensively for many government departments, crown corporations, and private sector firms in Canada, U.S., Caribbean, Europe and South Africa.

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