



ARE WE STAMPING OUT ENTREPRENEURSHIP IN PURSUIT OF INVESTOR PROTECTION?

Revoking the Northwest Exemption Will Impair Private Capital Markets AND the Alberta Advantage!

JONATHAN K. ALLEN
MBA, CIM, PRESIDENT
CALGARY URBAN EQUITIES

Many exempt participants are likely unaware or perhaps unmoved by recent steps by provincial regulators to revoke the Northwest Exemption. Though little used, the Northwest Exemption protects a vital tenant of the Exempt Market to which all jurisdictions west of Ontario have been a party since the Exempt Market Dealer framework was introduced in 2010.

In fact, the Northwest Exemption, known as Blanket Order 31-505 to Alberta regulators, lends important nutrients to the soil that EMDs are tilling in their efforts to cultivate good, consistent issuer dealflow and lasting investor relationships. Exempt market participants, whether dealer, representative, advisory or investor, should take careful note of the recent and planned revocation of the NWE by regulators throughout Northern and Western Canada.

Through study and business practise over the last 35 years, I have understood the profound connections between provincial securities regulation and regional economies, influencing business (and even social) cultural identities. To wit, the Alberta Advantage represents a credible, modern-day political, business (and social) identity, based largely on a historically low comparative “frictional cost” (read: government bureaucracy, taxation) of owning and running a business. This has long engendered a willingness and ability among Alberta and Canadian entrepreneurs to raise capital and begin or grow an enterprise.

An early financial innovation in Alberta, Junior Capital Pools (JCPs) – and later Capital Pool Companies (CPCs) – provided a relatively “low friction” way of raising capital by new and growing companies, who could then potentially ‘grow up’ to one of Canada’s public financial markets. Lightly regulated, they were used alongside even less formal and private investment vehicles to organize risk capital for risky projects – and our province flourished with business growth for 50 years.

So, what changed?

Alberta’s place as an economic driver of tens of billions in economic benefit to Canadians is historically rooted in its practical and permissive securities regulatory framework. The Alberta Securities Commission is a standout among provincial regulators, for policies and mechanisms which have supported public and private business risk-taking, particularly in energy, real estate and technology.

Unfortunately, for several years prior to 2007-8 when Canadian financial markets began to tremble, some very large, speculative real estate investment schemes were conceived and marketed to private investors, by mostly inexperienced and occasionally fraudulent entrepreneurs. During and after the debt crises of 2008-10, virtually all of them failed – effectively vapourizing billions of investor capital – (far too) much of it from unsophisticated or unqualified investors. Their large losses produced a predictable outcry among investors, with many (futilely) seeking protection after the fact from regulators.

In response to the public furor, the CSA introduced NI 31-103 in 2010 – appropriately targeting reforms to the marketing and distribution of exempt market securities. While regulatory oversight and market data has arguably improved, the new EMD framework has also dramatically reduced the cost advantage the Exempt Market had long held over public markets for accessing capital. This has discouraged would-be entrepreneurs, employers and investors due to higher transaction costs and other “frictional costs” – including “regulatory risk”.

At the time of its formation, and as a condition of its *ratification*, the regulators insisting on the Northwest Exemption (of which Alberta was a leading proponent) sought *specifically* to preserve business access to private, risk capital by avoiding

excessive red tape.

Despite this and ever since, the CSA and provincial securities regulators have continuously attempted to discourage its use and revoke the exemption. The BCSC tried unsuccessfully in 2013 and has now succeeded in 2018 – bringing along Manitoba, Northwest Territories, Yukon and Nunavut – quite likely as a casualty of the CSA’s national regulatory unification strategy.

Alberta, Saskatchewan and Quebec regulators are now currently considering (read: planning on?) revoking this important mechanism – the last vestige of “low friction capital” available to Canadian business people, through qualified investors, in the Exempt Market.

How Can This Be Allowed to Happen?

The ASC Notice and Request for Comments – August 15, 2018 reflects a clear bias for revoking Blanket Order 31-505 in its tone, rationale and timeframe allotted for response – not to mention highly limited circulation. The ASC’s consultation period ran a mere 35 calendar days: the last 2 weeks of August and the first 2 weeks of September. Not exactly timed for optimal response by Alberta’s small business community, most of whom have no idea that this facile exemption even exists.

EMDs are perhaps better attuned but no more likely to comment. They bear the primary burden of regulatory scrutiny of professional standards and practises and they strive to balance this with profitable dealflow. Along with regulatory risk, they have little direct financial incentive to advise either issuers or investors of the Northwest Exemption – it is outside of their sphere of influence and accountability (NI31-103), as the NWE typically reflects a more direct connection between qualified investors and the issuing enterprise.

At the same time, most regulatory bureaucracies (excepting Alberta, until recently) seem intent on eliminating the Northwest Exemption under the premise of ‘improved investor protection’ and ‘low use’. Never stated but easily inferred, however, is the bureaucratic tendency to “regulate or eliminate”.

Why Are Regulators Doing This?

In their August 2018 notice, the ASC cites “negligible impact on capital raising...represented only 0.11% of total funds raised...” (Note: no timeframe given) as its primary reason for the revocation. That’s akin to killing a honeybee because it’s small and underfoot, rather than simply leaving it alone and encouraging its reproduction and pollination tendencies.

Eliminating the Northwest Exemption due to lack of use is a weak, if not disingenuous, rationale given regulators’ enduring bias against it and the risk (yes, regulators can easily undermine any offering) this has represented to issuers in attempting to employ it. The fact that this “negligible impact” rationale was based on measurements taken during a punishing economic downturn in Alberta should also be considered – *is this really the right time to be choking off rather than supporting simpler capital raising strategies for private SME business owners?*

The ASC also cites that, “there appears to be a concerning level of non-compliance”, which sounds rather circumspect – particularly given their ‘negligible’ argument mentioned above. The non-compliance claim is not quantified but it follows that it’s a mere fraction of the “0.11% of total funds raised”. Citing this as the basis for further investor protection belies the fact that accredited investors should, and largely do comprise much of the capital source for capital raises under the Northwest Exemption. Revoking the Northwest Exemption to eliminate noncompliance would be an egregious display of regulating a market out of existence!

Are Investors Really at Greater Risk with NWE Issuers?

Alberta and the prairie region in general, were settled by risk takers and people of hardy stock. Hard work, perseverance,

risk-taking, common sense and a desire to ‘make their own way’ are hallmarks of yesterdays ranchers, today’s entrepreneurs and tomorrow’s innovators.

Many accredited investors have succeeded by taking business and financial risks that professional risk managers would consider ‘ill-advised’. It is no coincidence that many active, private investors also have significant business and professional experience, reflecting even higher risk tolerance and investment knowledge. They more naturally align with higher risk, business-specific investment opportunities, especially for higher capital growth and returns.

In parallel, investment issuers using the Northwest Exemption are much more likely to be a going concern, non-investment business – usually aligning their interests and objectives with those of the investors they’re seeking. The Northwest Exemption specifically precludes its use for the business of simply raising capital, thus it is of little use to inexperienced fund managers or fraudsters, making it less prone to significant or sustained abuse.

Is There a Better Alternative?

Now is an ideal time for the ASC to step boldly, with the support of exempt market participants, in distinguishing our province for its accommodative policies for private capital formation. Amidst the hollowing out of the Alberta Advantage that continues, seemingly unabated, there is an opportunity for the ASC to meaningfully *simplify the rules even further and increase their responsible practise by both businesses and investors*. Rather than revoking the NWE due to limited use, why not raise awareness of, and promote it *for* limited use. This simple policy mechanism, with minimal regulatory support, could be better understood and utilized to enhance and preserve the realizable value of the Alberta Advantage.

An alternative to revocation, in keeping with the goal of *investor protection*, is to advance the premise of investor qualification to include investor education, registration and accountability. Increasing investor accountability along with issuer

guidance on improving compliance, combined with the existing conditions for using the exemption, would be a far more constructive approach to maintaining a smooth and efficient market for riskier capital.

At the same time, EMDs could benefit both indirectly – by advising or referring issuers to advisors on capital raising under The Northwest Exemption – or directly through distribution support within the EMD framework. Regardless, supporting a more diverse range of legitimate products in the marketplace is a healthy philosophy for all exempt market participants. By encouraging these issuers and their early capital requirements, even indirectly, EMDs can build relationships while promoting best practises and success for issuers and investors alike.

What Can We Do?

EMDs and other exempt market participants, not to mention businesses throughout Canada and investors in general, should oppose the proposed revocation. It will constrain the free flow of private risk capital and erodes the value of the Exempt Market in Canada. Issuers and finders who access the Northwest Exemption represent a demand for capital that cannot be met effectively through the EMD framework. They are often too small or too infrequent to warrant the organizational investment necessary to profitably operate in compliance with NI31-103. Yet, in spite of this or perhaps because of it, accredited investors often prefer the more direct investment opportunities these smaller investment vehicles offer.

Continuing to nurture both issuer and investor interests by preserving the spirit and intent of the Northwest Exemption would preserve and potentially improve the functioning of private capital markets throughout Canada.

Jonathan K. Allen, MBA, CIM is President of Calgary Urban Equities Ltd., a real estate development and advisory company, and CUE Creative Services Ltd., a marketing technology and services company. Both CUE and CUE Creative are based in Calgary and operate throughout Western Canada.