The OSC's step backward in helping small and mid-sized businesses

JEROME HASS, SPECIAL TO FINANCIAL POST | February 15, 2016 3:40 PM ET

FotoliaLightwater Partners' Jerome Hass: To achieve the objectives of enhanced capital-raising for small and medium-sized enterprises, we urge the OSC to amend its proposed regulations to include investment funds.

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On Jan. 13, 2016, new regulations came into effect in Canada's largest capital market that were intended to increase access to the exempt market, both to facilitate capital-raising for small and medium-sized enterprises (SMEs) and to harmonize Ontario's regulations with the rest of the country. But don't expect to be able to "invest like the rich" in these exempt markets anytime soon, since neither objective will be fully achieved by the proposed regulations.

The Ontario government has recognized SMEs as key drivers in increasing jobs, productivity, and innovation. In order to grow and prosper, SMEs need access to capital. The province's Jobs and Prosperity Fund will put $250 million annually towards small and medium-sized businesses. But investment funds are vastly more important: In Ontario, they raise $80 billion annually in the exempt market — about 320 times more capital. And they do so despite the fact that, historically, only a tiny fraction of Canada's population, just 1.3 per cent, qualified to participate in these markets as "accredited investors."

Opening Ontario's exempt market to more Canadians by lowering income and wealth thresholds for the Offering Memorandum Exemption is long overdue, and laudable. This will allow approximately 15 per cent of the Canadian population to be eligible to participate in exempt markets. What is perplexing is the decision to explicitly exclude investment funds from most of the market access liberalizations. New exemptions are provided to all other issuers, but specifically leave out investment funds. This will prevent investment funds from using the new exemptions to raise capital the funds could then use to invest in SMEs.

Investment funds are one of the main suppliers of capital to SMEs and are also responsible for two-thirds of the capital raised in the exempt market. By excluding them from the liberalizations, the objective of making capital available to SMEs will be severely impaired. Rather than spending taxpayer dollars on government subsidies to promote productivity and innovation, we have here the opportunity for a cost-free alternative: Remove the barriers that limit the private sector's ability to provide capital to SMEs.

The large bank-owned or insurer-owned asset managers or subsidiaries of foreign-owned asset firms, by their very size, cannot focus on investing in SMEs due to their liquidity constraints. In practical terms, it is the smaller independent asset managers who focus on investing in Canadian SMEs. These managers are more likely to rely on the exempt market to raise capital. As a result of this policy to exclude investment funds, Canada's small and mid-sized businesses will continue to be denied access to capital.

The Ontario Securities Commission (OSC) justifies its decision to explicitly exclude investment funds on the basis of "investor protection." It may come as a surprise to investors — and regulators — that some exempt market products have a below-average risk profile. Under OSC rules, all securities sold in the exempt market are classified as "high-risk" investments regardless of the nature of the investment. It should be noted that the OSC chose to ignore addressing the risk level of exempt-market securities; its approach focuses on *how* these securities are distributed rather than *what* is distributed. As Canadian capital markets have evolved and developed, it is a shame that Canada's largest securities regulator has not.

Basing the decision on protecting investors is a curious argument logically, since it suggests the OSC does not deem its newly created class of "lower-threshold investors" to be sophisticated enough to purchase investment funds managed by professional portfolio managers (who are themselves regulated by the OSC). Yet this same class of investors can now become stock-pickers and purchase unlisted securities, ventures, or private limited partnerships directly in the exempt market. In other words, they can purchase these individual securities through an exemption, but they can't buy into a managed investment fund consisting of these same securities. Ironically, the new regulations direct investment flows away from registered investment professionals in favour of private issuers that are not subject to OSC registration or companies that are not subject to supervision by a stock market.

To achieve the objectives of enhanced capital-raising for small and medium-sized enterprises, we urge the OSC to amend its proposed regulations to include investment funds. Ontario's businesses deserve better.

Jerome Hass is a portfolio manager at Lightwater Partners Ltd. and a former economist and policy analyst with the Ontario Ministry of Finance.