OSC EXEMPT MARKET REVIEW
OSC NOTICE 45-712
APPENDIX C – CAPITAL RAISING IN CANADA AND THE ONTARIO EXEMPT MARKET

1. Introduction

As a securities regulator, the Ontario Securities Commission is committed to evidence-based policy development. As part of our work on new capital raising prospectus exemptions, we are researching the capital raising environment for Canadian businesses, particularly small and medium-sized enterprises (**SMEs**). We also continue to collect and analyze data on exempt market activity in Ontario. Our ongoing research and analysis will inform our work on new or additional capital raising prospectus exemptions.

This appendix summarizes some relevant findings from the research that we have conducted to date.

2. The capital raising environment for Canadian businesses

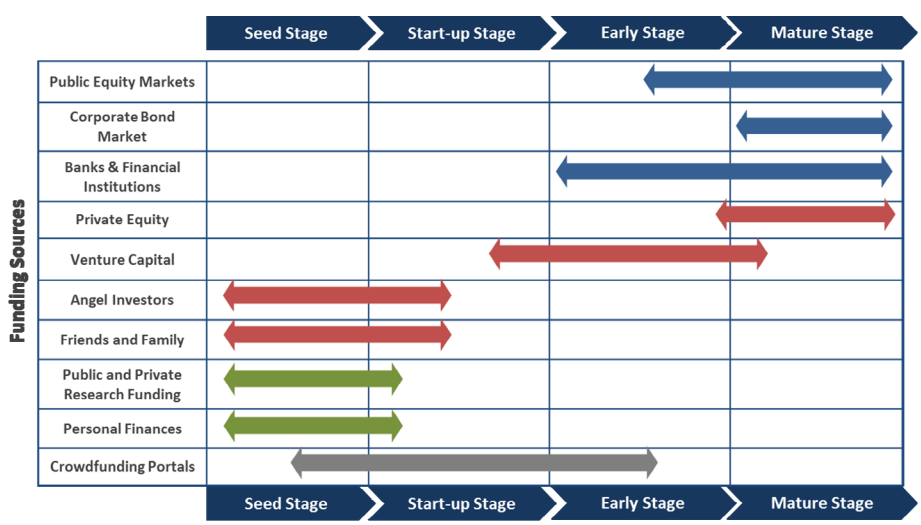
Topic	Key findings
Key external funding sources for Canadian businesses	• Based on recent data, the key external funding sources for Canadian businesses are: o bank lending, o corporate bonds and other debt securities, and o equity issuances.
Bank lending	• Credit provided to businesses by banks and other financial institutions reached $145 billion in 2012, approximately 34% of which was disbursed to SMEs in Canada.
Corporate bonds and other debt securities	• Corporate bond issuance reached an all-time high of approximately $83 billion in 2012. • In 2012, almost 75% of capital raised by issuers other than investment funds in the Ontario exempt market was raised through the issuance of some form of debt securities.
Equity issuances	• Issuers listed on the Toronto Stock Exchange (**TSX**) and TSX Venture Exchange (**TSXV**) raised approximately $51 billion in 2012, representing a 13% increase from the previous year. However, the amount of equity capital raised by new issuers (i.e. initial public offerings (**IPOs**)) continues to decline and represented less than 5% of the total capital raised in the public equity markets in 2012. • Equity capital raised by reporting issuers through supplementary public offerings and private placements continued to represent the majority of capital raised by issuers listed on the TSX and TSXV. • Private placements are an important method through which listed issuers, especially those listed on the TSXV, raise capital. However, the proportion of capital raised by issuers listed on the TSXV in this manner has declined from 88% in 2007 to 67% in 2012. • In 2012, approximately $7 billion was raised in the Ontario exempt market through the issuance of equity by issuers other than investment funds. Non-reporting issuers raised close to 80% of that amount.

Topic	Key findings
Venture capital	• Venture capital firms have raised and invested less than $2 billion annually in the last five years, with an increasing focus on later-stage deals and also on deals with smaller investment sizes of under $1 million.
Key sources of SME funding	• Based on recent data, SMEs primarily rely on internal or personal financing. For SMEs that obtain external financing, banks and credit unions are the two top sources. SMEs seek and obtain this type of debt financing more often than equity financing. • Nevertheless, equity is an important source of capital for SMEs. In the case of smaller SMEs that obtained external financing, the average amount of equity financing obtained exceeded the average amount of debt that the SME could access through borrowing.
SME funding constraints	• There is evidence that SMEs in the innovation sector (i.e., idea-based or R&D intensive businesses) may face funding constraints at the pre-commercialization or early stages of development. Some possible factors that may contribute to this situation are: o limited availability of bank lending due to lack of cash flows or collateral, and o challenges in attracting venture capital due to lack of proven technologies and markets.

A. Overview of potential funding sources

Canadian businesses raise capital to fund their operations from a variety of sources. The level of reliance on different funding sources may change as a business grows and develops. Figure 1 provides an illustrative and highly simplified map of potential funding sources along the various stages of a company's development, from funding an idea in the seed stage to financing a full market expansion in the mature stage.

Figure 1: Potential sources of financing by stage of development

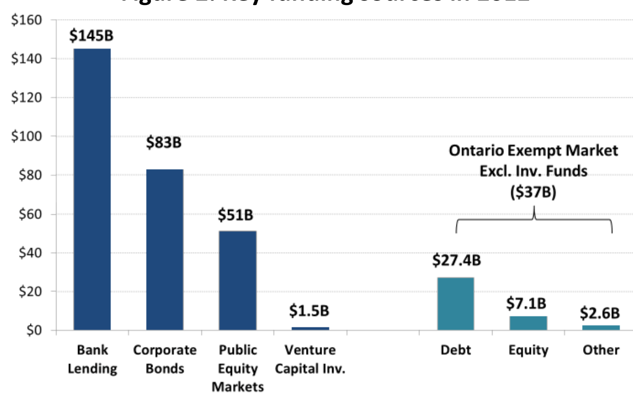


B. Key external funding sources for Canadian business

In 2012, the key external funding sources for Canadian businesses were, in order of importance:

- bank lending,
- corporate bonds and other debt securities, and
- equity issuances.

Figure 2: Key funding sources in 2012



Notes:

1. There are overlaps in amounts reported. Capital raised through public equity markets include private placements which are also reported through exempt distribution filings in Ontario. Similarly, some portion of corporate bonds may include issuances of debt through the exempt market.
2. For purposes of assessing capital raising by businesses, the total amount raised in the Ontario exempt market excludes filings of exempt distributions by investment fund issuers. We note that this amount could be larger since it does not include capital raised through the exempt market in other provinces or account for the capital raised under the private issuer exemption or control person exemption, neither of which requires a report of exempt distribution to be filed with the OSC.

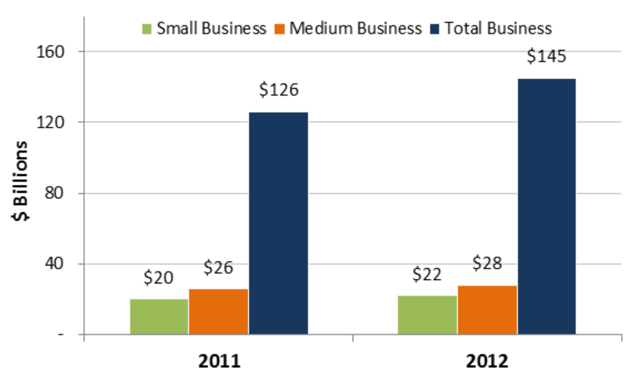
Source: Statistics Canada, Industry Canada, OSC filings.

The following sections provide more detail regarding these key funding sources, as well as a discussion of venture capital.

Bank lending

Banks and other financial institutions lent Canadian businesses approximately $145 billion in 2012. Approximately 34% ($50 billion) of that amount was issued to SMEs that had debt (loan) authorization limits of less than $5 million.[1]

Figure 3: Credit from banks and other financial institutions

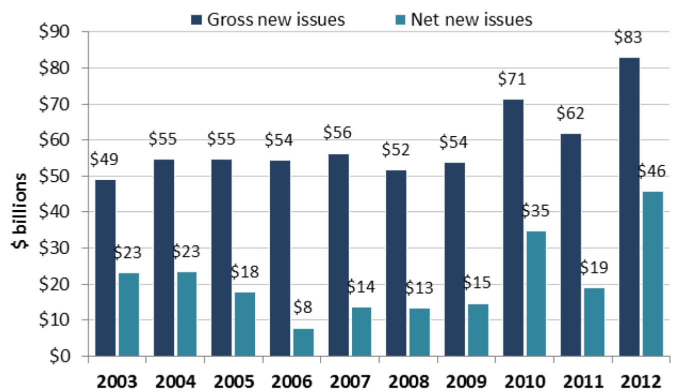


Source: Statistics Canada.

[1] For purposes of the *Biannual Survey of Suppliers of Business Financing*, Industry Canada categorizes businesses with debt authorizations of less than $1 million as small businesses and those with debt authorization levels of between $1 million and less than $5 million as medium-sized.

Corporate bonds and other debt securities
Corporate bond issuance in Canada reached an all-time high of approximately $83 billion in 2012.

Figure 4: Corporate bond issuance in Canada



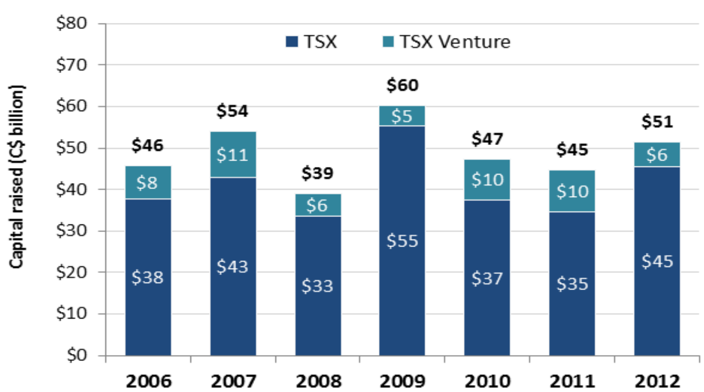
Source: Statistics Canada.

In 2012, almost 75% of capital raised by issuers other than investment funds in the Ontario exempt market was raised through the issuance of some form of debt securities (see Figure 23).

Equity issuances

Listed issuers
In 2012, issuers listed on the TSX and TSXV raised a total of $51 billion in equity. TSXV-listed issuers raised $6 billion of that amount.[2]

Figure 5: Total equity capital raised on TSX and TSXV

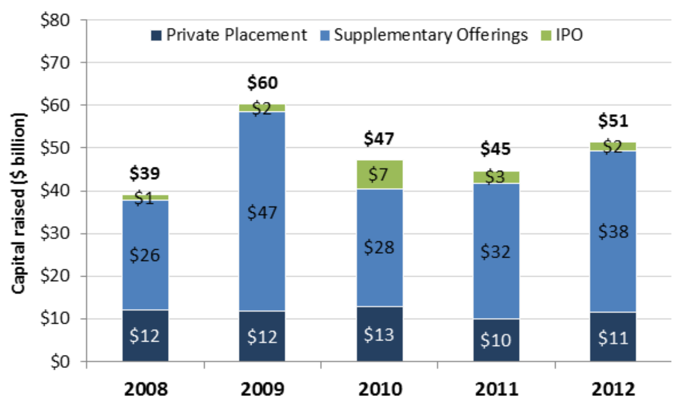


Source: TMX, Market Intelligence Group Report.

2 In addition to the $51 billion raised by issuers in 2012, approximately $5.1 billion was raised by structured products and exchange-traded funds on the TSX.

The majority of equity capital raised was through offerings in the public market (supplementary offerings and IPOs). Private placements represented 22% of the total capital raised by listed issuers in 2012.

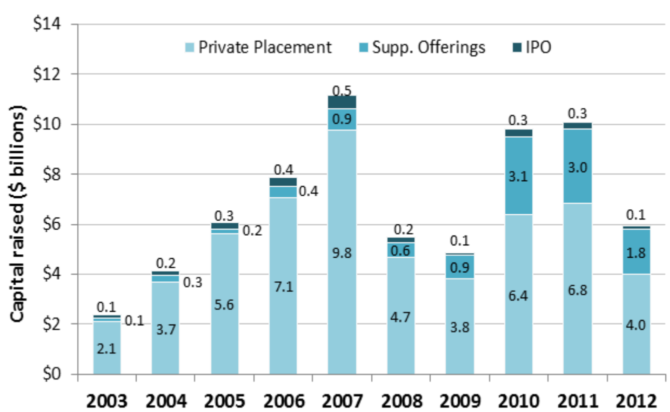
Figure 6: Total equity capital raised on TSX and TSXV
By type of offering



Source: TMX, Market Intelligence Group Report.

For junior issuers listed on the TSXV the proportion of capital raised from private placements has decreased from 88% in 2007 to 67% in 2012.

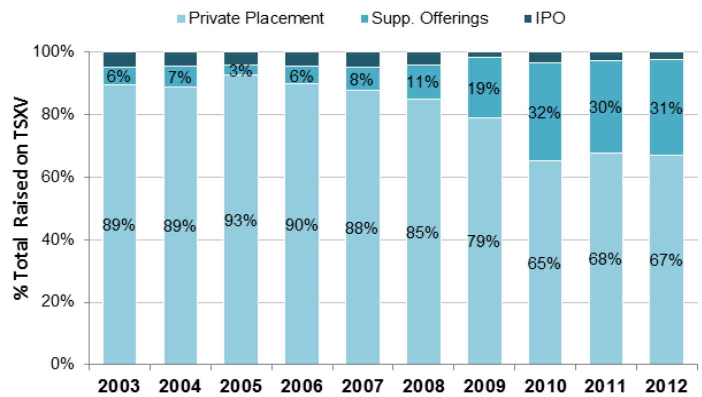
Figure 7: Equity capital raised on TSXV by type of offering



Source: TMX, Market Intelligence Group Report.

Equity capital raised by existing issuers listed on the TSXV through supplementary public offerings has increased significantly since 2008, from 11% of the total capital raised by issuers listed on the TSXV to approximately 31% in 2012.

Figure 8: Breakdown of equity capital raised on TSXV



Source: TMX, Market Intelligence Group Report.

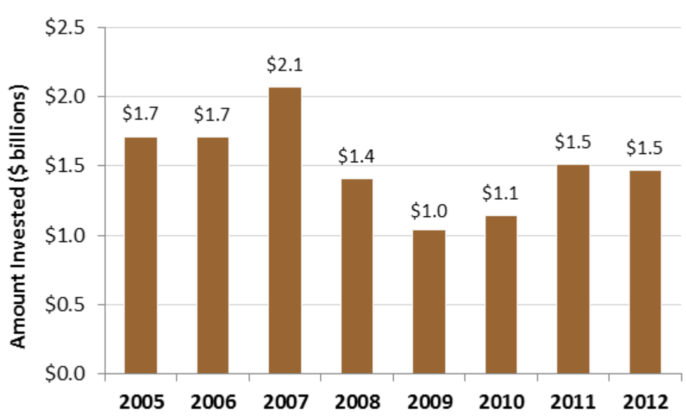
Non-reporting issuers

In the Ontario exempt market, approximately $7 billion of equity capital was raised by issuers other than investment funds and the majority (80%) of this amount was raised by non-reporting issuers.

Venture capital

Total capital invested by Canadian venture capital firms remains below pre-crisis levels. In 2012, approximately $1.5 billion was invested by venture capital firms in Canadian businesses.

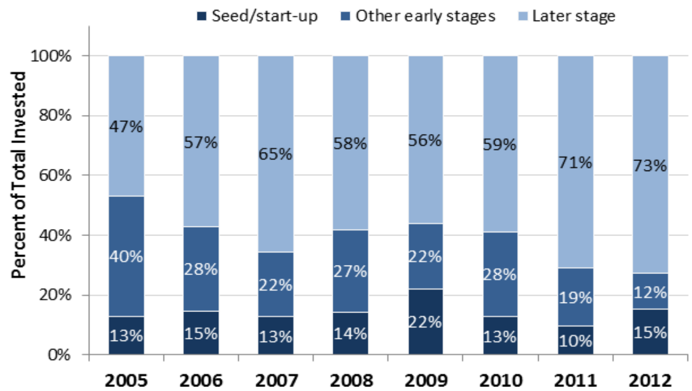
Figure 9: Amount invested by venture capital firms in Canada



Source: Industry Canada, Venture Capital Monitor and Thomson Reuters Canada.

Canadian venture capital firms have become more conservative, concentrating their investments in later-stage deals, which attracted approximately 73% of all investment dollars in 2012.

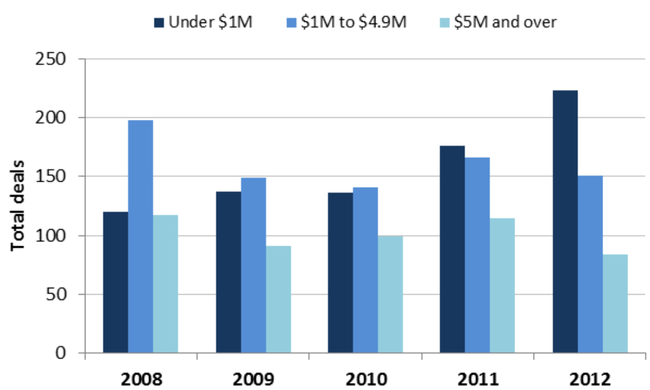
Figure 10: Breakdown of venture capital investment dollars By stage of development



Source: Industry Canada, Venture Capital Monitor and Thomson Reuters Canada.

In the last few years, Canadian venture capital firms also have been participating in more deals with smaller investment sizes. In 2012, venture capital firms invested in 223 deals with investment sizes of under $1 million, which represented 49% of all deals made that year.

Figure 11: Distribution of venture capital deals by investment size



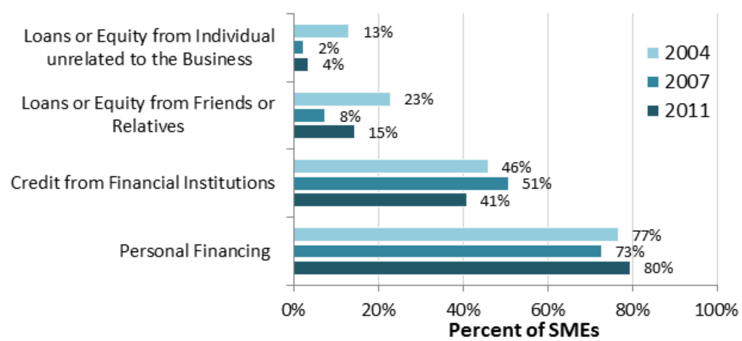
Source: Industry Canada, Venture Capital Monitor and Thomson Reuters Canada.

C. Key sources of SME financing

We reviewed data from a survey conducted by Statistics Canada on the financing and growth of SMEs[3] in 2004, 2007 and 2011 to better understand the key sources of financing for SMEs. The survey was completed by a representative sample of active SMEs[4] in Canada that are listed in Statistics Canada's Business Register.[5] In 2011, more than 80% of SMEs in the sample were businesses with less than 20 employees and approximately 5% of the businesses were less than two years old.

At the start-up stage, personal finances were the most relied upon source of funds for starting a business followed by credit from financial institutions. Loans or equity financing from friends or relatives were relied on by more SMEs than loans and equity financing from unrelated sources.

Figure 12: Sources of financing relied on by SMEs to start up a business



Source: Statistics Canada, Industry Canada Survey on Financing of Small and Medium Enterprises, 2004, 2007, 2011

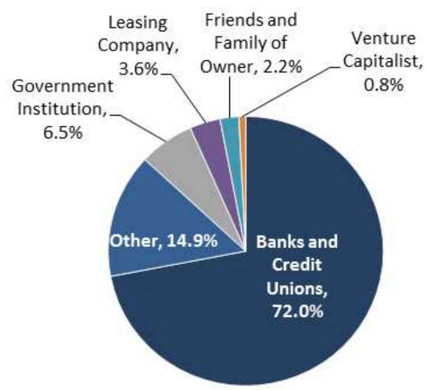
3 According to Industry Canada, companies with less than 500 employees and annual revenues of less than $50 million are considered SMEs.

4 Statistics Canada's Business Register is used as the survey frame for the target population, which excludes enterprises with 0 or 500 or more employees, with over $50 million in gross annual revenue and enterprises coded as being non-profit, cooperatives, joint ventures, and municipal/federal government. Financing and leasing companies, co-operatives, subsidiaries, non-profit organisations, government offices, schools, hospitals and other public sector organisations are also not covered by the survey. The sample size for the 2011 survey was 25,007 businesses and generated a completion rate of 39.8% or 9,957 respondents. The sample was stratified by region, industry type, size, age of business and participation in the *Canadian Small Business Financing Act* guarantee program.

5 The Business Register includes a list of active businesses in Canada that have been assigned a NAICS code and meet at least one of the following criteria:
- is an employer (i.e., has employees),
- is a corporate tax filer (T2),
- is a GST registrant with sales greater than $0,
- an individual has filed a tax return (T1) showing business revenue greater than $0, or
- shows evidence (obtained via profiling activities) of size).

Past the start-up stage, SMEs continued to rely primarily on internal or personal financing, with only 36% of SMEs seeking external financing in 2011.[6] Banks and credit unions were the top two sources of funding for SMEs in 2011. They provided funds to approximately 72% of SMEs that requested external financing.

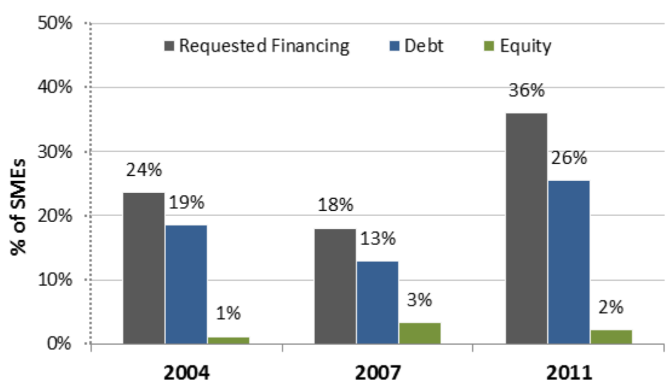
Figure 13: Providers of external financing for SMEs in 2011



Source: Statistics Canada, Industry Canada Survey on Financing of Small and Medium Enterprises, 2011.

Consistent with the above, SMEs requested debt financing[7] approximately 10 times more often than equity financing in 2011.

Figure 14: SMEs that requested external financing – debt vs. equity



Source: Statistics Canada, Industry Canada Survey on Financing of Small and Medium Enterprises, 2004, 2007, 2011. Note: Chart does not show other forms of external financing requested such as lease, trade credit and government financing.

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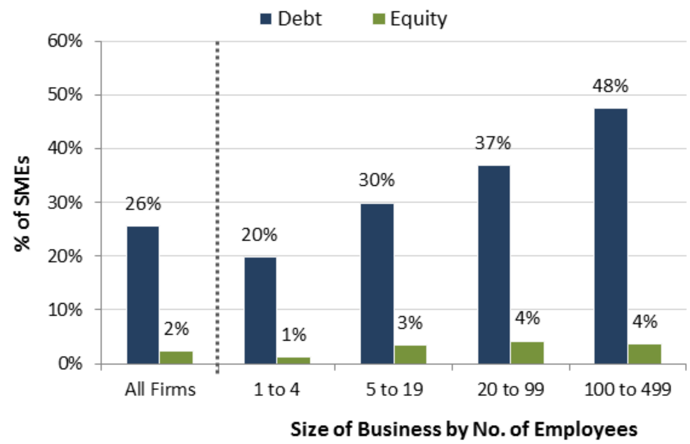
6 Among SMEs that did not seek external financing, the majority or 88% indicated that no financing was required and less than 5% indicated that they did not seek financing because it was too costly or difficult to obtain.

7 Debt financing includes term loans, non-residential mortgages, business lines of credit or business credit cards.

Larger SMEs were more likely to seek external financing (either debt or equity) than smaller SMEs.

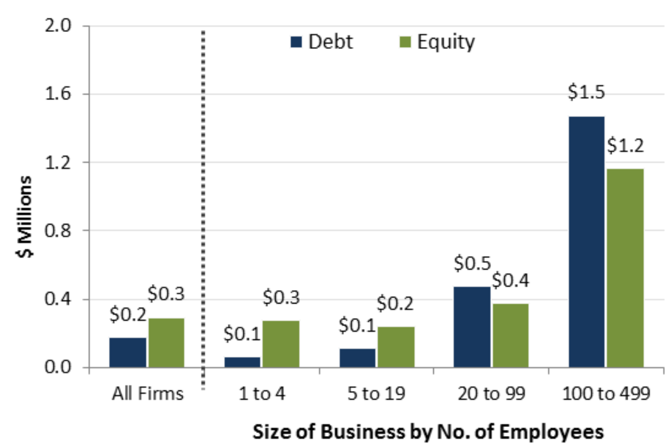
Figure 15: Percentage of SMEs that requested debt vs. equity financing in 2011



Source: Statistics Canada, Industry Canada Survey on Financing of Small and Medium Enterprises, 2011.

However, despite SMEs seeking and obtaining more debt than equity financing, the average amount of equity financing provided per SME slightly exceeded the average level of debt authorized (i.e., the amount the SME was authorized to borrow from a lender). In the case of smaller SMEs with less than 20 employees (who represented approximately 80% of all SMEs surveyed), the average amount of equity financing obtained significantly exceeded the average level of debt authorized.

Figure 16: Average of largest debt authorized vs. average equity provided to SMEs in 2011



Source: Statistics Canada, Industry Canada Survey on Financing of Small and Medium Enterprises, 2011.

D. SME funding constraints

Based on the data from Statistics Canada, among SMEs that did not request external financing (64% of all SMEs in 2011), only a minority (less than 5%) indicated that they did not seek external financing because it was too costly or difficult to obtain. The majority (88%) said that they did not require financing.

However, the Statistics Canada data may not represent all start-ups, especially those with no revenues or that do not meet the requirements for inclusion in the Business Register. A lack of granular information and uncertainty about the viability of individual businesses makes it difficult to assess whether start-up growth is subject to financing constraints, business management challenges or both. Nevertheless, there is some evidence indicating that SMEs in the innovation sector (i.e., idea-based or R&D intensive businesses) may face funding constraints at the pre-commercialization or early stage.[8] Some possible factors that may contribute to this situation are:

- limited availability of bank lending, and
- challenges in attracting venture capital.

Limited availability of bank lending
Banks often are not suited to providing financing to SMEs in the innovation sector. Banks want to ensure that repayment of their loans is given priority should a company become insolvent, and therefore look for cash flows or collateral to secure repayment. Idea-based or R&D-intensive firms, however, may not be in a position to satisfy these bank requirements, thus limiting their access to bank lending.

Challenges in attracting venture capital
In Canada, venture capital firms over the last five years have invested less than $2 billion annually in businesses and have been more focused on lower risk, later-stage deals with proven technologies and markets. As a result, SMEs at the earlier and higher-risk stages of development may have difficulty attracting venture capital.

3. Exempt market activity in Ontario in 2012[9]

Relevant findings

- The exempt market continues to be an important part of Ontario's capital markets.

- Since 2009, the amount of capital raised in the exempt market has consistently increased. Approximately $104 billion was raised in the exempt market in Ontario in 2012, an increase of approximately 20% from 2011.

- While investment funds consistently raise the largest proportion of funds, issuers other than investment funds also raise a significant amount of funds. In 2012, the amount of capital raised by issuers other than investment funds increased 32% from 2011 to $37 billion, and the percentage of total capital raised by these issuers in the exempt market increased from 32% to 36%.

- Most of the capital raised by issuers other than investment funds was:
    - raised by non-reporting issuers (69% of capital raised), although the proportion raised by reporting issuers has slightly increased compared to previous years,
    - in the form of debt securities (74% of capital raised), and
    - by issuers that raised greater than $100 million (64% of capital raised) per distribution reported.

- The accredited investor exemption remains the most used prospectus exemption, accounting for approximately $94 billion or 90% of the total raised in the exempt market.

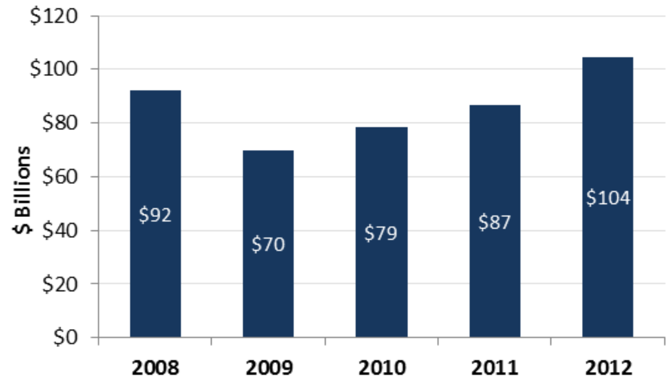
[8] Michael Grant, "Financing Innovation by Established Businesses in Canada", online: The Conference Board of Canada <http://www.conference.board.ca>; Sorin Cohn, "Beyond R&D: Gaining Economic Value Through Effective Commercialization of Innovations", online: Canadian Advanced Technology Alliance <http://www.cata.ca/files/PDF/2012/Draft-ExecutiveSummary-of-Commercialization-Study-SCohn-24March2012.pdf>; The Innovation Chain, *The Funding Gap*, online: Sustainable Development Technology Canada <http://www.sdtc.ca/index.php?page=the-funding-gap&hl=en_CA>.

[9] We note that this exempt market data is limited because it is based on reports of exempt distribution filed with the OSC. Only specified prospectus exemptions trigger a requirement to file a report. As a result, this data does not capture all exempt market activity.

A. Size of the exempt market

In 2012, approximately $104 billion was raised through reported distributions in the exempt market in Ontario, an increase of 19.5% from 2011. We note that not all capital raised in the exempt market was raised by Canadian issuers and owing to data limitations, we are unable to estimate the percent raised by foreign issuers.

Figure 17: Exempt market capital raised in Ontario



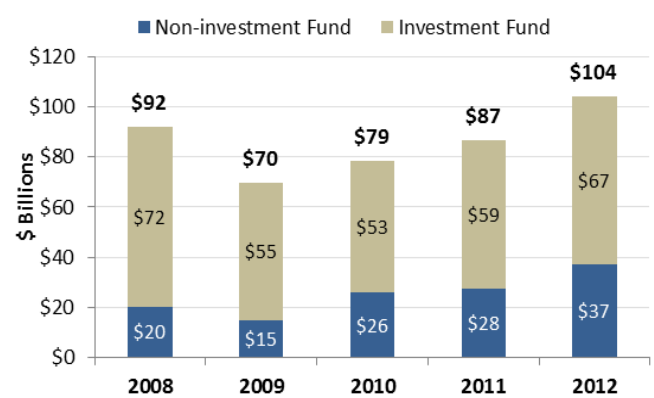
Source: OSC filings.

B. Investment funds versus issuers other than investment funds

Investment funds[10] accounted for approximately 64% of the total capital raised in the exempt market in Ontario in 2012 (or $67 billion). This represented a 14% increase from 2011.

The amount of capital raised by issuers other than investment funds increased 32% from 2011 to $37 billion.

Figure 18: Ontario exempt market capital raised
Investment fund vs. non-investment fund



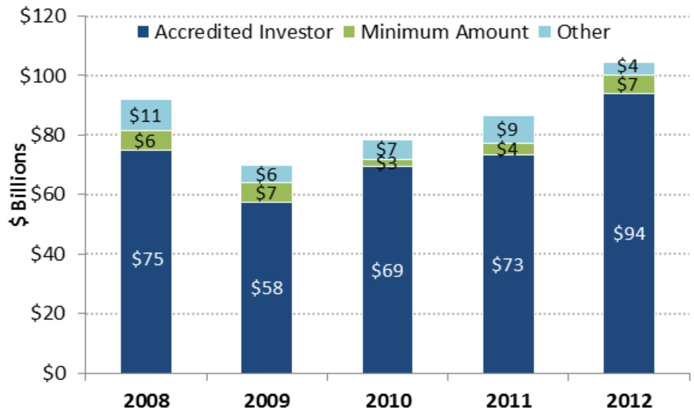
Source: OSC filings.

[10] We note that the data for distributions of investment fund securities reflects distributions to both individual and institutional investors of both public and private investment fund securities. We also note that this data reflects purchases and not redemptions of investment fund securities.

C. Use of the accredited investor and minimum amount exemptions

In 2012, approximately $94 billion was raised in Ontario under the accredited investor prospectus exemption and approximately $7 billion was raised under the minimum amount prospectus exemption.

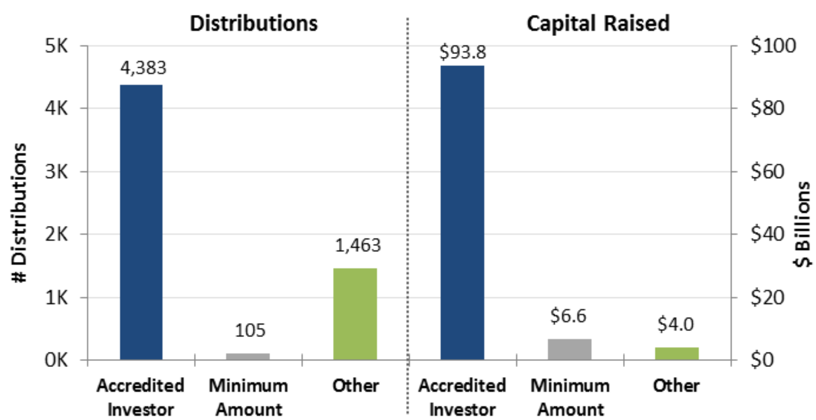
Figure 19: Ontario exempt market capital raised
By exemption type



Source: OSC filings.

The accredited investor exemption remains the most commonly used prospectus exemption by amount raised and number of distributions.

Figure 20: 2012 Distributions and capital raised in Ontario

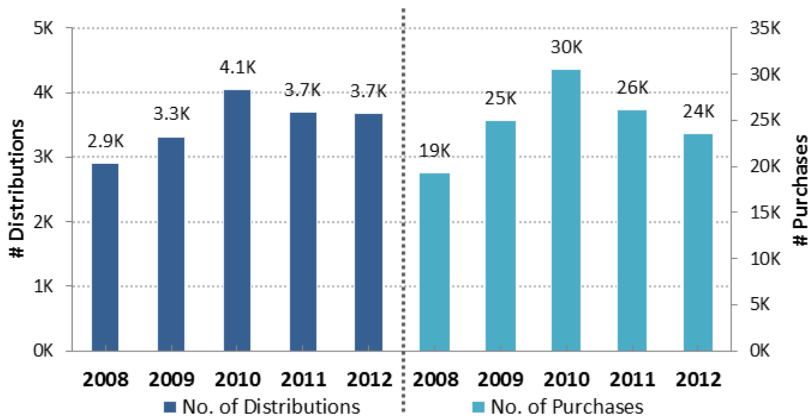


Source: OSC filings.

D. Exempt market activity by issuers other than investment funds

In 2012, 3,680 distributions by issuers other than investment funds were reported to the OSC, involving approximately 23,545 purchases from Ontario investors.

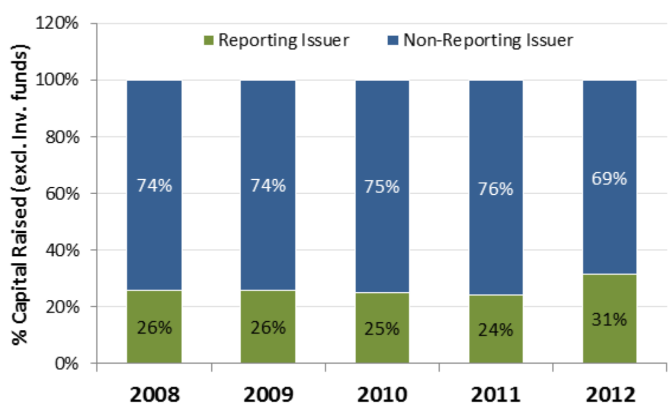
Figure 21: Ontario exempt market activity (excluding investment funds)
Number of distributions and purchases



Note: Filings of exempt distribution reports with zero dollar values were excluded from the analysis.
Source: OSC filings.

In 2012, approximately 69% of the capital raised in Ontario by issuers other than investment funds was raised by non-reporting issuers (such as private companies). There has been a slight increase in the proportion of capital raised by reporting issuers that are not investment funds.

Figure 22: Ontario capital raised (excluding investment funds)
Reporting vs. non-reporting issuers

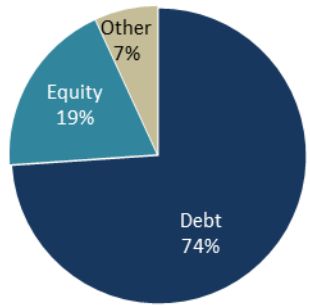


Source: OSC filings.

E. Type of securities offered by issuers other than investment funds

Approximately 74% of the capital raised in Ontario by issuers other than investment funds was raised through the issuance of a debt-related security. The breakdown by type of security is similar for both reporting and non-reporting issuers.

Figure 23: 2012 Ontario capital raised (excluding investment funds) by asset class



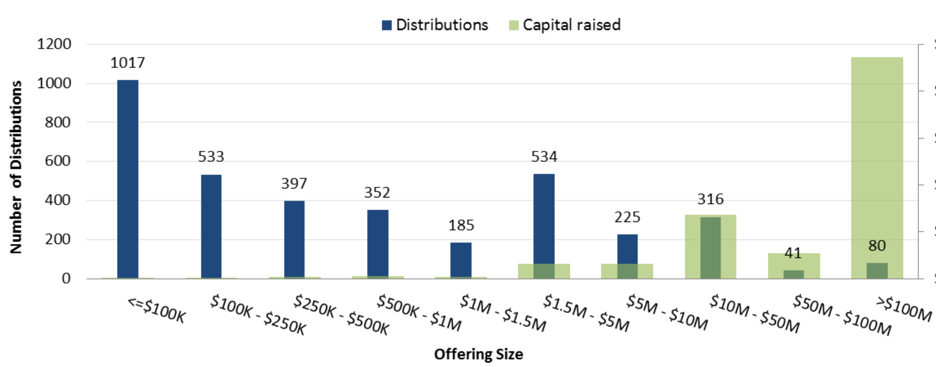
Note: Securities classified under "Debt" include notes, bonds, debentures, loans, promissory notes and certificates issued as part of mortgage related securitizations. Securities classified under "Equity" include common shares, preferred shares, limited partnership interest, warrants, flow-through shares, American depository shares, and stock options.

Source: OSC filings.

F. Comparison of offering size by issuers other than investment funds

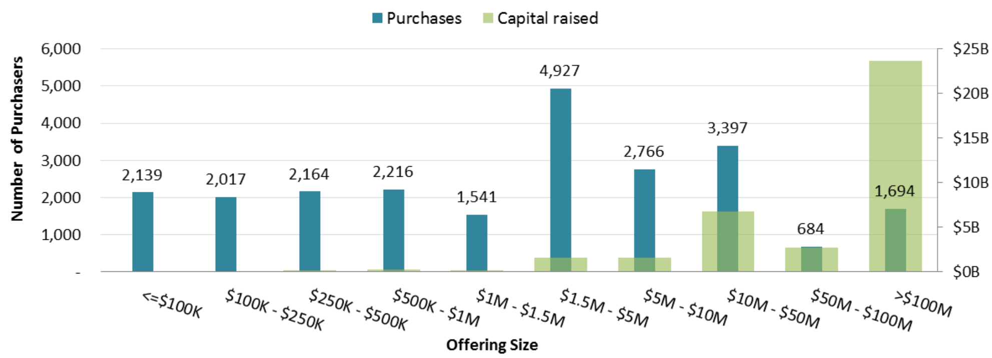
The majority of capital raised in the Ontario exempt market in 2012 was by relatively larger issuers seeking large sums of capital from a disproportionately smaller group of investors. Approximately, 2% of all distributions by issuers other than investment funds had offering sizes of greater than $100 million. These distributions accounted for 7% of purchases but represented approximately 64% of the total capital raised in Ontario by issuers other than investment funds.

Figure 24: Number of distributions by offering size



Source: OSC filings.

Figure 25: Number of purchases by offering size



Source: OSC filings.