

Canadian Securities Administrators C/O:

Anne-Marie Beaudoin, Corporate Secretary  
Autorité des marchés financiers  
Tour de la Bourse 800, square Victoria  
C.P. 246, 22e étage  
Montréal, Québec H4Z 1G3

AND:

The Secretary  
Ontario Securities Commission  
20 Queen Street West  
Suite 1900, Box 55  
Toronto, Ontario M5H 3S8

July 12, 2013

Dear Mesdames/Sirs:

Re: PROPOSED AMENDMENTS TO  
NATIONAL INSTRUMENT 62-103 EARLY WARNING SYSTEM

I appreciate this opportunity to comment on the proposal by the Canadian Securities Administrators to amend the early warning system established in National Instrument 62-103.

Based on my 12 years as a small cap portfolio manager in Canada, I have grave concerns that the proposed changes will materially reduce the capital available to small and medium sized companies in Canada from institutions and other large investors, and that all participants and beneficiaries of the small cap capital markets (including the Canadian economy more broadly) will be harmed. Participants that will feel the knock-on effects of the proposed measure include: small cap fund managers (whose regulatory burden in terms of time and money spent will increase materially); the boutique investment dealers whose primary business is raising institutional capital for small cap companies and trading small cap stocks on behalf of institutions; the stock exchanges (who will suffer accelerated de-listings in the small cap segment, where—according to CIBC—companies with a market cap under \$500million represents over 90% of listings in Canada); the boutique law firms whose primary market is servicing the needs of publicly listed small cap companies; and—*most importantly*—the small

cap companies themselves, who will lose a critical source of investment capital and market liquidity.

For the reasons above, and those described in greater detail below, I submit that the public interest would not be served by implementing the key features of the proposals for small and medium capitalization companies. I would welcome the opportunity to speak with anyone at the CSA or OSC in more detail about the issues I have highlighted in this letter, and why I believe the knock-on effects of the new reporting regime—if applied to small cap stocks—would be so negative and so far-reaching on so many participants.

### **An elaboration on two specific points**

I and many of my colleagues in the small cap markets have numerous concerns, including:

- Many institutional investors currently limit themselves to owning less than 10% of a company as a matter of internal policy. In the event that the threshold is reduced from 10% to 5%, these investors will sell half of their holdings in each portfolio company to avoid application of the new limit. This will have a devastating impact on the share prices, cost of capital, and access to capital for these companies.
- Lowering the reporting threshold from 10% to 5% will have the impact of effectively doubling the minimum market cap threshold that many institutions will use in their investment policies, thereby cutting many small cap companies off from an important source of capital, and causing a permanent reduction in trading liquidity within the small cap space.

The following thought experiment will help to illustrate this problem:

Assume that you are the portfolio manager of a \$1billion small cap fund (such as might exist at an institution like CI or Mackenzie, or Front Street Capital). Assume also that you are trying to keep the portfolio to a maximum of 50 positions, and that, as a matter of internal policy, you will not take a position in a company which requires you to report—at this point, that limits you to 9.9% ownership in a company. At this point, that means that your average position size in the portfolio is \$20million (because  $50 \times \$20\text{million} = \$1\text{billion}$ ), and that the smallest company you can invest in has a \$200million market cap (because \$20million is 10% of \$200million). Now let's calculate the impact of having the reporting threshold lowered to 5%: all of a sudden, the smallest company you can invest in is a company with a \$400million market cap (because the smallest possible position size--\$20million--is 5% of \$400million). *KEY POINT: looking at this broadly, lowering the reporting threshold will cut off a broad swath of companies from being able to access institutional capital.* For the fund in this thought experiment: the new reporting rules would mean that companies below

\$400million market cap would not have access to capital from this institution, versus a threshold of \$200million market cap before the new rule.

The exodus of institutional capital from the small cap market caused by the proposed rule would have severe, long-lasting impact on many participants in the small cap market (and ultimately the economy) in Canada, including: the companies themselves; the boutique investment banks (for whom the primary activity is raising money for small cap companies from institutions); the law firms who serve these small cap companies and boutique dealers; and even the exchanges themselves—primarily the TSX Venture Exchange. *(Keep in mind that, according to CIBC, of approximately 4,000 listed companies in Canada, only about 260 have market capitalizations above \$500million.)* The bottom-line is that if these rules are implemented, it is not too much of a stretch to postulate that institutional participation in the sub-\$500million market cap space will all but vanish within a fairly short period of time, with devastating consequences for the health of a wide variety of players, including—most importantly--the small cap companies themselves.

## **Recommendations**

I understand that recent episodes with companies like Telus and CP (where large activist US hedge funds intending to disrupt existing management and Board structures were able to accumulate large positions in these mega-cap companies without detection) argue for bringing US reporting rules into Canada for large companies. I would argue, however, that the market structure in the small cap market in Canada gives rise to imperatives and circumstances which argue for some parameters being applied which would allow the existing reporting rules to continue operating in certain markets and with companies below some pre-determined size.

My suggestion, respectfully submitted, has two features:

- 1) Issuers listed on the CSNX and the TSX Venture Exchange would continue to be subject to the existing reporting regime.
- 2) A market capitalization threshold would be established for TSX listed companies so that large/mega cap companies would be subject to the new reporting regime (thereby solving the issues highlighted by the Telus and CP situations), but TSX listed companies below a specified market cap threshold (for example, \$500million) would not be subject to the new regime, and would continue to be subject to the existing rules. (It would be simple to apply a cut-off value as of December 31 in each year and therefore easy for investors to identify the companies that are subject to the new reporting levels and those that are not.)

A quotation from CNSX Markets' submission on this subject is relevant here:

“Although this approach would sharply narrow the number of companies subject to the new reporting rules, it would be consistent with the aims set out by the CSA for the reforms. Consistency in approach with our major trading partners is a laudable goal, but only when dealing with comparable circumstances. The fact of the matter is that neither the US nor the UK has a robust equity capital formation system in place for early stage companies.” Applying the proposed rules to Canada’s publicly listed small cap companies will, I contend, have the unintended consequence of largely dismantling Canada’s equity capital formation system for small and early stage companies.

I reiterate that I would welcome the opportunity to speak with anyone at the CSA or OSC in more detail about the issues I have highlighted in this letter, and why I believe the knock-on effects of the new reporting regime—if applied to small cap stocks—would be so negative and so far-reaching on so many participants.

Thank you for considering this submission.

Hugh C. Cleland, CFA

Portfolio Manager and Executive Vice President

BluMont Capital Corporation