The Listed Issuer Financing Exemption – An Early Holiday Gift?

"Noli equi dentes inspicere donati" (Never Look a Gift Horse in the Mouth) – Common Proverb

The Canadian Securities Administrators (CSA) introduced the *Listed Issuer Financing Exemption* which allows eligible reporting issuers to issue free trading stock as a part of a private placement transaction without the need for a prospectus. This looks like a "gift" to the Canadian Small Cap space...

- **The new Listed Issuer Financing Exemption allows the sale of "free trading" equities to institutional, as well as retail investors, in connection with private placement financings.** With this Listed Issuer Financing Exemption, Canadian reporting issuers can now issue free trading stock as a part of a private placement financing WITHOUT the need for a prospectus. For those who are eligible, this eliminates the 4-month hold requirements and should provide issuers greater access to capital, at a significant cost savings. As per amendments to the National Instrument 45-106, this new prospectus exemption is expected to come into effect on November 21, 2022.

- **Why Are the Securities Regulators Doing This? Reason #1: They are Simply Allowing Small Cap Issuers to "Save Time and Money".** While the timeline for a prospectus offering can be lengthy, the associated costs can also be an impediment to raising capital. According to the SEDAR agency fee list, the costs associated with filing a preliminary prospectus, a preliminary base shelf prospectus, a preliminary base PREP prospectus or a pro-forma prospectus can range from a low of $4,250 to over $105,000 depending on the jurisdiction in Canada! Please note that these costs are all in addition to the fees due to the exchanges, securities dealers, accounting firms, and law firms for the preparation, execution and filing of these documents.

- **Why Are the Securities Regulators Doing This? Reason #2: This Will Make Certain Small Cap Capital Raises More Attractive to Buyers.** According to traditional investment theory, Small Cap stocks should outperform the broader indices given their ability to provide above-market revenue and earnings growth. That, coupled with their relative illiquidity and general lack of market understanding, provide inefficiencies that lead to lower valuations, making them very attractive investment opportunities. However, after decades of Small Cap outperformance due to the "size effect", Small Cap stocks have actually UNDERPERFORMED the Large Cap peers and the broader markets since the original discovery of the size effect back in 1981. By providing an alternative to the traditional private placement structure, and allowing freely tradable securities, the regulators have effectively expanded the investor base for Canadian Small Cap issuers.

- **The new Listed Issuer Financing Exemption Should Result in Lower Discounts on Small Cap Capital Raises.** Under the current regulation, when an issuer offers securities to accredited investors via a private placement, the underlying shares usually come at a significant discount to market to compensate the buyers for the restrictive nature of the newly issued shares. Depending on the securities regulator, the maximum discount on the shares could be as high as 25%. With the Listed Issuer Financing Exemption, issuers will have broader public market access and will be able to issue "free trading" shares, which should result in smaller price discounts on these financings.

- **The Case for the Canadian Small Cap Issuer.** As per above, Small Caps have underperformed the Large Caps over a long-time horizon; however, there are still reasons for investors to own Canadian Small Cap stocks, especially in the right environment. While Small Caps tend to underperform during market corrections, they tend to outperform during market rallies. During the market corrections in 2007-2009, 2014-2016 and 2020, the S&P/TSX Composite Index was down 44%, 24% and 37%, while the S&P/TSX Small Cap Index was down 60%, 39% and 46% respectively. However, during the market rallies in 2009-2011, 2016-2017 and 2020-2022, the S&P/TSX Composite Index was up 80%, 34%, and 96% while the S&P/TSX Small Cap Index outperformed posting gains of 156%, 63% and 166% respectively. While we are likely headed into a recession, if we aren't there already, the market tends to be forward looking, so now could be the perfect time to invest in Canadian small caps.

Macro Overview

According to the new "Listed Issuer Financing Exemption" Eligible Issuers can now issue "free trading" stock as part of a private placement WITHOUT a prospectus…

On September 8, 2022, the Canadian Securities Administrators (CSA) announced the amendment of National Instrument 45-106 Prospectus Exemptions (NI 45-106) to introduce a new prospectus exemption available to reporting issuers that are listed on a Canadian stock exchange. This new exemption, called the Listed Issuer Financing Exemption, allows eligible reporting issuers to issue free trading stock as a part of a private placement financing without the need for a prospectus. Simply stated, this new Listed Issuer Financing Exemption allows the sale of "free trading" stock to institutional, as well as retail investors, in connection with private placements. Yes, that is correct. With this Listed Issuer Financing Exemption, Canadian reporting issuers can now issue free trading stock as a part of a private placement financing WITHOUT the need for a prospectus. For those who are eligible, this eliminates the 4-month hold requirement and should provide these issuers greater access to capital at significant cost savings. As per amendments to the National Instrument 45-106, this new prospectus exemption is expected to come into effect on November 21, 2022.[1] This should be a "boon" for small cap issuers looking to raise capital more efficiently and effectively.

*"Following this work, the CSA developed the Listed Issuer Financing Exemption, a prospectus exemption for small offerings that, although available to all issuers, would benefit smaller issuers more specifically." – **the CSA, September 8, 2022**.*

Why is This Important?

In order to fully understand why this change is important for both issuers and investors, one must also fully understand the current process of capital raising and prospectus offerings here in Canada. While each province and territory in Canada has its own securities laws and regulator, the laws are largely harmonized.[2]

According to the Ontario Securities Commission (OSC), any company that wishes to offer its securities to the public must prepare a detailed disclosure document, known as a "prospectus". The prospectus includes specific, detailed disclosures about the company, its business and the securities being offered.[3] Furthermore, according to the Ontario Securities Act, the prospectus must provide *"full, true, and plain disclosure of all material facts relating to the securities issued or proposed to be distributed."*[4] The OSC's role in any new securities offering is to review these prospectus filings to ensure that they comply with Ontario securities law. Depending on the size or stage of the business, companies may use different types of prospectuses to sell their securities to the investing public. These include a long-form prospectus, short-form prospectus, shelf prospectus or post-receipt pricing prospectus. Certain stakeholders, be it issuers or investors, do not fully grasp how long and arduous the prospectus process can be for companies wishing to raise capital.

The Current Prospectus Submission and Review Process: Time is Money

As the principal regulator in Ontario, the OSC reviews prospectus filings through an 8-step process to ensure that they are legally compliant:

Prospectus Submission And Review Process

Step 1 – Identify

Principal Regulator
- The issuer determines in which jurisdiction to file the prospectus and identifies the principal regulator.
- The OSC is the principal regulator in Ontario.

Step 2 – Pre-file Application

Pre-file Interpretation
- The issuer can choose to submit a "pre-file" application to the OSC.
- The OSC can provide an interpretation of securities legislation as it relates to the specific filing.

Step 3 – Pre-file Review

Pre-file Review
- The issuer can apply for a "confidential pre-file review" of a prospectus.

Step 4 – Preliminary Filing

Preliminary Prospectus
- The issuer files the preliminary prospectus with the OSC.

Step 5 – Preliminary Review

OSC Preliminary Review
- The OSC reviews this preliminary prospectus, issues a response in the form of a comment letter, and tries to clear any concerns with the issuer to prepare for the final prospectus.

Step 6 – Final Filing

Final Prospectus
- The issuer files its final prospectus.

Step 7 – Final Review

OSC Final Review
- The OSC reviews the final prospectus and supporting materials.

Step 8 – Final Receipt

Begin Selling Securities
- The OSC issues a final receipt, allowing the issuer to begin selling securities related to the prospectus.

Source: INFOR, Ontario Securities Commission (OSC)

While some of the steps diagrammed above seem quite simple, this process can take several months from start to finish, which can be an impediment to issuers looking to raise capital in a timely fashion.

Short-form or Shelf Prospectus Timeline

Short-form / Shelf Prospectus	
Time	**Requirement**
Day 1	▪ Submit Pre-filing Application
Within 4 Working Days of Submitting the Prefiling Application	▪ Receive Principal Regulator Disposition of the Pre-filing Application
Following Resolution of the Pre-filing	▪ File Preliminary Prospectus
Within 3 Days of Filing the Preliminary Prospectus	▪ Receive Principal Regulator Preliminary Prospectus Comments
3 Days – 90 Days from Receiving OSC Comments	▪ Resolve Prospectus Comments and File Final Prospectus
Within 2 Days After Filing the Final Prospectus	▪ Principal Regulator Issues a Final Receipt, Allowing the Issuer to Begin Selling Securities Related to the Prospectus

Long-form Prospectus Timeline

Long-form Prospectus	
Time	**Requirement**
Day 1	▪ Submit Pre-filing Application
Within 4 Working Days of Submitting the Prefiling Application	▪ Receive Principal Regulator Disposition of the Pre-filing Application
Following Resolution of the Pre-filing	▪ File Preliminary Prospectus
Within 10 Days of Filing Preliminary Prospectus	▪ Receive Principal Regulator Preliminary Prospectus Comments
Up to 90 Days from Receiving OSC Comments	▪ Resolve Prospectus Comments and File Final Prospectus
Within 3 Days After Filing the Final Prospectus	▪ Principal Regulator Issues a Final Receipt, Allowing the Issuer to Begin Selling Securities Related to the Prospectus

Source: INFOR, Ontario Securities Commission (OSC)

According to the OSC, if a company is already a reporting issuer in a Canadian jurisdiction, and has continuous disclosure documents including its financial statements, annual information form (AIF), etc., the regulator is generally able to complete an initial review, including preliminary comments, of a preliminary short-form or shelf prospectus within three business days[5] after submitting a pre-filing application. The comments attempt to clear up any concerns with the issuer in preparation for filing a final prospectus. However, it is worth noting that the issuer has anywhere from 3 days to 90 days to resolve any prospectus comments from the OSC (or any other principal regulator) and file the final prospectus. Once the final prospectus is filed, the regulator issues a final receipt, which then allows the issuer to begin selling securities related to the prospectus. History shows that when including "pre-file" applications, "confidential pre-file reviews", preliminary prospectus reviews, incorporation of comments into the final prospectus, final prospectus filings, additional OSC review, the entire process can take in excess of 100 days before the issuer receives final receipt!

What about Private Placements?

As mentioned above, under Ontario securities law, any security offered to the public must be offered under a prospectus. Again, the prospectus provides details of the issuer, the securities being offered, and is filed with the regulator. In certain cases, securities may be offered without a prospectus and these offerings are sometimes referred to as "private placements" or "exempt distributions".[6] These prospectus exemptions can help issuers raise capital from investors while avoiding the time and expense of preparing and filing a prospectus.

Most exemptions from the prospectus requirement are set out in National Instrument 45-106 Prospectus and Registration Exemptions[7]. The most commonly used prospectus exemption is the "Accredited Investor" exemption. This allows issuers to distribute securities to qualified investors (both retail and institutional) who meet certain asset, income, or net worth thresholds in a timely manner. Then, for most exempt distributions, a form (Form 45-106F1) must be filed no later than 10 days after the distribution date. This process looks fairly simple and, according to the OSC, has proven to be very effective. In December 2020, the OSC published a report highlighting the activity in Ontario's exempt market from 2017 to 2019 and noted that during 2019 **"*approximately 3,200 corporate (non-investment fund) issuers reported $88.6 billion in capital raised, through prospectus exempt distributions, from approximately 35,200 Ontario investors*."**[8] In addition, during that year institutional investors accounted for 96.3% of total capital raised versus only 3.7% from retail individual investors, while 95% of gross proceeds were raised using the Accredited Investor (AI) exemption and 90% of issuers relied on the AI exemption.[9]

However, there is a catch. It is important to note that the BUYERS of these exempt distributions are restricted in their ability to SELL these securities. For most private placements, investors in the offering could be restricted to a "4-month" hold on any shares purchased as part of the offering. This makes the purchasing of any shares via a private placement very restrictive as it prevents investors from monetizing any short-term gains or, painfully, capping any short-term losses. Anecdotally, this is becoming more and more of an issue with institutional investors as compliance officers across the country continue to frown on the amount of "4-month hold paper" held in various Canadian mutual fund portfolios.

In what looks to be "manna from heaven", the new Listed Issuer Financing Exemption will allow issuers to file the necessary documents within 3 days of the original press release and close and complete the distribution within a TOTAL of 45 days.

Listed Issuer Financing Exemption Timeline

Listed Issuer Financing Exemption	
Time	**Requirement**
1 – 3 Days	▪ Prior to Soliciting Offers from Investors and Distributing Securities, the Issuer Must: – File a News Release Announcing the Offering – Prepare and File a Listed Issuer Financing Document Within 3 Days After the Date of Such Form, and Post a Copy of the Form on the Issuer's Corporate Website
Within 45 Days of the News Release	▪ Close the Distribution
Within 10 Days of Closing of Distribution	▪ File a Report of Exempt Distribution

In addition to this expedited timeline, this new exemption allows the issuer to distribute FREE TRADING stock to potential investors who are looking to participate in the offering.

Why Are the Securities Regulators Doing This?

Reason #1: They are Simply Allowing Issuers to "Save Time and Money"

The Canadian Securities Administration (CSA) states that *"The Listed Issuer Financing Exemption will provide a more efficient method of capital raising for reporting issuers that have securities listed on a Canadian stock exchange and that have filed periodic disclosure documents required under Canadian Securities legislation"*.[10] This all makes sense. Simply, the regulators are really allowing small market capitalization or "Small Cap" issuers to save time and money when they seek to raise capital through the distribution of securities. If you refer to Annex A of the "CSA Notice of Amendments to National Instrument 45-106 Prospectus Exemptions to Introduce the Listed Issuer Financing Exemption", one of the reasons for support of the new exemption includes the realization that small cap issuers face disproportionately higher financing costs relative to the amount of capital being raised.[11] This definitely makes sense considering the fact that there are significant costs associated with raising capital here in Canada.

The Cost of Doing Business...

The Securities Regulators

While the timeline for a prospectus offering can be lengthy, the associated costs can also be an impediment to raising capital more efficiently. According to the SEDAR agency fee list[12], the costs associated with filing a preliminary prospectus, a preliminary base shelf prospectus, a preliminary base PREP prospectus or a pro-forma prospectus can range from a low of $4,250 to over $105,000, depending on the Canadian jurisdiction! Why is there such a wide range in costs? Once again, Canada is one of the few G8 nations that does not have an umbrella securities regulatory agency or authority at the federal level. Instead, Canadian securities regulation is managed through the laws and agencies established by each of the 10 provinces and 3 territories who collectively form the CSA. On December 22, 2011, the Supreme Court of Canada ruled that the proposed Canadian Securities Act was "not valid" under the constitution and the federal government could not unilaterally impose a national securities regulator given that securities regulation belonged to the provinces.[13] Whether or not the implementation of a true national securities regulator will happen in Canada is up for debate, but for now, issuers must deal with the cost of filing a prospectus on a province by province basis.

More specifically, The Alberta Securities Commission (ASC) charges $2,000 for a prospectus filed plus an additional $2,000 where there are one or more selling security holders whose securities may be distributed under the prospectus.[14] In addition, the ASC charges $250 when the distribution value is less than $1 million, other than the exercise of a right under a special warrant, another $250 for every amendment filed and $100 for every technical report filed with the prospectus. For non-reporting issuers, the base fee is the greater of $200 or 0.025% of gross proceeds.

The British Columbia Securities Commission (BCSC) charges a flat fee of $2,500 at the time of filing of the prospectus plus an additional percentage fee of 0.025% based on the proceeds raised in the province of British Columbia.[15] The BCSC also charges an additional $1,000 for the filing of an AIF by an issuer other than a mutual fund, another $250 for any amendment to a preliminary prospectus, prospectus or AIF, another $500 for filing a technical or engineering report with a preliminary prospectus, pro-forma prospectus, prospectus, AIF, amendment to a preliminary prospectus or prospectus, etc.

The OSC charges reporting issuers $3,800 for any preliminary or pro forma prospectus (including PREP) filing, additional fees of $2,500 for each technical report not previously incorporated in the prospectus as well as a host of incremental fees of $500, $1,000, $1,800, $20,000, $55,000, $83,000 and $110,000 depending on the application or exemption.[16] The OSC also charges a "Corporate Finance Participation Fee" that can range anywhere from $1,070 to $100,500 depending on the size of the company based on a market capitalization range from $10 million to $25 billion.[17]

The Autorité des marchés financiers (AMF) in Quebec charges $1,201 for each draft prospectus and a portion of the gross proceeds of the total financing (0.04% x 25% x gross value of the issue - $1,201) for a final prospectus. The AMF also charges $6,002 for a preliminary shelf prospectus, $301 for any amendment to the prospectus, $148 for a geological report, $600 for an application for an exemption, etc. etc.[18]

**Please note that these costs are all in addition to the annual participation fees associated with the continuous disclosure requirements mandated by the OSC, the BCSC, the ASC and the other Canadian Securities regulators.*

The Exchanges

The costs mentioned above do NOT include the other regular costs of being a reporting issuer listed on a Canadian exchange. For those entities listed on the TSX Venture Exchange (TSX-V) there are a host of other fees to be considered. There is an annual sustaining fee that ranges from $5,200 to $90,000 based on market capitalization (less than $5 million to $440 million or above), financing fees for any capital raise that can range from $750 to $55,000 depending on the size of the private placement/public offering, financing fees for bonus shares/loans that can range from $500 to $30,000 depending on the deemed value of the shares issued, and filing fees that can range from $200 to $30,000 depending on the action whether it be a stock option plan, a reviewable transaction or a share split.[19]

The Professionals

Investment dealers who commit to selling the securities of a listed issuer charge a sales commission that can range anywhere between 5% and 10% depending on the value of the securities sold. These securities may also include a full or half warrant, which also bear a higher cost of capital and could result in additional dilution in the future.[20]

Separately, accounting firms can charge anywhere from $12,000 to $80,000 depending on whether it is a first-time audit prior to a listing, or a regular audit conducted on an annual basis. It is probably worth noting that according to a recent study by the International Federation of Accountants, audit fees in Canada hit a seven-year high in 2020. According to the study, the average audit fee as a percentage of revenue rose to 0.33% for Canadian companies listed on the TSX, surpassing the old high of 0.30% seen in 2016 and again in 2019.[21]

Finally, legal counsel is required to conduct due diligence to help management teams satisfy the regulatory requirement of ensuring there is full, true, and plain disclosure of all material facts about the company. Again, the legal costs can range from $5,000 up to $100,000 if it is a first-time listing, a complicated transaction that requires extensive due diligence, or part of the Company’s continuous disclosure requirements.[22]

The costs outlined above are particularly expensive, especially for the Canadian Small Cap and Micro-Cap issuer. The definition of “Small Cap” may vary depending on the jurisdiction, but typically this includes companies with a market capitalization of between $250 million and $2 billion, while Micro-Caps include those companies who live below the $250 million market cap threshold.[23] Whether you are a Small Cap or a Micro-Cap, these costs could prove to be an impediment to raising the capital necessary to fund your company’s growth plans. This is exactly why a “more efficient” method of raising capital is required for Small Cap issuers here in Canada.

Why Are the Securities Regulators Doing This?

Reason #2: This Will Make Certain Capital Raises More Attractive to Buyers…

The Underperformance of Small Cap stocks continues…

According to traditional investment theory, small cap stocks should outperform the broader indices given their ability to provide above-market revenue and earnings growth. That, coupled with their relative illiquidity and general lack of market understanding, provide inefficiencies that lead to lower valuations, making them very attractive investment opportunities. This tends to be an inefficient asset class as close to 25% of all Small Cap stocks in the index, have either no analyst or one single analyst, providing research coverage.[24] This presents mispricing opportunities. Over time as these companies continue to execute, and more investors discover these undervalued opportunities, the market "arbs away" these inefficiencies, which inevitably leads to higher valuations in the future. The literature supports this view. Please note that in 1981 author Rolf Banz stated in his paper titled "The Relationship Between Return and Market Value of Common Stocks", that small cap stocks tend to outperform large cap stocks on a risk adjusted basis: *"The results show that, in the 1936-1975 period, the common stock of small firms had, on average, higher risk-adjusted returns than the common stock of large firms. This result will henceforth be referred to as the 'size effect'."*[25] This led to the incorporation of the size of the company as a factor in the 1992 Eugene Fama and Kenneth French three factor asset-pricing model. Fama and French then stated that *"two easily measured variables, size and book-to-market equity, combine to capture the cross-sectional variation in average stock returns associated with market β, size, leverage, book-to-market equity, and earnings-price ratios."*[26]

However, many years and many publications later, it appears that this is no longer the case. Small cap stocks have actually UNDERPERFORMED the large cap peers and the broader markets since the original discovery of the size effect back in 1981. More specifically, since 1981 the Russell 2000 Index (white) has underperformed the S&P 500 (yellow):

Source: Bloomberg

Over the last 10 years, we have seen something similar in Canada, and a recent article suggests that an investment strategy focused on small cap investing has UNDERPERFORMED over the past decade. The S&P/TSX Small Cap index is up about 13% (yellow) while the S&P/TSX Composite index is up over 60% (white) since November 2012. This is even more pronounced in the U.S. as the Russell 2000 Index is up ~22% while the S&P 500 is up 165% during that time period!

Source: Bloomberg

Risky "Lottery Tickets"?

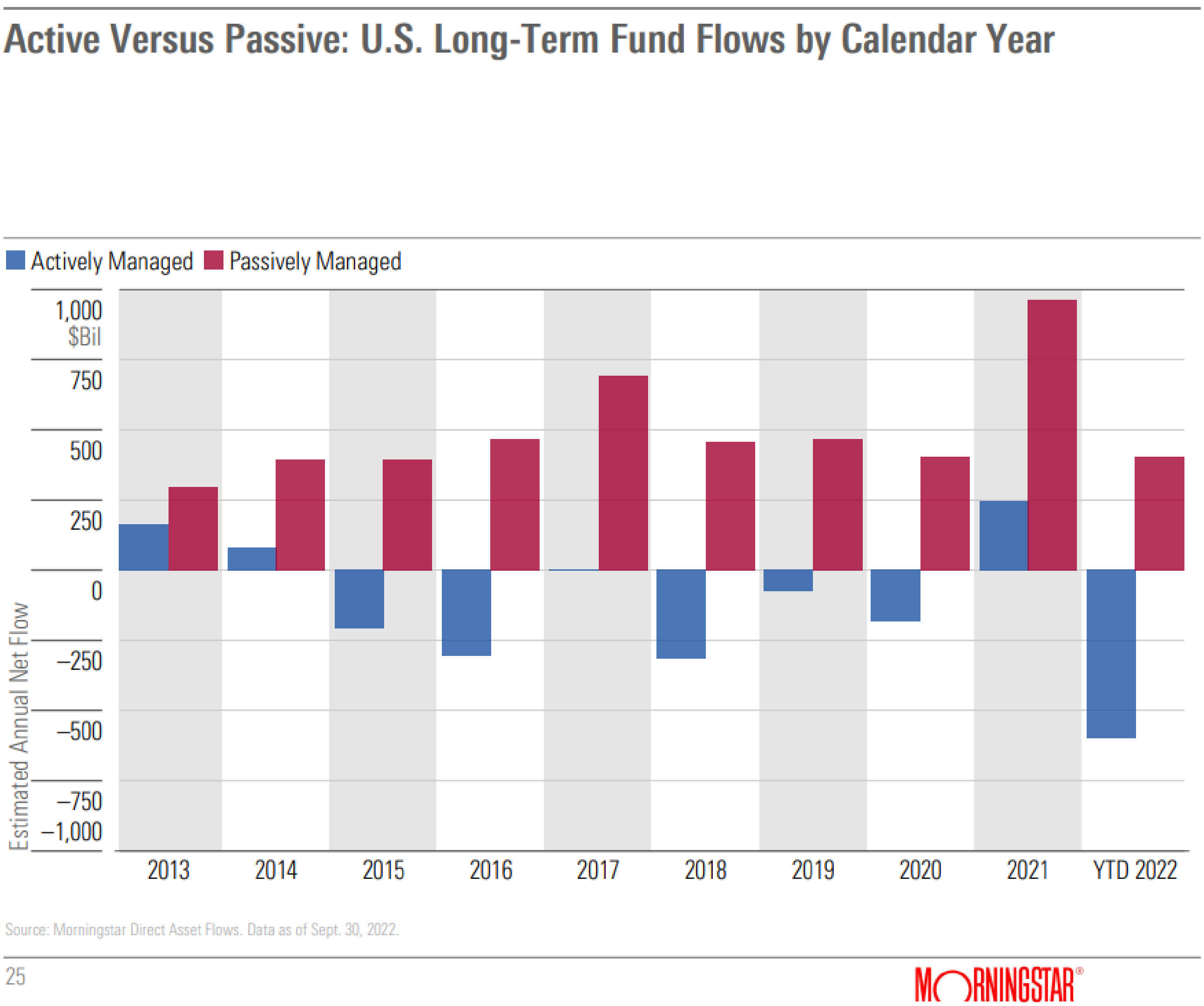
One of the reasons for this underperformance in small caps could be the notion that this universe of stocks contains many very risky stocks that drag down the returns for the entire index. These so-called "lottery ticket" stocks are attractive to investors due to their perceived absolute return potential however, statistically these stocks usually have a lower-than-average risk-adjusted returns when compared to other stocks in the peer group.[27]

A Flight to Quality?

Another explanation is perhaps an investor "flight to quality" reminiscent of the "Nifty Fifty" buy and hold stocks from the 1960s and 1970s. The "Blue Chip" stocks of today share similar characteristics to those old Nifty Fifty stocks in that they tend to trade at higher valuations than the overall index but provide investors a perceived margin of safety given their size and popularity. Believe it or not, quite a few of those old "Nifty Fifty'" stocks like American Express, Coca-Cola, General Electric, McDonald's, Merck, 3M, Pfizer, Procter & Gamble and Walmart are still members of the S&P 500 today. However, over the past several years the FANG stocks (Facebook/Meta, Amazon, Netflix, and Google/Alphabet) have taken over as the "go to" stocks for institutional and retail investors alike. Prior to the recent tech sector correction, with each member more than doubling over the past five years, the FANG stocks showed tremendous growth with limited relative volatility making them very attractive to institutional as well as retail investors. This was at the expense of "riskier" small cap stocks and intuitively makes sense because as an investor why "pay up" for growth and bear both the operational and liquidity risk when you can own a "mega-cap" stock that offers a very similar growth profile with much less perceived risk? Even though these tech highflyers have corrected materially this year the small caps still seem to suffer disproportionately as the Russell 2000 Index currently trades at only 19x forward earnings, which is very close to the historical lows. Anecdotally, the same thing is happening in Canada where, according to Bloomberg, the S&P/TSX Small Cap Index is currently undervalued as it trades at only 11x forward earnings which is also very close to the historical lows!

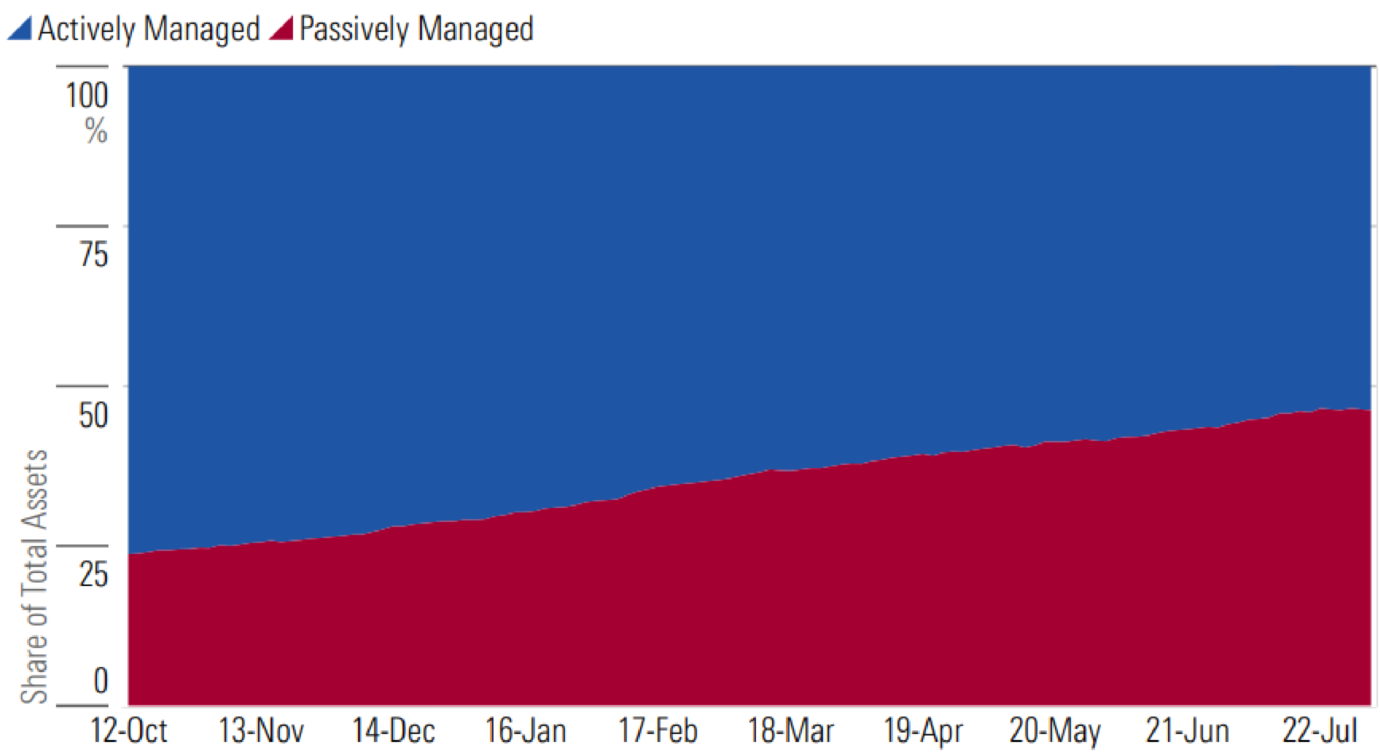
Passive vs Active Asset Management?

The data clearly shows that passive asset management continues to take market share away from active investing. According to Morningstar, in the U.S. over the 10-year period ended June 2022, only 25% of all active funds beat the average return of their passive peers. Whether it's active management's inability to outperform the index, the lower fees associated with ETFs and other passive products, or the use of technology, which allows retail investors to move money around quickly and efficiently, this trend continues. More specifically, over the past two years, passive managed funds have seen approximately $1.4 trillion of positive inflows, while actively managed funds have seen net outflows in excess of $250 billion. In addition, over the past decade, the share of passively managed U.S. Long-Term Fund total assets has gone from less than 25% in 2012 to ~45% today.[28]



Source: Morningstar

Active Versus Passive: Share of U.S. Long-Term Fund Total Assets



Source: Morningstar Direct Asset Flows. Data as of Sept. 30, 2022.

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Source: Morningstar

In Canada, we are seeing much of the same movement towards passive management. According to the Investment Funds Institute of Canada (IFIC), as of September 30, 2022, so far there has been close to $19 billion of mutual fund net redemptions year-to-date, versus ~$21 billion of inflows for ETFs.[29]

Mutual Fund Net Sales/Net Redemptions ($ Millions)*

Asset Class	Sep. 2022	Aug. 2022	Sep. 2021	YTD 2022	YTD 2021
Long-term Funds					
Balanced	(4,992)	(2,429)	4,318	(14,321)	53,974
Equity	(2,884)	(333)	1,855	(401)	32,235
Bond	(1,915)	(382)	1,606	(8,771)	14,767
Specialty	1	90	424	1,215	4,746
Total Long-term Funds	(9,790)	(3,053)	8,203	(22,278)	105,722
Total Money Market Funds	825	(52)	(205)	3,639	(6,688)
Total	(8,965)	(3,105)	7,998	(18,639)	99,034

ETF Net Assets ($ Billions)*

Asset Class	Sep. 2022	Aug. 2022	Sep. 2021	Dec. 2021
Long-term Funds				
Balanced	11.4	11.8	11.0	12.1
Equity	179.7	191.2	201.8	225.2
Bond	75.0	75.8	87.8	89.6
Specialty	10.1	10.3	11.5	13.6
Total Long-term Funds	276.2	289.1	312.1	340.5
Total Money Market Funds	11.4	9.6	6.3	6.6
Total	287.6	298.7	318.3	347.1

Source: IFIC

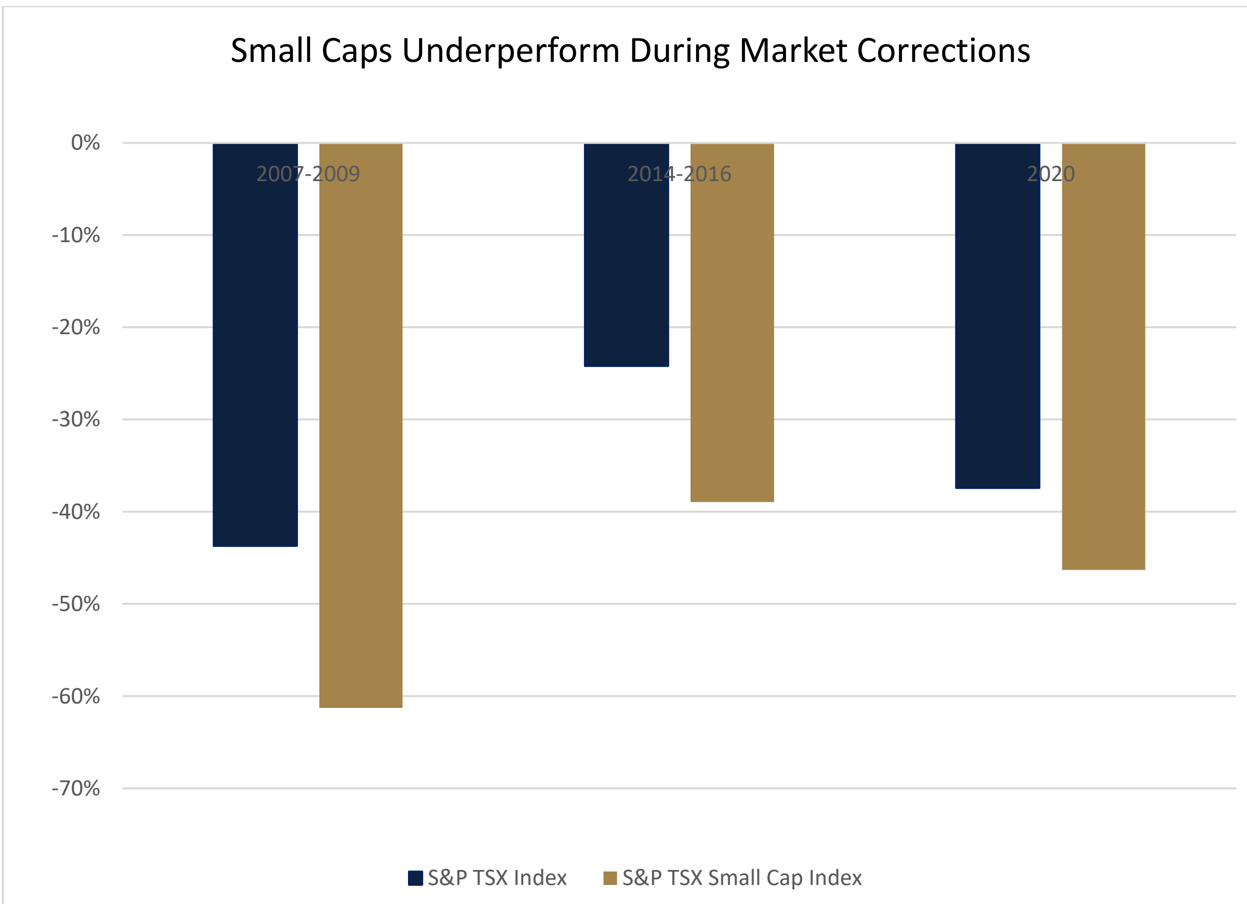
Whether it is due to the "lottery ticket" effect, a flight to quality, or the growth of passive asset management, at the end of the day there are multiple theories that attempt to explain the historical erosion of the "small cap premium" or the 'size effect'. However, there may be an even simpler answer as to why the Canadian small cap stocks are underperforming - there are simply LESS Canadian small cap investors in the market buying these stocks.

There are currently over 5,000 mutual funds offered in Canada. These mutual funds can have varying mandates which allow, or restrict, what types of securities they can purchase. The most common type of mutual funds tends to be equity funds, which invest in shares of Canadian businesses. However, there are other types of common mutual funds including fixed income funds that invest in bonds, and money-market funds, which invest in short term paper like treasury bills.[30] Within this large group of fund families sits the Canadian small cap funds. According to the Canadian Investment Funds Standards Committee (CIFSC), there are over 120 funds in Canada dedicated to investing in Canadian small cap businesses.[31] This is down slightly from 133 small cap funds or approximately $12 billion in AUM dedicated to that asset class in 2002.[32] It is important to note that of these 120 small cap funds today, close to 25% of these funds are classified as Canadian Focused Small/Mid Cap Equity Funds. Why is that important? While the CIFSC mandates that *"Funds in the Canadian Small/Mid Cap Equity category must invest at least **90%** of their equity holdings in securities domiciled in Canada"*, Canadian **Focused** Small/Mid Cap equity Funds only need invest "*at least **50%** of their equity holdings in securities domiciled in Canada*".[33] Certainly we are not naming names, but portfolio managers have been taking advantage of this distinction that allows them to buy U.S. or International small cap stocks in their Canadian "Focused" portfolios for a very long time. More importantly, this has taken capital away from the traditional Canadian small cap issuers.

The Case for the Canadian Small Cap Issuer…

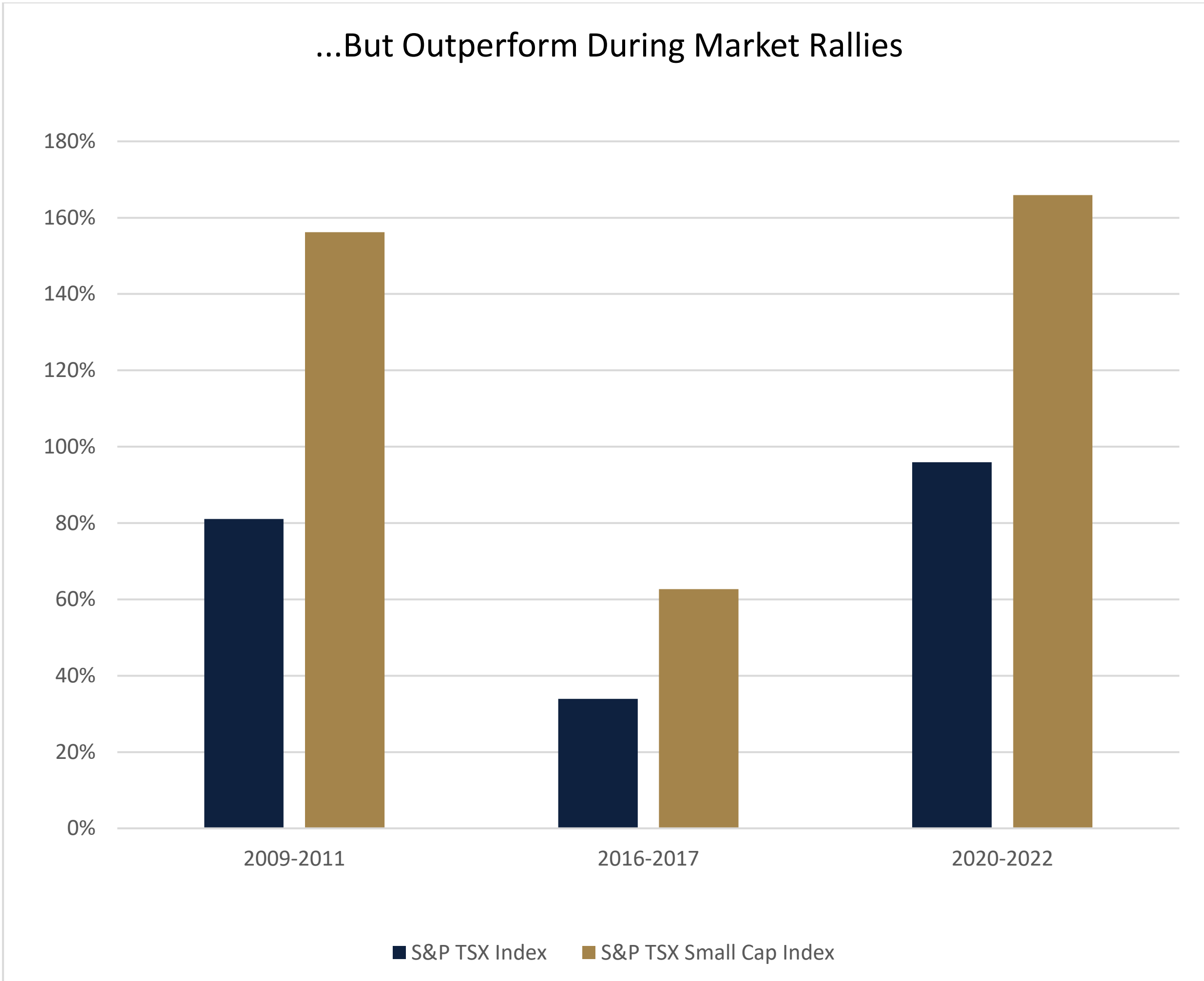
Once again, we define "Small Cap" as Canadian companies with a market capitalization of between $250 million and $1 billion. According to Bloomberg, there are 227 constituents of the S&P/TSX Small Cap Index with a collective market capitalization of C$138.28 billion and, as expected, the highest weights in this index are the materials and energy sectors with a 30% and 22% weighting respectively.

We stated earlier that small cap stocks have underperformed the large cap peers and the broader markets since the original discovery of the size effect back in 1981. In retrospect, we probably should have stated that over a longer time horizon, small caps have underperformed the large caps. Thanks to our friends at Connor, Clark and Lunn,[34] we are reminded that there are still reasons for investors to own Canadian small cap stocks, especially in the right environment. While we are likely headed into a recession, if we are not there already, small caps tend to underperform during market corrections. We saw this more recently during the Global Financial Crisis in 2008-2009, the market correction in 2015-2016 and the COVID-19 pandemic in 2020:



Source: Bloomberg

However, history shows that when markets are rallying, small cap stocks tend to outperform the broader market:



Source: Bloomberg

It is also worth repeating that small cap stocks have greater operational flexibility, which gives them the ability to provide above-market revenue and earnings growth. In addition, these businesses tend to be founder-led and have high insider ownership, which results in a greater alignment of interest with shareholders. Small caps also offer diversity away from the heavily weighted financials and cyclicals sectors representative of the larger S&P/TSX Composite Index and can give investors more exposure to underweighted sectors such as materials, consumer staples, consumer discretionary, real estate and healthcare. This also tends to be an inefficient asset class, as a significant number of Canadian small cap stocks have essentially zero or very limited research coverage which presents further mispricing opportunities and a higher chance of outsized returns for investors. *Finally, we tend to think of many Canadian small caps as "publicly-traded private companies". Simply stated, investing in Canadian small caps is akin to having "private equity" like exposure in often-undervalued, founder-led, tightly-held, high-growth businesses, WITH the ability to "freely" liquidate these positions to either mitigate losses or maximize investment returns in a timely manner.*

With the Listed Issuer Financing Exemption, these companies will now be allowed to sell free trading stock, which should be more attractive to investors, therefore giving these small cap issuers greater access to capital.

Who is Eligible?

According to the CSA, for issuers to use the Listed Issuer Financing Exemption, the issuer must have been a reporting issuer in a Canadian jurisdiction for at least 12 months. The issuer must also have a class of equity securities listed on a Canadian stock exchange and must be compliant with continuous disclosure requirements under Canadian securities legislation. The issuer CANNOT be an investment fund, Capital Pool Company (CPC), Special Purpose Acquisition Company (SPAC), or issuer whose principal asset was cash in the preceding 12 months.

What are the Limitations?

The CSA has mandated that the size of the offering is limited to the greater of a) C$5 million; or b) 10% of the issuer's market capitalization up to a maximum total dollar amount of C$10 million during any 12-month period. In addition, an issuer cannot use the exemption if, during any 12-month period, the distribution will result in an increase of more than 50% of the issuer's total outstanding listed equity securities. At the time of the offering, under this exemption, the issuer must reasonably expect that it will have available funds to meet its buiness objectives and liquidity requirements for a period of 12 months following the offering. Only listed equity securities or units consisting of listed equity securites plus warrants (convertible into listed equity securities) can be distributed under the exemption. According to our friends at BLG (Borden Ladner Gervais), by definition, this should include flow-through shares. Finally, the issuer cannot use the proceeds raised under the exemption to fund a significant acquisition, a restructuring transaction, or any other transaction that requires approval from any security holder.

What are the Advantages?

In addition to the cost savings and the greater access to capital discussed earlier in this report, small cap issuers stand to benefit in another way - reduced price discounts on these public offerings. Under the current regulation, when an issuer offers securities to accredited investors via a private placement, the shares usually come at a significant discount to compensate the buyers for the restrictive nature of the newly issued shares. Depending on the securities regulator, the maximum discount on the shares could be as high as 25%. More specifically, the TSX and TSX Venture Exchange allow up to a maximum 25% discount for any market price up to $0.50 per share and a 15% discount for any stock that trades above $2.00 per share.[35] We note that this maximum discount to market price refers to the closing market price on the day preceding the official issue of a press release announcing the transaction, and does NOT include the exercise price of any warrant included in the offering. In other words, the discount could be even larger than the maximum allowable, if one includes the value of the warrant in any unit offering. With the Listed Issuer Financing Exemption, issuers will have access to the broader public market and will be able to issue "free trading" shares which should result in smaller discounts.

What are the Disadvantages?

As far as we can tell, potential officer and director liability is the only risk to this new exemption. Under the exemption, the CSA states that *"[u]* issuer executive and director liability *nder the exemption, issuers, and in some jurisdictions, the executives signing the offering document and the issuer's directors will be subject to statutory liability if the offering document contains a misrepresentation."*[36] Unlike a prospectus offering, there is no certificate page signed by underwriters and the offering document will not be reviewed by CSA staff in advance. Therefore, in the event of a misrepresentation, the exemption imposes primary offering liability against the issuer and, depending on the jurisdiction, the officers that sign the offering document as well as the directors.

**A special thank you to BLG (Borden Ladner Gervais) for their thoughts and interpretations regarding this new exemption.*

In conclusion, the Listed Issuer Financing Exemption provides a more efficient means for Canadian small cap issuers to raise capital. The exemption significantly reduces the time required to raise funds via a prospectus, virtually eliminates the execution risk associated with completing and filing a prospectus, and drastically reduces the costs associated with the regulators, exchanges, and professionals required to execute a prospectus in connection with a public offering. The exemption also provides Canadian small cap issuers with greater access to capital as it broadens the universe of potential investors by allowing the issuance of free trading securities as part of the offering. This is a "win-win" for both small cap issuers and investors. In short, the Listed Issuer Financing Exemption is a "gift" from the regulators, so the holidays have come early for Canadian small cap issuers as well as Canadian small cap investors. While we are likely headed into a recession, the market tends to be forward looking so now could be the perfect time to invest in Canadian small caps.

We would be pleased to speak to any issuers or institutional investors about the content of the report, and the implications for Canadian small caps going forward.

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FOOTNOTES

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Thank you for your interest.

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