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Under Construction: Why Alberta's exempt market needs work

The province's exempt market has been cleaned up considerably of late, but one of its insiders thinks there's still more work to be done

Sep 10, 2013

by Max Fawcett

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In late 2009, National Instrument 31-103 was proclaimed in force by the Canadian Securities Administrators in an attempt to better regulate the various exempt markets across the country and create some measure of accountability for the people who operated within it. But for many Albertans who were already invested in the exempt market, 31-103 proved to be too little, too late. By the time it was passed into law, it was clear that they would never see the money that they invested with real estate firms like Bridgecreek, Concrete Equities and the Harvest Group of Companies, among others, either because of deliberate fraud or massive incompetence on the part of the people running those outfits.

Frank Lonardelli was at the heart of that storm, and he saw what it did to those people. As the newly appointed CEO of the Harvest Group, he was charged with trying to make at least a little bit of lemonade out of the lemons. But he quickly discovered that the situation was worse than it had looked when he agreed to take the job, and soon found himself travelling up and down Highway 2 in order to tell rooms full of investors that they'd never see their money. "I saw 8,000 to 12,000 people that bought bonds that had no hope in hell of ever seeing their equity within a five-year period of time, or the face value returned," Lonardelli says. "There must have been



Frank Lonardelli, former CEO of the Harvest Group of companies, says the exempt market needs further changes
Photograph Bryce Meyer

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100 to 150 people crying at the end of my presentations and hugging me and saying, 'Thanks for telling us the truth.' So yeah, it certainly was difficult."

He'd seen that situation from both sides, too. Back in 2005, he had the difficult duty of settling his mother's estate after she died of cancer. She was a widow, and she'd raised four kids in Winnipeg after emigrating there from Naples Italy. But when Lonardelli took a look at the investments that she'd been allowing a financial planner to manage on her behalf, he discovered that the planner had convinced her to liquidate her ultra-safe government bonds and put the proceeds into a private holding company that he was using to make some decidedly more risky investments. As it turned out, she wasn't the only one who got suckered. "On the flight over, I called my lawyer and my sister up, and I said, 'You need to know what happened to mom here – and you probably should be aware that if he did it to mom, he did it to other families.' Well, he did it to other families – between eight and 13 of them." In the end, Lonardelli managed to get her money back – and that of the other families affected – after about six months' worth of wrangling with the Canadian Securities Commission and the Manitoba Securities Commission, along with the financial planner himself. They were lucky. The Albertans that he had to deliver the bad news to a few years later as the CEO of the Harvest Group weren't. And they weren't alone, either.

Craig Skauge, the president and founder of the National Exempt Market Association, says that the industry is far better equipped to root out fraud and incompetence than it was before 31-103 was introduced. "In the past, it was all self-serving," he says. "The Bridgecreek guys were raising money for Bridgecreek. The Concrete [Equities] guys were raising money for Concrete. They were telling whatever story they wanted, and there was nobody there to verify it. Now, you have third parties like Raintree and Pinnacle that are raising money for third-party deals, and they're taking a very deep look under the hood – at the deal, at the people behind the deal – before they'll raise money for them."

But Lonardelli, who is now the CEO of Arlington Street Investments, isn't nearly as confident that the industry has left its troubles in the past. His company deals in commercial real estate, and raises some of the capital that it uses to scoop up undervalued properties (like its 8th Avenue Limited Partnership, which was recognized as the 2013 Commercial Real Estate Deal of the Year by the Exempt Market Dealers Association of Canada) on the exempt market. He says that while he's noticed some significant improvements, there are still some important changes that have yet to be made.

Those changes need to begin, he says, with making sure that the people interacting with the investing public – the exempt market dealers – are better trained and more closely scrutinized. "It's the irony of this market," he says. "The exempt market has to be the most nuanced space in the capital markets, with the most complicated and diverse set of products. Yet it has representatives selling the product that have the lowest level of proficiency. That's a deadly combination."

He also wants to see exempt market issuers provide an annual disclosure of their operations. "I guess people might say, 'Gee, that sounds like a lot of regulation, a lot of disclosure,'" Lonardelli says. "No – those are table stakes. If you're going to take that kind of money from those people, then you should probably provide that information. And if you're not, you shouldn't be part of the business."

As the president and founder of the National Exempt Market Association and the president of Exempt Experts and Target Capital, Skauge has a vested interest in avoiding that kind of outcome. "It's a really critical time for this industry," he says. "There isn't room for a lot of screw-ups right now because there were so many in the past. There can't be those high-profile blowups for this segment of the capital markets to continue with any level of credibility. The next few years will say a lot."

Skauge thinks that the last few have already said a lot, and he's particularly pleased with the impact that that 31-103 has had on the way that the province's exempt market dealers operate.

His views about the role that regulation plays in the sector have evolved over the last few years, too. Back in 2008, when he made a written submission to the Ontario Securities Commission and the Alberta Minister of Finance, he insisted that more regulation wasn't needed. "It seems to me that the Canadian Securities Administrators are trying to fix something that is clearly not broken," he wrote. "The pendulum of regulation has swung far enough and the current regime is serving

"The exempt market has to be the most nuanced space in the capital markets, with the most complicated and diverse set of products. Yet it has representatives selling the product that have the lowest level of proficiency. That's a deadly combination."
– Frank Lonardelli, Arlington Street Investments

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investors well. There is no problem and therefore no solution (i.e. additional regulation) is required.”

Today, though, he concedes the changes contained in 31-103 were needed, and that more may well be required. He largely agrees with Lonardelli's prescription for a combination of greater financial disclosure by issuers and better education and certification for the people selling exempt market securities. “We're working with a number of education providers on redeveloping the course that they have to take,” Skauge says, “and we'd like to see some continuing education requirements as well. I'd like to see an actual designation.”

Skauge may be in favour of more education and disclosure, but he doesn't want to see the exempt market regulated out of existence. “One of my biggest contentions is the fact that everything in this space is still categorized as high risk,” Skauge says, “when factually that's not the case. It very well may have been the case in the past, but now you have registrants under the full view of the ASC. I don't think it's fair to categorize this world the same way as the pre-31-103 world.”

And, he says, Alberta needs the exempt market more than ever. “When 2008 hit, credit tightened up drastically at the banking level, particularly for small- and medium-sized businesses. It's almost as though those who don't want money can get it lent to them readily, and those who need money, well, tough luck. And while that may be prudent on the bank's behalf, it doesn't help the economy.”

Finding that balance between protecting investors and facilitating market access for those looking to raise capital is an ongoing challenge for the ASC's Bill Rice. As its chair and CEO, he's responsible for protecting investors from unscrupulous operators (like Concrete Equities' David Jones and David Humeniuk, for example), but the far bigger threat might be posed by their own behaviour.

“We spend a great deal of time and money trying to warn people that they should look after themselves, that they should take appropriate steps to evaluate risk, that they should get advice, that they should take the time, that they should get involved with professional advisors, that they shouldn't let themselves be subjected to pressure tactics,”

Rice says. “But in the end it's the investor who is going to make his or her own choice.” Skauge agrees with Rice. “I think if a lot of people did the amount of due diligence before investing that



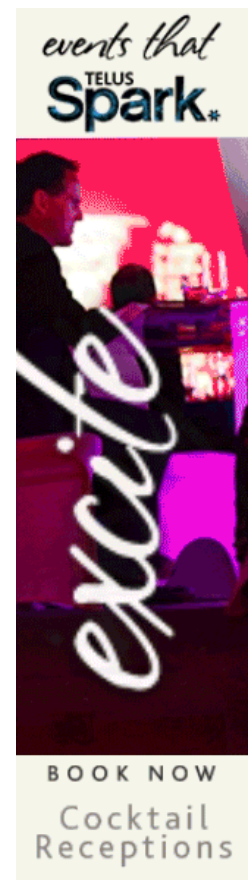
Frank Lonardelli
Photograph Bryce Meyer

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they've done after, they'd have been better served. Don't get me wrong: I feel bad for any investor that lost money, particularly in fraud. But people were too trusting with the people selling the products."

Herein lies perhaps the biggest challenge of all that the people working within the exempt market have to face. The premise upon which the entire market is based – that the people making investments in the exempt market have, as the Ontario Securities Commission says, "a certain level of sophistication; the ability to withstand financial loss; the financial resources to obtain expert advice; and the incentive to carefully evaluate the investment given its size" – may be fundamentally, even irreparably, flawed.

Marian Passmore, the associate director of FAIR Canada, a national non-profit organization that represents the interests of Canadian shareholders and investors, certainly thinks that could be the case. "What we see is that wealth is not a proxy for knowledge or sophistication, and it just allows people to go after investors with sufficient funds," she says. "We've criticized that exemption, and suggested that it should be designed differently."

"It's a really critical time for this industry." – Craig Skauge, National Exempt Market Association

And while Lonardelli isn't willing to go quite that far, he says that investors need to be better prepared if they're going to put their savings – often, a substantial portion thereof – to work in the exempt market. "Investors always get hosed because they don't know the questions to ask," he says. "They walk in, the first question they ask is, 'How much money am I going to make?' as opposed to, 'How much money are you going to make?'"

Equally important, he says, is the fact that people operating in the exempt market also need to start asking some questions of each other. "If I'm going to spend any time in the exempt market, I need it to be healthy," he says. "It has to be asking some tough questions, and we have to be holding each other accountable." That hasn't happened yet, he says, noting that, for example, while exempt market dealers are now better regulated than they were before, many of them still haven't faced up to the fact that they were responsible for moving a lot of the product that eventually turned sour. "What were the responsibilities of the dealers who basically sold this product that defaulted? I don't know – I guess you could say there was no regulatory regime, so therefore there wasn't any responsibility," he says. "But I don't know if that washes."

Skauge, for his part, seems to agree. "I don't think we can ignore our past. Some of the people in the exempt markets like myself are from the pre-31-103 world, so I don't think we can ignore it. Does it help? No. But it's reality."

And while Lonardelli may be a critic, he doesn't think that the exempt market's checkered past means that it's inherently or irreparably dysfunctional. "Even in the public market we make mistakes, as good as all the smart executives and the scrutiny and regulatory regimes are," he says. "Companies still go bankrupt, they still become insolvent, they still don't hit their revenue targets." He's even willing to cut the people responsible for some of the higher-profile blowups a bit of slack. "In this exempt marketplace, there are a lot of people who really thought they could do it," he says. "I've been an entrepreneur for 17 years, and I know what that feels like."

The attrition process that's taken place over the last few years, meanwhile, will have a cleansing effect on the entire sector. "I believe that, as those guys go away, they'll be replaced by people who actually know what they're doing," Lonardelli says. "And the dealers that made a bunch of mistakes, they're going to ask better questions. They're going to think about what they're putting on their shelves, because it's not in their interest to have those deals blow up as well." But until the exempt market dealers and issuers who were around pre-31-103 are truly willing to take a hard look at the role they played in those blowups, Lonardelli says that the market as a whole won't be able to truly move past them. "That's the problem with trying to create a better exempt market – it's having that conversation about what you learned about your mistakes. If you can't admit to the mistake you made, there's no conversation to have."

North By Northwestern

For all the improvements made to the Alberta exempt market, and particularly to the way that dealers are regulated, there's still a fairly large problem that has yet to be addressed. Under the Northwestern Exemption, issuers don't have to register with the ASC provided they confine their operations to British Columbia, Alberta, Saskatchewan, Manitoba, the Northwest Territories, Nunavut and the Yukon and comply with the terms and conditions of the exemption. FAIR Canada's Marian Passmore thinks it needs to be repealed – immediately.

Why? "It allows people who aren't registered to sell high-risk exempt market products to the

investing public, and so there is a lack of ability to oversee those individuals,” she says. “There’s no background check, and the only information that they require is a form that has basic contact information. They could have been sanctioned by another regulatory organization, or even convicted of a criminal offense, and still sell in the exempt market in Alberta. So, for example, Earl Jones [the convicted Montreal fraudster who bilked family, friends and investors out of a combined \$50 million] could go out to Alberta and set up shop.”

NEMA’s Craig Skaug wants to see the exemption repealed as well, noting that its elimination wouldn’t affect those looking to do one-off issuances. “Publicly, we’re in favour of it. There’s nothing preventing an entrepreneur right now from going out and raising money on a one-off. He doesn’t have to be registered under a dealership or under the Northwestern Exemption. It’s there for those guys that make a living raising money, but don’t want to be registered.”

The British Columbia Securities Commission is already exploring the possibility of repealing the exemption.

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