# Exempt Market Review

## Thoughts on OSC Staff Consultation Paper 45-710


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First, I would like to thank the Ontario Securities Commission for providing me an opportunity to participate in its Exempt Market Review. The document that has been put together, OSC Staff Consultation Paper 45-710, is thoughtful, comprehensive and very well-written and I would like to commend the OSC team for such an excellent draft. I have provided below my thoughts on the consultation questions on different issues. I will be quick to emphasize that I do not have legal or regulatory expertise; so these thoughts are more from the perspective of a business academician.

**Response to Consultation Questions:**

**Prospectus Exemption Based on Relationships with Issuers**

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1. ***Is the 50 security holder limit under the private issuer exemption too restrictive? If so, what limit would be appropriate?*** The 50 security-holder private issuer limit is too restrictive. This category includes a wide range of individuals who may be considered to be knowledgeable because of a relationship with the investor. It also includes "accredited investors". Perhaps, the limitcould be set at 75 or 100.
2. ***Should the OSC consider re-introducing the closely held issuer exemption?*** The closely held issuer exemption need not be introduced especially in light of the proposed new initiatives to broaden the exempt market.
3. ***Should the OSC consider adopting a family exemption that allows for securities to be issued to an unlimited number of family members of the directors, executive officers or control persons of the issuer or its affiliate?*** I am conflicted about the issue of whether the OSC should consider adopting a family exemption that allows for securities to be issued to an unlimited number of family members and others. In support of this argument is that other provinces have this exemption. Hence, if OSC adopts this measure, it would serve to harmonize regulations across provinces. On the other hand, I also feel that the reasoning behind OSC not adopting this exemption is sound; i.e. it will allow, securities to be issued to an unlimited group of unaccredited investors. It is true that by virtue of being "friends and family" these individuals are likely to have good personal knowledge

of the investor. However, I wonder about the practical challenges of assessing close personal friendships.

**Exploration of Crowdfunding**

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1. ***Would a crowdfunding exemption be useful for issuers, particularly SMEs, in raising capital?*** Yes,I believe that a crowdfunding exemption would be useful to SMEs which typically have challenges in accessing capital. At initial stages, often the only recourse for a start-up is to bootstrap, seek capital from friends, family etc as funds from angels, VCs or more traditional funders such as banks may not be forthcoming. More affluent investees have an advantage to the extent of having greater access to personal funds from friends and family members. Crowdfunding can actually provide a more level playing field in this regard. Indeed, equity crowdfunding can be used to raise funds for diverse initiatives for which investors can expect to earn a return on their investment.

   The document has noted that equity crowdfunding would be amenable to certain types of funding and that, for instance, the model may not be appropriate for financing working capital. While I agree that equity crowdfunding may not be suitable for raising funds to meet short term business needs (such as working capital), I feel that such needs could be financed through P2P crowdfunding lending sites.
2. ***Have we recognized the potential benefits of this exemption for investors?*** The potential benefits of this exemption for investors have been recognized in the "consultation" document.
3. ***What would motivate an investor to make an investment through crowdfunding?*** For 'Non-securities" crowdfunding, investors' interests, passions, beliefs could play a big role in motivating them to invest. For securities crowdfunding, an expectation of a return on invested capital would play a role as well.
4. ***Can investor protection concerns associated with crowdfunding be addressed and, if so, how?*** Investor protection concerns associated with crowdfunding can be addressed in a number of ways. First are the investment limits that have been suggested in the document. Also, the document has sought to put in place limited disclosure requirements, keeping in mind the framework of the JOBS Act or OM requirements in other jurisdictions. Information available to investors through such disclosure could also help to reduce the risk of potential abuse or fraud. Also, it is my understanding that crowdfunding portals would be entrusted with a "gatekeeper" role as has been provided in the JOBS Act (as described in page 54 of your document). These responsibilities include doing due diligence, including background and regulatory checks, pertaining to entities it lists which could further help mitigate the risk of abuse or fraud.
5. ***Are there concerns with retail investors making investments that are illiquid with very limited options for monetizing their investments?*** There are concerns about the illiquidity of

the investments of retail investors. However, this is one of the risks they will be taking voluntarily. There is a provision of investors having to sign a "risk acknowledgement" document.

Presently, there are only a few equity crowdfunding portals globally. One of these, the Australian Small Scale Offerings Board (ASSOB), has a platform that enables the secondary sale of securities for entities that list through this portal.

6. ***Are there concerns with SMEs that are not reporting issuers having a large number of security holders?*** An SME with a large number of small investors can have benefits and pitfalls. On the benefits side, a successful crowdfunding campaign can provide "proof of concept" and in a sense some market validation that may be helpful to the issuer for raising further funds from angels or VC's or other accredited investors. A large number of small investors could also enable an accredited investor to make an investment with a controlling interest relatively easily. On the other hand, accredited investors may be uncomfortable to invest in such circumstances because of the perceived risk of being grouped with the management team and sued for damages or misrepresentation if things go badly wrong.

7. ***If we determine that crowdfunding may be appropriate for our market should we consider introducing it on a trial or limited basis?*** The idea of introducing crowdfunding on a limited basis has merit. One possibility is to introduce it through a specified crowdfunding portal that will specialize in equity crowdfunding. This portal could, in effect, undergo a learning curve, and hopefully become a robust role-model that other portals can, down the road, emulate. Another platform could start a P2P lending site and specialize on that model.

   An opposite model of introducing equity crowdfunding is to not put any restrictions on the number of crowdfunding platforms but to "let the market decide". In such a competitive environment, the better managed, more responsible platforms are likely to survive. Competitive pressures would lead platforms to implement governance standards and policies that would be beneficial to investors.

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**Issuer restrictions**

1. ***Should there be a limit on the amount of capital that can be raised under this exemption? If so, what should the limit be?*** I believe there should be a limit on the amount of capital that can be raised under this exemption. The reason for the limit is to have a cap on any possible fraud or abuse that may take place. I believe the proposed limit of $1.5 million in a 12-month period is reasonable.
2. ***Should issuers be required to spend the proceeds raised in Canada?*** I do not feel it is necessary to require users to spend the proceeds raised entirely in Canada. This would create an unnecessary obstacle and may actually prevent many SME's from being able to

raise funds through crowdfunding. I understand that an important rationale for spurring initiatives such as equity crowdfunding is to provide more opportunities for SME's in Canada and, thereby, create more employment. It would, therefore, be necessary to ensure that a sizeable proportion of the proceeds are spent in Canada. Perhaps, a cap (eg. 25%) could be put in place on the maximum amount of funds that could be spent outside Canada.

**Investor protection measures**

1. ***Should there be limits on the amount that an investor can invest under this exemption?*** There should be limits on the amounts investors can invest under this exemption. In this document, the suggested limits per investor are $2500 for a single investment and $10,000 in total. I feel that income level should play a role in determining the limits as has been done, for instance, with the JOBS Act. However, I also understand that this may not be feasible as information about investor income or net worth may not always be available.
2. ***What information should be provided to investors at the time of sale as a condition of this investment?*** Regarding disclosure requirements, I believe the items listed on page 29 "provision of disclosure at point of sale" are quite good. I recognize that sometimes investors may seek to include an array of potential risks to mitigate any potential liabilities (i.e. the "boilerplate" approach). However, this could also have the effect of dampening investor enthusiasm for funding the company. Also, the provision regarding the signing of a risk disclosure form is important as it ensures awareness by investors of potential risks .
3. ***Should issuers that rely on this exemption be required to provide ongoing disclosure to investors?*** I believe issuers should provide ongoing disclosure to investors. Equity crowdfunding platforms in other countries have this requirement. For instance, the Australian Small Scale Offerings Board (ASSOB) requires all entities profiled through its platform to provide "quarterly activity statements" on their profile pages. In this context, the items stipulated under "provision of ongoing disclosure" on page 30 of the OSC are appropriate, in my view.

   There could be a question as to whether such ongoing disclosure should be stipulated through regulation or whether, in a competitive environment, should be left to crowdfunding portals to put in place voluntarily. My preference would be for crowdfunding portals to require such information for the benefit of investors.
4. ***Should the issuer be required to provide audited financial statements to investors at the time of sale or on an ongoing basis? Is the proposed threshold of $500,000 for requiring audited financial statements (in the case of a non-reporting issuer) appropriate?:*** The stipulation for audited financial statements (under "provision of

disclosure at point of sale”, page 29) if the proceeds of the distribution are greater than $500,000 (for lesser amounts, certification by management) are also reasonable provisions in my view.

5. ***Should rights and protections, such as anti-dilution protection, tag-along rights and pre-emptive rights, be provided to shareholders?*** Anti-dilution protection could be helpful, especially if convertible securities (eg. convertible preferred) are being issued. Tag-along rights could be helpful to minority shareholders. Pre-emptive rights would be useful as well. However, I do not feel these should be stipulated as part of an overall regulatory framework. Such rights are best negotiated between SME management and investors based on individual circumstances.

**Funding portals and other registrants**

1. ***Should we allow investments through a funding portal (similar to funding portals contemplated by the crowdfunding exemption in the JOBS Act)?*** We should allow investments through a funding portal. The definition of “funding portal” provided in the JOBS Act and articulated in page 54 of the document is clear to me.
2. ***What obligations should a funding portal have?*** The funding portal should play a responsible gate keeper role. It should be impartial in the sense of not having any business interests in the entities it lists. In this regard, I like the provisos that detail the activities the portals cannot engage in (listed on page 54). Also, the portal should, at a minimum, conduct due diligence involving background and regulatory checks to reduce the risk of fraud. The provisions articulating the portals responsibilities under the JOBS Act that are detailed on page are quite good.

   I should mention some portals also do due diligence on the “quality” of the project or listing entity. This could include the specifics of the “pitch” or business plan (eg. Crowdcube, ASSOB). The credentials of the management team may also play a role. I recognize, however, that this additional due diligence does not have to be stipulated through regulations. I do feel, however, that those platforms that provide this additional service will, in the long run, become more successful and robust.

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**OM Exemption**

1. ***Should an OM exemption be adopted in Ontario? If so, why?*** Yes, I believe an OM exemption should be adopted in Ontario. Ontario is currently the only Canadian province without an OM exemption. While the intent has been to protect unaccredited investors,

this rationale will not hold if equity crowdfunding regulations are implemented in Ontario.

2. ***Should there be any monetary limits on this exemption?*** There should be monetary limits on this exemption. The limits should be the same as for crowdfunding exemption.
3. ***Should a purchaser be required to rely on investment advice from an adviser in order to rely on this exemption?*** I do not believe a purchaser needs to receive investment advice from an advisor in order to rely on this exemption.
4. ***Should there be mandatory disclosure required in an OM? If so, what level of disclosure should be required?*** The scaled disclosure requirements that have been proposed (consistent with crowdfunding regulation), as described in page 61, are good. I feel that, in addition, the risk factor disclosures could be useful and should be there. Also, purchasers should sign a risk acknowledgement form.

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**Sophisticated Investor Exemption**

1. ***Would the concept be useful to issuers, particularly SMEs, in raising capital?*** I found this to be an interesting concept. It is true that individuals with high income or net worth may not necessarily be more knowledgeable as their wealth me be inherited. In this regard, this exemption does indeed seek to focus on individuals who may have the skills to make more informed investment decisions.

   As has been pointed out in this document, the usefulness of this exemption to issuers will be limited to the extent that a relatively small number of individuals will meet this criterion,.
2. ***Are there sufficient investor protections built into this exemption?*** I am concerned that the individual's income or assets do not at all play a role in this exemption. In this respect, there could be a question as to whether adequate investor protections have been put in place. I understand that bringing in income and assets as additional components could defeat the purpose of this exemption. Therefore, one possible compromise could be to have set investment limits for this exemption that are broader (more generous) than the limits specified for crowdfunding or OM exemptions for unaccredited investors. For instance, the limits could be $15,000 for individual investments and $75,000 overall. I have just included these numbers to illustrate my point but I feel that some reasonable limits should be put in place.
3. ***Should we require an investor to satisfy both a relevant work experience condition and an educational qualification condition or would one suffice?*** I would place more emphasis on the educational qualification condition than on the work experience

condition as has been defined in the document. I feel that just a year of work experience (at any level) in the investment industry may not be sufficient.

It could be possible to include both (i.e. educational qualifications and one year of work experience in the investments industry) as requirements. In my view, this approach would be too restrictive. It is likely to favour individuals with qualifications that are more applicable to the investment industry.

I would, therefore, suggest going with educational qualifications and one year of "relevant" work experience. Here, the one year of work experience should be in activities that would normally be commensurate with the educational qualifications. I recognize that the work experience condition may be difficult to implement in practice.

4. ***How should we define the relevant work experience criteria?*** As I have suggested above, one year of "relevant" work experience could be put in as a requirement together with the educational qualification condition. However, there could be instances where the work experience condition alone would suffice. For instance, this exemption could perhaps be provided to individuals with three or more years of work experience in the investments industry even if they have not met the educational qualifications condition.
5. ***What educational qualifications should be met? Should we broaden the relevant educational qualifications?*** Perhaps, in addition to the qualifications mentioned in the document, the CA (Chartered Accountant) and CGA (Certified General Accountant) designations could be additional educational qualifications that would meet the condition.