February 28, 2013

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Toronto, Ontario M5H 3S8

Dear Sir,

I am writing in response to your request for feedback on Consultation Paper 45-710. I have been an entrepreneur off and on for the past 15 years, raised funds from over 50 private investors in Ontario and abroad, and invested myself in 10 private companies.

As both an investor and an entrepreneur, I am strongly in favor of enhancing the current exemptions, and adding new ones. I have found the current regime highly restrictive, as someone who is (i) highly knowledgeable in early stage investing, and (ii) who wants to invest in early stage companies, but who (iii) unfortunately does not meet the wealth and income portions of the accredited investor criteria. This forces me to invest primarily in early stage businesses I run myself, or those few run by close friends or family (a very limited pool), which results in an insufficiently diversified personal investment portfolio.

Responses to Section 2.2 Current Regulatory Approaches
Is the 50 security holder limit too restrictive? I ran a private Ontario company that found its fundraising activities constricted by the 50 security holder limit. For that company, a limit of 100-150 holders would have been appropriate, and would have enhanced our ability to raise funds, helping the business.

Comments on closely held issuer/family/other exemptions: I am not knowledgeable enough to comment on the closely held issuer and family exemptions, beyond stating that I am in favor of providing more opportunities for private investors who do not pass the means test of the accredited investor legislation to still be able to invest. It has been frustrating as an investor being unable to invest $5,000 (my standard investment amount) in multiple small business opportunities because I (i) did not have $1,000,000 in assets, (ii) was living off savings, (iii) was not related to the issuer, (and, (iv) the user had passed their limit of 35). To be blunt, in my case the legislation feels like illogical punitive repression of those Ontarians who fall short of being millionaires, rather than protection.

Responses to Section 5.2 Crowdfunding
Would a crowdfunding exemption be useful for SMEs raising capital? As someone who has run three SMEs as CEO, the answer is a strong yes. I have had to turn away at least twenty investors in my previous business for not being accredited investors (the firm was the subject of many press articles, making it of interest to small investors, who wanted to put a few thousand dollars in, as they would in a public investment). If I had been able to actively solicit such investments on our website, this could easily have been tripled, resulting in a significant amount of money for a firm that could have used it.

Have we recognized the potential benefits for investors? I am strongly in favor of democratizing the exempt market for all investors. ‘Democratize’ says it very well. I believe it is an important mission of the regulators to consider the potential benefits to all

Ontarians, not just the wealthy. The current rules by definition are discriminatory: they allow only the rich to invest freely in all opportunities. In the interest of fairness, this must change. We need rules written for the benefit of the masses, not just the elites.

What would motivate an investor to invest through crowdfunding? It could be one of many things: knowledge in a certain area, a belief in the future of a certain technology, a desire to back a certain cause or to support a local business. There are also investors, like myself, who are unhappy with the current investment opportunities available to us: who may believe that banks and investment funds charge fees that minimize our returns; who may believe more money is made in pre-public markets; and who may believe that public markets give insufficient knowledge to understand your investment (paradoxically, the best CEOs in private markets tell their investors far more, far more frequently than public market companies do, because (i) they can do so under the protection of confidentiality agreements, and (ii) they are not legislated to report in restrictive ways, hence can be more open).

Can investor protection concerns be addressed? The draft legislation already has the best possible investor protection written in: a limit of $2,500 per firm per year and $10,000 per year per investor. I believe these numbers are very well chosen.

What measures are most effective at reducing potential abuse and fraud? Fraudsters are a minority in all markets, and they will ALWAYS find ways to abuse their victims, no matter what rules you put in place (it should be obvious to all that fraud and abuse goes on today in public and private markets under the current restrictive rules).

The best possible potential protection is to make the cost of abuse and fraud so high that fraudsters are motivated to look for easier targets, and move away from your market. This is best done through aggressive enforcement. The OSC should allocate funds to specifically hire an enforcement team whose only job is to prosecute people who commit fraud in the crowdfunding market. Having a 'fraud reporting' line prominently posted on all crowdfunding sites where all investors (and fraudsters) can see it, for instance, is good signalling. If the funds are not available, then the OSC should consider a special levy (e.g., 1-2%) on all funds raised via crowdfunding allocated solely to enforcement.

Another effective protection against abuse and fraud is to keep a reputation management system. I should be able to go to one place, whether approved by the OSC or run by the OSC, where I can see a list, at a minimum (i) of all people who have had been prosecuted, gone bankrupt, been associated with firms that have done the same, etc, and ideally, (ii) where comments/reviews are attached to users by people who have done business with them. This second system is highly effective for eBay, and is the reason why their marketplace is a success. This reputation management system is only useful where it is centralized: if I can move from one market maker to another, and my reputation does not follow me, I can be a serial fraudster. If my reputation stays with me, the benefits of fraud are often outweighed by the costs in lost future opportunities.

Are there concerns with retail investors making illiquid investments? The only concerns with retail investors making illiquid investments could be if they do so with an inappropriately large portion of their portfolio. The limits are set low enough per year and per investment that this should not be a concern. Within a couple of years, the investors will viscerally understand illiquidity, even if they did not when they first invested. This is especially true if the risks of illiquidity are made clear to them on documents they sign as

part of their investment. We should note than an illiquid private equity investment is far better than day trading in public markets/doing online FX trading, or other investing activities open to all … and private equity is, in fact, a means of (very risky) forced long-term saving, which can be of benefit even to the financially vulnerable.

Are there concerns with SMEs having a large number of security holders? I have personally run two companies: one with five security holders, and one with 50 security holders. I had many fewer problems with the company with 50 security holders. The secret was frequent investor communication. In the five-holder company I communicated irregularly, and often got upset investor phonecalls. In the fifty-holder company, I communicated monthly, sharing the good and bad (without concern that my updates would ever be used against me in a court). If I was over-optimistic one month, within a few months my shareholders became disillusioned, because they could see I wasn't delivering on my promises: I rapidly learned to under-promise. The best possible way to enable SMEs to manage large numbers of holders would be to encourage (or even legislate) frequent updates. From experience, monthly updates would be best. These should be of unrestricted format: simply forcing SMEs to communicate monthly with their investors, no matter what they share, would help both the SME and the investors.

*[**Note:** I am the CEO of VentureLynx, a company that has built what one person referred to as 'the SEDAR for private companies'. I am happy to share our expertise on best practices in reporting for private companies with the OSC, should that be useful. The comment about monthly reporting being highly valuable for private companies does not presuppose the use of any particular platform to share this information.]*

Should we consider introducing crowdfunding on a trial basis? I believe that crowdfunding is best introduced both promptly, and on a permanent basis (if that does not get in the way of promptness). Person-to-person transactions are an inevitable trend with today's information technology and reputation management tools. I firmly believe that ten years from now, crowdfunding will be practiced in all jurisdictions, with those that adopted it first having the largest economic benefit. The OSC needs to figure out how to do crowdfunding right: introduce it, and adapt legislation as you go until you get it right.

Should there be a limit on the amount of capital raised? If you are already limiting the investment to $2,500 per person, and if you follow the suggestion of an enforcement team specifically targeted at fraudsters in the crowdfunding market (only), it is hard to think of a rationale for limiting the capital raised under this exemption.

Should issuers be required to spend the proceeds raised in Canada? Absolutely not. As a CEO, I can tell you that today many businesses are international almost from day one. Spending proceeds locally – and more importantly proving it – would require significant administrative expense (keeping special accounting books allocating specific funds raised and expenses to specific geographies) for little benefit. So long as the issuer is Canadian, why should the OSC care where the funds are spent?

Should there be limits on the amounts that an investor can invest under the crowdfunding exemption? Yes, I believe this is the best protection the OSC can give. The $2,500 per company and $10,000 per year may ultimately be on the low side. It seems like a very good place to start, with a good balance between giving an opportunity for excluded investors to finally participate in this market, and protecting these investors from large losses.

What information should be provided to investors at the time of sale? A streamlined information statement, financial statements as available, and risk acknowledgement all seem sensible to provide. It is important to note that, paradoxically, the more legal risk the management team sees themselves as taking in this information statement, the less information the team provides. (Without legal risk, we say more, to raise more funds.) The format should be loose, with an emphasis on deterring intentional fraud rather than allowing prosecution for minor inconsistencies or over-optimism.

The risk statement should include prescribed language (based on guidance) provided by the OSC, which describes the risks of investing in an early stage, illiquid stock in very harsh and direct terms, including industry stats (e.g., “80% fail”). Having this clearly in the risk statement is a good antidote to any over-optimism on behalf of the issuer.

The requirement for auditing of financial statements can be onerous. The going rate for an audit for an early stage company (when I did one last three years ago) was $25,000 and could easily rise to $40,000. That is a significant amount of funds to pay when you are raising $500,000, especially when that may represent two years operating funds or more. The result is a payment of 10% of yearly operating fees for an audit. Shareholders should have the right to waive the audit, in return for the company reinvesting these funds in the business rather than in audit fees.

Should issuers that rely on this exemption be required to provide ongoing disclosure to investors? Yes. The ideal guidance would be to provide a monthly report to investors, in whatever format the issuer chose, with penalties not applied unless the company goes 60 days without reporting. This report should be made available on an online platform, where all investors have equal and timely access to it. Ideally, the investors are also able to ask questions (so all can see the answers) and make comments on this platform (so investors can mobilize each other in the event of fraud).

Should audited statements be required? Audited statements should be waived or required based on a majority vote of the shareholders, both by number and percentage. Ideally such a vote should be easy for shareholders to participate in, e.g., be taken with an online survey tool. The proposed forced audit is inappropriate, and the $500,000 limit is considerably too low, as answered above, since it is economically inefficient (up to 10% of yearly fees going to an audit) for both the investor and the entrepreneur.

Should specific rights and protections be provided to shareholders? The best way to ensure rights are given to shareholders would be a different approach: legislate that companies that use the crowdfunding exemption can have only a single class of shares at the time of crowdfunding, i.e., common shares (and/or securities convertible only to common shares). In this case, the principals behind the company will be highly motivated to put rights and protections in for their own benefit, since they will be forced into the same class of shares. The provision will also encourage companies to clean up their capital table before using crowdfunding, which is good for prior holders.

It will also remove considerable possibilities for abuse. Having multiple classes with multiple rights is a standard tool to disadvantage small shareholders at the advantage of larger/more powerful ones. Eliminating special classes may not be popular in the investment community, who often use special share provisions to their advantage. From personal experience in over a decade in private company investing, this single change would strongly protect the small/common shareholders who are often otherwise abused.

Should funding portals be required? I believe that funding portals are not a necessary requirement for the crowdfunding exemption. As an investor, I should be free to invest up to $2,500 in a company I find interesting, whether such a company wishes to use a funding portal (which frequently takes 7% of the funds raised as fees) or not; whether they want to add a few 'crowdfunded' exemption investors to a much larger round raised with accredited investors or not. I believe, for the benefit of investors primarily, that funding portals should be permitted, but not be legislated as necessary. (If they are legislated, then they should only apply where a large number of investors are taking advantage of the crowdfunding exemption at once, e.g., 50 or more).

What obligations should a funding portal have? There are many different models for how a funding portal can be run. Some funding portals can have a business model of carefully vetting every deal before it is put on the portal, others may do rudimentary vetting, and still others may list opportunities on a 'buyer beware' basis. These are different business decisions, which involve significantly different costs for investors and issuers. Some may prove to be far better for both investors and issuers than others. We don't know which model is best. As business decisions they should not be legislated by the OSC. Portals will rapidly gain a reputation as good marketplaces to belong to, or places to be beware of. The OSC, or a party approved by the OSC, who keeps the suggested central registration system of infractions by individuals (with open access to all investors) should also keep an open record of infractions by portal – which will be a strong incentive to portals to clean themselves up. Let me underline the earlier suggestion, that the OSC should be aggressive in prosecuting fraud (through a crowdfunding-specific enforcement team, paid by 1-2% levies from the industry if necessary), especially in the case of portals that appear to be enabling fraud.

Should funding portals be exempt from certain registration requirements? Yes. Almost by definition, online marketplaces are set up as 'utilities' that enable buyers and sellers to meet freely and frictionlessly. Take eBay as the largest and most successful example. Legislators do not require eBay to hire experts in antiques to evaluate the antiques sold over their platform – eBay has no advisory capabilities whatsoever, and yet they run a highly efficient, highly effective marketplace, fraught with the theoretical possibility of fraud (including international sales, where the buyer pays a seller they do not know on the premise that the seller will ship the promised product and not just take the money and run) – yet with an actual extremely low fraud rate. They do this through an effective reputation management system, where 'the crowd' polices itself, and fraudsters lose reputation and hence lose the ability to participate in the marketplace. New participants, who lack reputation, often find their ability to do business is constrained significantly, until they earn reputation. Anyone doing business with a new participant recognizes the significant added risk they are taking on, and takes steps to mitigate their risk (e.g., through a smaller order that they can afford to lose).

To the extent that the funding portal is holding funds, they should meet solvency requirements. However, if the portal sets up arrangements where funds are held in trust, not on the portal's own books – or if funds are transferred directly from investor to investee with the portal being only a facilitator, such requirements become unnecessary.

Funding portals should definitely be required to be transparent about their commercial relationships with issuers. The best way to minimize fraud continues to be aggressive targeted enforcement of crowdfunding fraudsters (including portals): no matter how restrictive the rules, fraudsters will come in if enforcement is lax, and flee if it is strict.

Responses to Section 5.3: OM Prospectus Exemption

Should an OM exemption be adopted in Ontario? I am not knowledgeable enough to provide a direct answer. However, my experience as an entrepreneur may be informative. As background, most entrepreneurs have very limited funds available in their business. It is much more cost effective to prepare materials yourself (often at an effective salary of $20/hr), than it is to pay expensive advisors to prepare these documents for you (often at an hourly rate far in excess of $200/hr).

I was recently offered the chance to raise funds from a Vancouver-based investor, who was interested in our business. I already had a business plan prepared. This individual asked me to send them an OM, of the form approved in BC. I downloaded the materials from the government website, and attempted to rework the business plan to match the approved form. I frankly gave up on the job, and did not pursue the investment, because the OM form was so intimidating (for a relatively sophisticated entrepreneur). It has been a few months, and I remember both struggling with the content, and being concerned about my legal situation as the entrepreneur if I made an inadvertent misrepresentation.

If an OM exemption is put in place, it should be structured in such a way that normal everyday entrepreneurs can draft an OM themselves, with perhaps only 2-3 hours of review by an expensive expert. That will make it much more likely to be used, and much more useful to small businesses.

If you do adopt an OM exemption, the $1.5 million limit seems much more appropriate here than it is in the case of crowdfunding.

Responses to Section 6.2: Investment Knowledge Exemption

Would the 'knowledgeable' investor exemption be useful? I am strongly in favor of "knowledgeable investor" exemption. I literally laughed at the comment that this will have a 'potentially small impact', because in the circles in which I am active, this exemption would be welcomed and used frequently. Entrepreneurs are very knowledgeable about early stage businesses, and almost by definition do not earn over $200K per year (since their shareholders like to minimize salary and increase equity compensation). We want to invest in other entrepreneurs, and often find the majority of our personal net worth tied up in illiquid stock (i.e., our own) for many years, even when the business is highly successful. The people who are most knowledgeable about early stage businesses, and most motivated to invest in them, are the ones who are also most unable to invest in the industry under the current criteria. SME owners want to support other SMEs. Let us!!

Are sufficient investor protections built in under this exemption? I believe that yes, they are. Knowledge is a much better protection to the investor than wealth. For instance, despite my passion for early stage investing, I am well aware that my personal portfolio needs to be strongly diversified. Excluding companies I run myself, I have never had more than 30% of my portfolio in all early stage investments combined. You don't need to legislate that: it is obvious to me as a knowledgeable investor.

Should one of work or education suffice? I believe that either education or work should suffice. I am the holder of an MBA (and hence would thankfully qualify, at long last), who has spent my career in management consulting followed by entrepreneurial leadership positions. I have never worked in the investment industry: I have learned about the financing of small companies by running them – arguably the best training.

What education requirements should be met? I clearly believe an MBA is a good qualification. I also believe a Masters in Finance is logically another program that merits approval, in addition to the CFA and CIM. In a world where learning is moving to free online video learning without formal accreditation, we also need other options (see next).

Are there other proxies for sophistication we should consider? Ontario citizens who have the knowledge to invest should not be excluded because they have not been privileged enough to be able to afford an MBA or the considerable time and expense of a CFA or CIM. Rather than prejudge whether the qualifications are sufficient, Ontario should also allow investors to prove their sophistication through an open exam. This exam could be delivered by a third party, licensed by the OSC, who would charge participants to recover their costs. The firms that offer other standardized tests, like the GMAT, would probably be interested. This is the fairest way to allow Ontarians to prove their sophistication, without limiting access. Make rules for the masses, not the elites.

Minimum amount exemption: as a side note, the minimum amount exemption is ludicrous. With less than $1M in wealth, I can't invest $150,000 in thirty firms to diversify my risk, but I CAN invest it in one firm, giving me very concentrated risk. Luckily I am not that foolish … but not everyone is as sophisticated as I am. (In my previous company, one prospective US-based investor proposed qualifying with this exemption: I refused his money). It should be eliminated/replaced by the 'sophisticated investor' exemption.

Responses to Section 6.3: Investment Advisory Exemption
Should we consider an exemption based on advice provided by a registrant? I can only comment as a member of the public, not a registrant. I strongly agree with the suggestion that the exemption should only apply if the registrant has a fiduciary duty to act in the best interests of the client (and hence can be prosecuted if they do not).

Responses to Section 7.2: Electronic Filing
Concerns over e-filing? My only concern, as a taxpayer, is that the OSC does not yet mandate electronic filing. I hope it happens soon.

Responses to Section 7.3: Additional Information Required
Are there concerns over requiring this additional information? Yes. I have raised money from many private investors. Most are (in my mind unduly) concerned with personal privacy. They wish to limit the amount of information they give about themselves to 'the government'. Specifically, the request for the investor's age range and work status is likely to be highly objectionable, and it feels like a personal invasion of privacy for me to be forced to ask this question. The work status is an especially ridiculous question, since this is in constant flux, and having an answer at one point in time does not say anything about what it may be even one month later.

The requests for additional information on the issuer are generally reasonable, as a protective measure for investors, and to aid in prosecution. The 'industry categorizations' used have in my case always been impossible to complete: by definition, high technology companies are often creating new categories that do not exist. General categorizations are far more useful to work with in our case than specific ones.

Are there other types of information we should require in the report? No, unless there is other information that would help with prosecution of fraudsters.

Responses to Section 8:1: Additional Comments
A general comment on the text: the OSC emphasizes concerns over the 'financial literacy' of retail investors and the requirement for expert advice. It is worth pointing out the best entrepreneurs are almost never accountants or financial advisors … who make money as advisors precisely because they cannot lead wildly successful businesses.

We have a shortage (some would say crisis) in financing in the SME markets today precisely because funds are controlled by finance experts (e.g., at banks and investment funds) who are uncomfortable investing in early stage businesses: they wait until the financial numbers are stable and predictable before providing funding. Individual investors, who may have a much higher risk tolerance, and who can be much better at predicting the success of a business before the financials make it clear – often due to their specialized knowledge of the industry or local market or even reputation of the individuals leading the company – are being forced out of the investment market. Their money is forced into banks, where it sits uninvested, under the firm control of the 'financial experts'. This hurts both investors and chronically capital-starved SMEs.

Retail investors should be expected to understand that they can lose everything with an early stage investment. This risk warning should be clear, strong, and simple to understand. Whether they understand a balance sheet matters much less then if they understand the business. Yearly financials hardly matter: by the end of a year the business is often a success or failed: monthly reporting of any news matters much more. Business knowledge (even just knowing the company is selling a product or service that you would like to buy) matters much more than financial knowledge in predicting early stage business success.

Are there prospectus exemptions we should consider in addition? No. I think the OSC has done an excellent job here. To underline, I believe the key additional new exemptions should be the 'Investor Knowledge Exemption' and the 'Crowdfunding Exemption'. Both will be of great help to early stage investors and entrepreneurs. I also believe the 'Minimum Amount Exemption' should be eliminated.

Thank you for your excellent work to date on this file: simply the fact that the OSC is considering these exemptions is encouraging. The broad lines of the exemptions seem to be well designed. I hope, on behalf of all early stage investors and SMEs, that you will put them into force.

Kamal Hassan
Toronto, ON
kamal@venturelynx.com

(Further personal details omitted because letters are public: email me if you need them.)

P.S. I also encourage you to think hard about shifting the emphasis in investor protection away from overly restrictive legislation and towards aggressive prosecution. It is disappointing that legislation and enforcement are not presented as a package, where investor protection is delivered through either side as appropriate to the case. Written laws protect us from law-abiding businesses only (i.e., stop the public from investing in law-abiding SMEs); ONLY enforcement of laws can protect the public from fraudsters.