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MEMORANDUM

March 1, 2013

BY E-MAIL: jstevenson@osc.gov.on.ca

John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8

Re: OSC Staff Consultation Paper 45-710 – Considerations for New Capital Raising Prospectus Exemptions

1. Introduction

We are pleased to provide this document in response to OSC Staff Consultation Paper 45-710 – Considerations for New Capital Raising Prospectus Exemptions (the "**Consultation Paper**").

Our firm, Wildeboer Dellelce LLP, has been and remains one of Canada's most active law firms in the area of early stage technology company financing. Over the past 20 years, we have acted on behalf of numerous issuers, venture capitalists, angel networks and private investors, as well as registered dealers and exempt market intermediaries in this area. We have seen, up close, the difficult challenges that Ontario entrepreneurs face in raising risk capital to fund their start-up business ideas.

Ontario residents must face two basic facts. First, employment expansion and related economic growth in the knowledge industries - primarily technology and advanced manufacturing - are critical to Ontario's future success. Second, a shortage of adequate capital to fund business incubation and growth is a significant issue for the knowledge industries in Ontario, particularly for technology companies.

A third, less well known development, is a trend in venture funding to move away from large, single funder investments in unproven companies or technologies, to a more graduated system of early investments by syndicates of investors to support milestone/stage based development of businesses. This development dovetails with a reduction in the front end capital investment costs for starting many of today's technology businesses. We believe this lower capital cost model is also the case for businesses in other non-technology areas, primarily as a result of changes in Internet and social technologies.

Our experience has shown us that in the current business environment, important early stage investments for Ontario based start-up companies, particularly for up to the first $500,000 in critical start-up risk financing, are exceptional. Too few companies are successfully managing to secure these funds. The reality is that most companies are investing considerable time, effort and energy, to obtain substantially less investment. Given the importance of start-ups to Ontario's future success, this needs to change. We believe that a significant change in approach to the regulation of the exempt market under Ontario securities laws in relation to start-up companies is needed. As a central tenet of its regulatory review, we suggest that the Ontario Securities Commission (the "**OSC**") consider how innovative approaches to securities regulation can be harnessed to create a regulatory environment that acknowledges the unique issues, risks and opportunities of venture capital markets and helps to foster the growth of early stage companies in Ontario.

The Consultation Paper is a timely and positive contribution to the dialogue on addressing this issue. We think that the Consultation Paper is an excellent initiative by the OSC to address an area of securities regulation which needs improvement. We cannot stress enough the importance of this initiative to start-up businesses in this province. We strongly encourage OSC staff to move quickly following consultation to propose and implement under the existing authorities conferred on the OSC further concrete actions to streamline and liberalize the rules for access to capital for start-up companies.

While we appreciate the potential initiatives explored in the Consultation Paper, our primary purpose with this response is to propose an alternative regulatory solution that we believe would more suitably address the serious business issues posed by Ontario start-ups, without sacrificing the regulatory framework that Ontario has created, thus making it easier to attract capital to encourage the Ontario based start-up community to thrive.

1.1. Summary of the Proposal

Our proposal, using the existing legislative and regulatory authority conferred on the OSC, is to have a new prospectus exemption created for Ontario based corporations (primarily Ontario or federally incorporated corporations but also corporations from other Canadian jurisdictions and perhaps certain foreign jurisdictions, such as Delaware, having an active business presence in Ontario) that are start-ups (the "**Start-up Exemption**").

Under the Start-up Exemption, eligible start-up issuers (which could be defined as any business which is not an investment fund, or which could be initially limited to companies primarily engaged in the information technology, clean technology and life sciences disciplines, with less than 50 employees) would be allowed to issue securities of any kind for gross proceeds of up to a specified threshold (for example, a maximum of $1,000,000 in capital raised in any year) on an exempt basis from the prospectus requirements under the Ontario *Securities Act*. As an approximate "rule of thumb", a per employee revenue metric of $100,000 to $200,000 is not unreasonable, meaning that, in practical terms, this exemption would permit companies ranging in revenue size from $0 to $10,000,000 in annual revenues to rely on this exemption to support their capital formation activities.

In addition to the annual financial restriction on the use of the Start-up Exemption and the need to qualify as a "start-up", a separate aggregate lifetime limitation would be imposed for the use of the Start-up Exemption. For example, the Start-up Exemption could be made available to companies for their first three years of existence, during which they could issue securities for maximum gross proceeds of $3,000,000 (alternatively, a higher limit could be used, such as five years with gross proceeds of up to $5,000,000). Finally, individual investors would be limited to a maximum investment in a particular issuer in a year, for example $5,000. Investors would be permitted to make multiple investments in the maximum amount using the Start-up Exemption in a year, provided no two investments were in the same issuer or any related issuers.

In order to utilize the Start-up Exemption, start-up issuers would also be required to provide investors with a form of term sheet containing certain required disclosure regarding the financing and the issuer, and obtain a risk acknowledgement form countersigned by investors prior to closing in a prescribed form which expressly and clearly identifies the investment to potential investors as a start-up investment which may be a highly risky investment in which there is a strong chance that the investment will not be successful. The provided term sheet would also be required to provide a summary of any documents pertaining to the transaction or the issuer that affect the rights of security holders. To increase the effectiveness of these summaries at protecting investors, issuers would assume liability for misrepresentations. As a further protection, investors could be given rescission rights upon discovery of a misrepresentation. However, we note that, in practical terms, both the "cooling off" period proposed in

the Consultation Paper, and the broader issue of liability for misrepresentations in a reduced compliance environment, need to take into account the reality of the investment decisions involved (i.e. a cooling offer period makes little sense for a venture investment, you are in or you are not) as well as the fact that many of these issuers are typically high risk, pre-revenue, or early stage revenue companies, with a high probability of failure (making the possibility of after the fact disputes as to misrepresentations troublesome if used by investors or their counsel simply to recover investment losses).

To monitor use of the Start-Up Exemption, issuers taking advantage of the exemption would be required to file a report of exempt distribution using the existing 45-106F1. This would represent an increase from the reporting requirements applicable to the existing private issuer exemption, which is frequently used by Ontario's start-ups to facilitate early stage financing transactions at present.

To ensure effective governance, and given the potential for larger groups of small shareholding investors, availability of the Start-Up Exemption could require issuers to adhere to certain elements of the governance system applicable to public issuers, such as having representation from non-management / non-founder investors on their board of directors, providing for minimum annual disclosure to shareholders, and requiring standard drag-along piggy-back provisions (common in shareholders agreements for closely held companies). These provisions, combined with the statutory protections for shareholders under corporate law in Canadian jurisdictions in the form of delivery of audited annual financial statements (except where waived), annual meetings, proxy solicitations and oppression remedy relief, should be adequate to address governance and fairness issues.

As a further measure safeguarding investor protection, it could be required that, with respect to any financing involving a Start-Up Issuer, at least one investor meeting the "accredited investor" definition (with a possible additional requirement that they be registered in an established angel investor network or registered venture capital fund) must meet a minimum participation level (for example a "lead order" representing a minimum of 20% of the proposed offering) for any financings completed using the Start-up Exemption. For further detail on investor protection under the Start-up Exemption please see the section below entitled "Objectives of Securities Law and the Start-up Exemption".

2. The Current Environment

There is a demonstrated appetite at both the federal and provincial government levels for the development of the Ontario venture capital space. The discussion paper "Access to Risk Capital for High-Growth Ontario Firms" published by the Ontario Ministry of Research and Innovation on May 30, 2011 (the "**Ontario Report**") emphasizes the vital role of risk capital in creating and retaining high growth companies and jobs in the province and sets out a proposal for the introduction of tax credits to spur venture capital investment by angel investors and multinational corporations. Despite this, the Ontario Report indicates a bleak landscape for Ontario venture capital. **As a percentage of GDP, Ontario's investment in venture capital is 40% less than British Columbia, 50% less than Quebec, and 1/7th that of California and Massachusetts. This lagging of these global innovation jurisdictions is the result of a decline in venture capital investment in Ontario from $770 million in 2005 to $424 million in 2010.** The federal government is working to combat this trend and has recently pledged $400 million towards investment in Canada's venture capital space. **It needs to be emphasized that current capital formation issues in Ontario's start-up sector are not caused by, or the result of, government action (or inaction). The combined impact of federal and provincial programs in Ontario have made it - from a public policy point of view - one of the world's most accommodative systems in terms of tax subsidies and incentives. These policies are necessary but not sufficient prerequisites for success.** Ontario is not Silicon Valley and it never will be.

However, to build on and amplify these government initiatives, securities regulation must be flexible enough to enable the development of a stronger, grass roots, "confederated" culture of venture capital investment in Ontario. To this end, securities regulators in Ontario need to recognize that the venture capital space in general, and the Canadian venture capital space in particular, is a unique market which requires a unique regulatory approach. **This begins with the acknowledgement that the venture capital space is primarily about highly risky investments which have a very low chance of success.** A recent article notes that, in the U.S., over 1,000 start-ups that have received seed funding in the past few years will "die on the vine" and will fail to obtain Series A funding, resulting in over $1 billion of US early stage venture investment being wasted on failed companies.[1] While this may appear at first glance to be a market failure, this is part of the natural process of distilling down the masses of start-ups to those that have the greatest potential for success. Through this process, the value of the few companies that emerge successful, and the economic prosperity they bring to Ontario, will far outweigh the detriment of the investment dollars lost to investors funding the many companies that fail to succeed.

Despite the substantial need for this high risk venture capital, Ontario start-ups are largely restricted to raising money from a limited pool of investors in Ontario who are considered "accredited". Many of this generation of these investors, to the extent they wish to be active in the Ontario start-up funding sector, have already made commitments to do so. Many of them are simply tapped out. The capital resources of "accredited investors" as a group allocable to venture capital investment are finite and in many cases these investors may already be committed to the full extent of their tolerance for venture capital investment. Our proposal in this sense is not unlike the current reality on the ground of "leveraging" government funding programs such as FedDev's Investing In Business Innovation program through "matching" accredited / angel investor dollars (on a $2 to $1 basis). It promotes the amplification, through leverage, of the relatively small number of accredited investor dollars available (certainly by comparison to any US standard, for example) by attracting larger pools of funds from a broader group of investors, each of whom is making smaller "bets".

To achieve the levels of incubation, innovation and expansion in Ontario's start-ups required to position Ontario as a uniquely differentiated global leader in the venture capital space, we must embrace a regulatory system that accepts the higher failure rates endemic to start-ups, enables broader participation in funding these investments more easily at lower cost, and diversifies the risk and cost of these failures across a broader pool of willing investors. In order to enable successful companies to emerge in or relocate to Canada, and stay in Canada, we need to allow investors to make risky investments in seed stage start-ups, acknowledging that a great percentage of these investments will fail. This objective contrasts many of the traditional policy objectives of public interest investor protection and risk mitigation implicit in securities regulation. We therefore need to adapt our existing securities regulations to recognize the unique characteristics of venture capital investments and permit broader participation by the public in start-up company investments. More specifically, we believe that securities regulation in the venture capital context needs to allow the general public the freedom to make investments in risky start-up companies, and focus exclusively on eliminating the risk to investors of exploitive business practices such as insider transacting, fraud, deceit and money-laundering.

3. Inputs for the Development of the Start-up Exemption

We have suggested the Start-up Exemption based on the following statements of principle:

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[1] http://www.cbinsights.com/blog/trends/seed-investing-report

(i) The Ontario general public is capable of understanding the nature of an investment in an Ontario start-up. In the Internet age, the general public is highly empowered to access information about investing in start-up companies and to assess their likelihood of success.

(ii) The restriction on public access to venture capital markets is asymmetrical with other regulatory policies which allow the general public to make investments in real estate and certain businesses as well as to allocate personal savings towards intrinsically exploitive practices such as lotteries, gambling and other "taxes on fools". Investments in Ontario start-ups offer a much greater risk weighted return than these latter alternatives; but individuals are precluded currently from making these venture investments. As long as start-up investments are expressly and clearly identified to potential investors as highly risky investments in which there is a strong chance that the investments will not be successful (i.e. akin to gambling) and the total financial loss by an individual investor in any particular start-up is limited by investment limits under the Start-up Exemption, members of the general public should be provided with as much opportunity to "gamble" on start-up companies as they can on horse racing, and if they choose to do so, there should be an element of "buyer beware" that prevails in light of the nature of the investment, provided that there are no misrepresentations, fraud or other deceit.

(iii) Ontario has continued to make significant strides globally as a financial services center and our initiative ties into this broader theme as well. By making the Start-up Exemption expansive and inclusive, Ontario would be promoting a welcoming posture for the entire "ladder" of investment capital that services early stage companies at each step in their development process, enhancing our potential to be a global center for venture capital investment. An integral step in this process is developing an innovative framework for securities regulation that encourages investment from a broad range of investors in Ontario's start-ups, and that encourages companies in the information technology, clean technology and life sciences areas to locate meaningful aspects of their business operations here to access that more dynamic funding environment.

4. The Start-up Exemption

The Start-up Exemption would be a new prospectus exemption that would be available exclusively to Ontario based start-ups. This exemption is suggested with three goals in mind:

(i) maximizing the capital raising opportunities available to start-ups in, coming into and / or operating businesses from Ontario;

(ii) improving the efficiency of capital raising transactions for Ontario start-ups by reducing the associated transaction costs; and

(iii) providing appropriate reporting requirements that improve the transparency of Ontario's venture capital space and allow the OSC and other governmental agencies unprecedented access to information on how markets are functioning for venture capital.

4.1. Availability

The Start-up Exemption would be available to any corporation incorporated in any Canadian jurisdiction having less than 50 employees and a business in the information technology, clean technology or life sciences area based in Ontario. Under the Start-up Exemption, eligible issuers would be permitted to raise, on a prospectus exempt basis, a maximum of $1 million annually and $5 million during the entire

period for which they qualify to use the Start-up Exemption. Issuers would become ineligible for use of the Start-up Exemption on the date which is 5 years from the date of their incorporation. Finally, individual investors could be limited to a maximum investment in a particular issuer in a year, for example $5,000. Investor’s would be permitted to make multiple $5,000 investments using the Start-up Exemption in a year, provided no two investments were in the same issuer or any related issuers.

Issuers who wished to use the Start-up Exemption would be required to maintain a simple capital structure, consisting only of common shares, preference shares with certain prescribed simplified terms, debt convertible for common shares and/or non-convertible debt. If an issuer had an employee stock option plan, it would be limited to reserving for issuance more than 20% of its issued and outstanding securities. These provisions, while prescriptive, mirror the current structure and process of capital formation in seed issuers. They would also streamline and simplify the process of creating a start-up corporation and protect investors from purchasing complex securities with unpredictable returns.

The Start-up Exemption would be available to start-up issuers regardless of whether they are reporting issuers or private companies. In the case of reporting issuers, there are many reporting issuers in Canada that are effectively start-ups and that face the same issues as private company start-ups. Investors in these start-up companies that are reporting issuers would obviously benefit from the continuous disclosure obligations to which reporting issuers are subject. The central issue for use of the Start-up Exemption would be whether the issuer is a start-up issuer. We appreciate that there may be concerns with start-up issuers that are not reporting issuers having a large number of security holders and, accordingly, it may not be inappropriate to limit the number of security holders which a start-up issuer could have unless it was a reporting issuer.

4.2. Capital Raising Transactions

Issuances of securities using the Start-up Exemption (“**Start-up Sales**”) would be subject to certain requirements which would be designed to provide investor protection while minimizing constraints on capital raising activities and also reduce transaction costs associated with closing transactions and regulatory compliance. Start-up Sales would not be permitted to be the subject of a commission, finders’ fee or similar payment (or, alternatively, such payments would be subject to a low maximum of 3% of the value of the sale).

Start-up issuers would be required to report all Start-up Sales using the existing Form 45-106F1. This would represent an increase from the reporting requirements applicable to the existing private issuer exemption, which is frequently used by Ontario’s start-ups to facilitate early stage financing transactions.

4.3. Secondary Market Sales

Secondary sales of securities issued under the Start-up Exemption would be required to comply with existing resale rules.

4.4. Sponsorship

One potential implementation of the Start-up Exemption could use the investment IQ of existing participants in the venture capital space as a proxy for determining the safety of investments. This would mirror government initiatives that allocate capital to start-ups by matching investments made by certain angel investors. Under this implementation of the Start-up Exemption, issuers would be required to have at least one subscription from an accredited investor registered in an established angel investor network or a registered venture capital fund (together, “**Sponsor Investors**”). The aggregate amount of subscriptions accepted from non-accredited investors in a financing using the Start-up Exemption would be limited to

the aggregate of proceeds raised from Sponsor Investors. Alternatively, Sponsor Investors would be required to subscribe for a minimum percentage of the offering. It would be required that issuers make it explicitly clear to all investors that the Sponsor Investors are in no way vetting (or liable for) their investments. This mirrors the practical reality on the ground of the current Ontario angel investing environment: lead order commitments are made by key investors within the current angel networks and others "pile on".

4.5. Documentation

In order to reduce transaction costs and improve investor protection, we recommend that prior to issuing securities to an investor using the Start-up Exemption, investors be provided with a standardized form of term sheet and risk acknowledgement agreement. Issuers would be required to include in the term sheet a summary of all documents relating to the issuer and the particular financing that affect the rights of security holders, such as terms of the securities to be issued and any shareholder agreements.

4.6. Crowdfunding

While the Consultation Paper's consideration of crowdfunding is laudable in its embrace of a new method of accessing capital, we believe that great consideration needs to be given to the risks and the harm to other areas of the capital markets that could arise from crowdfunding. Crowdfunding perhaps poses more risks than any method of financing before it; crowdfunding facilitates investments from an exceptionally geographically and educationally diverse group of investors who have an unprecedented lack of information about issuers operated by individuals who can maintain total anonymity and avoid accountability for the failure of their businesses. While appropriate regulation could reduce or eliminate these concerns, the proposed approach of creating an exemption for crowdfunding, without providing similar exemptions for all other methods of financing would create a systemic bias towards its use. This is problematic because crowdfunding is facilitated by private operators which charge commissions on all proceeds raised through their services. If Ontario start-ups are required to use crowdfunding to raise funds from non-accredited and non-related investors, they will suffer as all of their capital raising activities become subject to the fees of crowdfunding service providers.

We believe that the Start-up Exemption would operate as a counterparty to any proposed crowdfunding exemption which would provide issuers with the option to raise funds from non-accredited and non-related investors without resorting to the use of private crowdfunding portals. We have found it noteworthy that a number of the primary proponents of crowdfunding at recent public consultation events appear to have personal interests (through investment in or ownership of "platforms" proposed to be positioned for this crowdfunding purpose) and appear to have given limited thought to some of the fundamental issues of compliance, investor protection, anti-money laundering and other similar frameworks that have been put in place across many other industries (banking, legal services, insurance, real estate, etc.) for investor protection and public interest considerations.

5. <u>Objectives of Securities Law and the Start-up Exemption</u>

While the Start-up Exemption would greatly increase the ability of the public to invest in Ontario start-ups, we do not believe that it would be inconsistent with the stated objectives of Ontario securities law:

(i) to provide protection to investors from unfair, improper or fraudulent practices; and

(ii) to foster fair and efficient capital markets and confidence in capital markets.

5.1. Unfair, Improper or Fraudulent Practices

Though the Start-up Exemption contemplates a significant reduction in restrictions on sales of securities to the public, we believe that appropriate investor protection in the context of the nature of start-up investments would be provided through basic disclosure regarding start-up issuer investments, express and clear identification of start-up investments as highly risky investments in which there is a strong chance that the investments will not be successful, limits on use of complex securities and reporting of the use of the Start-up Exemption. By requiring all transactions to be reported on Form 45-106F1, the capital raising activities of Ontario's start-ups can be monitored with greater care. Finally, the limits on annual, lifetime and per investor proceeds raised by issuers through the Start-up Exemption would contain the extent of any harm done due to an abuse of the system and provide additional protection to investors.

In the event that further protection of public investors is required, the Start-up Exemption could require the participation of one or more Sponsor Investor in any Start-up Sale, as described more particularly in the section above entitled "Sponsorship".

5.2. Fair and Efficient Capital Markets

We believe that the Start-up Exemption would foster fair and efficient capital markets by making our capital markets a better option for Ontario start-ups to raise critical early stage financing and providing a broader base of public investors with greater access to start-up investment opportunities if they wish to invest in them.

6. Implementation

We believe the Start-up Exemption could be implemented under the OSC's rule making power pursuant to section 143(1) of the Ontario *Securities Act.*

7. Other Comments On Consultation Paper

In addition to our suggestion of the Start-up Exemption, we also offer the following comments on certain aspects of the Consultation Paper and your related presentation materials:

a. **"If It Ain't Broke…."** The market data in the Consultation Paper is excellent and shows that the exempt marketplace is currently very active and vibrant for exempt financings ($4Billion+) and accredited investors (less than 4% of Ontario residents). Most of that funding involves structured product and similar securities placed with institutions and high net worth individuals. This system works well for these purposes and this is good. Our Start-Up Exemption speaks to the challenges significantly smaller companies face in raising money and the needs of the 96% of Ontario residents who do not have access to deal flow because they do not meet specified income and asset thresholds, and who may very much want to participate in that market for a variety of reasons.

b. **Offering Memorandum considerations.** Subject to earlier considerations around investor protection and related protective measures, we see limited value in requiring offering memoranda in the venture capital context as a condition of obtaining access to a relaxed prospectus exemption regime. Offering memoranda are costly to prepare and, for early stage and pre-revenue companies, they offer limited insight for potential investors. That said, an offering memorandum based exemption may be appropriate for graduates of the Start-up Exemption that are not ready to pursue an initial public offering but would like to raise capital from non-accredited investors.

c. **"Investment Knowledge"** is not necessarily correlated with investment industry participation. If the OSC wishes to take a prescriptive route in exempting individual investors based on their educational qualifications and / or financial expertise, either the categories through which this may be obtained should be substantially broadened (for example, to include most university educated and professionally qualified individuals as well as anyone running their own business) or individuals should be permitted to attest to their qualification (at the same time acknowledging that they are making high risk investments without customary investor protection measures).

d. **Registrant participation.** We do not believe this should be mandated or encouraged for Start-Up Exemption issuers. It should be at their discretion. The reality of the market is that most venture capital and angel investors do not wish to have registrants involved due to transaction cost and perceived lack of value. We believe it is preferable to permit issuers themselves to decide whether or not to engage registrants (or others) to assist in the selling process. The focus of regulatory interest here should be on issues of conflict of interest and adequate disclosure of issuance costs.

8. Who We Are

Our firm, Wildeboer Dellelce LLP, is an innovative business law firm which has been highly active in the Canadian technology financing space for the last 20 years. Since inception we have been involved in many of the biggest Ontario start-up success stories, often from a very early stage of growth. We know what it means to boot strap a company from the ground up and are actively engaged in ground level business building in Canada through initiatives such as our support or sponsorship of the Waterloo Hyperdrive Accelerator program, Backbone Magazine's "Start Me Up" competition and CBC's Dragons' Den. Members of our firm have participated as issuer or investors counsel in transactions at every stage in the capital lifecycle for tech, clean tech and life sciences issuers in which hundreds of millions of dollars have been raised. Clients have included many of Canada's bank owned and independent investment banks, venture capital firms, private investors, leading angel networks (including notably the Golden Triangle Angel Network, Canada's most active and successful angel network, as well as the Essex, York, Angel One, Maple and Sudbury networks), and a diverse range of issuers including for or in relation to many household name Canadian success stories in the tech sector. We also act for many of the "next generation" of issuers now emerging in the Toronto-Waterloo corridor, from the Waterloo Accelerator Center, Communitech Hub, Velocity, Ryerson Digtal Media Zone and MaRs ecosystems.

9. Contact

These are personal opinions of the authors and do not reflect the views of Wildeboer Dellelce LLP as an organization or the views of the other partners and employees of Wildeboer Dellelce LLP. For more information, please contact:

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