DAVID E. THRING
Suite 4400, 181 Bay Street
Toronto, ON
M5J 2T3

BY EMAIL

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Ontario Securities Commission
20 Queen Street Ist
19th Floor, Box 55
Toronto, Ontario
M5H 3S8

Attention: John Stevenson, Secretary

Dear Sirs:

Re: OSC Staff Consultation Paper 45-710 - Crowdfunding

I appreciate the opportunity to participate in the consultation process. I hope these comments in support of a prospectus exemption to permit crowdfunding will be helpful in your deliberations.

Background

I am a partner in a national law firm and have practiced corporate law for more than thirty years. The comments set out in this letter represent my personal views and do not reflect the views of my firm or (to my knowledge) any of my partners.

In April 2012, when the U.S. adopted the *Jumpstart Our Business Start-ups (JOBS) Act*, I published an article advocating the adoption of crowdfunding in Ontario as a potential new source of capital for small and medium business enterprises (SMEs) to promote innovation. In response to the article, I received inquiries from about a dozen people, all of whom were existing capital market participants interested in establishing portals or otherwise exploiting the new concept. I did not receive a single enquiry from an entrepreneur or SME. While this sample size may not be statistically significant, it does indicate that, if there is enthusiasm for crowdfunding, it currently resides with people in the financial services industry who wish to establish portals. It is my view that, while the portals should play an important role, the primary policy objective (and indeed, the opportunity) should be to benefit start-ups and SMEs by providing a new source of financing to launch new businesses or take existing ones to another level.

Private Issuer and Closely Held Exemptions

The consultation paper asks a preliminary question: "Is the 50 security holder limit under the private issuer exemption too restrictive?". In my experience, it is not. Typically shareholders of private issuers enter into shareholders agreements to manage their interests, and 50 is an unwieldy number (as is 25, for that matter). However what often limits the utility of the private issuer exemption is the requirement that an investor who is not an accredited investor must have a relationship with the issuer or its founding or controlling shareholders. While the private issuer exemption is an important component of the venture capital spectrum, it is of limited use because it does not allow solicitations to the "public", however defined. In this respect, the private issuer exemption is the opposite of a crowdfunding exemption, which by definition will allow an issuer to solicit the public.

It follows that, if the OSC permits crowdfunding, it should in principle also re-introduce the closely held issuer exemption. Both are premised on there being no limit on the number of prospective investors whom an issuer may approach. Whether the "approach" is on-line, or by some other means, should not make a difference. If the OSC chooses to re-introduce the closely held issuer exemption, it should carefully consider whether the limits of $3 million and 35 investors should be increased, and whether an offering memorandum should be mandatory. In the venture capital spectrum, could the closely held issuer exemption be used by SMEs to finance projects which require more capital than $1.5 million (the proposed limit for issuances by crowdfunding)?

What might the crowdfunding market look like?

The consultation paper begins the discussion on crowdfunding by asking: "what would motivate an investor to make an investment through crowdfunding?" The answer will of course differ for each investor and each project, ranging from taking a flyer or gamble on one extreme to, on the other, making a donation because of some non-monetary affinity to the issuer or project. Existing crowdfunding sites which use the reward model recognize this range, and offer a variety of "perks" priced at increasing levels. The subscriber can choose the perk and rate of return (real or perceived) which he or she wants. But the reward model generally stops short of offering anything which is a gamble, or purely speculative.

When securities are added to the mix, the opportunity for crowdfunding will be to allow the internet to be used as a powerful tool to help profit-motivated investors to finance legitimate projects. The challenge will be to avoid creating on-line boiler rooms which flog worthless penny stocks – sort of an on-line securities porn.

One would expect that issuers using crowdfunding will be very creative. They may use legal entities other than corporations; for example, Mountain Equipment Co-op, on-line. They may issue time-limited rights of participation or royalty interests, before issuing shares. They may be

inclined to issue non-voting shares, before voting. Indeed, the issuance of common shares as we know them may well be the last resort for fundraising. One might expect the market will be naturally suspicious of the motives of an entrepreneur offering to dilute equity ownership (ie control) of his or her project to the crowd, and the corresponding pre-money valuation (explicit or implicit) at which a common share offering is priced.

Take for example a pre-revenue SME which wishes to expand its lab to complete a commercial prototype for a consumer health product it has invented. The issuer's on-line pitch to raise money for the lab might be as follows: for $100, an investor would receive his or her name engraved on a plaque at the lab; for $500, a tour of the lab, once completed; for $1000, lunch or dinner with the CEO; for $2000, a voucher redeemable for a 3 year supply of the product, after production starts; for $2,500, a non-voting, non-transferrable, preferred share redeemable (with cumulative dividends at 4%) at a future date from proceeds of sale of the product in the first year; for $5,000, a royalty interest of x% on the first 10,000 units of production; etc. A creative promoter might be able to achieve his or her fundraising goal without ever giving up common shares. The preferred shares and royalty interest in this example would, of course, be securities, distributable only in compliance with applicable law. But will dollars spent by an investor on perks which are not securities count towards that investor's annual or single investment crowdfunding limits? At what stage in the menu of perks should a funding portal be involved?

Issuer Restrictions

The consultation paper describes a concept idea for the crowdfunding exemption which includes the following issuer restrictions:

- Issuers should be incorporated, and have their head offices located, in Canada.
- The exemption should not be available for distributions by investment funds.
- Complex products, such as derivatives and securitized products, should not be distributed under the exemption.
- The exemption should be available for distributions by both reporting and non-reporting issuers.
- No more than $1,500,000 should be raised by an issuer in any 12-month period under the exemption.

The consultation paper asks if the exemption should be introduced for one or more particular industry sectors, as a trial. This is an opportunity for the provincial government to consider whether, as a matter of policy, crowdfunding might be better suited for, and have an immediate impact on, particular sectors in which it is difficult to raise start-up capital (such as, for example, bio technology, clean energy, etc.). SMEs are the backbone of the economy and create jobs, but

only a small portion (in Canada, less than 5%) of firms are innovative SMEs (that is, firms which spend more than 20% of their investment expenditures on research and development). Various groups are now advocating the use of crowdfunding to stimulate innovation.

Regarding the proposed $1,500,000 limit, the OSC should commit to review it and all other monetary features of the exemption after 12 or 18 months, to make adjustments based on market experience. Should different industry sectors have different limits?

An issuer should not be required to spend the proceeds raised in Canada. Such a requirement will be hard to enforce and perhaps may raise issues under NAFTA and other international trade agreements. It would however assist investors to make a fully informed decision if, in the description of use of proceeds in the information statement, the issuer is required to indicate where the money will be spent.

Investor Protection Measures

The proposed concept idea lists the following investor protections:

- Any investor should be able to buy securities under the exemption.
- There should be a limit on the amount any single investor may invest.
- A monetary cap will be easier to administer than an approach that requires disclosure of, and limitations based on, an investor's net income or net worth.
- The exemption should be limited to distributions by an issuer in securities of its own issue.
- The streamlined disclosure required for an information statement to be provided at the time of distribution should be prescribed.
- Advertising should be prohibited, except for on-line notices posted by the issuer or the funding portal directing investors to the portal.
- Investors should have rights if misrepresentations are made, and rights of withdrawal.
- Investors should sign risk acknowledgement forms.
- There should be restricted resale periods for securities issued under the exemption.

On the question of disclosure, the hallmark of securities regulation has always been "full, true and plain disclosure". I suggest the OSC should be more willing to relax the requirements of "full" disclosure in prescribing minimum requirements for the information statement. I assume the information statement will be published on-line by the portal and filed by the issuer with the

OSC as a public document. As the concept idea suggests, the contents of the information statement should be certified by management of the issuer. The information statement should be brief - few investors read lengthy documents. However, prospective investors will share their opinions, and so the issuer and funding portal should be encouraged to have links to social media where investors may post their bona fide observations about the issuer and the securities being offered. This is the advantage of the "crowd" and the internet – the dissemination of relevant information can be by means other than mind-numbing prospectus type disclosure. The opportunity presented by crowdfunding is that risks inherent with relaxing "full" disclosure requirements will be off-set by social commentary by prospective investors of varying degrees of sophistication.

Similarly, the mandatory requirements for provision of financial statements, audited or unaudited, on the initial distribution should be carefully re-considered. Start-ups typically do not have financial statements of any kind. Accounting firms which have reviewed or audited statements for an existing SME are not likely to willingly consent to the publication of those statements online, or expose themselves to potential liability to crowdfunding investors. In most cases the SME was not a public company when the review or audit was performed – if it had been, the accountant's scope of work and fees may have been substantially different. So instead of publication of existing financial statements, perhaps the issuer should provide in the information statement only a summary of key data. *Quare* whether the funding portal should have a due diligence obligation to tie-back the summary to the financial statements? The OSC also should consider whether forecasts will be allowed in the information statement, and if so, what the requirements will be. Should forecasts be allowed, without review by the issuer's accountants, as long as underlying assumptions are clearly articulated and appropriate warnings are given? Perhaps the answer should be "yes" if indeed the main line of protection for investors is the maximum investment limit (currently proposed at $2,500).

Whether the proposed limits of $2,500 per investment, and $10,000 aggregate per calendar year, are too low is open to debate. One advantage of keeping the limits relatively low is that, in the case of voting shares, no single investor will attain a large enough block to influence voting. I note there is potential for mischief where an investor might cause purchasers controlled by him or her (eg children or trusts or corporations) to circumvent the limits – perhaps in the case of individuals, a purchaser should be of legal age.

One unavoidable consequence of issuance of shares by crowdfunding is that an issuer will acquire a large number of shareholders. This raises many issues. Ownership of the shares must be accurately recorded, something for which SMEs are not known. Perhaps securities issued under the exemption to more than 100 or 200 investors should have CUSIP identifiers as a special asset class? This would be simply for good order, not to facilitate trading. Perhaps the funding portal should also have a due diligence obligation to ensure that the issuer sets up good share-ownership records? If the securities are voting, any applicable requirements for proxy

solicitations and information circulars for shareholder meetings may have to be relaxed for SMEs.

As the consultation paper points out, securities issued under the exemption will be illiquid. Any applicable requirements for later-stage IPOs, issuer bids or take-over bids under existing laws may have to be reviewed and revised to permit crowdfunding investors to participate fully in liquidation events. For example, should a crowdfunding issuer which subsequently becomes a reporting issuer be required to have 3 years' of audited financial statements before being allowed to do an IPO? Or a secondary offering? Should an issuer wishing to bid and buy-back securities from crowdfunding investors have an expedited means to do so?

Also as mentioned in the consultation paper, and in every commentary written about crowdfunding, concern about fraud is paramount. However this concern must not be limited to just the initial issuance of securities. Nor should concerns about an issuer's performance be limited to just the first distribution. It is often a great challenge for SME's to execute their business plans on budget and on time. One needs only look at the fundraising success, and subsequent delays of getting to market, of "Getpebble.com", a consumer product business launched in 2012 on kickstarter.com with much fanfare. Perhaps an issuer raising over $500,000 (or some other specified amount) should be required to define performance milestones in the information statement and to place the net proceeds of the share offering in an escrow account, to be released only as the milestones are achieved? Also, it may be desirable to restrict issuers from using proceeds to repay loans or other amounts owing by the issuer to its founders or promoters. The policy objective should be to encourage "new money" to be raised to finance growth, rather than repay old debts to insiders.

A crowdfunding issuer should be required to provide ongoing continuous disclosure on at least an annual basis. Ontario should follow the U.S. lead and require that an issuer provide investors with its financial statements and reports of its results of operations, in accordance with prescribed minimum requirements. Perhaps the funding portal should be required to keep an open internet page for the issuer for a minimum period (say, for example, 2 years) after the initial distribution on which the issuer may publish regular progress reports, with links to social media in which investors can articulate their opinions or degree of satisfaction regarding the issuer's performance? I note that under existing corporate statutes, if the issuer is a corporation, its financial statements will have to be audited unless each year 100% of its shareholders vote to exempt the corporation from the audit requirement. With hundreds (and perhaps thousands) of shareholders, it is unlikely that a crowdfunding issuer will ever achieve unanimity on an audit exemption vote, so the natural consequence of a crowdfunding distribution of shares is that thereafter the issuer's financial statements will have to be audited. From a policy perspective, requiring continuous disclosure of the issuer's audited financial statements may be desirable despite (as the consultation paper notes) the high cost of an audit.

The consultation paper asks whether rights and protections, such as anti-dilution protection, tag-along rights and pre-emptive rights, should be provided to shareholders. Perhaps, in consultation with the CVCA and other experienced participants in the venture capital industry, a template could be developed setting out basic rights, privileges, restrictions and conditions recommended for common and preferred shares being issued to crowdfunding investors. An issuer could then either adopt the template or post a blacklined version showing how the shares it intends to issue deviate from the template. It is reasonable to assume that investors will expect minimum protections, and should be entitled to an explanation if they are not provided. In particular, careful consideration should be given in the template to voting rights, and accountability of officers and directors to shareholders. In addition, the shares should be structured so as not to impede future rounds of fund raising as the SME grows.

The consultation paper suggests that books and records maintained by the issuer are to be available for inspection by purchasers and OSC staff. I note that existing corporation laws give shareholders only limited rights of access to books and records. With respect to the OSC, will it have the resources to carry out such reviews, and what will be the penalties to which an issuer will be subject for malfeasance?

Finally, existing securities laws limit communications by issuers to potential investors during the pre-marketing and waiting periods on distributions of securities by prospectus. The policy rationale of these rules is to ensure that all investors have equal access to information, to deter conditioning of the market before the IPO, to deter insider or tippee trading and to ensure that the all statements made by the issuer are in the prospectus, for which the issuer and the underwriters are liable for misrepresentation. These rules restrict management of an issuer from commenting on social media (or elsewhere) during pre-marketing and waiting periods, among other things. This is to be contrasted with crowdfunding in which, based on the reward model, engaging audiences on-line is crucial to gaining awareness, momentum and success in a fund-raising campaign. Should management be allowed to engage in ongoing dialogue with investors on social media during the course of a crowdfunding offering of securities? Again, perhaps the answer should be “yes” if the main line of protection for investors is the maximum $2,500 limit.

Funding Portals

The concept idea proposes that, with respect to funding portals:

- Distributions should be made only through registered funding portals.
- The funding portals must play a “gatekeeper” role and take reasonable measures to reduce the risk of fraud.

Some of the responsibilities of the portal may be unique, because of the nature of the internet and the special role with the portal will play to facilitate crowdfunding. For some existing categories

of registrants, the OSC may wish to issue guidelines or otherwise prescribe additional requirements. Other existing registrant categories may not be suitable, or the OSC may wish, in consultation with IIROC and other stakeholders, to create a new, single purpose category of registrant for crowdfunding portals.

The compensation earned by the portals should be disclosed and transparent. By way of example, the popular U.S. website "Indiegogo.com" facilitates crowdfunding based on the reward model (as opposed to the equity securities model). The Indiegogo website explains that Indiegogo receives commission at a flat rate of 3% of the funds raised. In return, Indiegogo provides the online infrastructure and does preliminary screening for fraud.

Should a funding portal be permitted to receive "founders' shares", "underwriter's options" or any other securities as part of its compensation? Likely not, since having an equity stake may put the portal's self-interests in conflict with the investors. At a minimum, if the portal or its affiliates intend to buy shares of the issuer, that purchase should only be at the same price paid by other investors and should be fully disclosed in advance.

Each portal should be allowed to promote itself, through social media and communications or "alerts" transmitted on-line to the portal's subscribers. Realistically, in order to be viable, the portal will have to receive sufficient deal-flow, and so its hands should not be tied too much when it comes to self-promotion. From a policy perspective, it is desirable for portals to "get the word out" and bring SMEs to the market.

As indicated in the concept idea, portals should be obligated to perform some of the "listing processes" usually performed by stock exchanges (such as background checks). The portals should have responsibility for ensuring that the information statements posted by issuers on the portals' websites include the requisite "financing facts", "issuer facts" and "registrant facts". In some instances, the portals could even be responsible for validating some of the facts (or where the facts cannot be validated, issuing an appropriate warning in the same fashion as Wikipedia sometimes does). Perhaps the portals could also be responsible for periodically monitoring comments posted by the crowd on linked social media sites (so as to reduce the risk of planted or staged commentary which has sometimes occurred on sites such as Tripadvisor.com)?

As mentioned previously, the portal may be asked to play a role to facilitate on-line continuous disclosure by the issuer for a defined period (perhaps 2 years). This may simply done be by way of a link to the issuer's own website if the issuer has robust self-disclosure. Perhaps the portal should have an obligation to post a deficiency notice on the portal's website if the issuer is in default of its continuous disclosure obligations during the defined period? In any event, to provide a backstop for liability for adequate performance of its various obligations, it may be prudent for a new entity seeking registration as a funding portal to be required to meet minimum capital adequacy and proficiency tests.

Other Suggestions

The funding portals should not offer investment advice or recommendations, nor should they be expected to evaluate the merits of the issuer's business. There may therefore be a role in crowdfunding for a new independent rating agency, set up as either a not-for-profit or for-profit entity. Such an agency could be similar to, for example, Ecocert Canada, an agency which certifies organic products according to principles established by the Canadian General Standards Board and other recognized standards. There are similar non-government agencies in other sectors. In the case of crowdfunding, participation by an SME in the rating exercise could be voluntary, and if requested by the SME, the new agency could analyze and rate both quantitative and qualitative aspects of the SME's business. It could evaluate the robustness of the SME's business plan, the thoroughness of its budgeting, the likelihood of success of achieving milestones, whether the SME has title to key technology or other rights, etc. The evaluation could be made against criteria which could be well defined and published on the agency's website. Such a validation by a third party might both assure investors and bring order to the funding market. Once it is up and running, the costs of operating such an agency could be covered by fees paid by prospective issuers. The rating could be applicable for the initial offering of securities and then could be renewed annually thereafter. As the rating agency's role grows and becomes more accepted in the market, perhaps the per investment and annual aggregate limits on investment could be gradually increased.

I would be glad to discuss any of these comments with the OSC staff at any time.

Sincerely,

Signed: "David E.Thring"

David E. Thring

DET: ak