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We appreciate the opportunity to comment on the proposed amendments.

**RE: OSC EXEMPT MARKET REVIEW—OSC STAFF CONSULTATION PAPER 45-710 CONSIDERATIONS FOR NEW CAPITAL RAISING PROSPECTUS EXEMPTIONS**

Advocis, The Financial Advisors Association of Canada, appreciates the opportunity to provide comments on the *OSC Exempt Market Review—OSC Staff Consultation Paper 45‑710 Considerations For New Capital Raising Prospectus Exemptions* (the OSC Consultation Paper).

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## EXECUTIVE SUMMARY

Advocis is pleased to comment on the Ontario Securities Commission's recent *Staff Consultation Paper 45-710.* The OSC is to be commended for this initiative, which has the potential to open up new vistas in our capital markets for investors and entrepreneurs alike.

The exempt market is a vast area of investment capital and opportunity. Exempt market products range from highly sophisticated wrap products and exotic derivatives to reasonably straightforward instruments such as basic real estate investment trusts or principal-protected notes. But most exempt products share a common characteristic—their ability to offer the possibility of long-term positive returns with degrees of risk and volatility which range from the relatively low to the exceptionally high. There is, quite literally, a vast range of products which are suitable for many kinds of investor in the exempt market.

Advocis recognizes that it is beneficial—and necessary—for Ontarians to have stringent regulation in the exempt market that protects investors but does not unduly restrict the ability of issuers to raise capital and of investors to access a broad range of products.

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However, continuing the *status quo* in Ontario is problematic: maintaining current limits on the access of individual investors and entrepreneurs to the exempt market will have damaging consequences on the number of investing options open to investors and their advisers and on the amount of available investment capital, which in turn will negatively impact the job and wealth creation generated by Canadian start-ups and small- to medium-sized enterprises.

At present, the vast majority of Canadians are prohibited from participation in the exempt market. Even many highly sophisticated investors and entrepreneurs are effectively disenfranchised from access to the exempt market products or capital, as the case may be. The situation is more pronounced in Ontario, where non-accredited investors are simply denied access to exempt market securities, regardless of whether they have the sophistication to properly gauge the quality and suitability of the investment product or are able to obtain advice from a registered investment dealer. Advocis believes that participation in the exempt market should not be limited to those individuals who fall within a narrow segment of the population as defined under current prospectus exemptions. The current arbitrary income or net assets tests are not necessarily indicative of financial literacy or demonstrative of an ability to withstand financial loss. It is our belief that the current exemptions represent too blunt an instrument to efficiently and fairly foster access to capital while meeting investor protection concerns. As a result, a large pool of risk capital is unavailable to Canadian companies.

It must be emphasized that the task of the regulator in the exempt market is a difficult one: determining the proper balance between investor protection and market integrity as against efficient access to capital for companies is no easy task. However, recent regulatory action in the exempt market—most of which concerns the actions of dealers who fail to properly abide by "Know Your Client" rules—suggests that the major source of fraud and abuse does not lie with the retail investor. Accordingly, Advocis believes that many investor protection concerns can be effectively addressed through exemptions which entail the involvement of a registered financial advisor who is a member of a professional association. Such an organization should require that the advisor act in the best interest of the client, meet ongoing continuing education (CE) obligations, and carry a suitable amount of professional liability (E&O) insurance. The presence of such an advisor in an exempt market transaction is a cost-effective and practical solution to the need for enhanced investor protection. In terms of investor fairness, the *status quo* in Ontario confers an unfair privilege on individuals fortunate to be invested in certain corporate pension plans which invest in the exempt market. These individuals benefit from their funds' investments in exempt market securities—securities in which most Ontarians cannot access retail investors. Consequently, Advocis offers qualified support for the OSC's four prospectus exemption proposals, as they will help unlock this source of capital and democratize access to exempt market investments.

**Crowdfunding Exemption**

Equity crowdfunding entails funding an enterprise by raising small amounts of capital from a large number of people over the Web. Ontario's crowdfunding model—which is many aspects replicates the U.S. *JOBS Act*—would be available for both reporting and non-reporting issuers

but not for investment funds or selling securityholders.

Advocis would support a modified, two-tiered version of the OSC's proposed crowd-funding model. In Advocis' approach, in tier one the investment cap for individual investors would be a maximum of $500 per investment up to a total of $2,000 in a 12-month period; for tier two, it would be a maximum of $15,000 per investment up to a total of $60,000 per year in a 12-month period. The issuer cap on the amount of capital which could be raised in a 12-month period would be a maximum of $250,000 in tier one and a maximum of $5,000,000 in tier two. The main difference between the tiers would be the compliance costs and the amount of capital at risk—the chief concerns of entrepreneurs and investors, respectively. The point-of-sale and ongoing disclosure obligations would be relaxed for small start-ups using tier one, but become more stringent for small- to medium-sized enterprises relying on tier two. In both tiers an investor in a crowdfunding enterprise should be advised by the portal that he or she should consult with a registered financial advisor—who, it should be reiterated, is a member of a professional association and carries suitable professional liability insurance—in order to review and understand the investment's details and its implications before executing the risk acknowledgement form. The risk acknowledgement form should also indicate that as a general principle an investor's total exempt market holdings should not amount to more than 10% of the investor's total portfolio, due to illiquidity concerns.

**Offering Memorandum Exemption**

Ontario currently does not have the offering memorandum (OM) prospectus exemption which is available in all other Canadian jurisdictions under National Instrument 45-106 *Prospectus and Registration Exemptions*. Unfortunately, the OSC's proposed OM exemption is almost identical to its crowdfunding exemption. The main differences between this OM exemption and crowdfunding one are that an investment under the OM exemption would not need to be conducted through a funding portal, and that the involvement of a registrant would not be required, unless the issuer or an involved intermediary is in the business of trading in securities.

Advocis believes that that the maximum amount in the OSC's proposed OM exemption (restricting an investor to $2,500) is too low and impractical for investors, issuers and exempt market dealers. Advocis believes that the investor's limit should be $100,000 for the first three years of the exemption's operation. This limit should be understood to be subject to the general principle that an investor's total exempt market holdings should not amount to more than 10% of the investor's total portfolio, due to illiquidity concerns. The risk acknowledgment form for the OM exemption should make this principle clear. A retail investor who is not an accredited investor should be required to receive advice from a registered advisor who is a member of a professional association with the E&O, CE and client interest requirements outlined above.

**Sophisticated Investor Exemption**

The OSC's third proposed exemption would exempt distributions to "sophisticated" investors, without restrictions on the type of security, the size of the investment or the offering. However, the investor must have worked in the investment industry for at least one year in a

position that requires knowledge of securities investments, hold an acceptable designation or degree, be provided with basic information about the offering at the point of sale, and execute a risk acknowledgment form. Advocis supports this exemption. It broadens the potential base of investors without exposing the average investor to undue temptations to chase high returns. Investment knowledge and experience, though hard to measure, are the best available proxies for investor sophistication. A similar exemption is available in the United Kingdom's regulatory regime and has proven workable to date.

**Advice from Registrant Exemption**
Subject to several qualifications, Advocis agrees with the position taken in the OSC's *Consultation Paper* for a prospectus exemption on distributions to investors who have received "appropriate" advice from a registered investment dealer. As well, Advocis does not believe that the exemption should require a contractual agreement that that the dealer has a fiduciary duty to act in the best interests of the investor.

**Private Placement Reporting**
Advocis has also offered some suggestions on addressing the need for better data on exempt market activity, on improved reporting requirements, on the importance of and regulation of the exempt market, and on other possible exemptions.

## PART ONE: BACKGROUND AND CONTEXT

### a). Advocis: Who we are

Advocis, The Financial Advisors Association of Canada, is the country's largest and oldest professional membership association of financial advisors and planner. Through its predecessor associations, Advocis proudly continues over a century of uninterrupted history of serving Canadian financial advisors and their clients. Our more than 11,000 members are licensed to sell life and health insurance, mutual funds and other securities, and are primarily owners and operators of their own small businesses who create thousands of jobs across Canada.

As a voluntary organization, Advocis is committed to professionalism among financial advisors. Advocis members adhere to our published *Code of Professional Conduct*, uphold standards of best practice, participate in ongoing continuing education programs, maintain professional liability insurance, and put their clients' interests first. Across Canada, our members spend countless hours working one-on-one with individual Canadians on financial matters Advocis advisors are committed to educating clients about financial issues that are directly relevant to them, their families and their future.

Our following comments on the OSC's proposal reflect the priorities of Advocis' members and their clients.

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## b). Background to the exempt market

### (i). Recent efforts to review and rationalize exempt market capital raising

On December 14, 2012, the OSC released *OSC Staff Consultation Paper 45-710—Considerations for New Capital Raising Prospectus Exemptions* (the "OSC *Consultation Paper*") which examines four ideas for potential capital raising prospectus exemptions; crowdfunding, an offering memorandum exemption for Ontario, and exemptions for sophisticated investors and investors who have received advice from investment dealers. Pursuant to its examination of these four proposals, the OSC Paper reviews the main prospectus exemptions currently available in Canada, and references similar exemptions in the United Kingdom, the United States and Australia. In addition to a broad range of consultation questions relating to the four exemption ideas, the OSC now requests comment on consultation questions relating to the private issuer, closely held issuer and family, friends and business associates prospectus exemptions, and seeks input on proposed changes to the form and content of exempt distribution reports on Form 45-106F1.

This *OSC Consultation Paper* is therefore another step in the OSC's effort to expand the scope of its review of prospectus exemptions that began after the Canadian Securities Administrators ("CSA") issued *CSA Staff Consultation Note 45-401 Review of Minimum Amount and Accredited Investor Exemptions* (the "CSA Notice") on November 10, 2011, which set out background information on the two eponymous prospectus exemptions under review.

On June 7, 2012, the OSC expanded its exempt market review to consider whether there is potential to foster greater access to the capital markets for start-ups and small and medium sized enterprises. It published *OSC Staff Notice 45-707—OSC Broadening Scope of Review of Prospectus Exemptions*. In this notice, the OSC announced that it will expand its review of the prospectus exemptions available in Ontario, and provide issuers, investors, dealers and other interested stakeholders with the opportunity to comment on the accredited investor prospectus exemption and the minimum purchase prospectus exemption and the broader issues raised during the CSA consultation period, including possible of harmonization of Ontario prospectus exemptions with those available in the rest of Canada. Finally, in September 2012, the OSC established an Exempt Market Advisory Committee.

Advocis is pleased with the OSC's serious and sustained examination of the possibilities for investing and capital raising in Ontario's exempt market.

### (ii). Main features of the exempt market

In Canada, as in most Anglo-American legal jurisdictions, asset managers, when purchasing securities for funds that they manage or offering securities in those funds, must do so on the basis of a prospectus or pursuant to a exemption to the prospectus

requirement. In Canada, the most frequently used prospectus exemption is the "accredited investor" exemption. It is available for sales of securities to qualified entities and individuals deemed to be sufficiently sophisticated so as to not require the protections afforded by prospectus disclosures. Included among the qualified entities—many of which are advised by asset managers—are a variety of financial institutions—including banks, trust companies, pension funds, registered charities, investment funds, domestic and international governmental bodies, and entities other than individuals or investment funds with net assets of $5,000,000 or more. As well, an individual investor may qualify as an accredited investor if he or she, alone or with a spouse, owns financial assets with an aggregate net realizable value over $1,000,000; has net assets of at least $5,000,000 million; or has a net income before taxes in excess of $200,000 alone, or $300,000 together with the spouse. The offering of a security by way of a prospectus exemption, such as the accredited investor exemption, does not require that a written document describing the business and affairs of an issuer be provided to prospective purchasers.

Securities purchased pursuant to a prospectus exemption are subject to resale restrictions or hold periods. Typically, when a distribution of securities is made pursuant to a prospectus exemption, it triggers the requirement to file an Exempt Distribution Report and is subject to a restricted resale period. A common example is a private fund, the securities of which are not listed on a Canadian exchange. Its securities are therefore not freely tradable in the Canadian market. However, in the absence of any contractual restrictions in a fund's formation documents, such securities may be tradable or transferable pursuant to a further prospectus exemption – typically, to another accredited investor.

Many private placement exemptions require within 10 days of the distribution that the issuer file a report of trade with the securities regulators in each provincial jurisdiction in which the securities are sold, pay a regulatory filing fee, and, if applicable, file a copy of the offering memorandum. Outside of Ontario, the offering memorandum exemption permits the issue of securities pursuant to certain prescribed disclosures, such as disclosure regarding various conflicts of interest, and disclosure relating to a purchaser�because statutory rights of action for damages or rescission where the offering memorandum contains a misrepresentation.

The sale and purchase of prospectus-exempt securities in Canada has become increasingly important for investors and issuers, particularly for those who participate in the exempt capital market in Ontario, Alberta and British Columbia. The total amount of capital raised through all prospectus-exempt distributions reported to the OSC in 2011 was approximately $142.9 billion. Approximately $86.5 billion of that was raised directly in Ontario, of which approximately $72.8 billion was raised using the "accredited investor" prospectus exemption.

## PART TWO: PROSPECTUS EXEMPTIONS BASED ON RELATIONSHIPS WITH THE ISSUER

National Instrument 45-106 sets out most of the available prospectus exemptions. Start-ups typically use the "private issuer" and "accredited investor" exemptions. To qualify as a "private issuer," the company may have no more than 50 non-employee shareholders, all of whom must have a relationship with the issuer, its founders, or its management.

**Is the 50 security-holder limit under the private issuer exemption too restrictive?**
Yes, the 50-security-holder private issuer limit is too restrictive. A primary concern for any exempt market issuer is the creation of large and administratively unwieldy numbers of small shareholders. However, the OSC does not deem an issuer to become a public company once it exceeds a certain number of shareholders.

**If so, what limit would be appropriate? Please explain.**
Advocis would suggest the limit be readjusted upward to 75 security-holders in the interest of enhanced capital-raising. The category includes a wide range of individuals who may be considered to be knowledgeable because of a relationship with the investor. Since the category also includes "accredited investors," Advocis suggests that no limit be placed on the number of individual accredited investors willing to participate.

**Should the OSC consider re-introducing the closely held issuer exemption in addition, or as an alternative, to the private issuer exemption? If yes, should the conditions be changed?**
The closely held issuer exemption should not be re-introduced, especially in light of the proposed crowdfunding and offering memorandum exemptions under review here. There are legitimate protection concerns with any friends, business associates and/or family-based exemption which allows securities to be issued to a potentially large if not unlimited number of family members and other persons. Advocates of such an exemption in Ontario base their case on the need for more access to capital by issuers—an argument which loses its force if one or more of the exemptions at issue in this paper are allowed—as well as on the harmonization principle, i.e., that this exemption is laudable simply because other provinces have it. It is a mistake to re-introduce the closely-held issuer exemption in order to permit securities to be issued to a potentially large group of unaccredited investors on the basis of a policy rationale which asserts that, by virtue of being friends or family with the issuer, these persons are therefore in possession of useful personal knowledge of the issuer and the business. This proposition is dubious, and the impracticalities of properly determining who qualifies under a closely-held issuer category are well-known.

**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 affiliates? Please explain.**

No. Like the closely-held issuer exemption, this is another instance of a prospectus exemption in which the OSC is in disharmony with the rest of the country. The major problem with the absence of these types of exemptions in Ontario is that situations arise in which close business associates or close personal friends of a director or an officer of an issuer who live in any province other than Ontario are eligible to purchase a security of that issuer—while Ontario-domiciled family, friends and business associates cannot, unless they earn in excess of $200,000 per year or otherwise qualify as accredited investors. Although this disharmony raises a concern of basic investor equality across provincial jurisdictions, Advocis does not believe that the OSC should offer this exemption.

Indeed, in the absence of a qualified investor requirement under a family exemption, it strikes Advocis as problematic to allow for the unlimited recruitment of family members into the issuer and its affiliates. Familial pressures could easily lead to family members being brought into an exempted issuer at the expense of their making properly informed financial decisions. To be clear: by "properly informed," we mean from the long-term perspective of the individual family member, and not from the perspective of the issuing entity.

**Are there other changes that should be made to the current Ontario exemptions referred to above?**

At present in Ontario, OSC Rule 62-504 restricts the "non-reporting issuer" exemption for take-over and issuer bids to those issuers with fewer than 50 non-employee shareholders. This means that sales and buy-backs of shares must comply with the full formal take-over or issuer bid regime applicable to public companies. After an issuer has over 50 non-employee shareholders, the private issuer exemption is no longer available. Since that exemption also covers resale of the shares, investors in private companies operating under that exemption find it difficult to sell their shares when the company no longer qualifies for the exemption. Advocis would suggest that the OSC consider lifting such resale restrictions when accredited investors or a registrant is involved in such transactions.

## PART THREE: CONSIDERATIONS FOR CROWDFUNDING

### Crowdfunding: A general overview

The introduction of equity crowdfunding would provide a means of addressing some of the concerns raised about the exemptions discussed in Part Two, above. At about $85 billion, private investing is a significant source of capital for Canadian firms. A federal study on SME financing reported that if wealthy Canadians found it easier to invest in and exit private market opportunities, this capital pool for entrepreneurial companies

could grow to be 20 times the size of institutional venture capital.[1] Crowdfunding is a way of funding ventures by raising, in the main, small amounts of money from large numbers of people, typically through a Web portal. Crowdfunding would often involve far more investors per offering than many of the exemptions discussed here. Many of these crowdfunders would have no pre-existing relationship with the company, and they may or may not be accredited investors. The portal allows for offerings of securities directly over the Internet to investors, including non-accredited, retail investors in prospectus-exempt offerings.

Much press has been devoted to the United States' recent *Jumpstart Our Business Startups Act* (the *JOBS Act;* passed April 5, 2012), which created a crowdfunding exemption subject to the adoption of still-to-be-released rules by the Securities and Exchange Commission. Despite the rules having not yet been promulgated, enthusiasm for crowdfunding south of the border has already reached a tipping point of sorts: in February 2013, the U.S. publisher John Wiley & Sons, Inc. released *Crowdfund Investing For Dummies*.[2]

**Evidence from other jurisdictions**

Evidence from other jurisdictions indicates that equity crowdfunding will attract a large number of investors, many of whom will not qualify as accredited investors or otherwise be particularly experienced or sophisticated about investing. With crowdfunders, unlike the case with venture capitalists or angel investors, the pool of funders has no personal contact with the investee and often minimal knowledge of the business, other than what is presented through the crowdfunding portal.[3] Moreover, the geographical separation between the entrepreneur and the investors prevents the latter from conducting a more direct review of the business being funded. This will no doubt lead to inefficiencies in the allocation of capital. The combination of less stringent regulation in crowdfunding and neophyte entrepreneurs and investors will result in allegations of misrepresentation and fraud. And of course the very nature of start-up enterprises guarantees investor losses in any crowdfunding scheme.

However, crowdfunding advocates assert that the Australian and U.S. measures for combating fraud from funding portals should suffice for Canada as well. It is certainly possible that a properly funded and regulated crowdfunding portal may meet *de minimus* investor protection standards through leveraging the tremendous reputational hazard afforded by the spotlight of social media. In the U.S., crowdfunding sites such as

[1] Thomas Watson, "From Private Practice; Exempt Market Trading Spurs Economic Development, But Stacks The Deck Even Further Against Regular Folks Looking For The Next Big Investing Craze," *Financial Post Business Magazine*, June 19, 2012, p. 22.
[2] Sherwood Neiss, Jason W. Best and Zak Cassady-Dorion, *Crowdfund Investing For Dummies*. New York: Wiley, 2013.
[3] See Kristof De Buysere, Oliver Gajda, Ronald Kleverlaan, and Dan Marom*, A Framework for European Crowdfunding*. (2012) (www.crowdfundingframework.eu).

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Indiegogo and Kickstarter have shown at times extraordinary sensitivity to public criticisms of misuse. More recently, online portals and private exchanges have begun to rely on sophisticated algorithms for quick and early indications of possible fraud. All of this suggests that portals might in time become a useful fraud detection and prevention mechanism for regulators.[4]

Crowdfunding has become a billion dollar global industry.[5] Yet, it must be admitted that it currently enjoys a somewhat hyperbolic reputation as being the "next big thing" which will close the funding gap confronting many small issuers.[6] Still, jurisdictions which ignore the possibilities of crowdfunding may do so at their peril. Certainly the possibility exists for investors and even issuers to engage in a kind of crowdfunding arbitrage, which could result in a drain of capital to more innovative jurisdictions where crowdfunding exists. Moreover, other jurisdictions have already seen the rise of under- or unregulated crowdsourcing services that pose risks to unwary investors, which may argue in favour of a crowdfunding trial by one or more provincial jurisdictions. It is worth noting that the New Brunswick Securities Commission has expressed a strong interest in crowdfunding experimentation.[7] And, as will be discussed below, the Australian experience has been very positive.[8]

**The OSC's proposed model**

The OSC's conception of a crowdfunding exemption incorporates many of the investor protection elements of the crowdfunding exemption in *JOBS Act*. All investments would be made through a funding portal registered as a dealer or adviser, although the OSC has indicated it will consider exempting funding portals from certain dealer or adviser registration requirements. Still, portals would be prohibited from offering investment advice or recommendations, soliciting, and compensating employees and others for solicitations or based on the sale of securities. Given its "gatekeeper" role, the funding portal would be required to take reasonable measures to reduce the risk of fraud.

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[4] See Fraser Milner Casgrain LLP's "Will Canada Make Room For Crowdfunding," in *Canadian Exempt Market Watch*, January 2013, Vol. 3, Issue 1, pp. 4-8.

[5] See Massolution/Crowdsourcing LLC's *Crowdfunding Industry Report* (April 2012), one of the first profiles of the global crowdfunding industry.

[6] C. Steven Bradford, "The New Federal Crowdfunding Exemption: Promise Unfulfilled," *Securities Regulation Law Journal*, Vol. 40, No. 3, Fall 2012.

[7] See Norm Betts, "Stepping Out of the Crowd – Equity Crowd Funding." In New Brunswick Securities Commission, *Making Headway: Reporting on the New Brunswick Securities Commission's Fullsail capital markets initiative*. Autumn 2012, p. 1. See also Remo Zaccagna, "Securities Body Gives Students Quick Course on Crowdfunding," *The Chronicle Herald*, March 8, 2013. Online at http://thechronicleherald.ca/business/911013-securities-body-gives-students-quick-course-on-crowdfunding.

[8] Gerrit K.C. Ahlers, Douglas Cumming, Christina Günther and Denis Schweizer, "Signaling in Equity Crowdfunding" October 14, 2012. p. 29. Online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2161587.

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The exemption would only be available if the issuer—and its parent and principal operating subsidiary, if applicable—is incorporated or organized under Canadian laws and the issuer has its head office located in Canada. This is only sensible, since the objective is to facilitate capital raising for SMEs in Canada. The exemption would be available for both reporting and non-reporting issuers, though not for investment funds or selling securityholders. Further, the issuer could not raise more than $1,500,000 under this exemption in any 12-month period, nor advertise an investment except through the funding portal or the issuer's website. Only certain types of securities could be distributed under the crowdfunding exemption: common shares, non-convertible preferred shares, non-convertible debt securities that are linked only to a fixed or floating interest rate and securities convertible into common shares or non-convertible preferred shares. Advocis believes this is sensible, since distributing securities other than these relatively easy-to-understand ones would lead to significant investor protection concerns.

The exemption would allow these securities to be sold to any investor, regardless of income, net worth or investment sophistication. However, in terms of investor protection, certain requirements would have to be met:

- **investment limits**: the amount an investor could invest in reliance on the exemption would be capped at $2,500 in any single investment and a maximum of $10,000 per calendar year;

- **disclosure requirements**: at the time of distribution, the investor must be provided with a streamlined information statement (certified by management, describing the key risks facing the issuer, and providing information about the offering, the issuer, the funding portal itself and any other registrant involved) and one year of financial statements (which must be audited if the issuer is a reporting issuer or if the proposed offering will exceed $500,000; otherwise the statements may be certified by management);

- **risk acknowledgement**: at the time of distribution, the investor must execute a risk acknowledgement form confirming that he or she falls within the investment limits, understands the illiquid nature of the investment (if in a non-reporting issuer) and understands that he or she may lose—and can bear the loss of—the entire investment;

- **statutory rights**: provision would be made for a two-business day "cooling off" period and for statutory rights in the event of a misrepresentation; and

- **ongoing disclosure**: provision would also be made for ongoing disclosure in the form of annual financial statements, which must be provided within 120

days of year's end. Issuers would also be required to keep prescribed records containing key information on the securities and securityholders.

**Would a crowdfunding exemption be useful for issuers, particularly SMEs, in raising capital?**

Yes. It would provide a more accessible means for SMEs to raise capital, particularly those neophyte enterprises which are not yet of interest to traditional avenues of capital-raising, such as banks, venture capitalists, and angel investors. For such early-stage companies, often the only options for start-up capital are family, friends, and business associates. More recently, early-stage capital-raising has been driven by the efforts of unregistered parties—the so-called "finders." Equity crowdfunding could put an end to this potentially problematic non-registrant activity.

**Capital raising and the importance of crowdfunding**

In order to foster fair and efficient capital markets, a regulator must balance the costs of investor protection with the ability of firms to access capital. So why should a regulator support crowdfunding, given its potentially tremendous attendant risks for investors? In Canada, it is often said that start-ups, emerging businesses and small businesses lack sufficient access to capital: traditional sources of credit, such as commercial bank loans, are generally hard to secure for start-ups and emerging enterprises, as they lack significant assets or cashflow to borrow against.

Small businesses are of great significance to the Canadian economy and of critical importance to that of Western Canada, where their contribution to gross domestic product and percentage of employment are considerably higher than the national averages. In British Columbia, 98 per cent of businesses are categorized as small (less than 50 employees).[9] Such companies are export-driven, and often strongly focused on research and development. As a result, they are dependent on a variety of sources of external financing beyond the traditional ones of owner's equity, angel funding and bank loans. In order to grow, they need to raise capital in a relatively inexpensive manner. But raising equity capital through the use of a prospectus exemption is essentially too costly a proposition for them.[10]

Recent numbers from Statistics Canada that show that while 85% of small businesses survive their first year, only 51% are still alive after five years.[11] Statistics Canada notes that:

[9] *"Small business 'gazelles' - Western Canada's key economic driver," November 3, 2010. From Invest Right (A program of the British Columbia Securities Commission), Online at www.investright.org/news_post.aspx?id=654&blogid=213.*
[10] *Ibid*.
[11] Statistics Canada, "Key Small Business Statistics - July 2012." Online at http://www.ic.gc.ca/eic/site/061.nsf/eng/02717.html.

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> About 70 percent of firms survived for two years, 62 percent survived for three years and 51 percent of firms survived for five years. The fact that half of the businesses survive their first five years of operation suggests that these businesses are able to attain competitive advantage in their markets.[12]

This suggests that easier access to capital for SMEs through a tier-two crowdfunding portal may help some of them survive longer and further cement their competitive advantage.

Crowdfunding, however, can provide a more level playing field for those seeking capital across a range of economic sectors, with investors knowledgeable in a particular business sector able to use their own unique personal or professional knowledge to evaluate the issuer's merits. Many investors will be attracted by the prospect of participating in the development of an innovative new product or arts-based initiative; others, by investing a small sum in what they consider to be a promising venture. For example, a software engineer who otherwise pays little attention to investments may be able to evaluate with a fair degree of insight and probity a tech start-up. In short, crowdfunding has the potential to raise funds for diverse initiatives for which investors have varying probabilities of investment risk and return.

**How effective is crowdfunding?**

There is some evidence from other countries on the efficacy of crowdfunding for SME capital raising. While crowdfunding is still in its infancy in Anglo-American legal jurisdictions, there are some interesting indications from the Australian Small Scale Offerings Board (ASSOB), which is a crowdfunding facility for small businesses in Australia. Like the OSC's proposed crowdfunding portal, with ASSOB listing costs and compliance costs are substantially reduced in comparison to prospectus-driven distributions.

The Australian Securities and Investments Commission permits registered funding portals to act as introduction services and to market securities on an issuer's behalf, provided they disclose the high-risk nature of early-stage investments.[13] They act as hubs for investors to review investment data and purchase securities. Issuers are limited to raising capital from no more than 20 unaccredited investors in any 12-month period, to a maximum amount of $2,000,000.[14]

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[12] *Ibid*.
[13] See ASIC Class Order 02/273, *Business introduction or matching services*. Online at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/co02-273.pdf/$file/co02-273.pdf.
[14] See Australian Commonwealth Consolidated Acts*, CORPORATIONS ACT 2001 - SECT 708*, Online at http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s708.html.

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ASSOB has been in business since 2006 and now has over 100 listed companies. This makes it one of a handful of equity crowdfunding platforms with sufficient data to permit a statistically significant analysis. ASSOB's portal allows investors to browse small equity offerings of start-ups and to buy shares in these ventures. During registration, potential investors must supply certain personal information, including how much they will invest, and acknowledge their awareness of the potential risks involved in exempt investments. Once registered, investors can peruse the general information on the offerings, including company name, type of security, industry, status of the capital-raising, total amount of funding sought, etc.

If the investor is interested in a specific offering, he or she then accesses a detailed offering overview and can download detailed offering documents. The offering documents are prepared by the entrepreneurs aided by sponsors (professional financial advisors or accountants). Although offering documents are prepared individually for each entrepreneur, they all conform to the same disclosure regimes, and must include offering details, key investment highlights, any milestones achieved to date, the business model and the purpose of the capital-raising, financial projections, the enterprise's ownership structure, and descriptions of the management team and external board members.

Based on this information, an investor can then apply for shares. A 10% security deposit is required at the time of application, with the remaining 90% due when the minimum number of shares is sold. If the minimum number is *not* sold within the specified time frame, the equity offering does not become effective and investors are refunded their 10% deposits. The minimum number of shares is set individually for each start-up, and can differ significantly from the total funding amount requested.

A 2012 paper provides a statistical review of Australia's crowdfunding experience.[15] The results of the study are instructive and strongly suggest that crowdfunding, when retail investors and/or entrepreneurs are guided by a market intermediary like a financial advisor, can prove successful. As the authors note:

> With respect to policy implications, our data also highlight the fact that the crowdfunding market operates in a largely rational manner, even among retail investors who are arguably less sophisticated. Crowdfunding investors seem to pay a great deal of attention to the financial and governance material that firms provide.[16]

Given the crowdfunding experience in the U.S., the U.K., and Australia, and given Canada's current economic climate, a revisiting of the traditional regulatory restraints on

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[15] Ahlers, *supra* note 8, pp.11 -12.
[16] *Ibid*.

the ability of small enterprises' ability to conduct public solicitation of investors seems both laudable and pressing (and perhaps inevitable in one or more jurisdictions in a country with 13 different securities regimes). Moreover, the advent of social media as an informational tool widely accessible has the potential to erode traditional models of private market activity. These factors have led one leading U.S. crowdfunding expert to propose a higher-risk crowdfunding exemption which is tied to a low-cost compliance regime with minimal disclosure which has an annual offering limit of $250,000 for firms, and an annual limit on individual contributions of $500 per investor.[17]

Finally, it is worth noting that while private market investing is approximately an $85 billion source of capital for Canadian firms, a federal study estimates that if affluent Canadians found it easier to access private market opportunities, the capital pool for SME companies could grow to be 20 times the size of our institutional venture capital.[18]

Based on all the forgoing, Advocis is confident that the crowdfunding exemption has significant potential to assist in the capital raising efforts of SMEs.

**Have we recognized the potential benefits of this exemption for investors?**
Yes. The potential for crowdfunding to make a positive impact on early-stage financing in Ontario is significant, provided it is part of a larger and well-coordinated system of prospectus exemptions. Advocis would also note that the potential for crowdfunding to help improve the financial literacy of Ontarians—both investors and entrepreneurs—is tremendous.

As well, crowdfunding may help eliminate the geographical boundaries of capital formation—a major consideration in a country as large as Canada with a dispersed population. Given that angel investors tend to cluster in metropolitan areas such as Silicon Valley or Silicon Alley, start-ups are often required to move to these areas to gain access to start-up capital. By helping to eliminate the need for personal connections to early-stage investors, crowdfunding could break down a major barrier to accessing start-up capital. Entrepreneurs outside of Canada's large urban centres may find in crowdfunding a means to financing startups that local banks would never support.[19]

If the OSC proceeds with crowdfunding, it will require a model which gives it the flexibility to adjust the portal's regulation until it finds the right balance between investor protection and capital raising in the largely untested online channel. Certainly right crowdfunding model could help position Ontario as a jurisdiction which is friendly to small, start-up entrepreneurialism and a locus of a new innovation culture.

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[17] Steven C. Bradford, Crowdfunding and the Federal Securities Laws, *Columbia Law Review* (No. 1, 2012), p. 149.
[18] Watson, *supra* note 1, p. 22.
[19] Fox Rothchild LLP, "Power to the Crowd! The Promise (and Pitfalls) of Crowdfunding." Corporate Alert, April 2012.

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**What would motivate an investor to make an investment through crowdfunding?**

No doubt many investors will possess a depth of knowledge of what the enterprise seeking their capital intends to accomplish. Such investors are a kind of lower-ranking business angel. Others will have non-financial motivations for investing, such as helping bring to fruition what they judge to be a socially beneficial product or service or a project which otherwise reflects their own values or promises some immediate benefit to their local community. In the U.S., certain Kickstarter projects show how many willing funders there are for any given enterprise, even without a promise of future income or profit.[20]

Recent research on the European experience of crowdfunding indicates that there are three different motivations for people who want to participate in crowdfunding:

> **Social return**: Under a social return motivation, the funders are already satisfied when they see that a project can be realized. They often do not expect to see a significant return directly to themselves for the investment. They typically seek a non-pecuniary return in the form of communal benefits. The model is normally that of donation-based crowdfunding and it is used extensively by non-profit organizations.
>
> **Material return**: Under a material return motivation, the funders receive a product or service as the reward for their investment. The business model used for this is typically pre-sales crowdfunding, where an investor pays the project owner in advance. The project owner then uses the funds as working capital to create the product or service. The objective or economic value of the return is not commensurate with the original investment; the real value is its subjective value to the funder. For example, a concert funder may receive entrance tickets for a concert along with a personal meeting with the musicians as a reward for a donation which is several times larger than the public ticket price.
>
> **Financial return**: If a funder likes a crowdfunding proposal, but also wants seeks a financial return, he can invest via loan- or equity-based crowdfunding. The project owner then uses the loans or equity-based capital to collect investments against interest or dividend payments.[21]

[20] See the discussion in Fraser Milner Casgrain LLP's "Will Canada Make Room For Crowdfunding," *in Canadian Exempt Market Watch*, January 2013, Vol. 3, Issue 1, pp. 4-8.

[21] De Buysere *et al*., *supra* note 3, pp. 12-13.

Worldwide, these typologies have been replicated in many jurisdictions offering crowdsourcing in general and crowdfunding in particular.

**Can investor protection concerns associated with crowdfunding be addressed and, if so, how?**
Yes. Investor protection can and must be effectively addressed without undermining the promise of crowdfunding to deepen the pool of potential investors. The easiest to implement mechanism for limiting investor exposure to the risk of fraud or loss involves establishing a limit on the amount an individual may invest. As a means of minimizing risk exposure, this "bright line" standard, while somewhat arbitrary, avoids a box-ticking, form-based bureaucratic approach that could deter investor participation.

Another option is to permit staggered entry to the crowdfunding market for both issuers and investors, initially permitting only lower amounts to be raised or invested.[22] Or, instead of setting limits on investor income, one could establish a sliding scale of increased disclosure and compliance requirements based on various factors, such as the market capitalization of the firm, the number of shares issued, or the size of the public float. As the New Brunswick Securities Commission noted in its recent newsletter on the possibilities offered by crowdfunding:

> We must be creative and think of ways of protecting the investor at the time of the investment. We could have "stepped limits" on the amount of investment—a maximum amount that anyone could invest with only identifying information provided, and larger amounts tied to income and/or assets.[23]

**Crowdfunding is inherently risky**
In the United States, a substantial amount of comment has been devoted to the need to recognize the inherent risks associated with crowdfunding, and to acknowledge that the intended purpose of crowdfunding is to offer easy access to a higher risk category of investments. As the prominent securities scholar C. Steven Bradford notes in "Crowdfunding and the Federal Securities Laws":

> The SEC should adopt an exemption to facilitate crowdfunded securities offerings. That exemption should include the basic features outlined above. Issuers should be able to raise a maximum of $250,000-$500,000 each year without registration or other information requirements, provided that each investor invests annually no more than either $500 or 2% of the

[22] Jake van der Laan, "Equity Crowd Funding - Seizing the Investor Education Opportunity," In NBSC, *Making Headway: Reporting on the New Brunswick Securities Commission's Fullsail capital markets initiative*. Autumn 2012, p. 5.
[23] Betts, *supra* note 7, p. 1.

investor's annual income, whichever is greater. Until then, investors should be free to withdraw from the offering.

The enactment of a crowdfunding exemption would be no panacea. None of the requirements that this article propose will guarantee that investors receive their expected returns. None of these requirements will protect investors from the losses often incurred by investors in small businesses. None of these requirements will prevent fraud. That is not the point of the proposed crowdfunding exemption. Instead, the proposed crowdfunding exemption is an attempt to promote small business capital formation by exempting offerings where the cost of registration clearly exceeds any possible benefits. The proposed exemption allows smaller, unsophisticated investors to act as capitalists and to learn by doing, while protecting those investors from catastrophic losses they cannot bear. Finally, the proposed exemption attempts to bring securities regulation into the modern world of social networking and the Internet, to reconcile the regulatory requirements of 1933 with the realities of 2011.[24]

**The Advocis Crowdfunding Model**

Advocis believes that in order to properly account for the risks and opportunities inherent in the crowdfunding model, an approach of steeped limits tied to disclosure levels has much merit to it. For the sake of administrative and regulatory expediency we would suggest that a two-tier system based on clearly understandable bright line standards is the preferred option. The most salient features of such a model are captured in the table below and discussed in the following question-and-answer text where appropriate.

| **Feature** | **Tier One** | **Tier Two** |
|---|---|---|
| **Investment Cap for Individual Investors** | A maximum of $500 per investment up to a total of $2,000 in a 12-month period. | A maximum of $15,000 per investment up to a total of $60,000 per year in a 12-month period. |
| **Issuer Cap on Amount of Capital Which May Be Raised** | A maximum of $250,000 in a 12-month period | A maximum of $5,000,000 in a 12-month period. |
| **Risk Acknowledgment Form** | Yes. | Yes. |
| **Point of Sale Disclosure** | Yes, but minimal. | Yes. |
| **Ongoing Disclosure** | Yes, but minimal. | Yes. |

[24] Bradford, *supra* note 17, pp. 150-151.

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| Feature | Tier One | Tier Two |
|---|---|---|
| **Other** | An investor in a crowdfunding enterprise should be advised by the portal that he or she should consult with a registered financial advisor in order to review the investment's details before executing the risk acknowledgement form.<br><br>This registrant advisor should be a member of a professional association which requires he or she act in the best interest of the client, meet ongoing continuing education requirements, and carry suitable professional liability insurance<br><br>The risk acknowledgement form should also indicate that as a general principle an investor's total exempt market holdings should not amount to more than 10% of the investor's total portfolio, due to illiquidity concerns. | An investor in a crowdfunding enterprise should be advised by the portal that he or she should consult with a registered financial advisor in order to review the investment's details before executing the risk acknowledgement form.<br><br>This registrant advisor should be a member of a professional association which requires he or she act in the best interest of the client, meet ongoing continuing education requirements, and carry suitable professional liability insurance<br><br>The risk acknowledgement form should also indicate that as a general principle an investor's total exempt market holdings should not amount to more than 10% of the investor's total portfolio, due to illiquidity concerns. |

*Table 1*. The Advocis Crowdfunding Model.

**What measures, if any, would be the most effective at reducing the risk of potential abuse and fraud?**

The CSA has made combating fraud a key priority; indeed, the CSA's 2012 report contains separate statistics on fraud for the first time. Securities regulators handled 34 fraud cases last year—seven per cent of all total cases.[25] In the past, fraud cases were often counted as illegal distributions, which had 53 cases last year, down by 24 cases from the year before.[26] Similarly, the OSC reports that it concluded proceedings against a total of 63 individuals and 37 companies in 2012 with almost half of them involving

[25] Barbara Shecter, "Canadian regulators make fighting fraud a priority," *Financial Post*, February 21, 2013. Online at http://business.financialpost.com/2013/02/21/canadian-regulators-make-fighting-fraud-a-priority/.
[26] *Ibid*.

allegations of fraud.[27] What should be noted here is that in terms of investor protection, Advocis believes that the compilation and regular public dissemination of crowdfunding-fraud-specific statistics should be an urgent priority in the event that such an exemption is granted by the OSC.

With regard to investor protection *before* the fact of fraud occurs, there are several anti-fraud mechanisms which should prove easy to implement and come at a relatively low cost to the prospective investor. Chief among these are the use of a registered financial advisor, enhanced escrow rules and the leveraging of both portals and the larger online community as gatekeepers:

a) escrow: To prevent investors losing money to projects which fail because they are underfunded, the portal as a registrant could hold the investors' funds in escrow until a minimum level of the desired investment amount is attained. This would let investors recover their funds if the investee fails to raise the publicly-stated minimum base level of funding.

b). portal as gate-keeper: To mitigate the possibilities of fraud, the portal could undertake the responsibilities elucidated in the OSC's *Consultation Note*, such as due diligence in the form of background and regulatory checks, et cetera.[28]

c). portal-based investor education: Since an investor will be required to create an account with a portal website in order to invest, the OSC could require the investor complete a substantive investor education component to ensure that the investor attains a minimum understanding of the crowdfunding investment process and the risks of start-up financing.[29]

d). online community as gate-keeper: As suggested above, social media can be used as a tool of fraud prevention. Use of the internet and social networking will allow funders to perform research on the entrepreneurs before deciding if they want to invest. There is also an argument for creating another level of accountability by building in the capacity to make public comments regarding the enterprise.

e). third-party review entities: To mitigate risk and ensure greater credibility and reliability in the quality of a particular sector's offering, a

[27] James Langton, OSC makes fighting fraud a priority," *Investment Executive*, February 28, 2013. Online at http://www.investmentexecutive.com/-/osc-makes-fighting-fraud-a-priority?utm_source=newsletter&utm_medium=nl&utm_content=investmentexecutive&utm_campaign=INT-EN-All-afternoon#sthash.QQuuMXYk.dpuf.
[28] See *OSC Staff Consultation Paper 45-710*, p. 54.
[29] Jake van der Laan, *supra* note 22, p. 5.

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portal could turn to third-party agents to undertake additional due diligence on particular proposed distributions in their field of expertise. Experts on particular niche market start-ups could be consulted to provide a more thorough vetting of proposals.

f.) portal competition: If crowdfunding is adopted, the emergence over time of more crowdfunding platforms should create more competition among platforms, so that to remain competitive, a portal's fraud detection and vetting services will become important points of comparative advantage.[30] In a competitive environment, the more responsible portals are likely to survive as competitive pressures would encourage them to implement governance standards and policies beneficial to investors. It should be noted here that a rigid standardization of crowdfunding responsibilities at the outset would discourage portal experimentation and hamper evolution toward the most effective and user-friendly forms of investor protection.

g.) professional financial advice: Perhaps most importantly, there should be a requirement that an investor in a crowdfunding enterprise must consult with a registered financial advisor in order to review the investment's details before executing the risk acknowledgement form.

For the individual investor in the exempt market who lacks significant investing experience, access to expert advice becomes a more compelling necessity. Accordingly, Advocis believes that the involvement in the exempt distribution of a registrant who has an obligation to recommend only suitable investments and is accountable to the investor with respect to those recommendations, would protect investors more effectively than the existing approach. We believe that the registrant should be accountable through membership in a professional association for financial advisors which requires the advisor to act in the client's best interests, carry suitable professional liability insurance, and meet ongoing continuing education obligations.

Although the differences in the respective abilities of intermediaries and individual investors to accessing information vary from product to product, it is safe to say that most individual investors are unable to devote the resources necessary to developing a comprehensive understanding of a product's features, benefits and risk characteristics. In such cases, regulation should offset such informational imbalances by shifting a portion of the responsibility for assessing information to registrants and

[30] De Buysere *et al.*, *supra* note 3, pp. 12-13.

> other financial intermediaries. This is why Advocis believes that regulation is needed which requires portals to indicate that individual investors should receive formal advice from a registrant. Simply warning investors of potential risks and prompting them to educate themselves before investing has proven to be insufficient time and again. A brief statement on the risk acknowledgement form provided at the point of sale and on the web portal and pre-sale documentation which advises the investor to consult a financial advisor would remove confusion on the part of the typical retail investor and help the OSC achieve its policy objective of providing clarity in this area to members of the investing public.
>
> Finally, this requirement would not apply to an accredited investor or one relying on any exemptions based on sophisticated investor status.

**Are there concerns with retail investors making investments that are illiquid with very limited options for monetizing their investments?**
Yes, there are significant concerns about the illiquidity of the investments of retail investors. As C. Steven Bradford, a leading scholar on the U.S. *JOBS Act*, notes:

> For equity crowdfunding there is also a question about liquidity in the secondary markets, as access to capital, especially equity, for SMEs remains very limited and the possibilities for further funding or exits for the crowd funders are closed. Efforts to combine crowdfunding and business angel investing have been made and are one potential solution, but this will remain a solution for a select few businesses and projects.[31]

With regard to the restrictions on resale, Bradford notes that the U.S. Congress has sought to restrict the resale of crowdfunded securities, based on the argument that such restrictions are necessary because a resale market may not provide new investors with direct access to the information available on the crowdfunding site itself, thereby making re-sales more open to fraud. Bradford disagrees, stating that:

> Restrictions on resale are neither necessary nor desirable, although their presence will not unduly chill use of the exemption. The existing crowdfunding sites do not maintain trading markets, and they cannot easily establish such markets without registering as exchanges or alternative trading systems. If crowdfunding platforms do establish their own trading platforms, information about the entrepreneur and the offering is available on-site. Given the small amounts invested, active trading markets are unlikely to develop outside the crowdfunding site. Resale restrictions are likely to serve only as a trap for the unwary.

[31] Bradford, *supra* note 17, pp. 142.

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> Unsophisticated investors, who are unlikely to understand or even be aware of such restrictions, would be exposed to liability whenever they sell their crowdfunded securities to Uncle Ernie or Aunt Emma. And, if resale restrictions are given any teeth, such re-sales could cause issuers to lose their exemptions. Given the limited danger, resale restrictions are undesirable.[32]

Clearly, investors using this exemption could wait years before seeing a return, if ever. Yet this will be a voluntary risk, one which should be canvassed thoroughly in the risk acknowledgement form. The Australian crowdfunding portal, the Australian Small Scale Offerings Board or ASSOB, enables the secondary sale of securities for entities that list through it. In the U.S., the performance of www.secondmarket.com has shown that illiquidity concerns may be managed through the introduction of secondary "private" market platforms which could contract with primary market portals.

Given all of the foregoing, Advocis would suggest that OSC registrants be allowed to re-sell exempt market products to qualified retail investors, provide that the purchaser qualify as an accredited investor or otherwise consult with a registered financial advisor, and sign an appropriate risk acknowledgement form which emphasizes the general principle that an investor's total exempt market holdings should not amount to more than 10% of the investor's total portfolio, due to illiquidity concerns.

**Are there concerns with SMEs that are not reporting issuers having a large number of security holders?**

Yes. There are pros and cons for SMEs having a large number of security holders. Among the drawbacks are the following considerations:

> **a) impediment to efficient decision-making**: As a matter of law in Canada, to conduct shareholder business it is typically the case that a corporation must hold a duly-constituted shareholder's meeting or, alternatively, have 100% of shareholders all sign a written resolution. For SMEs this requirement presents serious administrative and governance difficulties and makes it resource-intensive to effectuate fundamental changes to the business—a potentially fatal characteristic for health- and tech-based SMEs. Even the "routine housekeeping" required under corporate law can prove costly in terms of time and money. It could be that crowdfunding investors should be pooled under a single trustee model for reasons of administrative efficiency and tax effectiveness.

[32] Bradford, *supra* note 17, pp. 143-144.

**b) preventing follow-on funding**: Down the road, potential angels or other investors may see a large number of securityholders as an obstacle to their ability to consolidate control of the enterprise, thereby forcing them to reject the company as an investment opportunity.

However, there can also be benefits to having a large number of securityholders, such as:

**a) retention of control**: A large distribution to a large number of shareholders may be beneficial for an early-stage company, since it will not have to give up control to another entity simply to access funds.

**b). attracting one major funder**: After signs of initial success in its enterprise, an issuer may be able to quickly move into richer pool of investors and attract major funding from accredited investors, angels or even banks.

**If we determine that crowdfunding may be appropriate for our market, should we consider introducing it on a trial or limited basis? For example, should we consider introducing it for a particular industry sector, for a limited time period or through a specified portal?**

Advocis believes that it would be useful to introduce crowdfunding on a 36-month trial basis. This should be a sufficient length of time to allow for investors and entrepreneurs to decide if they wish to rely on the exemption and for the emergence of any significant issues, thus permitting the OSC to review and modify the process as necessary.

It is worth noting that in the U.S., the *JOBS Act* was driven by the received wisdom that the costs of becoming a public company are now too prohibitive for smaller issuers. According to this view, the initial public offering process is too costly for smaller issuers because of the relatively fixed underwriting fee of 7 percent of the New York Stock Exchange. However, as John C. Coffee, Jr., notes:

> Recently, new and better research has appeared, concluding that the proponents of deregulation have vastly overstated the impact of regulatory costs on IPOs. In December 2012, Professor Jay R. Ritter, probably the leading financial economist in the IPO field, and his colleagues released a new paper arguing that the number of IPOs has declined, not because of regulatory costs, but because for the privately-held firm "the value-maximizing growth strategy is to sell out to a larger company that can quickly integrate a new technology into its related products and realize economies of scope and scale." *Mergers and*

> *acquisitions, not regulation, are the forces eclipsing the smaller IPO*.[33] [Emphasis added. Footnotes in original text removed.]

Assuming that the data referenced by Coffee reflect the capital markets in Canada, it is not yet clear at this point if crowdfunding will be a needed means of addressing a significant lack of access to public equity markets for established, medium-sized firms (which are the firms most likely to be using the second-tier of our proposed crowdfunding model).

Beyond that, we also believe that it would be problematic for the OSC to limit crowdfunding to one particular sector, since this would limit the "wisdom of the crowd" benefits realized by crowdsourcing, and would also incentivize some entrepreneurs into "force-fitting" their start-ups into the pre-identified category, with resulting harm to both the entrepreneur and the investor.

**Issuer restrictions**

**Should there be a limit on the amount of capital that can be raised under this exemption? If so, what should the limit be?**

Yes. It is essential to limit the amount of capital available under this exemption in order to cap possible fraud or abuse. Investing in start-ups and emerging businesses can be exceptionally risky, particularly for the unsophisticated investor. This is why Advocis believes any crowdfunding exemption scheme must contain limits on the size of the investment permitted and on the overall amount which the enterprise may raise during a defined period of time. Crowdfunded offerings should also include a funding goal and should not close until that goal is met. It could be that the TSX Venture Exchange should be designated as the primary portal, with other candidates making their case to qualify as a portal to the OSC thereafter.

Under a Tier-One-style crowdfunding exemption, Advocis believes that a proposed limit of $250,000 in a 12-month period is reasonable.

Under a Tier-Two-style crowdfunding exemption, which has more rigorous protections, Advocis believes that a proposed limit of $5,000,000 in a 12-month period is reasonable.

**Should issuers be required to spend the proceeds raised in Canada?**

Advocis believes that it would be desirable to require that a significant amount of the proceeds raised through a crowdfunding scheme spent in Canada.

[33] John C. Coffee, Jr., "Gone With the Wind: Small IPOs, the JOBS Act, and Reality," *The CLS Blue Sky Blog*, February 1, 2013. Online at http://clsbluesky.law.columbia.edu/2013/02/01/gone-with-the-wind-small-ipos-the-jobs-act-and-reality. See also Jay Ritter, "Reenergizing the IPO Market," *The CLS Blue Sky Blog*, January 3, 2013. Available online at http://clsbluesky.law.columbia.edu.

Under a Tier-One-style crowdfunding exemption, Advocis believes the issuer should be restricted to spending within Canada all proceeds which are raised. The failure rate under this tier will be significant, and Canadians should be the major beneficiaries of capital raising benefits under this exemption.

Under a Tier-Two-style crowdfunding exemption, Advocis believes a maximum of 25% of the funds raised should be eligible to be spent outside of Canada. For the more sophisticated SME issuers operating pursuant to this tier of the exemption, any limit on how the funds may be spent will likely be seen as an encroachment, and if the restriction percentage is too onerous, some may decide to forego the use of the crowdfunding exemption as a result. However, the desire to ensure that Ontarians benefit economically from the exemption overrides, in our mind, a 25% restriction on where the issuer can spend the capital.

In the event that a Tier-Two-style crowdfunding exemption proves successful in terms of minimal rates of fraud and misrepresentation and acceptable rates of enterprise failure,[34] the OSC in time may wish to consider a full-reciprocity approach, in which enterprises are permitted to both raise capital and spend the proceeds outside of Canada as they deem appropriate.

**Investor protection measures**

As U.S. securities legal scholar C. Steven Bradford notes in his review of the *JOBS Act*, making the exemption too complicated and expensive is the essential regulatory hazard faced by the Securities and Exchange Commission:

> To be useful to small business issuers, a crowdfunding exemption needs to be relatively simple and inexpensive. Regulatory cost is, after all, why registration is not a viable option for these offerings. The largest section 4(6) [of the *JOBS Act*] offering will only be for $1 million and many offerings could be for much less than that. For offerings that small, it will not take much regulatory cost to eliminate crowdfunding as an option.[35]

**Should there be limits on the amount that an investor can invest under this exemption? If so, what should the limits be?**

Yes: as in all exempt market offerings, there should be limits—regulatory or self-imposed—on investor exposure as a means of curtailing risk. However, in the non-prospectus realm of equity crowdfunding, it is crucial to ensure that the exemption casts "the investor net" far enough to properly realize the tremendous potential of a web-

[34] Obviously defining these rates and collecting and analyzing data on them would be a highly complex task in itself; indeed, the cost of doing so could outweigh the benefits of a full reciprocity regime, at least from the standpoint of the regulator.

[35] Bradford, *supra* note 6, p. 24.

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based platform. As always, the problem is striking the balance between investor protection in the form of enhanced disclosure and reduced risk exposure on one hand and the ability of firms to access capital on the other.

Much comment on the *JOBS Act* has been devoted to proposing amendments which would tie an investor's income level to maximum investment amounts. But recent exempt market experience in Ontario shows how easy it is for individual investors to assert that they fulfill either the minimum amount or accredited investor exemptions and then gain access to potentially unsuitable exempt market products. The standard ways of policing these types of exemptions—self-verification on the part of the individual investor, or mandating that the distributor conduct a robust investigatory review (at the point of sale and periodically thereafter) of every individual investor's income or net worth—would prove, in the former case, to be ineffectual and, in the latter, would render compliance costs exceptionally problematic for a crowdfunding venture where hundreds of investors may seek to invest in a single enterprise.

Other variations of the *JOBS Act* approach propose a much lower investment cap for investors as a way of reducing risk exposure. Bradford, in his "Crowdfunding and the Federal Securities Laws," argues that:

> The SEC should adopt an exemption to facilitate crowdfunded securities offerings. That exemption should include the basic features outlined above. Issuers should be able to raise a maximum of $250,000-$500,000 each year without registration or other information requirements, provided that each investor invests annually no more than either $500 or 2% of the investor's annual income, whichever is greater.[36]

For the type of two-tiered crowdfunding exemption Advocis is proposing, we find the OSC's proposed limits of $2,500 per investment and $10,000 per year to be too restrictive from the perspective of SMEs seeking to raise capital. Under the second tier of our two-tiered exemption, Advocis believes a proposed limit of $15,000 per company up to a total of $60,000 for all investments in a calendar year is reasonable. Cautious investors will of course choose to invest well below these caps, depending on their risk appetites and portfolio liquidity. It is worth noting here that under the Australian crowdfunding platform model, which is the platform with the most statistically rich data set available, the mean crowdfunding investment is about $300,000.[37] The Australian model comes with fairly comprehensive disclosure requirements, which the second tier of Advocis' split-level proposal would seek to largely emulate.

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[36] Bradford, Bradford, *supra* note 17, p. 149.
[37] Ahlers *et al*., *supra* note 8, pp.11 -12.

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Under the first tier of our proposed exemption, Advocis believes a proposed limit of $500 per investment up to a total of $2,000 for all investments in a calendar year is reasonable. We believe that any investor likely to use the first tier of a two-tier model would be able to absorb the loss of such an investment.

**What information should be provided to investors at the time of sale as a condition of this exemption?**

Here we get to the heart of the issue of crowdfunding: how best to balance investor rights and protections with ease of access to market for capital seekers. As in any other market, the costs to a firm to avail itself of the crowdfunding option is directly related to the costs of informational disclosure.

In crowdfunding, disclosure is the key component of consumer protection and the single greatest compliance risk for issuers. As a general observation, crowdfunding platforms across the globe require the following disclosures:

- names and addresses and other identifying information for investees, and for any existing large shareholders;
- a statement detailing how much capital the enterprise seeks to raise and what it plans to do with it, including a description of the enterprises business plan and goals;
- the particulars of what the investor may receive in return for the investment;
- any significant events or development in the life of the company that would have a deterrent effect on investment; and
- completion of some form of investor education or execution of a risk disclosure form to ensure awareness by investors of the potential risk.

In light of these standard requirements, Advocis in general supports the OSC's proposed requisite provisions for disclosure at the point-of-sale: the streamlined information statement, the risk acknowledgement form, and the cooling-off period, subject to the statements made further on in this document.[38]

**Disclosure: what do investors want?**

Data from the Australian portal ASSOB suggests that its crowdfunding market operates in a "largely rational manner," even among individual retail investors who are arguably less sophisticated than accredited investors, and that crowdfunding investors "seem to pay a great deal of attention to the financial and governance material that firms provide."[39]

[38] *OSC Exempt Market Review—OSC Staff Consultation Paper 45-710 Considerations For New Capital Raising Prospectus Exemption,* p. 29.
[39] Ahlers *et al.*, *supra* note 8, p. 29.

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In Canada, the results of a small 2011 online survey of exempt market issuers prepared for the CSA provides some indication of what disclosure investors would like to receive. The survey concluded—not surprisingly—that investors ranked the receipt of information on a regular basis as important; however, they also indicated the *source* of that information—advisor or broker or issuer—may not be as critical to them.[40] Overall, investors reported that they received just the right amount of reporting on their exempt market securities, regardless of the source. It is worth noting that for the investments at issue in the survey, online information was readily available and often accessed by investors between reporting periods.[41] In fact, the desire for more online information was a recurring comment.[42] All of this indicates that the use of a Web portal as an information and disclosure source for crowdfunding would be an acceptable mechanism to investors. The survey also indicated that investors are definitely not willing to pay for information on exempt market securities from their advisor, broker, exempt market dealer or issuer.[43]

In terms of the types of disclosure, investors were satisfied with the receipt of regular financial statements and annual and quarterly reports from the issuer. Somewhat surprisingly, the survey indicated that investors felt that the investment valuation information they received was ideal.[44] Also worth noting for the introduction of any disclosure regime for this exemption is the that fact that while the polled focus groups were constructed to reflect a varying degree of investment knowledge and sophistication, no one group appeared to be more knowledgeable about investments and securities than any other, and accredited investors generally manifested the same level of knowledge reviewed by the poll as retail investors.[45]

European research on crowdfunding indicates that investees want enterprises to be transparent about the aim of a crowdfunding project, the persons and related companies benefiting from the project, and the transaction costs associated with the project. [46] Certain minimum disclosure standards for investor protection seem to be preferred options throughout Europe, including requirements to share the details of the business plan and of ownership in the start-up and to use standardized documentation to enable transnational business crowdfunding to become more transparent.[47]

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[40] Lori Bottrell, The Brondesbury Group, *Results of Investor Focus Groups and Personal Interviews Background Report for Online Survey of Exempt Market Investors*. Prepared for the Canadian Securities Administrators. October 12, 2011, p. 3.
[41] *Ibid*., p. 3.
[42] *Ibid*., p. 18.
[43]*Ibid*., p. 3.
[44] *Ibid*., p. 3.
[45] *Ibid*., p. 6.
[46] *Ibid*., p 44.
[47] David Röthler and Karsten Wenzlaff, *Crowdfunding Schemes in Europe.* EENC Report, September 2011, p 47.

**The Costs of Disclosure and the Impact on Crowdfunding**

Overall, the European experience of crowdfunding has indicated problems with the costs of disclosure compliance—in particular, the ability of badly undercapitalized start-ups to pay for up-front compliance costs entailed by standard securities disclosure. Similarly, in the U.S., experts have noted that the cost of regulatory minimal disclosure requirements can very easily exceed the benefit of enhanced access to capital. Bradford notes that:

> Mandatory disclosure requirements like those will unduly increase the cost of crowdfunding. Entrepreneurs will need to hire attorneys and accountants to comply, and the increased cost will drive away small, marginal entrepreneurs. Crowdfunding site operators might help entrepreneurs to complete the required disclosure, but that does not eliminate the cost… The proponents of strong mandatory disclosure requirements are missing one of the important facets of the argument for small business exemptions. For offerings below a certain size, the cost of *any* regulatory requirements—even a minimal disclosure requirement—exceeds the benefit. For those small offerings, an *unconditional* exemption makes sense. No matter how attractive registration and standardized disclosure seem in the abstract, they make no economic sense for the very small offerings that crowdfunding facilitates.[48]

Elsewhere, Bradford is more explicit on why the *JOBS Act* may prove highly problematic to issuers in terms of compliance costs, and argues that it will not take much regulatory cost to eliminate crowdfunding as an option:

> [A]ny regulatory requirements that are imposed on issuers need to be relatively simple and easy to comply with. The entrepreneurs behind these small startup companies often lack legal and financial sophistication. And complicated filing and disclosure requirements invariably demand lawyers and accountants, increasing the expense of using the exemption.
>
> The issuer disclosure requirements in the new crowdfunding exemption are neither simple nor inexpensive. Issuers must furnish full financial statements for even the smallest offerings. Those financial statements must be reviewed by independent public accountants if the offering is for $100,000 or more, and audited if the offering is for more than $500,000. And, unlike other small business exemptions, the crowdfunding exemption imposes continued, annual reporting requirements even after the offering is completed…. some of the disclosure items require a rather sophisticated understanding of corporate law and finance…. [such as requirements that

[48] Bradford, *supra* note 17, p. 143.

> the issuer] explain "how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions"…
>
> *To comply with these two requirements, a budding entrepreneur must have the foresight to predict the future transactions in which the business might engage and the knowledge of corporate finance needed to describe how securities might be valued in those transactions and the risks those future transactions could present to security holders. The entrepreneur must also have the legal knowledge necessary to explain the pitfalls of minority ownership*.[49] [emphasis added]

Finally, it should be noted that other provincial securities commissions have considered the cost of audited statements as a barrier to capital raising for firms. The Alberta Securities Commission (ASC) recently eased the requirements for issuers to raise capital through its offering memorandum exemption. The ASC issued a blanket order that provides relief from certain financial statement-related requirements, and in particular the requirement under its offering memorandum exemption for an audit on annual financial statements. This was in response to issuers' complaints which convincingly argued that the audit requirement was particularly costly and onerous for a start-up.[50]

The British Columbia Securities Commission (BCSC) recently published for comment a proposed prospectus exemption intended to facilitate access to capital by small businesses. Under the proposed new exemption, issuers will only need to include unaudited financial statements prepared using private enterprise GAAP in the offering memorandum.[51]

In sum, giving the foregoing observations and arguments, Advocis would propose the following for an initial disclosure regime pursuant to crowdfunding. Such information should be submitted to the portal and made available publicly.

| Type of Disclosure | Tier-One Crowdfunding Exemption | Tier-Two Crowdfunding Exemption |
|---|---|---|
| **Investment opportunity** | A basic, brief description of the investment opportunity | A description of the investment opportunity, including the stated |

[49] C. Steven Bradford, Bradford, *supra* note 6, at p. 25.
[50] See CSA Multilateral CSA Notice 45-311, *Exemptions from Certain Financial Statement-Related Requirements in the Offering Memorandum Exemption to Facilitate Access to Capital by Small Businesses.*
[51] See BCN 2013/03 Notice and Request for Comment - *National Instrument 45-106 Prospectus and Registration Exemptions Proposed Prospectus Exemption to Assist Capital Raising by Small Businesses*.

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| Type of Disclosure | Tier-One Crowdfunding Exemption | Tier-Two Crowdfunding Exemption |
|---|---|---|
| **Investment opportunity** | purpose and intended use of the proceeds of the offering. | purpose and intended use of the proceeds of the offering. |
| | A brief description of the business and the anticipated business plan of the issuer. | A detailed description of the business and the anticipated business plan of the issuer. |
| | The target offering amount, the deadline to reach that amount, and regular updates regarding the progress of the issuer in reaching that amount. | The target offering amount, the deadline to reach that amount, and regular updates regarding the progress of the issuer in reaching that amount. |
| | The price to the public of the securities. | The price to the public of the securities, or, in the event the investor and investee agree on a purchase commitment, disclosure of the valuation method used to determine share price, and a 5-business-day period for rescinding the purchase commitment upon receipt in writing of the final share price. |
| **Enterprise details** | The name, legal status, physical address, and website address of the issuer. | The name, legal status, physical address, and website address of the issuer. |
| | A list of managers and directors. | The names of the directors and officers and each person holding more than 20 of the shares of the issuer. |
| **Financial information** | A description of the financial condition of the issuer and the issuer's unaudited financial statements certified by the CEO to be true and complete in all material respects; and<br><br>if the company is already operating, income tax returns filed by the issuer for the most recently completed year. | A description of the financial condition of the issuer, including a description of the ownership and capital structure and all valuation methods employed regarding the offering;<br><br>for amounts of more than $250,000 but under $500,000, any income tax returns filed by the issuer for the most recently completed year and the issuer's unaudited financial |

| Type of Disclosure | Tier-One Crowdfunding Exemption | Tier-Two Crowdfunding Exemption |
|---|---|---|
| **Financial information** | | statements certified by the CEO to be true and complete in all material respects;<br><br>for amounts greater than $500,000 but less than $1,000,000, financial statements reviewed by an accountant independent of issuer in accordance with Canadian GAAP for private enterprises; and<br><br>for amounts greater than $1,000,000, audited financial statements. |
| **Risk Acknowledgement Statement / Investor Education Requirement** | With regard to a crowdfunding investor's mandatory review and execution of a risk disclosure forms in order to reduce the likelihood of fraud or abuse, Advocis suggests that for each investment made in a unique company, the risk acknowledgement form emphasize the high risks of investment losses associated with start-up businesses and emphasize the desirability of consulting with a registered financial advisor.<br><br>This advisor should be a member of a professional association which requires that advisors act in the best interests of their clients, meet ongoing continuing education obligations, and carry suitable amounts of professional liability insurance. | With regard to a crowdfunding investor's mandatory review and execution of a risk disclosure forms in order to reduce the likelihood of fraud or abuse, Advocis suggests that for each investment made in a unique company, the risk acknowledgement form emphasize the high risks of investment losses associated with start-up businesses and emphasize the desirability of consulting with a registered financial advisor.<br><br>This advisor should be a member of a professional association which requires that advisors act in the best interests of their clients, meet ongoing continuing education obligations, and carry suitable amounts of professional liability insurance. |

*Table 2.* The Advocis Crowdfunding Model—Crowdfunding Disclosure.

**Should that information be certified and by whom?**
Yes. Please see the chart immediately above.

**Should issuers that rely on this exemption be required to provide ongoing disclosure to investors? If so, what form should this disclosure take?**
Yes. Advocis believes that there should be ongoing disclosure in the form of regular financial statements and an update of the project status relative to its promised deliverables and other milestones. In other jurisdictions, equity-driven crowdfunding requires such disclosure. The Australian crowdfunding platform ASSOB (the Australian Small Scale Offerings Board) requires all of its listed enterprises to provide "quarterly activity statements" on the profile pages on the portal. It is possible that in a jurisdiction with multiple and competing crowdfunding platforms, some platforms would voluntarily require their listed enterprises to offer more information than the required minimum in order to attract more investors.

Such ongoing disclosure can be accomplished for start-ups through email and updates to the enterprise's website and to the portal. SMEs, using the second tier portal can employ these newer methods, as well as the traditional ones such as shareholder information circulars distributed through the portal or a transfer agent, etc.[52] For each tier, the issuer should be required to keep documented records which contain, at a minimum, information on the securities issued by the issuer, the date of the issue, and the distribution price, the names of all security holders and the size of their holdings, and a breakdown of the use of funds raised.

Advocis would propose the following for an ongoing disclosure regime pursuant to crowdfunding.

| **Disclosure Provided** | **Tier-One Crowdfunding Exemption** | **Tier-Two Crowdfunding Exemption** |
|---|---|---|
| **Project Update** | Brief quarterly updates of the project status relative to its promised milestones and deliverables. | Quarterly updates of the project status relative to its promised milestones and deliverables. |
| **Financials** | More detailed semi-annual activity statements certified by management showing how the proceeds have been spent and progress taken towards realizing the business goals. | Quarterly regular financial statements certified by management; if the issuer has more than $500,000 but less than $1,000,000 in public shares, financial statements reviewed by |

[52] De Buysere *et al.*, *supra* note 3, p. 16.

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| Disclosure Provided | Tier-One Crowdfunding Exemption | Tier-Two Crowdfunding Exemption |
|---|---|---|
| **Financials** | | an accountant independent of the issuer in accordance with Canadian GAAP for private enterprises; and<br><br>if the issuer has more than $1,000,000 in public shares, audited financial statements. |
| | Management-certified annual financial statements: see the requirements in *Table 2*, above. | Annual financial statements subject to the same requirements in the cell directly above. |
| **Delivery** | Such ongoing disclosure can be accomplished through email, updates to the enterprise's website and the portal. | Such ongoing disclosure can be accomplished through email, updates to the enterprise's website and the portal, and traditional methods like shareholder information circulars distributed through transfer agents or other industry-recognized legal actors. |

*Table 3.* The Advocis Crowdfunding Model—Ongoing Disclosure.

**Should the issuer be required to provide audited financial statements to investors at the time of the 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?**

Requiring audited financial statements as part of the disclosure at the point of sale is problematic. Audited statements can easily cost more than $20,000, which is excessive for the type of start-up envisaged by the crowdfunding models. At the initial launch, the start-up will likely have very little substantive financial information and requiring that information be audited will likely do little to eliminate risk exposure for the investor. Audited statements at the point of sale in general will be costly and burdensome for enterprises and will serve as a barrier to capital raising.

Advocis would suggest that audited statements be required only if the proceeds of the distribution are greater than $1,000,000. In the case where proceeds of the distribution are less than $1,000,000, certification by management is sufficient.

**Should rights and protections, such as anti-dilution protection, tag-along rights and pre-emptive rights, be provided to shareholders?**

The decision to offer any such rights should be a matter solely in the provenance of the issuer. In saying this, Advocis is assuming that the portal would not be responsible for the additional transaction costs represented by the introduction of these rights. No doubt all of these shareholder protection measures would be attractive to investors. Anti-dilution protection would be helpful if convertible securities are offered. Tag-along rights could prove attractive to minority shareholders. Advocis would suggest that such protective measures only be available under the second tier of its proposed two-tier platform, as most start-up entrepreneurs using the first tier would not be able to understand, issue and provide administration for such shareholder rights. Nor would they have the ability to pay for advice on them. These rights are best suited for established SMEs seeking to raise additional capital through the second tier exemption. The use of such measures should be at the discretion of the investee's management.

**Should we allow investments through a funding portal (similar to the funding portals contemplated by the crowdfunding exemption in the JOBS Act)?**

Advocis believes that the OSC should allow crowdfunded capital raising through funding portals. Such portals will create an easily accessible intermediary for both investors and investees.

**If so: What obligations should a funding portal have?**

According to the OSC's proposal, all investments made under the crowdfunding exemption must be made through a registered funding portal. The funding portal would play a "gatekeeper" role and take reasonable steps to reduce the risk of fraud. The funding portal must be registered in an existing or restricted dealer or adviser category, although the OSC may consider exempting funding portals from such requirements depending on the portal's proposed business model and the OSC's continued review of crowdfunding.

Advocis agrees that the funding portal must play a responsible gatekeeper role which includes avoidance of conflicts of interest, such as possessing a business interest in any of its listed entities. Mandatory *de minimus* standards of due diligence involving background checks on issuers and their employees will reduce fraud. Other necessary requirements are that the portal:

1. be registered with the Ontario Securities Commission;
2. be open to the general public;

3. mandated to clearly disclose how it is paid by the investee or investor in the transaction;
4. provide through email or online postings a mechanism to allow investors to communicate about each offering;
5. require investors to execute a risk acknowledgement form or fulfill a simple education requirement before investing;
6. ensure that crowdfunded offerings are only advertised through the portal or on the issuer's website;
7. be required to hold money in escrow until the capital-raising target is achieved or it is determined that that investors should recover their money if and when a minimum level of investment is not met;
8. annually publish, in the interests of transparency, such data as:
    a. total volume of investments on the platform,
    b. total volume of investments in each enterprise's project(s),
    c. total number of investors on the platform,
    d. total numbers of investors per project, and
    e. total numbers of projects on the platform.[53]
9. be prohibited from investing and its employees from investing in the listed offerings; and
10. be prohibited from offering investment advice.

Intermediaries should be permitted to charge issuer fees in order to maintain orderly operations, pursuant to the framework for exempt market dealers which is set out in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*. These fees should include:

- various operational and platform fees including for software/hardware purchases, maintenance and upgrades, for hosting investment data, for maintaining escrow accounts, for compiling and disseminating mandatory information, etc.;
- deal fees to be applied only upon successful funding of a deal;
- fees to cover mandatory due diligence; and
- fees to cover clearinghouse and wire charges, cheque deposits, etc.

**Should funding portals be exempt from certain registration requirements? If so, what requirements should they be exempted from?**
Yes, funding portals should be granted some exemptions.

Below we offer some points of clarification which should be addressed by the OSC regarding the registrant status of a funding portal and any possible relief from various registrant requirements.

[53] Röthler and Wenzlaff, *supra* note 47, p 47.

**The position of portals under Canadian law**

In Canada, anyone "in the business" of trading securities must register with securities regulators in the interest of protecting investors and ensuring Canadian capital markets' integrity. Because operating a portal raises many of the criteria indicating a "business purpose"—the trigger for registration requirements under National Instrument 31-103—online crowdfunding portals are likely required to register. Indicia of having a business purpose include setting up a business to promote securities, intermediating in securities trades or making a market for them, taking compensation (whether transaction- or value-based) for these activities, and contacting anyone to solicit securities transactions.

Persons who are in the "business of trading" in securities are required to be registered as a dealer in each province where purchasers reside. "Trading" is broadly defined in Canadian securities law and includes not only the sale or disposition of a security for valuable consideration, but also any act, solicitation or conduct that is directly or indirectly in furtherance of the sale or disposition of a security As well, securities law requires a person or company engaging in, or holding itself out as engaging in, the business of advising others in respect of the buying, selling or investing in securities to be registered as an adviser in the local jurisdiction where advice is received.

Given the breadth of these triggers, even the activities of passive portals that contain only user-generated content could require registration. As well, the companies that use portals to raise funds might also need to register as dealers. Although issuers raising capital generally are not considered to be "in the business," this general rule may not apply if they trade in securities "frequently" or "solicit investors actively."[54]

In terms of advertising, Companion Policy 45-106 states in section 3.1 that issuers may use registrants, finders, or any form of advertising to solicit buyers under any of National Instrument's 45-106 prospectus exemptions. But National Policy 47-201 suggests that regulators will consider to be trading in Canada any person or company who posts on the Web any offering or soliciting of securities trades, as long as the post is accessible to persons or companies in Canada; as well, it states that anyone posting offering documents on the Web must register to trade in the local jurisdiction. So, while advertising and soliciting may be permitted for prospectus-exempt offerings, it seems that systematically doing so on the Web could recast such actions as trading and thus activate the dealer registration requirements. (Under the OSC model, crowdfunding offerings may only be advertised through the funding portal or on the issuer's website. Issuers would, however, be permitted to use social media to direct investors to the funding portal or their website).

[54] See Companion Policy 31-103CP *Registration Requirements and Exemptions*.

But registering as a dealer or advisor is complicated and expensive. National Instrument 31-103 states that intermediaries must be accredited and have the education, training, and experience to act as a broker or advisor. Registrants are expected to understand their investment products' structure, features, and risks well enough to advise investors on suitability. Registrants are also subject to "Know Your Client" obligations, which means they must learn their client's profile, investment goals, and risk tolerance. [55] It is imperative that portals be exempted from these requirements in order to promote timely placements and reduce compliance costs and resources.

To reduce these burdens on funding portals as registrants, the OSC should consider some type of "restricted dealer" status for them to efficiently and cost-effectively intermediate a private placement of fund securities. Otherwise, Advocis would emphasize that the prospect to a portal of assuming the full obligations of a registrant is likely to be an unattractive one, given the likelihood of encountering potentially low fees and unknown liabilities in any trial experiment of raising funds for start-ups over the internet.

**Recent OSC comments and rulings**

In this regard, it is worth noting that the OSC has recently commented on several new business models, which leads Advocis to believe that a portal could easily be required to be a registrant under a form of restricted dealer status. In August 2012, the OSC granted relief to an investment dealer from the obligation to register as an adviser in order to provide suitability advice in the ordinary course of its dealer business. The OSC noted that "providing suitability advice via a hybrid online platform is novel but this model otherwise fits within the existing regulatory framework. Section 8.23 of NI 31-103 allows a registered dealer to provide suitability recommendations without also having to register as an adviser."[56] This particular investment dealer also obtained relief from certain IIROC rules.

As noted, the fundamental question with regard to a funding portal is whether it should be considered "in the business" of trading or advising and therefore subject to the dealer or adviser registration requirements. The OSC recently listed several examples of entities that it considers to be in the business of trading or advising, including an internet platform that seeks to showcase investment opportunities to investors in return for fees from issuers and dealers that advertise on the platform, and "finders" and "investor relations" entities who participate in private placements and prospectus offerings in return for broker-type compensation. In terms potential relief for such business models, the OSC noted that:

[55] See National Instrument 31-103.

[56] OSC Staff Notice 33-738. 2012 OSC Annual Summary Report for Dealers, Advisers and Investment Fund Managers.

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> We continue to support innovative business models developed by industry that can benefit investors. In the case of entities that seek to advertise investment opportunities to investors through the internet, depending on the business model, we are open to considering exemptive relief from certain dealer requirements if these requirements are not appropriate for this type of entity, and if investor protection concerns can otherwise be adequately addressed.[57]

From the regulator's point of view, it is worth noting that there is ample precedent for relaxing registrant requirements. For example, under the Northwest Exemption, a non-registrant exempt market intermediary can engage in trading activities falling within specified capital-raising exemptions which are conducted in its own jurisdiction and those of the Northwestern block's other jurisdictions. The Northwest Exemption also provides such an intermediary with certain forms of relief from the registration requirements of National Instrument 31-103, as long as the individual is neither currently registered nor required to register, provides no suitability advice or financial services to purchasers, has no access to investor assets, and complies with mandated risk disclosure and regulatory filings.[58] Such conditions suggest that perhaps a non-registrant could fulfill many of a portal's responsibilities.

**Should a registrant other than the funding portal be involved in this type of distribution?**
Possibly. See below.

**If so, what category of registrant?**
As noted above, the possibility exists of creating a class of due diligence "experts" who specialize in analyzing issuances in particular niche markets in which they have expertise. Such individuals or firms could sell their analytical and forensic services to portals to promote timely and low-risk placements.

**Should additional obligations be imposed on the registrant?**
Should a 36-month trial period prove the crowdfunding model to be viable, the OSC may consider at that point in time the relaxing of some of the jurisdictional boundaries, so that crowdfunding funding efforts can attract foreign investment.

Similarly, should a trial prove successful, the OSC may also wish to relax advertising restrictions, so that companies could market offerings on a range of social media.

[57] *Ibid*.

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## PART FOUR: OFFERING MEMORANDUM PROSPECTUS EXEMPTIONS

Under section 2.9 of *National Instrument 45-106 Prospectus and Registration Exemptions*, every Canadian jurisdiction, other than Ontario, currently has an offering memorandum exemption. An offering memorandum is a detailed but purposely limited disclosure document designed to help investors evaluate investments. It is intended to be less onerous to prepare than a prospectus. As noted, Ontario is the only province that does not allow investors to buy an exempt-market security using the offering memorandum prospectus exemption. Securities are sold in Ontario using an offering memorandum, but Ontarians are only able to buy these securities if they qualify as accredited investors. This effectively restricts a large number of residents of Ontario from participating in the exempt markets. Based on eligibility for the accredited investor exemption, a mere 2% of Ontario's population would be allowed to invest in the exempt market, thus dramatically restricting the ability to participate in many alternative investments to institutions or the very wealthy.[59]

In contrast, in Alberta any investor can purchase a security that is offered pursuant to the offering memorandum prospectus exemption so long as the size of the purchase is limited to $10,000 for everyone but "eligible investors." British Columbia's broad exemption allows any number of buyers to invest any amount of money provided they execute a risk acknowledgement form and receive the proper offering memorandum document from the issuer. Different forms are prescribed for "qualifying" and "non-qualifying" issuers. Overall, Alberta applies more restrictions to its offering memorandum. Some provinces follow British Columbia's model; others, Alberta's.

The OSC's potential offering memorandum exemption imposes most of the issuer restrictions and investor protections and limitations contained in the proposed overcrowding exemption, including its inapplicability to investment funds, limitations on the amount that could be raised using the exemption in any 12-month period, and on the amounts each investor could invest. The notable differences, however, are that an offering memorandum investment would not need to be conducted through a funding portal, and a registrant would not be required unless the issuer or an intermediary is in the business of trading securities. As a result, the OSC's offering memorandum exemption would be significantly more constrained than the offering memorandum exemptions in the rest of Canada, which do not limit the amount that an issuer can raise in reliance on the exemption and have either no or less restrictive limits on the amount of capital individual investors can invest.

**Should an offering memorandum exemption be adopted in Ontario? If so, why?**
Yes, provided proper protection is included in the offering memorandum's requirements.

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[59] Greg P. Shannon, Q.C. and Darren M. Smits, Miller Thomson LLP, *Response to OSC Notice 11-766, OSC Statement Of Priorities For Financial Year To End March 31, 2013.*

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1. **Efficiency:** When properly constructed and regulated, the offering memorandum exemption is an efficient capital-raising tool for business and investors. It is a potentially powerful means for SMEs to raise capital without the high cost of drafting and filing a prospectus. For investors, the offering memorandum functions as an easy-to-understand document which also provides them with many of the rights afforded by a prospectus. The adoption of the offering memorandum exemption would be timely, as investors continue to search for alternative investments, given the ongoing volatility in equity markets over the past half decade.

   It should be noted that in the past, some consumer advocates have argued that many venture issuers do not use the offering memorandum exemption due to the costs associated with preparing the memorandum and compliance with the requirements of the exemption, and so adoption of the exemption by Canada's largest capital market would therefore not be of special importance. Moreover, such advocates argue, in the interests of consumer protection, listed issuers should rely on their continuous disclosure record for raising capital.

   Advocis disagrees with these arguments and believes that the OSC should be always be considering the creation of effective capital-raising opportunities. A substantial number of exempt market distributions provide working capital for SMEs and produce employment opportunities for Canadians, especially in Western Canada. This is in contrast to the sophisticated financial products issued by financial institutions to institutional investors, many of which are essentially "side bets" on the performance of the mortgage markets or other financial institutions, and which are of arguable value to Ontario's economy.

2. **Harmonization:** Ontario is currently the only Canadian province without an offering memorandum exemption. While the intent has been to protect unaccredited investors, this rationale will not hold if equity crowdfunding regulations are implemented in Ontario.

3. **Sufficient investor protection:** Registered dealers and their dealing representatives are subject to effectively identical requirements in terms of Know Your Client and Know Your Product requirements, suitability criteria, Customer Relationship Model-mandated disclosures, and other obligations with respect to dealing with potential investors. Given this, there is reasonable assurance that if an offering memorandum exemption is introduced which requires the intermediation of a dealer, then the interests of investors will be suitably protected.

4. **Investor fairness:** With large pension funds such as the Ontario Municipal Employees Retirement System and now the Canada Pension Plan accessing alternative investments, it is only fair to allow others access to the potential to benefit from the stability and increased returns available in the exempt market. The

*status quo* in Ontario confers an unfair privilege those individuals who hold corporate pension plans, because they are able to benefit from these funds' investments in exempt market securities—securities in which they could not invest in as retail investors. Meanwhile, individuals who rely solely upon their own RRSP for their retirement have little or no access to these markets. Moreover, in many sectors, public markets have proven to be riskier and more volatile than private equities. Indeed, in the last five years the average return in the public markets has been paltry: individual investors, like institutions, should be permitted where appropriate to invest in alternative markets for greater stability and improved possibility of higher returns. Allowing an offering memorandum would help the OSC to better fulfill its regulatory mandate and empower informed investors to make their own decisions, instead of imposing essentially arbitrary rules on investors based at times on inherited wealth, as is the case with the accredited investor and minimum amount exemptions. Finally, pursuant to point 3, above, exempt market dealers offer products similar or identical to those offered by investment dealers and must observe similar requirements for suitability and knowledge of the client and the product. Prohibiting them outright from working with 98% of the population is on the face of it excessively restrictive?

5. **Structural anomalies of the Canadian capital markets:** The costs of equity-cased fundraising impact start-ups and SMEs on a disproportionate basis. Experience indicates that equity-based financing relying on distributions to individuals below the threshold of $10,000 per individual transaction is simply not worthwhile to the enterprise. The time and cost per transaction in terms of disclosure and other compliance and transaction costs is too high to be justified. Each company and listing is unique, so it is difficult to determine exactly what costs to issue public shares. Expenses vary depending on the availability of up-to-date supporting documentation, such as financial statements, appraisals and expert reports, the complexity of the offering and any corporate restructuring, the number of jurisdictions where the company is filing a prospectus, and the market capitalization of the company to be listed. Most fees are incurred up front and are not reimbursable if the listing process is unsuccessful. All of these costs can mount unexpectedly as the process unfolds. In addition, the current system of raising capital also entails significant "opportunity cost" risk. The ability to raise capital on favourable terms is often time-sensitive. A streamlined tier-one style of crowdfunding should reduce opportunity cost risk.

   Another problem is Canada's decentralized structure of securities regulation. Research by the Canadian Bankers Association, using publicly available data, has demonstrated that the existing decentralized scheme of regulation has a substantial negative impact on all Canadian firms' attempts to raise capital. This burden,

however, falls disproportionately on start-ups and SMEs.[60] This decentralized regulatory structure limits SMEs' ability to tap into all of Canada's capital market and it imposes high costs on smaller firms.[61] While the incremental compliance costs associated with multiple jurisdictions are generally not material for large issuers,[62] smaller enterprises are less able to bear these costs and consequently to find as significant barriers to raising capital.

Many smaller companies also raise capital using prospectus exemptions. The differing treatment of exemptions across the provinces makes the process of raising capital more time-consuming and expensive for small and medium-sized businesses. The average potential savings per exempt distribution application under a single regulatory model was estimated at $1,124 in 2003.[63] Thus, the existence of multiple securities regulators in Canada imposes a further competitive disadvantage on smaller firms.[64]

**Should there be any monetary limits on this exemption?**

Advocis believes that that the maximum amount in the OSC's proposed offering memorandum exemption (restricting an investor to $2,500) is too low for investors and issuers and impractical from a transaction-processing perspective for issuer, investors and dealers. Many knowledgeable investors will avoid a particular investment because $2,500 is simply too small to justify a full review of an offering memorandum.

Another issue with the low investment limit in the OSC's proposal is the unusual position it places advisors *vis-à-vis* do-it-yourself investors: an advisor will have to inform a non-accredited client that he or she can elect between investing $2,500 through his firm, or investing five or ten or twenty times that amount in a similar high-risk start-up penny stock through an online discount broker. Somewhat perversely, in the latter case the investor is not provided with suitability advice or disclosure documents. But in the former case, the OSC's offering memorandum exemption would restrict the client to $2,500 in a start-up or SME, even after receipt of suitability advice, easy-to-read disclosure, and the acquisition of certain purchaser's rights.

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[60] Government of Canada, Parliamentary Information and Research Service (PIRS*). Reforming Canadian Securities Regulation*. September 19, 2005. Prepared by Tara Gray, Economics Division, and Andrew Kitching, Law and Government Division. Online at http://www.parl.gc.ca/Content/LOP/ResearchPublications/prb0528-e.htm#12.

[61] Canadian Bankers Association, The Impact of Multiple Securities Regulators on the Cost of Raising Capital for Small and Medium-Sized Businesses (February 2007), pp. 1-2. Online at http://www.cba.ca/contents/files/misc/msc_smeresearchreport_en.pdf.

[62] Charles River Associates, "Estimating the Incremental Costs of Multiple Securities Regulators in Canada," Submission to the Wise Persons' Committee to Review the Structure of Securities Regulation in Canada, 2003.

[63] *Ibid*.

[64] Canadian Bankers Association, *supra* note 64.

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Accordingly, Advocis believes that the investor's limit should be $100,000 for the first three years of the exemption's operation. This limit should be understood to be subject to the general principle that an investor's total exempt market holdings should not amount to more than 10% of the investor's total portfolio, due to illiquidity concerns. Any risk acknowledgment form to be used pursuant to this exemption should make this principle clear.

After that 36-month period, and in the absence of significant fraud or investor losses due to failures in the offering memorandum's investor protection requirements, the OSC should then consider moving to an unlimited amount. Given suitability requirements, there may not be a need for monetary caps within offering memorandums involving sales through an exempt market dealer. Suitability requirements should ensure that a client invests the right amount for their needs. By imposing proper and enforceable guidelines as to structure and content, the offering memorandum is in a sense a mini-prospectus. Companies relying on this exemption should be liable for any improper or false information. Again, most SMEs needing capital will be prepared to provide the requisite information to the investor and assume the liabilities associated with misrepresentations or other forms of abuse.

Moreover, requiring an issuer to sign a minimum of 600 investors in order to reach the $1,500,000 plateau suggests a level of administration and solicitation wholly impractical for SMEs. The $1,500,000 cap is also too low to account for the costs associated with the preparation and filing of an offering memorandum, particularly when a SME issuer has to cover the accounting and reporting, legal and compliance, and printing and delivery costs associated with hundreds of investors due to the maximum investment limit. The restrictions on an offering memorandum exemption increase the risk of under-capitalization which can lead to firm failure and therefore goes against a fundamental mandate of the OSC, protecting investors and fostering efficient capital markets.

Advocis does argue, though, that a major problem with offering memoranda is the requirement for audited financial statements from issuers, even those with no history of operations. Audited statements can cost $20,000 to $35,000, which is too expensive for most start-ups (which may very well have a paucity of meaningful information). Advocis would suggest that the point-of-sale and ongoing disclosure requirements for the second tier of its crowdfunding proposal would be suitable for offering memoranda. In addition, as a matter of practice, though not of legal necessity, offering memoranda often present information in a way that unsophisticated investors cannot understand, since they are often drafted as "mini-prospectuses" and typically cost from 40 to 60% of cost of a prospectus.

**Should a purchaser be required to receive investment advice from an adviser in order to rely on this exemption?**

A retail investor who is not an accredited investor should be required to receive advice from an advisor in order to rely on this exemption. There is no guarantee that the individual will understand offering memorandum's risk analyses and other key investment-critical information.

**If so, should those limits be in addition to any limits imposed under any crowdfunding exemption?**

This question is premature. Absent some sort of description of what a crowdfunding exemption would entail it is difficult, absent any context, to support any linking of monetary limits. Further, if investors relying on the offering memorandum exemption are being provided with a reasonable level of disclosure, why should an issuer be limited in the amount it can raise in aggregate through crowdfunding and reliance on the offering memorandum exemption?

**Should there be mandatory disclosure required in an offering memorandum? If so, what level of disclosure should be required?**

Yes. The disclosure requirements proposed by the OSC, largely consistent with the crowdfunding disclosure, are necessary. Disclosure of risk factors should also be mandatory, and the offering memorandum should incorporate penalties and rights of action for misrepresentations or material omissions. In particular, the provision of a statutory right of rescission, so the investor has the right to cancel the agreement and have the money refunded, is worth serious consideration by the OSC, and well as the ability to bring an action for damages where there is a misrepresentation in such a document. Nonetheless, the level of disclosure imposed should be below that required under a prospectus. Finally, all purchasers should be mandated to sign a risk acknowledgement form.

It should be recalled that the CSA's *Multilateral CSA Staff Notice 45-309—Guidance for Preparing and Filing an Offering Memorandum under National Instrument 45-106—Prospectus and Registration Exemptions,* which outlines a number of common deficiencies that provincial securities commissions have identified with respect to the disclosure provided in offering memoranda. While the offering memorandum exemption may provide for more investor democracy by allowing a wider spectrum of investors to participate in the exempt securities market, critics of the offering memorandum point to the number of common deficiencies in such documents as evidence of a prospectus exemption that does not provide adequate protection for the less sophisticated investor.

**Should we require registrant involvement as a condition of this exemption?**

**If so, what category of registration should be required?**

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To ensure an appropriate level of investor protection a registered investment dealer, exempt market dealer or portfolio manager should be involved in distributions under this exemption to individual investors. Registered dealers and their dealing representatives are subject to effectively identical requirements when dealing with clients – such as suitability requirements, the various Know Your Client and Know Your Product obligations, and the requisite Customer Relationship Model disclosures. This means that the individual investor in an offering memorandum exemption-related transaction facilitated by the intermediation of a registrant will be afforded appropriate investor protections. Moreover, retail investors who are not accredited investors should be required to consult a registered financial advisor prior to executing the purchase. This advisor should be a member of a professional association which requires that advisors act in the best interests of their clients, meet ongoing continuing education obligations, and carry suitable amounts of professional liability insurance.

While there is a perception that requiring the use of a registrant is somehow a paternalistic abrogation of an individual's decision-making autonomy, Advocis believes that the requirement of a registrant is not an unnecessary regulatory layering or an unreasonable regulatory cost; rather, it is in fact a justifiable requirement to ensure individual investor protection in the exempt market. The presence of a registrant is a fundamental issue of consumer protection; to argue that such third party involvement is an additional regulatory layering and represents only an additional cost to those involved in the transaction misses the essential point. Given the vagaries of reporting in the exempt market, having the "local knowledge" and experience of a registrant seems a necessary protection.

## PART FIVE: EXPLORATION OF A PROSPECTUS EXEMPTION BASED ON INVESTMENT KNOWLEDGE

The *Consultation Paper* considers a new prospectus exemption for distributions to "sophisticated" investors who satisfy a work experience requirement (at least one year in the investment industry in a position that requires knowledge of securities investments) and certain requisite educational achievements: a Chartered Financial Analyst (CFA) designation, or a Chartered Investment Manager (CIM) designation, or a Master's of Business Administration degree (MBA) from an accredited university. As with the accredited investor exemption, there would be no restrictions on the type of security that may be distributed, the size of the investor's investment, and the size of the offering. The investor would receive basic information about the offering, such as a term sheet, and prior to investment be required to execute a risk acknowledgment form. Advocis assumes that the term sheet would not constitute an offering memorandum under the *Securities Act* and no rescission rights would apply.

On the one hand, the OSC notes that this exemption may provide greater investment opportunities for so-called "sophisticated" investors and may increase the investor pool

for issuers. On the other hand, the OSC recognizes a number of challenges associated with the concept including: (a) a potentially small impact; (b) implementation and compliance issues; (c) appropriate framing of qualification criteria; and (d) implications for the registration regime.
Advocis supports this proposed exemption, because it would help eliminate one of the perverse outcomes of the current exempt market framework, which is that many knowledgeable investors are barred from exempt market participation because they fail to meet the accredited investor threshold of having a net worth of at least $1,000,000 (exclusive of the residence) or an annual income of at least $200,000, or $300,000 with a spouse. For example, consider a married pair of educated professionals who earn a combined $350,000 annually, are $100,000 in debt, rent their apartment and lease their cars. Although they have a negative net worth, they qualify as accredited investors. In contrast, consider the case of another married couple who earn a combined annual income of $280,000, hold no debt, own outright an $800,000 house, have $500,000 in RRSP securities and have $250,000 in cash holdings. They are also experienced long-time self-directed investors. Yet they do not qualify for accredited investor status.[65]

This sort of outcome is in direct contrast to the notions of fairness and access which are purported to inform the OSC's mandate. Advocis believes that the adoption of this exemption becomes an urgent issue of realizing equality in investment opportunities for those persons who fulfill a "sophistication" criterion in terms of being competent to determine their own investment objectives and risk tolerances by virtue of them personally exhibiting measurable educational and experiential requirements.

**Would this exemption be useful for issuers, particularly SMEs, in raising capital?**
Yes. Advocis supports this exemption. It broadens the potential base of investors without exposing the average investor to undue temptations to chase high returns. Investment knowledge and experience, though hard to measure, are the best available proxies for investor sophistication. As well, a similar exemption is available in the United Kingdom's regulatory regime and has proven workable to date.

We believe that the exemption would be useful to all issuers, including SMEs, because it would dramatically broaden their capital-raising opportunities. It will be recalled by many industry stakeholders that an earlier CSA consultation note queried whether the income threshold criteria for qualifying as an "accredited investor" under *National Instrument 45-106 - Prospectus and Registration Exemptions* is too low. It is a commonplace criticism of this exemption that wealth is a poor measurement of sophistication. Moreover, the income threshold test was perceived by many to be "undemocratic," since it restricted participation in the exempt market to a small group of investors who represented less than 1 per cent of the total population of Canada – i.e.,

[65] Watson, *supra* note 1, p. 22.

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in 2009, just 247,450 Canadians. To compound the problem, to account for inflation since 2001 when the exemption was brought in would raise the individual income threshold figure to $443,000, further reducing the number of eligible Canadians to 0.63 per cent of the population–156,520 Canadians.[66] In the final analysis, the "bright line" standard of the accredited investor exemption has led to a situation where certain individuals enjoy access to investment opportunities based on their income-generating capacity (which may very well be magnified by variables such as access to education and economic differences in the region of the individual's residence).

**Are there sufficient investor protections built into this exemption?**
This exemption is an issue of investor autonomy for those individuals who have demonstrated the capacity and desire to access exempt market products. Mindful of investor concerns, Advocis would however suggest that the exemption be adopted on a 36-month trial basis. In the event some of the criteria appear to be failing to ensure the desired level of investor protection, and certain individuals have placed their income or assets in jeopardy, then, instead of jettisoning the entire exemption, the OSC could consider a sliding scale of investment limits tied to the accumulation of market experience: for example, a person with one year of market experience could be limited to a $20,000 cap, a person with two years $30,000, and so on.

**Should we require an investor to satisfy both a relevant work experience condition and an educational qualification condition or would one suffice?**
Both the educational and experiential qualifications should be met. Advocis believes that the broad range of complex exempt market products means that one year of work experience may not be sufficient to enable an individual to make appropriate decisions, and so an educational requirement is necessary to ensure that the person can undertake appropriate self-directed research.

**How should we define the relevant work experience criteria?**
The United Kingdom work experience criteria include having worked in a "professional capacity" in the private equity sector or financing small- and medium-sized enterprises, or having been a director of a company with annual turnover of £1 million or more. If "professional" is defined to mean having provided financial advice to institutional or individual clients on a fee or commission basis, these criteria strike Advocis as appropriate.

**What educational qualifications should be met? Should we broaden the relevant educational qualifications?**

[66] Brian Prill, "Ontario Securities Commission Reviewing Financing and Investing Restrictions On Businesses, Investors,*" Blaneys on Business* (September 2012). Figures are from Statistics Canada, "Total Canadian Income Figures."

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Advocis would suggest that the Chartered Accountant (CA) and Certified General Accountant (CGA) designations be added. A less rigorous designation, such as the Canadian Securities Course (CSC) could be included, but with a ceiling on the amount investable under the exemption. Finally, we would suggest that exempt market securities dealers who are registered under provincial securities legislation in one or more jurisdiction in Canada be included.

**Are there other proxies for sophistication that we should consider?**
No. Given the very detailed range of proposed–and existing–exemptions now under review by the CSA and the OSC, Advocis does not believe that there is any need to consider further exemptions at this time.

## Part Six: Exploration of a Prospectus Exemption Based on Registrant Advice

**Should we consider a new prospectus exemption that is based on advice provided by a registrant?**
Yes. Advocis agrees, with some qualifications, with the position taken in the OSC's *Consultation Paper* for a registrant-advice-based prospectus exemption–that is, for distributions to investors who have received "appropriate" advice from a registered investment dealer. It should be noted that under the OSC's model "investment dealers" would not include other types of registrants, such as exempt market dealers, and that only dealing representatives within the investment dealer who are qualified to provide advice can do would be allowed to do so for the purposes of the exemption. The OSC states that exempt market dealers are specifically excluded from this exemption because of important differences in terms of the duties owed to a client and the proficiency, solvency, and other requirements applicable to an exempt market dealer, in comparison to those of an investment dealer or a portfolio manager. As well, existing prospectus exemptions would continue for distributions to portfolio managers acting on behalf of fully managed accounts.

More particularly, in the OSC model the investor would not need to satisfy any sophistication, income or net worth criteria. This exemption would require that an investment dealer (i) is providing advice to the investor in connection with the distribution, (ii) has an ongoing relationship with the investor, (iii) has contractually agreed that it has a fiduciary duty to act in the best interests of the investor, and (iv) is not providing advice in connection with the distribution of a "related issuer" or a "connected issuer."

Advocis does not believe that the exemption should require a contractual agreement that that the dealer has a fiduciary duty to act in the best interests of the investor. Such a requirement will effectively dissuade any dealer from using this exemption. Advocis also has issues with requirements (iii) and (iv), which will be explored below.

**If so, do you agree with limiting this exemption to a situation where the registrant has a fiduciary duty to act in the best interests of the client?**

No. Advocis sees it as a basic matter of freedom of contract that if parties wish to contract to embed a statutory duty into their relationship, they should be free to do so. Advocis would suggest that (iii) above be removed as a necessary condition of the exemption, since a court will find a fiduciary duty exists if the facts at issue warrant it. Of course, portfolio managers are under a statutory fiduciary duty, and it should be left to the Ontario Legislature to extend that statute-based duty to specific prospectus exemptions involving a registrant such as an investment dealer who must already meet significantly high standards of conduct.

**Do you agree that this type of exemption should be limited to certain types of registrants (e.g., investment dealers) or should this exemption be available for another type of registrant (e.g., an EMD)?**

As Advocis understands the proposal, this exemption would be for individual investors who would otherwise not qualify for exempt market purchases, except through the potential introduction of a crowdsourcing exemption. As such, they may well be largely drawn from the "rank-and-file" of Ontario's investing public, and deserve the more robust protections afforded by an investment dealer in comparison to an exempt market dealer.

Advocis would however suggest that the OSC explore the possibility that exempt market dealers and registered advisors who are members of a professional association which requires that they act in the best interest of the client, are subject to ongoing CE requirements, and carry suitable errors and omissions insurance be allowed to act pursuant to this exemption. This participation would be limited to transactions of certain classes of relatively straight-forward exempt market products, such as real estate investment trusts and principal-protected notes, transactions which could not comprise more than 10% of the individual's gross income for that year. An investment limit for the individual could also offer additional investor protection, as would a rule that, at the point of sale, the exempt product compromise no more than 10% of the individual's total portfolio. This would expand the investment opportunities available to many individual investors and of course assist in capital raising.

**Should this type of exemption be available for registrants that sell securities of "related issuers" or "connected issuers" (which would raise conflict of interest concerns, as explained in National Instrument 33-105 *Underwriting Conflicts* and Part 13 of NI 31-103)?**

Advocis supports this exemption for registrants selling securities of "related issuers" or "connected issuers," provided that all potential or real conflicts of interest are disclosed

in writing beforehand to the individual investor, who must sign an acknowledgement form that he or she has been informed of and understands the conflict(s), and that a right of rescission is available in the event a conflict was not disclosed. These conditions would eliminate the need for a fiduciary duty to be a necessary requirement of the exemption.

Advocis believes that a registrant selling securities of related issuers or connected issuers is in a privileged position of informational superiority and therefore may be able to identify and explain unique investment opportunities to individual investors—opportunities of which they would otherwise remain unaware. If any conflicts of interest are properly disclosed before the sale, and if the proposed sale is part of an ongoing relationship between the registrant and the individual investor, then that investor should be permitted to make the decision whether or not to purchase the securities.

**If so, would this be consistent with the registrant being subject to a fiduciary duty to the client?**
It would be consistent, at least to an extent, but a fiduciary duty is not needed in these circumstances. Please see the answer to the questions immediately above.

**Would exempting the issuer from a disclosure obligation have implications for a registrant's ability to conduct a meaningful KYP and suitability review?**
Yes. Disclosure obligations have significant implications in Know Your Product reviews and suitability assessments and should normally be a mandatory part of the distribution of securities. The presence of an ongoing relationship between the registrant and the retail client who seeks to rely on professional advice, coupled with mandatory conflict disclosure, should afford the client with significant protections pursuant to this proposed exemption.

**Do you agree that a registrant should be required to have an ongoing relationship with the client?**
Yes. For the purposes of this exemption a registrant should be in an ongoing relationship with the individual investor.

The fact that there is a mutually beneficial relationship between the parties should act as a major safeguard for preserving the efficacy and efficiency of the registrant's activities on behalf of the retail client.

There are a number of ways available to determine if the relationship is ongoing, including requirements that the parties be working together for a minimum period of six or 12 months before such an exemption may be relied upon.

**Should there be any restrictions on the type of security that could be purchased? For example, should this exemption be available for purchases of**

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**securities of investment funds and/or complex products (including securitized products and derivatives)?**
No. Given the desire of the retail client to rely on stringent, professionalized advice, the full panoply of appropriate exempt market products should be available to him or her.

**Should the existing managed account exemption described above be expanded in Ontario to permit purchases of securities of investment funds?**
Yes. This could be done on a trial basis with the mandatory collection of data from a special managed account exemption E-form to determine if there are significantly harmful effects in terms of asset allocations made on behalf of retail clients.

## PART SEVEN: ELECTRONIC FILING

Advocis supports the OSC's efforts to improve the quality and availability of information contained in Form 45-106F1 *Report of Exempt Distribution*, which is required to be filed with securities regulators when securities are sold under certain prospectus exemptions, and on any reasonable requirement that additional information be included in the Report. The OSC has identified in the *Consultation Paper* certain information that would provide it with a better understanding of the exempt market, including information about the issuer's directors and executive officers, and, in the case of investors, where the accredited investor prospectus exemption is used, the category of accredited investor under which the investor qualifies, and if the investor is an individual, the investor's age range and work status. Further, the OSC is requiring that such reports be filed electronically and include additional information regarding the issuer, the investor and the registrant, if applicable.

**Are there any concerns with mandating use of the E-form?**
No, except for the routine privacy concerns about the delivery and storage of the E-form. We believe that the costs of complying with the proposed informational requirements can be borne by registrants and will help the OSC formulate effective policies for both capital raising and consumer protection.

**Are there any concerns with requiring this additional information in the report? Please explain.**
No. The information being sought is clearly a necessity when it comes to the ability of regulators and, upon release of the collated information, to the ability of issuers and investors, to make informed decisions. Advocis welcomes the use of the form and suggests that tabulated results be posted on the OSC web site on a semi-annual basis.

**Are there other types of information that we should require in the report?**

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Directly and through self-regulatory organizations, the OSC oversees 1,300 firms and 66,000 individuals using a risk-based approach to compliance assessments.[67] The OSC has recently released *OSC Staff Notice 33-738*, its 2012 compliance report on dealers, advisers and investment fund managers. This report reflects the increasing importance ascribed by the OSC to registrant practices and registration issues. Over the last two years, over 80% of compliance reviews have resulted in requirements for enhanced or significantly enhanced compliance by registrants.[68] The OSC is working steadily to review and enforce the obligations of exempt market registrants, especially in regard to ongoing knowledge of clients and their investment objectives. More emphasis is being put on meaningful ongoing disclosure of conflicts by registrants and on disclosure of portfolio performance and costs.[69] All of this bodes well for investor protection in the exempt market.

Exempt market dealers or carrying on trading activities under prospectus exemptions received considerable regulatory attention in 2012. The compliance report indicates that the OSC:

- is concerned that EMD registrants are conducting insufficient due diligence on whether clients satisfy the statutory requirements applicable to "accredited investors," "minimum amount investors," and other categories of private placees;[70]
- believes that for EMD registrants, qualifications for prospectus exemptions are an integral part of the "Know Your Client" process;[71]
- reports inadequate disclosure of conflicts by EMDs and a failure by EMDs to invest funds as represented to their investors;[72]
- commenced a number of enforcement and registration suspension proceedings against EMDs for a multitude of infractions, including inadequate capitalization, deficient recordkeeping, conflicts of interest and inappropriate sales practices;[73]
- reported a number of cases of inadequately documented offerings and a tendency on the part of EMDs to engage in non-arm's length related party transactions; and
- has expressed concern that some private placements of securities to clients were done by the EMDs as a means of overcoming their capital deficiencies.[74]

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[67] OSC Staff Notice 33-738, 2012. *OSC Annual Summary Report for Dealers, Advisers and Investment Fund Managers*, pp-35 . 36. Online at http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20121122_33-738_annual-rpt-dealers.htm#_blank.
[68] *Ibid*. p. 35.
[69] *Ibid.*, p. 7.
[70] *Ibid.*, p. 14.
[71] *Ibid*.
[72] *Ibid.*, p. 22.
[73] *Ibid.*
[74] *Ibid.*, pp. 45 - 46.

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Advocis believes that these compliance concerns identified by the OSC with regard to the exempt market should inform any discussion on changes to the proposed E-form. More particularly, *OSC Staff Notice 33-738* details concerns about the performance of duties by chief compliance officers, including the observations that:

- registrant compliance systems are very often found to be inadequate;
- chief compliance officers do not always spend enough time implementing compliance systems because they perform their jobs on a part-time basis along with other duties either within a registered firm or for an entirely different employer; and
- there is a tendency on the part of chief compliance officers to not properly document compliance procedures or to perform ongoing self-assessments.[75]

Given this, an enhanced focus on chief compliance officers' activities and employment relationship with the firm seems justified.

As well, certain pieces of transactional information will help regulators determine what types of activities and omissions are correlated to fraud activity and fraud avoidance. Such information could conceivably include details of exempt market transactions such as:

- the nature of the exemption relied upon by each investor;
- efforts by dealers to confirm their investors' compliance with the terms of the exemption;
- a multivariate description of the issuer's compliance system which was used to review the distribution;
- copies of all documentation relating to the distributor's compliance procedures and a sample of any ongoing self-assessments;
- the number of investors participating in a crowdfunding or offering memorandum exemption and the amounts purchased;
- the disclosure investors received, and the timing and means of that receipt;
- the presence of a registrant in informing the investor of the placement or in soliciting the investor;
- potential conflicts of interest such a registrant, and the relationship, if any, between the registrant and the issuer; and
- the particulars of fees or commissions relating to the distribution of the exempt market product.

Finally, the OSC notes in the *Consultation Paper* that a number of exempt market dealers are not operating in a manner compliant with applicable regulatory

[75] *Ibid*., p. 40.

requirements. This suggests that the harvesting of EMD data on a special EMD E-form will be worthwhile. Advocis would note that in the interest of keeping compliance costs reasonable for SME start-ups, such information should not be required of distributors pursuant to crowdfunding exemption.

**Should we require more frequent reporting for investment funds? If not, why not?**

Yes. Such actors have the ability to bear the compliance burden and arguably pose a greater degree of potential harm to a larger pool of investors than other actors in the exempt market, such as, for example, SME start-ups.

## PART EIGHT: IMPLICATIONS FOR BROADENING ACCESS TO THE EXEMPT MARKET

Canada has a mature, competitive and well-regulated asset management sector. In the institutional market, pension funds and other institutional investors continue to seek higher returns through exempt market products such as investments in infrastructure, real estate investment vehicles and other alternative asset classes. But for individual investors, a relatively poor performance in equity markets over the last decade and falling asset values have directed retail investment distribution to fixed income, low-cost exchange-traded funds and money market products. Product developers continue to produce and market target-date and other life-cycle products which are, in the main, primarily suitable for the baby boomer retirement market. Lastly, there are signs of a possible move away from affordable commission-based passive investment products in favour of the fee-based advice model (which could lead to a U.K.-style post-RDR advice gap. All of this prejudices the young individual investor with a risk appetite and long investment horizon. For such investors, gaining access to the exempt market is currently the only real option.

Meanwhile, the exempt market continues to grow in importance as a means of capital raising activity in Canada. Prospectus exemptions are for SME issuers are crucial, since they allow for more equitable participation by companies and investors in the exempt market, which in turn may be seen as instances of fairness, market efficiency and investor protection. Additional benefits include ease of administration and cost. Many products in the exempt market are both risk- and reward-intense because they offer the potential to make larger returns and portfolio diversification. But many individual investors have public equity portfolios which negatively impacted by low exchange rates, volatile public stocks and the rise of high-frequency trading. Public equity markets are not the safe arena they once were. Even limited access to the exempt market could help improve portfolio positioning for many retail investors.

Against this backdrop, the OSC has stated that in considering changes to the prospectus exemptions available in Ontario, it will be guided by two principles: protecting investors

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from unfair, improper, or fraudulent practices, and fostering fair and efficient capital markets and confidence in those markets.

We would urge the OSC to keep the current state of our asset management sector in mind when considering the following:

a. **the decline in Canadian start-up capital**: venture capital investment in Canadian start-ups dipped to $1.1 billion in 2010, from $5.9 billion in 2000 [76];

b. **current market realities**: as shown above, the presumed safety of investments sold via prospectus versus those sold by alternate exemptions ignores financial realities;

c. **an undermining of the ability of individual investors to benefit from professional advice:** the OSC should consider the paradoxical fact that, due to income restrictions, most Ontario investors are not even able to invest in a private share fund recommended by a registered portfolio manager who is under stringent Know Your Client obligations. We would argue that once the investor engages a registrant who has a duty to recommend suitable products and the proficiency to assess them, and the investor has decided to entrust the registrant with the power to undertake discretionary investment decisions for him or her, then there is a much reduced need for regulators to draw distinctions between regular prospectus-driven investments and exempt market products. There is no evidence that making such distinctions in the name of a nebulous and inconsistently applied conception of investor protection prevents more harm than it causes. Once appropriate safeguards are met, further prohibitions simply represent a statement on behalf of the regulator that what purports to be professional advice is in fact anything but; if the problem with the quality of advice being provided means it is inappropriate for individual retail clients, then it is inappropriate for *all* clients, including institutional ones, and the OSC should act accordingly; and

d. **an undermining of the ability of individual investors to benefit from true portfolio diversification:** it is a truism that increased diversification naturally decreases an investor's investment risk. This may be the most compelling argument to open the exempt market to at least a portion of retail investors. It is somewhat perverse that in our potentially volatile housing markets the average Canadian is free to contract for a residential mortgage worth many hundreds of thousands of dollars, and can freely invest in volatile public equity markets online, without advice, but the same Canadian faces very stringent prohibitions from investing in private markets with advice.

[76] Watson, *supra* note 1, p. 22.

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**Are there prospectus exemptions, in addition to the concept ideas discussed in this paper that we should consider? Please elaborate.**

**Helping issuers avoid a "liability trap" with a substantial compliance rule**
This is not an exemption *per se*, but a suggestion on how—in the interests of providing a measure of stability—to best apply one or more of the exemptions discussed in the OSC's Consultation Paper, and is particularly apposite for the policing of a crowdfunding exemption.

It is to be expected that unsophisticated entrepreneurs may have difficulty understanding and therefore complying with certain disclosure requirements, which could lead them into a "liability trap." To qualify for the crowdfunding exemption, both issuers and intermediaries will have to comply with detailed requirements. Depending on the model adopted, understanding the totality of the requirements could amount to an exceptionally complicated task.

Under the proposed OSC crowdfunding model, compliance with *all* of the requirements is a necessary precondition of the exemption. As Advocis understands it, should either the issuer or the crowdfunding intermediary fail to comply with any of the mandated requirements, then the exemption becomes unavailable—regardless of the significance of the violation, or whether the issuer or intermediary reasonably believed they were compliant. If, for example, an issuer sold one dollar more than the permitted amount of securities in a 12-month period, the exemption would be lost for all of the sales, not just those that put the issuer over the limit. Similarly, if the intermediary portal failed to properly qualify a single investor by failing to have it execute a risk acknowledgement form, the exemption could be automatically lost for all investors. [77] Moreover, the issuer could be liable to all of the purchasers for rescission remedy. It is conceivable that the loss of the exemption could be retroactive if an issuer failed to file a required post-offering annual report.

It seems certain that during any trial launch of a crowdfunding exemption, some actors are bound to misinterpret disclosure requirements. Read literally, the proposed crowdfunding exemption does not account for whether an actor has knowledge of the wrongness of an act or event prior to committing; therefore, actors will be liable and the exemption denied even if the failure to disclose properly was merely negligent and not intentional.[78]

In the U.S., both the Regulation A exemption and the Regulation D exemption (exemptions from the registration requirements mandated by the *Securities Act* of 1933)

[77] These issues and the doctrine of substantial compliance in the context of the *JOBS Act* are canvassed by Bradford, *supra* note 6, at p. 26 in particular.
[78] Bradford, *supra* note 6, at p. 6.

include "substantial compliance" rules that protect an issuer even if the issuer failed to comply with the exemption in certain insignificant ways, including through provisions which protect an issuer if it reasonably believed the requirements of the rule were met, even if they actually were not.[79]

Accordingly, Advocis believes that the crowdfunding exemption should include a provision which would expressly give the OSC the authority to specify that an issuer that reasonably believed it met the requirements of the exemption or substantially complied with those requirements is still entitled to the exemption, in spite of the noncompliance. Such a "substantial compliance" doctrine may be needed if the OSC wishes to prevent unwary entrepreneurs who lack the money to pay for professional advice from falling into the liability trap and therefore losing access to an exemption which is conditional on compliance with *all* of the requirements.

The combination of complicated exemption requirements and relatively inexperienced issuers will no doubt prove problematic. Inadvertent violations are likely. And the consequence of even a minor violation could be extreme—potentially the loss of the exemption and liability to all of the investors for the full amount invested. The judicious application of a substantial compliance doctrine would not amount to a safe harbour for fraudsters or the incompetent. Every incentive for due compliance would remain, since no issuer would set out to attract the scrutiny of the regulator and potentially throw his or her enterprise into a process of potentially litigious review.

**The possibility of a non-complex product exemption**

Some consumer advocates will suggest the desirability of an exemption for "non-complex" exempt market products. Advocis disagrees with such a concept. Such an exemption would lessen the incentive for issuers to offer new and creative products, while giving less scrupulous distributors and resellers the incentive to force products into the "non-complex" category. Advocis believes that the focus should be on protecting investors who need protection, without hampering the access to suitable products for investors who can and are willing to bear risk. The goal of investor choice is as surely as deserving of promotion as is that of investor protection.

## LOOKING AHEAD

Advocis, The Financial Advisors Association of Canada, has appreciated the opportunity to provide comments on the *OSC Exempt Market Review*.

[79] *Ibid*. See also *Statement of C. Steven Bradford* at the Hearing on *The JOBS Act—Importance of Effective Implementation,* June 26, 2012, at p. 6. Hearing held pursuant to the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, Committee on Oversight and Government Reform, United States House of Representatives, 112th Congress, 2nd Session.

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To discuss any of the issues that we have raised, contact the undersigned, or email Ed Skwarek at eskwarek@advocis.ca.

We would be pleased to discuss these issues with you further.

Sincerely,

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