

OSC EXEMPT MARKET REVIEW

**OSC STAFF CONSULTATION PAPER 45-710
CONSIDERATIONS FOR NEW CAPITAL RAISING PROSPECTUS EXEMPTIONS**

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1. INTRODUCTION

1.1 Background on review

This paper sets out concept ideas for new capital raising prospectus exemptions in Ontario, which have been developed as part of the Ontario Securities Commission's (OSC) broadened exempt market review, more fully described below. A detailed summary of these concept ideas is set out in Parts 5 and 6 and Appendices A and B.

While this paper discusses these concept ideas, no decision has been made:

- whether additional capital raising prospectus exemptions are warranted, and
- if so, whether these concept ideas should be adopted (and on what terms) or whether alternative prospectus exemptions would be more appropriate.

No such decisions will be made without broad public consultation and discussion. This paper is the initial step in soliciting comments from all interested stakeholders on these important issues.

Exempt market regime

Major changes to the exempt market regime in Canada were last made in 2005 with the introduction of National Instrument 45-106 *Prospectus and Registration Exemptions* (NI 45-106), an instrument that substantially harmonized many of the prospectus exemptions available across the country.

NI 45-106 contains two key capital raising prospectus exemptions, the minimum amount and accredited investor exemptions. These exemptions were available in some jurisdictions prior to 2005, but were harmonized nationally in NI 45-106. At that time, the OSC chose not to adopt an offering memorandum (OM) exemption, unlike all other Canadian jurisdictions, due to investor protection concerns. Further, the OSC adopted a more limited version of the family, friends and business associates exemption available elsewhere.

Original scope of review

On November 10, 2011, the Canadian Securities Administrators (CSA) published CSA Staff Consultation Note 45-401 *Review of Minimum Amount and Accredited Investor Exemptions* (the **Consultation Note**). The Consultation Note focused on the minimum amount and accredited investor exemptions and asked questions designed to elicit feedback on whether these exemptions continue to be appropriate for our markets. The CSA conducted this consultation to identify issues that stakeholders may have about the use of the exemptions and to obtain information that would assist in deciding whether changes are necessary or appropriate.

Since 2005, the capital markets have experienced significant upheaval. As stated in the Consultation Note, the global financial crisis and recent international regulatory developments have raised questions about the use of the minimum amount and the accredited investor exemptions. These events have also raised broader questions about the distribution of exempt securities to supposedly sophisticated investors (such as accredited investors).

In Ontario, we consulted widely on the issues raised in the Consultation Note by holding four public sessions and by speaking directly with a wide range of stakeholder groups, including investor representatives, industry members, registrants, other regulators and legal and other advisors. In addition, the CSA received 109 comment letters in response to the Consultation Note.

A wide range of views was expressed in both the written comment letters and in our consultation sessions. One theme that emerged was the desirability of providing greater access to the exempt market for both issuers and investors. Another frequently expressed view was the desirability of harmonizing prospectus exemptions across Canadian jurisdictions. Other themes expressed included the diversity of the participants and products in the exempt market, issues related to the criteria for accredited investors, the appropriateness of the current minimum amount exemption and other possible options for prospectus exemptions.

Expanded exempt market review

Given the feedback received during the first consultation, the OSC decided to expand the focus of our review to consider whether there was potential to foster greater access by start-ups and small and medium sized enterprises (SMEs) to capital markets while maintaining appropriate investor protection. In this respect, the OSC noted that Ontario does not have all of the prospectus exemptions (such as the OM exemption) available in the rest of the country.

We announced our expanded review on June 7, 2012, with the publication of OSC Staff Notice 45-707 *OSC Broadening Scope of Review of Prospectus Exemptions* (the **Scope Notice**). The Scope Notice stated that, in light of feedback from stakeholders, we were broadening the scope of our review to consider whether the OSC should introduce any new prospectus exemptions that would facilitate capital raising for business enterprises while protecting the interests of investors.

The Scope Notice set out the specific steps we would take in the coming year to advance our expanded review. We indicated that, during the 2013 fiscal year, we would:

- publish a second consultation note in which we will seek further feedback on the exempt market regulatory regime and, in particular, explore whether the OSC should adopt any new prospectus exemptions and, if so, under what circumstances or terms,
- hold further public consultation sessions, and actively reach out to investors and meet with other stakeholders to obtain their feedback,
- consider the experience of the other CSA jurisdictions with prospectus exemptions not currently available in Ontario (the OM and family, friends and business associates exemptions),
- consider developments in other jurisdictions relevant to capital raising in the exempt market, including the *Jumpstart Our Business Startups Act* (the **JOBS Act**), and
- establish an ad hoc advisory committee.

Our Exempt Market Advisory Committee was established in September 2012 and we have consulted with them on our concept ideas for new prospectus exemptions. We now intend to actively consult on the issues we discuss in this paper.

1.2 OSC mandate and guiding principles

This policy review must take into account the OSC's dual mandate of:

- providing protection to investors from unfair, improper or fraudulent practices, and
- fostering fair and efficient capital markets and confidence in capital markets.

The objectives of this policy review are to consider how to best regulate the exempt market in a manner that:

- enhances its role in raising capital for businesses, particularly SMEs,
- provides retail investors with greater access to investment opportunities without compromising investor protection, and
- better aligns the interests of issuers and investors.

We are also guided by the statutory principle that business and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought to be realized.

In carrying out this policy review, it is important that we consider the exempt market as a whole and the range of prospectus exemptions available in that market. In that respect, we must consider the current policy reviews of the minimum amount and accredited investor exemptions as well as the proposed approach to securitized products distributed under the short term debt exemption. While there are currently multiple policy initiatives looking at different prospectus exemptions, we must consider in this policy review the full range of prospectus exemptions available in the exempt market, the rationale for those exemptions and the interplay of those exemptions with our concept ideas.

2. BACKGROUND ON EXEMPT MARKET

2.1 Prospectus and registration requirements

Prospectus requirement

One of the key principles of Ontario securities law is that securities may not be distributed unless a prospectus is filed with and received by the OSC.

A prospectus is a comprehensive disclosure document that sets out detailed information about the issuer and describes the securities being issued and the risks associated with purchasing those securities. However, a prospectus is not simply a disclosure document, but also gives rise to key purchaser rights. The *Securities Act* (Ontario) (the **Securities Act**) provides specific remedies to purchasers of securities under a prospectus including the right to sue for damages in the event of a misrepresentation in the prospectus. The persons that are required to sign the prospectus assume liability for the disclosure included in the prospectus.

In limited circumstances, securities may be distributed without a prospectus. This is typically referred to as an “exempt distribution” that occurs in the “exempt market”. As long as the terms of an available exemption are met, no disclosure is mandated to be provided to purchasers. As a result, the key statutory protections associated with a prospectus, such as the right to sue for damages in the event of a misrepresentation, do not apply. Private placements may, however, be made on the basis of some form of offering document which will attract liability under section 130.1 of the Securities Act in the event of a misrepresentation.

Exemptions from the prospectus requirement are primarily set out in NI 45-106. Generally speaking, each exemption is premised on a specific policy rationale that supports not requiring a prospectus in the circumstances. For example, an exemption may be premised on the nature of the security being offered, the characteristics of the purchaser or the fact that alternative disclosure is being provided (such as an information circular under a statutory procedure).

If a security is issued under a prospectus exemption, then in many cases that security can only be resold if certain conditions are met. These resale conditions are designed to ensure that there is sufficient disclosure available in the marketplace to allow a subsequent purchaser to make an informed investment decision.

An exempt distribution avoids the costs associated with a prospectus offering and may be a more effective means for a smaller issuer to raise capital.

Registration requirement

Registration requirements are imposed on persons and companies in the business of trading in securities or advising others in connection with securities. Although there is no requirement for issuers to distribute securities through a registrant, in many cases, as a practical matter, this will be necessary to sell the offering. The registration requirements are intended to ensure the suitability of individuals or firms for registration. The cornerstones of these registration requirements are:

- proficiency (only qualified persons can deal in securities, advise or manage investment funds),
- integrity (registrants are subject to business conduct rules and are held accountable for their securities related activities), and
- solvency (registered firms must be financially viable).

Registration requirements also require registrants to disclose conflicts of interest and to comply with Know-Your-Client (**KYC**), Know-Your-Product (**KYP**) and suitability obligations. In many cases, registrants base their KYP and

suitability determinations on prospectus or other disclosure provided by issuers. Accordingly, disclosure requirements that are imposed on issuers help support and inform registrants' compliance with their KYP and suitability requirements and these requirements may be viewed as complementary to the distribution process.

Registrants may, however, not be prepared to participate in smaller offerings or offerings by smaller issuers. We note that an issuer is not required to be registered where it is not carrying on the business of trading in securities.

2.2 Current regulatory approaches

Prospectus exemptions can be based on a number of factors, including the following:

- investor attributes, which are premised on the investor having a certain level of sophistication, the ability to withstand financial loss, the financial resources to obtain expert advice, and/or the incentive to carefully evaluate an investment,
- the investor's relationship with the issuer or its management,
- the investment size,
- disclosure provided to the investor, and
- the offering size.

In this section, we refer to prospectus exemptions available under the Canadian regime as well as similar exemptions available in the US, Australia and the UK. We refer to the approaches to prospectus exemptions in other jurisdictions where those approaches are relevant to the policy issues raised. Information included in this paper about the regulatory regimes in other jurisdictions is general in nature and is not intended to present a comprehensive review of the law in those jurisdictions.

A. Prospectus exemptions based on investor attributes

There are currently prospectus exemptions based on investor attributes in both the Canadian and foreign regimes discussed below.

Canadian regime

In Canada, the accredited investor exemption permits issuers to sell any amount or type of security to individuals who qualify as accredited investors. The exemption is premised on an investor being an institution or sophisticated organization, having the ability to withstand financial loss or the resources to obtain expert financial advice. The exemption is found in section 2.3 of NI 45-106. It is similar to the accredited investor exemption available in the US.

The definition of accredited investor includes specified governments, financial institutions and other entities. It also includes individuals who meet one of the following criteria:

- **Income.** An individual whose net income before taxes exceeded \$200,000 in each of the two most recent calendar years or whose net income before taxes combined with that of a spouse exceeded \$300,000 in each of the two most recent calendar years and who, in either case, reasonably expects to exceed that net income level in the current calendar year.
- **Financial assets.** An individual who, either alone or with a spouse, beneficially owns financial assets having an aggregate realizable value that before taxes, but net of any related liabilities, exceeds \$1 million.

- **Net assets.** An individual who, either alone or with a spouse, has net assets of at least \$5 million.

We are not seeking feedback on the accredited investor exemption as part of this paper. Feedback on this exemption was sought in the Consultation Note and the CSA is currently considering the feedback received. We will take that feedback into account in proposing any new prospectus exemptions as a result of this policy review.

Australian regime

The available exemptions from disclosure requirements are primarily set out in section 708 of Australia's *Corporations Act 2001* (**AU Corporations Act**). There are a number of types of securities offerings which are exempt from the requirement for a disclosure document. The relevant Australian prospectus exemptions that are based on investor attributes are as follows:

Sophisticated investor exemption

This exemption is governed by section 708(8), (9) and (10) of the AU Corporations Act and applies where offers are made to sophisticated investors:

- who invest more than a minimum amount of A\$500,000,
- are sufficiently wealthy (with net assets of at least A\$2.5 million or gross income for each of the last two financial years of at least A\$250,000), or
- have previous experience investing in securities that allows them to assess the details of the offer and their information needs (in which case the offer must be made through a dealer who is satisfied that the investor can make such assessments and provides reasons for this conclusion in writing).

Professional investor exemption

This exemption is governed by section 708(11) of the AU Corporations Act and applies where an offer is made to a licensed dealer or investment adviser who is acting as a principal in the transaction or to certain specific bodies such as banks, insurance companies or regulated superannuation funds or to a person who has or controls gross assets of at least A\$10 million.

UK regime

Section 85 of the *Financial Services and Markets Act* (**FSMA**) sets out the requirement for a prospectus in the UK. Exemptions to this requirement are set out in section 86 of the FSMA.

Offers to qualified investors

This exemption is governed by sections 86(1)(a) and 86(7) of the FSMA and applies where the offer is made to a qualified investor. A qualified investor is defined in the FSMA as:

- a person who is described as, or who has made a request to be treated as, a professional client in accordance with Annex II of the *Markets in Financial Instruments Directive* (**MiFID**),
- a person who is an eligible counterparty in accordance with Article 24 of MiFID, or
- a person whom any investment firm is authorized to continue to treat as a professional client in accordance with Article 71(6) of MiFID.

Clients that are considered to be professional clients are described in Annex II of MiFID and include:

- regulated financial institutions,
- large enterprises that meet minimum financial thresholds,
- national and regional governments, public bodies that manage public debt, central banks, international and supranational institutions such as the World Bank and other similar international organizations, and
- other institutional investors whose main activity is to invest in financial instruments.

In addition, an individual investor may request to be treated as a professional client by an investment firm. The investment firm must conduct an assessment of the expertise, experience and knowledge of the investor. In the

course of that assessment, two of the following criteria must be satisfied:

- The investor has carried out transactions, in significant size, on a securities market at an average frequency of ten per quarter over the previous four quarters.
- The size of the investor's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds €0.5 million.
- The investor works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

An individual investor may revoke in writing any prior request to be treated as a professional client.

B. Prospectus exemptions based on relationships with the issuer

Canadian regime

There are four notable capital raising prospectus exemptions that are based on an investor's relationship with the issuer:

- the private issuer exemption,
- the rights offering exemption,
- the family, friends and business associates exemption in Canadian jurisdictions other than Ontario, and
- the founder, control person and family exemption available in Ontario.

Private issuer exemption

The private issuer exemption in section 2.4 of NI 45-106 allows a non-reporting issuer to distribute securities to 50 people (excluding current and former employees of the issuer or affiliates) who fall within certain categories. For example, private issuer security holders include:

- directors, officers, employees, founders or control persons of the issuer,
- directors, officers or employees of an affiliate of the issuer,
- certain relatives of a director, executive officer, founder or control person and certain relatives of the spouse of a director, executive officer, founder or control person,
- a close personal friend or a close business associate of a director, executive officer, founder or control person,
- an existing security holder of the issuer,
- an accredited investor, and
- a person that is not the public.

These types of investors are generally thought to have a relationship to the issuer that allows them to, at least partially, mitigate the risks of the investment because of the closeness of the relationship or the fact that they have access to information from the issuer.

To be a private issuer, the articles of the issuer must include restrictions on transfer of securities other than non-convertible debt securities.

Some stakeholders have indicated that the private issuer exemption is a useful capital raising tool for SMEs. However, there are concerns that the limit of 50 security holders (other than employees and former employees) is too restrictive. Stakeholders have suggested that the limit could be increased without the issuer selling securities to the public.

Closely held issuer exemption

The closely held issuer exemption replaced the private issuer exemption in 2001 as a result of concerns highlighted in the Final Report of the Task Force on Small Business Financing.¹ The closely held issuer exemption was repealed in 2005 on the introduction of NI 45-106 and replaced with the private issuer exemption in the interest of harmony with other Canadian jurisdictions.

At the time, the closely held issuer exemption permitted issuers to raise a total of \$3 million, through any number of financings, from up to 35 investors (excluding employees who acquired securities under a compensation or incentive plan) without concern for the “qualifications” of the investors. It differed from the private issuer exemption in that the investors in a closely held issuer did not need to be in a specified relationship, be an accredited investor or not be a member of the public. In addition, closely held issuers were not restricted as to the number of prospective investors who could be approached under the exemption. The exemption was designed to facilitate financings of issuers at early stages by allowing issuers to access a finite amount of capital from investors who did not meet the accredited investor requirements.

The exemption was only available to issuers, other than investment funds, whose shares were subject to restrictions on transfer.

There were mixed views on the repeal of the closely held issuer exemption and the re-introduction of the private issuer exemption. Some stakeholders preferred the private issuer exemption, which was harmonized across Canada, while others thought the closely held issuer exemption was a useful way for SMEs to raise capital.

Rights offering exemption

The rights offering exemption in section 2.1 of NI 45-106 permits any issuer to offer, to its existing security holders, rights to acquire additional securities without a prospectus. Existing investors are assumed to have the information they need to make an investment decision based on their previous experience and knowledge as an investor with the issuer.

There are many conditions to the use of the rights offering exemption set out in both section 2.1 of NI 45-106 and National Instrument 45-101 *Rights Offerings (NI 45-101)*. The issuer must give the securities regulators prior written notice of the proposed distribution and the regulators have 10 days to object to the proposed distribution or confirm acceptable information has been delivered to them.

Under NI 45-101, the issuer must prepare a rights offering circular in the prescribed form that contains a brief description of the issuer, including its business, the planned use of proceeds, the resale restrictions of the securities to be distributed, the intentions of insiders regarding rights, underwriting conflicts, any escrow arrangements or stand-by commitments and details regarding the rights and how they may be exercised.

Family, friends and business associates exemption

The family, friends and business associates exemption in section 2.5 of NI 45-106 is available in Canadian jurisdictions other than Ontario. Under the exemption, a person can sell securities to investors who have a direct relationship or connection with the issuer. The permitted investors include:

- a director, executive officer or control person of the issuer or its affiliate,
- a family member (spouse, parent, grandparent, brother, sister, child or grandchild) of a director, executive officer or control person of the issuer or its affiliate,
- a family member (parent, grandparent, brother, sister, child or grandchild) of the spouse of a director, executive officer or control person of the issuer or its affiliate,
- a close personal friend or close business associate of a director, executive officer or control person of the issuer or its affiliate,

¹ Task Force on Small Business Financing, *Final Report* (published by the OSC: October 1996).

- a founder of the issuer or a family member (spouse, parent, grandparent, brother, sister, child or grandchild), close personal friend or close business associate of a founder of the issuer, and
- a family member (parent, grandparent, brother, sister, child or grandchild) of the spouse of a founder of the issuer.

The terms “close personal friend” and “close business associate” are not defined. However, there is guidance provided on both terms. A close personal friend is someone who has known the founder, director, executive officer or control person of the issuer for a sufficient period of time to be able to assess that person's capabilities and trustworthiness. Someone is not a close personal friend simply because they belong to the same organization, association or religious group. Nor is someone a close personal friend simply because they are a current or former customer or client. A close business associate is someone who has had sufficient prior business dealings with the founder, director, executive officer or control person of the issuer to be able to assess that person's capabilities and trustworthiness.

There is no limit on the number of investors or the amount of capital that can be raised using this exemption. There is no requirement to provide investors with any disclosure regarding the issuer or the offering. In Saskatchewan, the investor must sign a risk acknowledgement form.

The OSC did not adopt this exemption when NI 45-106 came into force. In a notice dated December 17, 2004, the OSC stated:

Ontario is not adopting the family, friends and business associates exemption as we do not believe that an exemption that allows securities to be issued to an unlimited group of non-accredited investors is appropriate for the Ontario market.

Founder, control person and family exemption available in Ontario

In Ontario, in lieu of the family, friends and business associates exemption, we have the founder, control person and family exemption in section 2.7 of NI 45-106. It applies to a distribution by an issuer of any security to a specified list of purchasers, which includes:

- a founder of the issuer,
- an affiliate of a founder of the issuer,
- certain family members of an executive officer, director or founder of the issuer, and
- a person that is a control person of the issuer.

The investors must have a pre-existing relationship with the issuer which would provide them with access to information about the issuer.

Australian regime

Sections 708(1) and (2) of the AU Corporations Act set out an exemption which permits an issuer to make a personal offer to a maximum of 20 unqualified investors over 12 months with no more than A\$2 million being raised in the 12 months.

A personal offer is:

- one that may only be accepted by the person to whom it is made, and
- made to a person who is likely to be interested in the offer, having regard to (1) a previous personal, professional or other relationship or (2) a statement made that the person receiving the offer would be interested in an offer of that kind.

Consultation questions

- Is the 50 security holder limit under the private issuer exemption too restrictive? If so, what limit would be appropriate? Please explain.
- 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?
- 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.
- Are there other changes that should be made to the current Ontario exemptions referred to above?

C. Prospectus exemptions based on investment size

Canadian regime

The minimum amount exemption in section 2.10 of NI 45-106 is premised on the investment being a minimum size such that an investor has the incentive to carefully evaluate it. This exemption permits any issuer to distribute securities to an investor that invests at least \$150,000 in a single investment, payable in cash at the time of the distribution.

We are not seeking feedback on the minimum amount exemption as part of this paper. Feedback on this exemption was sought in the Consultation Note and the CSA is currently considering the feedback received. We will take that feedback into account in proposing any new prospectus exemptions as a result of this policy review.

Australian regime

Australia has had a minimum amount exemption of A\$500,000 since 1989, set out in sections 708(8)(a) and (b) of the AU Corporations Act.

UK regime

The UK has had the following minimum amount exemption limits: €40,000 (1995), €50,000 (2005), and €100,000 (2012). Currently, there are exemption thresholds for both offers of securities with a denomination of at least €100,000 and where each investor must invest at least €100,000, as set out in section 86(1)(c) and (d) of the FSMA.

US regime

The US Securities and Exchange Commission (**SEC**) adopted a minimum amount exemption of US\$100,000 in 1979. In 1982, this limit was raised to US\$150,000, so long as the amount was at most 20% of the investor's net worth. With the introduction of the accredited investor exemption in 1988, the minimum amount exemption was rescinded. According to the SEC, it had concerns:

...that size of purchase alone, particularly at the \$150,000 level, does not assure sophistication or access to information. While some persons previously accredited would no longer be accredited (i.e., individuals

with net worths of \$750,000 but less than \$1 million [...]), many of the persons who used the \$150,000 purchaser item will now become accredited investors by virtue of [the accredited investor exemption].

D. Prospectus exemptions based on disclosure

Canadian regime

The OM exemption is found in section 2.9 of NI 45-106 and is available in Canadian jurisdictions other than Ontario. It can be relied on for a distribution by an issuer of a security of its own issue to a purchaser, provided that:

- the purchaser purchases the security as principal,
- the issuer delivers an OM to the purchaser in the prescribed form, and
- the purchaser signs a prescribed risk acknowledgement form.

There are two primary models of the OM exemption:

BC model

In the BC model, there is no restriction on the identity of the purchaser nor on the investment size. This model is found in section 2.9(1) of NI 45-106.

Alberta model

In the Alberta model, a purchaser may not invest more than \$10,000 unless the purchaser is an “eligible investor”. “Eligible investors” include persons whose:

- net assets, alone or with a spouse, in the case of an individual, exceed \$400,000,
- net income before taxes exceeded \$75,000 in each of the two most recent calendar years and who reasonably expect to exceed that income level in the current calendar year, or
- net income before taxes, alone or with a spouse, in the case of an individual, exceeded \$125,000 in each of the two most recent calendar years and who reasonably expect to exceed that income level in the current calendar year.

The Alberta model also limits use of the exemption by investment funds. Only mutual funds that are reporting issuers and non-redeemable investment funds may rely on this exemption.

This model is found in section 2.9(2) of NI 45-106.

The OSC did not adopt this exemption when NI 45-106 came into force. In a notice dated December 17, 2004, the OSC stated:

Ontario is not adopting the offering memorandum exemption. NI 45-106 contains two versions of the offering memorandum exemption, one for British Columbia, New Brunswick, Nova Scotia and Newfoundland and Labrador (the BC model) and one for Alberta, Manitoba, the Northwest Territories, Nunavut, Prince Edward Island, Quebec and Saskatchewan (the Alberta model).

The BC model permits sales in securities with an acquisition cost of any amount with no registrant involvement. Under this model, a non-accredited investor who does not have that ability to withstand financial loss may be able to invest, to an unlimited extent, in a private placement simply because he or she has received an offering memorandum and signed a risk acknowledgement form.

The Alberta model requires that purchasers either be “eligible investors” as defined in NI 45-106 or purchase securities at an acquisition cost of less than \$10,000. We are concerned that the threshold for eligible investors has been set too low. It includes a person whose net assets, alone or with a spouse, in the case of an individual,

exceed \$400,000... In addition, the definition of eligible investors includes a person that has obtained advice regarding the suitability of the investment. We are concerned that obtaining investment advice and receiving a lesser form of disclosure document is not an acceptable alternative to the prospectus regime, particularly if the issuer is not a reporting issuer and no continuous disclosure is available.

We are concerned that both models of this exemption may place investors in Ontario at risk as the offering memorandum is a non-vetted prospectus-like document provided to non-accredited investors who may not have the ability to withstand financial loss. This maintains the status quo in Ontario.

We note that these exemptions do not exclude a principal residence from the calculation of net assets.

Australian regime

In Australia, section 709(4) of the AU Corporations Act provides that a body offering to issue securities may use an offer information statement (**OIS**) for the offer instead of a prospectus if the amount of capital to be raised by the body issuing the securities, when added to all amounts previously raised by:

- the body,
 - a related body corporate, or
 - an entity controlled by a person who controls the body or an associate of that person,
- by issuing securities under an OIS is A\$10 million or less.

An OIS has lower disclosure requirements than a prospectus and the prescribed content of an OIS is set out in section 715 of the AU Corporations Act. It includes, among other things, the following information:

- the issuer and the nature of the securities being offered,
- the issuer's business,
- the use of proceeds from the offering,
- the nature of the risks involved in investing in the securities,
- the details of all amounts payable in respect of the securities,
- a statement that the OIS is not a prospectus and has a lower level of disclosure requirements than a prospectus,
- a statement that a copy of the OIS has been lodged with Australian Securities Investment Commission (**ASIC**) and that ASIC takes no responsibility for the content of the OIS,
- a statement that investors should obtain professional investment advice before accepting the offer, and
- a financial report for the issuer, which includes certain audited financial statements.

Please see section 5.3 below for consultation questions on an OM exemption.

E. Crowdfunding

Meaning of crowdfunding

Crowdfunding is a method of funding a project or venture through small amounts of money raised from a large number of people over the internet via an internet portal intermediary. There are at least five models of crowdfunding:

- **Donation model.** The practice of the crowd donating to a project or venture in exchange for nothing of tangible value.
- **Reward model.** The practice of the crowd donating to a project or venture in exchange for some tangible reward or a "perk".

- **Pre-purchase model.** The practice of the crowd donating to a project or venture in exchange for a future tangible reward (such as a consumer product).
- **Peer-to-peer lending model.** The practice of an online intermediary facilitating money lending between individuals to fund a business, usually in the form of unsecured personal loans.
- **Equity securities model.** The practice of the crowd investing in an issuer in exchange for securities.

The crowdfunding discussed in this paper involves the distribution of a security.

Crowdfunding under the JOBS Act

On April 5, 2012, the JOBS Act was approved and signed by President Barack Obama after receiving rapid congressional approval in both the United States House of Representatives and United States Senate. The JOBS Act is intended to help increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.

The JOBS Act contemplates broadened access to investment opportunities in the exempt market through a new crowdfunding exemption. While the JOBS Act creates a new exemption for “crowdfunding”, that exemption is subject to SEC rulemaking and crowdfunding for securities will only be legal in the US once the SEC rules are adopted. Many details of the crowdfunding exemption, including those around the funding portal, are still not clear as they will be dealt with by the SEC in rulemaking. The SEC is required to issue rules not later than 270 days following enactment of the JOBS Act (December 31, 2012). However, we note that there is speculation that there may be delays in meeting this deadline.

The following is a summary of the key provisions of crowdfunding as set out in the JOBS Act.

Availability of the exemption

The exemption is only available to domestic US issuers. It is not available to non-US issuers, issuers subject to public company reporting requirements and investment companies. The exemption could potentially be available to a Canadian issuer through its US subsidiaries. However, this is unclear absent SEC guidance.

Size of the offering and investments

Crowdfunding is a strategy designed to allow a company to raise up to \$1 million in a 12-month period by selling securities to the public.

The aggregate amount of securities sold to any investor within the previous 12-month period in reliance on the exemption cannot exceed:

- the greater of US\$2,000 or 5% of the investor’s annual income or net worth if either the annual income or the net worth of the investor is less than US\$100,000, and
- 10% of the investor’s annual income or net worth, not to exceed a maximum aggregate amount sold of US\$100,000, if either the annual income or net worth of the investor is equal to or more than US\$100,000.

Resale restrictions

The securities purchased under this exemption are subject to certain resale restrictions for one year. However, securities may be resold to the issuer, to an accredited investor, as part of a registered offering or to a family member of the purchaser under limited circumstances.

Intermediaries

Crowdfunding offerings must be conducted through an intermediary that is registered with the SEC as a broker or funding portal (defined as any person acting as an intermediary in a transaction involving the offer or sale of

securities for the account of others pursuant to the exemption that meets certain conditions) and with any applicable self-regulatory organization (**SRO**).

The intermediary must take certain actions, including:

- providing disclosures related to risks and other investor education materials, as the SEC by rule deems appropriate and ensuring that investors review such disclosures, affirm the risk of loss and answer various questions,
- taking such measures to reduce the risk of fraud, as will be established by the SEC, including background and regulatory checks on directors, officers and significant shareholders of issuers, and
- making such efforts as the SEC determines appropriate by rule to ensure that no investor in a 12-month period exceeds the crowdfunding investment limits.

Issuers relying on the exemption will not be permitted to advertise the terms of the offering, except for notices that direct investors to the intermediary.

Disclosure to be provided to investors

Issuers will be required to file with the SEC and provide to investors information such as:

- a description of the business and its anticipated business plan,
- a description of its financial condition (including audited financial statements where the specified target offering amount exceeds US\$500,000 or such other amount that the SEC determines appropriate),
- the names of officers and directors and greater than 20% shareholders,
- the stated purpose and intended use of proceeds,
- the specified target offering amount and deadline to reach that target,
- the price of the securities,
- a description of the ownership and capital structure, and
- such other information as the SEC prescribes by rule.

Securities issued under this exemption will not be subject to state blue sky securities laws (which are intended to protect investors from fraud).

Crowdfunding in other jurisdictions

Australian regime

No specific crowdfunding exemption or legislation appears to have been passed in Australia. However, an order of ASIC to permit business introduction or matching services may be facilitating equity crowdfunding activity.

ASIC Class Order 02/273 “Business Introduction and Matching Services”, which was made effective on March 11, 2002, provides an exemption from certain provisions of the AU Corporations Act for persons involved in making or calling attention to offers of securities through a business introduction service (the **AU Class Order**). The AU Class Order permits a person to bring together issuers seeking capital and investors without being subject to the full requirements of the AU Corporations Act, provided the terms of the AU Class Order are complied with.

For issuers that wish to offer their securities through a business introduction service, the AU Class Order limits such offers to the following:

- a personal offer to a maximum of 20 unqualified investors over 12 months, and
- with no more than A\$5 million being raised in that 12 months.

There are restrictions on advertising and recommendations of offerings under the exemption provided in section 734 of the AU Corporations Act. However, issuers and those making introductions are exempt from some advertising restrictions as a result of the AU Class Order.

On August 14, 2012, ASIC issued “12-196MR ASIC guidance on crowdfunding” (the **AU Notice**). The AU Notice appears to primarily focus on non-equity crowdfunding. It describes crowdfunding and states that project “sponsors or pledgers typically receive some reward in return for their funds”.

ASIC also highlighted some of the risks for operators of crowdfunding websites and for individuals investing in crowdfunded ventures, including:

- a risk of fraud being carried out through crowdfunding websites. ASIC suggests that website operators can help manage this risk by performing background checks on project creators.
- a risk that funded projects are not completed and the sponsors do not receive the rewards promised. The guidance suggests that website operators can manage this risk by assessing the viability of the project before it is posted to the website, requiring the project creator to provide more information and mandate reporting requirements on project progress.
- a risk that the money collected is lost due to fraud or bankruptcy of the website operator before the money is passed on to the project creator. The guidance states that a website operator can manage this risk by holding funds in a separate account.

ASIC has been monitoring the increased use of equity crowdfunding to identify arrangements that may be regulated by ASIC. In its guidance, ASIC highlighted that crowdfunding arrangements offering or advertising a financial product, providing a financial service or fundraising through securities may require a complying disclosure document depending on the approach taken.

UK regime

In the UK, the prospectus requirement is triggered for offerings of securities where:

- the total offering amount is €5 million or greater, or
- there are more than 150 investors.

Below these thresholds, a prospectus is generally not required. Despite the fact that a prospectus may not be required for small offerings of securities, a UK entity involved in securities distributions may still need to be registered with the Financial Services Authority (**FSA**) depending on the activities being conducted.

Equity crowdfunding in the UK is already active. For example, Crowdcube is a crowdfunding website founded in 2010 that allows businesses to raise money directly from investors. Crowdcube restricts participation to investors who can self-certify as high net worth or sophisticated investors.

In addition, on July 6, 2012, Seedrs Limited was launched as an equity crowdfunding platform in the UK. Seedrs is an online platform for investing in start-up businesses. It is structured such that Seedrs acts as the nominee for individual investors that want to invest through the platform, holding the shares on their behalf. Seedrs is registered with the FSA and is subject to restrictions on the type of business activities it can conduct as set out in its permission from the FSA.

On August 10, 2012, the FSA published a consumer information bulletin called “Crowdfunding: is your investment protected?”. The guidance warned investors that many crowdfunding opportunities are high risk and complex and are suited to sophisticated investors only. The notice also pointed out that these types of investments are generally illiquid and that investors should be careful about investing over the internet because of the risk of fraud. The FSA also expressed concern that some firms involved in crowdfunding may be acting without FSA permission or authorisation.

F. Prospectus exemptions based on offering size

Small issue exemption under the JOBS Act

Title IV of the the JOBS Act directs the SEC to amend existing regulations or adopt a new exemption to permit a new class of securities that are exempt from the registration requirements where the aggregate amount of all securities offered and sold in reliance on the exemption within the prior 12-month period does not exceed US\$50 million. The JOBS Act did not set a deadline for adopting these new rules and the SEC has not yet made changes to implement this exemption. Previously, the limitation was US\$5 million. Section 401 of the JOBS Act requires the SEC to review and increase the “small issue” offering amount biennially and to report to certain congressional committees on its reasons for not increasing the amount if it decides not to do so.

Section 401 of the JOBS Act outlines the details of how the exemption will operate. The exemption permits securities to be offered and sold publicly and exempts them from resale restrictions. The exemption applies to equity securities, debt securities and debt securities convertible into or exchangeable for equity interests, as well as any guarantees of such securities. The civil liability for false or misleading statements or omissions set forth in an offering document or oral communications will apply to such securities.

Unlike the other registration exemptions under the *US Securities Act of 1933*, this “small issue” exemption requires the issuer to file audited financial statements annually with the SEC. In addition, the exemption provides that the SEC may create rules or regulations that require an issuer relying on the exemption to make available to investors and file with the SEC an offering statement and periodic disclosure containing prescribed information about the issuer, its business operations, financial condition, corporate governance principles, use of investor funds and other matters.

Issuers relying on the exemption will be permitted to solicit investor interest prior to the filing with the SEC of any required offering statement on such terms as the SEC prescribes.

Securities issued under this exemption will also be subject to state blue sky securities laws (intended to protect investors from fraud).

2.3 Snapshot of exempt market activity in Ontario

The exempt market in Ontario has become increasingly important for issuers and investors.

Overall activity in the exempt market

The total amount of capital raised in Ontario through exempt distributions in 2011 was approximately \$86.5 billion.² This capital was raised by a diverse range of issuers using a variety of instruments, including debt, equity, asset backed securities, investment fund securities and derivatives. Approximately 32% of the capital raised in Ontario through the exempt market was raised by non-investment funds.³ Of the capital raised by non-investment funds in Ontario, approximately 23% was raised by the financial services industry. The mining and technology sectors represented only approximately 14% and 5%, respectively.

² We note that this exempt market data is limited because it is based on reports of exempt distribution filed with the OSC. Only specified prospectus exemptions trigger a requirement to file a report. As a result, this data does not capture all exempt market activity. We also note that this data reflects distributions to both individual and institutional investors under the exemption.

³ We note that the data for distributions of investment fund securities reflects distributions to both individual and institutional investors of both public and private investment fund securities. We also note that this data reflects purchases and not redemptions of investment fund securities.

Accredited investor exemption

In 2011, approximately \$72.8 billion was raised under the accredited investor exemption in Ontario. This is by far the most heavily relied upon prospectus exemption for which a report of exempt distribution is required to be filed with the OSC. In Ontario, it has historically accounted for over 70% of distributions and over 80% of capital raised in the exempt market in reported transactions. In addition, the largest distributions have been overwhelmingly conducted in reliance on the accredited investor exemption.

The following are highlights of the use of the accredited investor exemption in Ontario in 2011:

- Approximately 66% of the total amount invested under this exemption was invested in investment funds.⁴
- Approximately 85% of the total amount raised under this exemption was raised by non-reporting issuers.
- There were 4,575 distributions made under this exemption, with approximately 77% of those distributions being made by non-reporting issuers.
- Investment funds made approximately 41% of the distributions.⁵

Minimum amount exemption

The minimum amount exemption is less used. In 2011, approximately \$3.9 billion was raised under this exemption in Ontario.

The following are highlights of the use of the minimum amount exemption in Ontario in 2011:

- Approximately 49% of the total amount invested under this exemption was invested in investment funds.⁶
- Approximately 62% of the total amount raised under this exemption was raised by non-reporting issuers.

Appendix C contains a summary of the exempt market data reported to the OSC.

As part of this policy review, we are proposing to amend our exempt distribution reporting requirements to provide more accurate and useful information with respect to the use of these exemptions. Please see section 7.3.

2.4 Estimates of investors eligible to participate in the Ontario exempt market

As discussed above, under the existing capital raising prospectus exemptions, only certain individuals can invest in the exempt market. Specifically, the definition of “accredited investor” as set out in section 1.1 of NI 45-106 includes, among others, individuals who meet the specified income or asset criteria.

Based on available data,⁷ we have produced an estimate of the number of individuals who qualified as accredited investors in 2010 under the current thresholds. The minimum figure for the number of potential accredited investors was produced using only individuals qualifying under the individual and family income thresholds. This assumes high net worth individuals also earn income qualifying them as accredited investors and as such are captured. The larger figure assumes the opposite, namely that no high net worth individuals would also qualify under the income thresholds. Overall, we find the total number of individuals qualifying as accredited investors under the current income and assets thresholds is less than 4% of the Ontario and Canadian populations.

⁴ *Supra* note 3.

⁵ *Ibid.*

⁶ *Ibid.*

⁷ We have used 2010 Statistics Canada data on income, 2011 Ipsos Reid data on financial assets and 2005 Statistics Canada data on household assets. We have made a number of assumptions to deal with the limitations of the data.

Jurisdiction	Estimated number of potential accredited investors under current thresholds
Ontario	Between: <ul style="list-style-type: none"> ● 175,210 individuals (1.8% of Ontario taxfilers) and ● 351,970 individuals (3.6% of Ontario taxfilers)
Canada	Between: <ul style="list-style-type: none"> ● 391,030 individuals (1.5% of Canadian taxfilers) and ● 857,222 individuals (3.4% of Canadian taxfilers) <p>Ontario residents represent 41.0% to 44.8% of all potential Canadian accredited investors.</p>

Due to data constraints, identifying overlap between potential accredited investors qualifying under the income and asset thresholds is difficult. The lower bound estimate assumes complete overlap between the income and asset thresholds, providing the number of individuals in families with income over \$300,000 and individuals not in families, with incomes over \$200,000. The upper bound estimate assumes no overlap between individuals qualifying under the income and asset thresholds and also adjusts for individuals in families with incomes above \$200,000 but family incomes below \$300,000.

Appendix D contains more detailed information regarding income data for Ontario and Canadian taxfilers.

3. CURRENT INITIATIVES RELATED TO CAPITAL RAISING

3.1 Prior consultations on the exempt market

A. Consultation on the accredited investor and \$150,000 minimum amount exemptions

Key themes from feedback received

The Consultation Note published in November 2011 asked for feedback on a number of specific questions about the minimum amount and accredited investor exemptions. A wide range of views was expressed in both the written comment letters and in our consultation sessions. Some of the themes raised with OSC staff were:

- **Diversity of the exempt market.** There are different segments of the exempt market and a "one size fits all" regulatory approach may not be appropriate or sufficient.
- **Access to the exempt market by issuers.** Some stakeholders suggested that access to a broader range of investors through the exempt market may provide better support for SMEs.
- **Access to the exempt market by investors.** Stakeholders expressed divergent views on whether greater access to the exempt market should be provided to non-accredited investors. Some stakeholders supported "democratization" of the exempt market so that more individuals, rather than simply high net worth or high income individuals, would be able to make investments on a prospectus-exempt basis. Others focused on the investor protection concerns associated with broader investor participation in the exempt market.
- **Existing criteria for accredited investor status.** Stakeholders expressed divergent views on the appropriateness of the existing financial thresholds in the accredited investor exemption. While some found the current financial thresholds to be an appropriate basis for determining accredited investor status, many others suggested that these criteria are not an adequate proxy for sophistication, particularly given the fact that the financial thresholds have not been adjusted for inflation since the introduction of the exemption. However, we also heard that this exemption is critical to capital raising for businesses and any restrictive changes could have a significant impact.
- **Existing minimum purchase amount.** Many stakeholders questioned the rationale for the existing minimum amount exemption. Some suggested that it was time to repeal this exemption and that the accredited investor exemption is an appropriate alternative.
- **Other suggestions.** Some stakeholders submitted that the OSC should adopt an OM exemption, which would allow a broader range of investors to participate in the exempt market on the condition that some disclosure is provided. Others encouraged CSA members to renew their efforts to harmonize the current prospectus exemptions that exist in NI 45-106.

Status of CSA staff review of minimum amount and accredited investor exemptions

On June 7, 2012, the CSA published CSA Staff Notice 45-310 *Update on CSA Staff Consultation Note 45-401 Review of Minimum Amount and Accredited Investor Exemptions* (the **CSA Notice**). The CSA Notice indicated that given the number of comments and the diversity of the feedback provided, CSA staff will need further time to complete the review of the minimum amount and accredited investor exemptions. CSA staff will finalize the review and publicly report on their conclusions in 2013.

B. Consultation on distributions of securitized products

A separate CSA initiative to consider a new regulatory regime for the distribution of certain securitized products has been underway for some time. On April 1, 2011, the CSA published for comment a set of proposed rules that would establish a new framework for the regulation of securitized products in Canada. These proposed rules would introduce enhanced disclosure requirements for securitized products issued by reporting issuers. In addition, the proposals consider whether new restrictions should be implemented that would narrow the class of investors who can buy securitized products on a prospectus-exempt basis.

The CSA received 30 comment letters in response to these proposals. Commenters expressed differing views on how best to regulate securitized products sold on a prospectus-exempt basis. Some suggested that there does not seem to be a valid reason to identify securitized products as a class of securities that raise greater investor protection concerns, while others suggested that securitized products pose unique investor protection risks.

These consultations are ongoing and the CSA plans to publish amended proposals in 2013. We will take the feedback received on these proposals into account in proposing any new exemptions arising out of this policy review.

3.2 Proportionate regulation

Facilitating effective capital raising is a matter that must be addressed, not only in the context of the exempt market, but also of the public market.

In recognition of this reality and to address other concerns, on September 13, 2012, the CSA published for a second comment period proposed National Instrument 51-103 *Ongoing Governance and Disclosure Requirements for Venture Issuers*. It was originally published for comment on July 29, 2011. The comment period closed on December 12, 2012.

The proposed instrument is designed to:

- improve access to key information and facilitate informed decision-making by venture issuer investors by:
 - tailoring disclosure requirements to the circumstances of venture issuers,
 - eliminating certain disclosure obligations that may be of less value to venture issuer investors, and
 - providing supplemental disclosure that we think is relevant to venture issuer investors,
- allow venture issuer management more time to focus on the growth of their issuer's business by reducing the time venture issuer management must spend reading and trying to understand disclosure requirements through:
 - reducing the overall length and complexity of the instruments,
 - tailoring the requirements to focus on those applicable to venture issuers, and
 - streamlining and reducing disclosure redundancies, and
- enhance investor confidence in the venture market by introducing substantive governance standards relating to conflicts of interest, related party transactions and insider trading.

Under the proposed instrument, all venture issuers will be required to file an annual report and will therefore be able to access the public market through the short form prospectus system.

4. KEY ISSUES

4.1 Greater access to the exempt market for issuers and investors

It is important that we take into account the needs of both issuers and investors when considering new prospectus exemptions. Greater access to the exempt market is a theme we heard during our initial consultation. As part of this process, we will consider ways to align the interests of investors and issuers as much as possible.

Increased access to capital for issuers

A key purpose of this policy review is to examine how business enterprises, particularly SMEs, can have greater access to capital raising opportunities.

SMEs play an important role in the economy. In 2010, SMEs accounted for over 99% of the number of businesses in Canada.⁸ In 2005, the latest year for which Statistics Canada has reported data, SMEs accounted for over 54% of Canada's Gross Domestic Product (GDP).⁹ Further, SMEs accounted for 54% of Canadian job creation between 2001 and 2010.¹⁰ The statistics for Ontario for 2009 largely parallel these national statistics, except that SMEs only accounted for approximately 40% of the province's GDP.¹¹

One of our goals is to consider whether any new prospectus exemptions could improve capital raising options available to SMEs without unduly compromising investor protection. We recognize that facilitating capital raising has not been an express objective of securities regulation (except to the extent that it is subsumed in the purpose of fostering "efficient capital markets"). However, given the importance of SMEs to the economy, we should consider whether there are ways to streamline and improve on the prospectus exemptions currently available to SMEs.

Access to investment opportunities by investors

In addition to considering the impact of possible new prospectus exemptions on business enterprises, particularly SMEs, we are considering whether there is investor interest in greater access to investment opportunities in the exempt market. There are a variety of potential reasons for this:

- **Changing investor profile.** Given the demographic makeup of the Canadian population, the investment needs of Canadians are expected to change to some degree in the coming years. As the baby boomer generation moves into retirement, there will be a shift in investment focus by a segment of the population. As a result, some investors may seek a broader range of investment opportunities.
- **Availability of information on the internet.** Financial and business information is now widely available to the public over the internet. This allows for individual investors to do more of their own research on possible investment opportunities, rather than rely solely on investment professionals. At the same time, an increasing number of financial and investment transactions are taking place over the internet. One survey suggests that

⁸ Small Business Branch, *Key Small Business Statistics* (Ottawa: Industry Canada, July 2011) at 8, online: <[http://www.ic.gc.ca/eic/site/061.nsf/vwapj/KSBS-PSRPE_July-Juillet2011_eng.pdf/\\$FILE/KSBS-PSRPE_July-Juillet2011_eng.pdf](http://www.ic.gc.ca/eic/site/061.nsf/vwapj/KSBS-PSRPE_July-Juillet2011_eng.pdf/$FILE/KSBS-PSRPE_July-Juillet2011_eng.pdf)>.

⁹ Danny Leung, Luke Rispoli & Bob Gibson, *Small, Medium-sized and Large Businesses in the Canadian Economy: Measuring Their Contribution to Gross Domestic Product in 2005* (Ottawa: Economic Analysis Division, Statistics Canada, May 2011) at 6, online: <<http://www.statcan.gc.ca/pub/11f0027m/11f0027m2011069-eng.pdf>>.

¹⁰ *Supra* note 8 at 22.

¹¹ Ontario Ministry of Economic Development and Trade, *Snapshot of Ontario's Small and Medium Enterprises* (May 2010), online: <http://www.sbe.gov.on.ca/ontcan/1medt/downloads/SME_snapshot_may2010_en.pdf>.

up to 30% of Canadians are seeking financial advice from online news articles and blogs and from social media.¹²

- **Greater self-reliance in retirement.** The availability of traditional retirement investments, such as defined benefit pension plans, is much reduced today in Canada. As a result, investors must increasingly rely on their own investments and savings to meet their retirement goals. This arguably results in a greater need for the availability of diverse investment opportunities and strategies.

As a result of these factors, it is worthwhile to consider whether investors should have greater access to a wider range of investments, including investments available in the exempt market.

4.2 Investor protection concerns and concerns regarding registrant conduct

When considering possible new prospectus exemptions, we need to be aware of the problems that currently exist with the way that securities are distributed in the exempt market, so that we can create rules that will mitigate these harms.

Sales of securities on an exempt basis, especially to individual investors (commonly referred to as “retail” investors), raise a number of investor protection concerns. For example, with no mandatory disclosure required, it is left to investors to determine what information, if any, they require to make an investment decision and to request that information from the issuer. Retail investors may be at a disadvantage when it comes to negotiating with issuers. They may also not have the ability to determine whether the information provided to them is sufficient and to analyze the information received.

It can be difficult to quantify the exact nature and extent of the problems that may exist in the exempt market from a retail investor protection perspective. Problematic activity lies along a spectrum from unlawful activity such as fraud to activity that is within the letter of the law but nevertheless may cause harm. We have information on concerns about activities in the exempt market from a variety of sources.

Contact Centre complaints

We know from complaints received by the OSC’s Contact Centre that some investors who acquired securities under a prospectus exemption believe there was a problem or unfairness with the transaction.

Staff in the Contact Centre have received complaints from retail investors who acquired securities in the exempt market. These complaints suggest that retail investors may have difficulty making informed investment decisions in some cases. Specific complaints often focus on the fact that an investor was not aware of the risks associated with the securities that were acquired or did not understand what it means to be an “accredited investor”.

Concerns with the minimum amount and accredited investor exemptions

We also heard views expressed in our initial consultation on the minimum amount and accredited investor exemptions. Many stakeholders indicated that the exempt market raises investor protection concerns that need to be addressed.

In particular, the current minimum amount exemption has been criticized for being fundamentally flawed. Some stakeholders stated that having a certain amount of money to invest is not a proxy for sophistication, nor does it provide any assurance that an investor has the ability to withstand the loss of the investment. The minimum

¹² Rob Carrick, “Are we placing too much faith in banks’ advice” *The Globe and Mail* (November 7, 2012), online: <<http://www.theglobeandmail.com/globe-investor/personal-finance/household-finances/are-we-placing-too-much-faith-in-banks-advice/article5077728/>>.

amount exemption has also been criticized for requiring investors to invest a large amount in one security, which discourages diversification and may not be an appropriate investment choice for the investor.

Others have taken the position that the current thresholds for both the minimum amount and accredited investor exemptions are too low and should be adjusted for inflation. They argue that the original rationale for setting these thresholds has been watered down by the impact of inflation, potentially allowing a broader group of investors to participate in the exempt market than was originally intended.

Information from OSC “sweeps” – compliance reviews of EMDs

In recent years, we have identified significant compliance issues with some firms registered as dealers in the category of exempt market dealer (**EMDs**). The issues identified include:

- **Suitability.** A number of EMDs continue to sell exempt securities that are not suitable for their clients. Examples include selling high risk securities to low and medium risk investors, selling long term investments to clients with short term investment needs and not collecting sufficient KYC information to assess suitability.
- **Accredited investor qualification.** Certain EMDs have been selling exempt securities to clients who were not accredited investors. In May 2011, the OSC issued OSC Staff Notice 33-735 *Sale of Exempt Securities to Non-Accredited Investors*, that sets out our expectations of issuers and dealers who sell exempt securities to accredited investors.
- **KYP.** A number of EMDs fail to discharge their KYP obligations and are distributing unsuitable investments to clients. EMDs are expected to understand the structure and features of each security they recommend. Securities that are sold under a prospectus exemption may require a more extensive review because of the limited disclosure available.
- **Related parties.** We have identified numerous compliance deficiencies among EMDs that distribute securities of related parties where the same individuals manage both the EMD and the issuer. We found a number of cases of commingling and inappropriate use of investor proceeds by the EMD and/or the related party issuer.
- **Marketing and client disclosure.** The marketing practices of EMDs continue to be an area of concern. Many EMDs are providing materials to investors with information that is outdated or misleading or that contain unsubstantiated claims. In addition, we identified a continued lack of disclosure to investors on conflicts of interest, particularly with EMDs who trade in securities of “related issuers” and “connected issuers”.

5. CONSIDERATIONS FOR CROWDFUNDING AND OM PROSPECTUS EXEMPTIONS

5.1 Introduction

Stakeholders have suggested that we consider adopting a prospectus exemption to permit crowdfunding similar to the one found in the JOBS Act as well as a form of OM exemption. They submit that these exemptions would increase capital raising opportunities for issuers, particularly SMEs. They also have indicated that they would provide investors with more access to investment opportunities through the exempt market and thereby “democratize the exempt market”.

We view a crowdfunding exemption and an OM exemption along the same continuum. While these exemptions may be subject to different conditions, they both would allow retail investors greater access to the exempt market. We have historically limited investor access to the exempt market due to investor protection concerns.

Both of these exemptions are premised on some form of disclosure being provided to investors on which they could base an investment decision. One of the key differences between the two exemptions is that the crowdfunding exemption contemplates investing through an online funding portal, whereas distributions under the OM exemption historically have been made through more traditional investment channels.

We explore each of these options below.

We note that neither of these options is currently proposed to apply to investment funds. This approach is consistent with the JOBS Act, which excludes investment fund companies from the crowdfunding exemption. We also note that an investment fund that is advised by a registered adviser or a person exempt from registration already qualifies (as a form of institutional investor) as an accredited investor to invest in all types of businesses, including SMEs, on an exempt basis.

5.2 Exploration of crowdfunding

Permitting capital raising by allowing retail investors access to the exempt market would represent a significant change to the current exempt market regulatory regime. In addition, allowing investments to be made through the internet may raise heightened concerns regarding the potential risk of fraud and abuse. As a result, it is important to consider not only the potential benefits of crowdfunding, but also its potential challenges. The benefits and the challenges of crowdfunding for both issuers and investors have been the subject of much debate.

Issuer perspective

Crowdfunding arguably may provide a new source of capital for start-ups and SMEs that either have limited access to capital or have exhausted other available sources of capital. More traditional funding models may not be available to invest in these issuers and having a more diverse investor pool may lead to increased investment in underfunded businesses. Crowdfunding would also be less expensive than raising capital through a public offering.

Crowdfunding, however, may not be appropriate for all issuers. It would likely work best for projects that require relatively small amounts of capital as limits on investment and offering size will restrict how much can be raised through crowdfunding in a 12-month period. It may also not be an effective capital raising mechanism for issuers with less “marketable” projects that are less attractive to the crowd. For example, the crowd may be more interested in funding a film or an art project or supporting a community initiative, than providing an issuer’s

working capital needs. As a result, crowdfunding may not be a useful capital raising tool for issuers at all stages of development or in all industry sectors.

There may also be disadvantages associated with raising capital under this model. Crowdfunding may result in an issuer having a large number of potentially unsophisticated shareholders with relatively small interests in the issuer and thereby limit the issuer's future financing options. That may make it more difficult to attract angel investors and venture capital financing at later stages of development. In addition, a large number of shareholders may result in increased compliance costs under corporate law. On the other hand, having a large pool of investors with small interests may be attractive to angel investors or venture capitalist financing as this shareholder profile may facilitate acquiring a control position at a relatively low cost.

An issuer that distributes securities through crowdfunding will also have to provide ongoing disclosure to investors, which will result in costs to the issuer.

Finally, given the potential illiquid nature of the securities and the high business risk, investors may not receive a return in the short term or at all on their investment. That may in turn lead to lawsuits and a decline in investor interest in crowdfunding in the future.

Investor perspective

Crowdfunding may provide investors that do not qualify as accredited investors opportunities to invest in the exempt market. This would democratize the exempt market so that investment opportunities can be accessed by all investors, not just those with a high income or net worth. In particular, it would allow retail investors to participate, to a limited extent, in start-ups and SMEs.

However, there are a number of investor protection concerns associated with the crowdfunding model. The North American Securities Administrators Association (**NASAA**) has described it as one of the top investor threats in its 2012 Enforcement Report.¹³ NASAA has also highlighted potential fraud concerns in an investor alert and in its comment letter to the SEC.¹⁴

The concerns include the risk that crowdfunding will be subject to fraud and abuse. The existing non-equity crowdfunding models have reported a two percent rate of fraud.¹⁵ However, such a low rate of fraud may not apply to the equity crowdfunding models under consideration by securities regulators.

In addition, issuers may not be appropriately accountable to their investors regarding the use of the proceeds raised.

There are also concerns that investors may not fully understand the risks associated with their investment. For example:

- Investors need to understand that they could lose all of their money and it is important that they are able to withstand that loss.
- There will be limited disclosure made to investors at the time of distribution and on an ongoing basis.
- Investors need to understand that crowdfunding offerings will not have undergone the same level of due diligence as that undertaken in connection with a prospectus offering.

¹³ NASAA Enforcement Section, *North American Securities Administrators Association – Enforcement Report* (Washington: NASAA, October 2012), online: <<http://www.nasaa.org/wp-content/uploads/2012/10/2012-Enforcement-Report-on-2011-Data.pdf>>.

¹⁴ NASAA, News Release, "Laws Provide Con Artists with Personal Economic Growth Plan" (August 21, 2012), online: <<http://www.nasaa.org/14679/laws-provide-con-artists-with-personal-economic-growth-plan/>>; Comment letter from the North American Securities Administrators Association on SEC Regulatory Initiatives Under the JOBS Act: Title III - Crowdfunding (July 3, 2012), online: <<http://www.sec.gov/comments/jobs-title-ii/jobstitleii-40.pdf>>.

¹⁵ Quentin Casey, "Equity crowdfunding source of innovation, capital for startups" *Financial Post* (October 22, 2012), online: <<http://business.financialpost.com/2012/10/22/equity-crowdfunding-source-of-innovation-capital-for-startups/>>.

- It will be difficult for investors to value their investments unless the issuer becomes a reporting issuer in the future.
- Investors need to understand that they may not be able to resell their investment.
- There may be limited rights of recourse with respect to the issuer. Investors also need to understand that they will have little recourse to the funding portal.

Consultation questions

- Would a crowdfunding exemption be useful for issuers, particularly SMEs, in raising capital?
- Have we recognized the potential benefits of this exemption for investors?
- What would motivate an investor to make an investment through crowdfunding?
- Can investor protection concerns associated with crowdfunding be addressed and, if so, how?
- What measures, if any, would be the most effective at reducing the risk of potential abuse and fraud?
- Are there concerns with retail investors making investments that are illiquid with very limited options for monetizing their investments?
- Are there concerns with SMEs that are not reporting issuers having a large number of security holders?
- 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?

Crowdfunding concept

In order to explore the possibility of a crowdfunding exemption, we have developed a concept idea for this type of exemption solely for discussion purposes. Based on the feedback received from stakeholders and further consideration of investor protection and other regulatory concerns, we may decide not to introduce a crowdfunding exemption in this or any other form.

In developing this concept idea, we considered some elements of the BC and Alberta models of the OM exemption. We understand that BC, Alberta and certain other CSA jurisdictions are currently reviewing their OM exemptions based on market experience. We will consider the results of that review as part of our consultation process.

Our concept idea encompasses many of the investor protection elements of the crowdfunding exemption in the JOBS Act. As noted above, many details of the crowdfunding exemption, including those related to the funding portal, have not yet been resolved by the SEC in rulemaking. The SEC is required to issue rules not later than 270 days following enactment (December 31, 2012). However, we note that there is speculation that there may be delays in meeting this deadline.

There are three parties that would be involved in a distribution under the crowdfunding model: the issuer, the investor and the funding portal. We have discussed the elements of this concept idea relevant to each party below.

Issuer restrictions

There are four primary restrictions imposed on the issuer:

- **Qualification criteria.** In order to rely on this exemption, the issuer, its parent (if applicable) and its principal operating subsidiary (if applicable) must be incorporated or organized under Canadian federal laws or the laws of a Canadian jurisdiction and the issuer must have its head office located in Canada.
- **Limit on offerings.** The issuer cannot raise more than \$1.5 million under this exemption in any 12-month period.
- **Limit on security.** Only the following securities can be distributed under this 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.
- **Limit on advertising.** The issuer is not permitted to advertise an investment except through the funding portal or on the issuer's website. However, the issuer would be able to use social media to direct investors to the funding portal or the issuer's website.

Investor protection measures

This exemption could be used to sell securities to any investor, regardless of his/her income, net worth or investment sophistication. As a result, there are several conditions that are designed to provide greater investor protection:

- **Investment limits.** The primary investor protection measure is a limit on the amount of money an investor can invest. The investor cannot invest more than \$2,500 in a single investment under this exemption. In addition, the investor cannot invest more than \$10,000 in total under this exemption in any calendar year. Bright-line tests enhance the clarity and contribute to the simplicity of this important investor protection measure. The investment limits are intended to reduce the investor's exposure by capping the amount of money that the investor is placing at risk.
- **Provision of disclosure at point of sale.** At the time of distribution, the investor must be provided with a streamlined information statement that includes basic information about the offering, the issuer, the funding portal and any other registrant involved. In particular, the information statement must include a description of the principal risks facing the issuer as well as one year of financial statements, if any. If the proceeds of the distribution are proposed to be greater than \$500,000 or if the issuer is a reporting issuer, the financial statements must be audited. Otherwise, they can be certified by management.

The information statement must be certified by the issuer. In addition, the investor must be given statutory rights in the event of a misrepresentation in the information statement.

- **Risk acknowledgement.** Investors must sign a risk acknowledgement in which they confirm that:
 - they fall within the investment limitations,
 - they understand that they may lose their entire investment and they can bear that loss, and
 - they understand the illiquid nature of the investment (in the case of securities of a non-reporting issuer).
- **Two-business day "cooling off" period.** Investors must be provided with a two-business day right of withdrawal from the date of their investment decision in order to provide investors with an opportunity to consider the disclosure provided and reflect on their investment decisions.

- **Provision of ongoing disclosure.** The issuer must provide investors with annual financial statements. The issuer must also keep books and records which contain, at a minimum:
 - information on the securities issued by the issuer as well as the distribution price and date,
 - the names of all security holders and the size of their holdings, and
 - the use of funds raised.

Registration of funding portal

All investments under this exemption must be made through a registered funding portal.

As indicated above, under the JOBS Act, a crowdfunding portal will be required to obtain registration with the SEC as a broker or funding portal and with any SRO.

We expect that funding portals that carry on business in Ontario will also be required to register in an appropriate dealer or adviser category in Ontario, since the activities of the portals (i.e., showcasing investment opportunities to investors and matching issuers with investors) will generally constitute registerable trading or advising activity under the Securities Act. In this regard, we note that clause (e) of the definition of “trade” in section 1(1) of the Securities Act includes “any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of” a sale of a security and that a number of OSC and Court decisions have held that establishing a website that offers securities or information about securities offerings to investors through the internet constitutes an act in furtherance of a trade. Where this type of trading activity is conducted with regularity and for a business purpose, we will generally consider the funding portal to be “in the business” of trading or advising (depending on the particular business model) and therefore subject to the dealer or adviser registration requirement.

The registration requirement is an important investor protection measure necessary to address, among other things, integrity, proficiency and solvency requirements applicable to funding portals and the persons operating them. We also believe that the registration requirement will help address concerns relating to possible conflicts of interest and self-dealing and provide some assurance that funding portals will not be established or used to facilitate fraudulent offerings of securities to investors through the internet.

We recognize that, in light of the limited nature of a funding portal's activities, existing dealer or adviser categories, such as investment dealer, EMD or portfolio manager, may not be well tailored to a particular portal's business model. Accordingly, OSC staff would consider registration either in an existing dealer or adviser category or in a restricted dealer or adviser category. Similarly, we recognize that certain traditional dealer or adviser obligations, such as the obligation to provide client-specific suitability advice about investments that are made through a funding portal, may not be well suited to the portal's business model. We would consider exempting funding portals from specific dealer or adviser registration requirements, after considering the particular features of the portal's proposed business model and our continuing review of crowdfunding developments in other jurisdictions.

A more detailed summary of this concept idea, along with explanatory commentary, is set out in Appendix A.

Implications for registration regime

We note that no registrant, other than the funding portal, will be required to be involved in a crowdfunding distribution.

Consultation questions

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

Investor protection measures

- Should there be limits on the amount that an investor can invest under this exemption? If so, what should the limits be?
- What information should be provided to investors at the time of sale as a condition of this exemption? Should that information be certified and by whom?
- Should issuers that rely on this exemption be required to provide ongoing disclosure to investors? If so, what form should this disclosure take?
- 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?
- Should rights and protections, such as anti-dilution protection, tag-along rights and pre-emptive rights, be provided to shareholders?

Funding portals and other registrants

- Should we allow investments through a funding portal (similar to the funding portals contemplated by the crowdfunding exemption in the JOBS Act)? If so:
 - What obligations should a funding portal have?
 - Should funding portals be exempt from certain registration requirements? If so, what requirements should they be exempted from?
- Should a registrant other than the funding portal be involved in this type of distribution? If so, what category of registrant? Should additional obligations be imposed on the registrant?

5.3 Exploration of an OM prospectus exemption

An OM exemption would permit a distribution of securities based on a limited disclosure document.

In order to explore the possibility of an OM exemption, we have developed a concept idea for this type of exemption solely for discussion purposes. Based on the feedback received from stakeholders and further consideration of investor protection and other regulatory concerns, we may decide not to introduce an OM exemption in this or any other form.

We believe that certain of the terms and conditions applied to the crowdfunding exemption should be applied to the OM exemption. For example:

- The issuer, its parent (if applicable) and its principal operating subsidiary (if applicable) must be incorporated or organized under Canadian federal laws or the laws of a Canadian jurisdiction and the issuer must have their head office located in Canada.
- There would be a \$1.5 million limit on the amount of capital that can be raised under this exemption in a 12-month period.
- The exemption could not be used to distribute securities other than 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.
- There would be a limit on a purchaser's investment in a particular distribution of \$2,500 under this exemption and a limit of \$10,000 in total under this exemption in any calendar year.
- A limited disclosure document that includes basic information about the offering, the issuer and the registrant (if the securities are distributed through a registrant) must be provided to the purchaser.
- The purchaser must sign a risk acknowledgement form and must be provided with a two-business day right of withdrawal. In addition, the purchaser must have statutory rights in the case of a misrepresentation in the disclosure document.

There are two notable differences between the two exemptions. An OM investment would not need to be conducted through a funding portal and there would be no requirement for involvement of a registrant as a condition to reliance on the exemption (unless the issuer or any intermediary is in the business of trading in securities).

This concept idea is a prospectus exemption and is not an exemption from ordinary dealer registration or adviser registration requirements under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103)*. To the extent an issuer or intermediary may be considered to be "in the business" of trading securities or advising with respect to securities, ordinary registration requirements will continue to apply.

This concept idea, if implemented, will have implications for the registration regime since it will expand the class of investors with whom EMDs may deal. Through our compliance reviews, we have recently identified significant compliance issues and concerning trends with certain types of EMDs, particularly EMDs that distribute securities of "related issuers" and "connected issuers". Although these concerns may also apply to other classes of registrants, we have highlighted these concerns in relation to EMDs since the proposed exemption will expand the class of investors with whom an EMD may deal. Broadening the prospectus exemption regime may heighten these current issues with these types of EMDs.

A more detailed summary of this concept idea, along with explanatory commentary, is set out in Appendix A.

Consultation questions

- Should an OM exemption be adopted in Ontario? If so, why?
- Should there be any monetary limits on this exemption? If so, should those limits be in addition to any limits imposed under any crowdfunding exemption?
- Should a purchaser be required to receive investment advice from an adviser in order to rely on this exemption?
- Should there be mandatory disclosure required in an OM? If so, what level of disclosure should be required?
- Should we require registrant involvement as a condition of this exemption? If so, what category of registration should be required?

6. CONSIDERATIONS FOR PROSPECTUS EXEMPTIONS BASED ON SOPHISTICATION AND ADVICE

6.1 Introduction

Stakeholders have suggested that we consider adopting prospectus exemptions that would allow a distribution to an investor where:

- the investor is sophisticated and has knowledge of investments, or
- the investor receives advice about the investment from a registrant.

Both of these options can be viewed as extensions of the current accredited investor exemption. That exemption is based on an investor having one or more of the following:

- a certain level of sophistication,
- the ability to withstand financial loss, and
- the financial resources to obtain expert advice.

These options are similarly based on investor sophistication or expert advice.

We explore each option below to obtain feedback from stakeholders on whether these options would be useful to issuers trying to raise capital and appropriate for investors wishing to invest in the exempt market. This feedback will inform our analysis before we decide whether the OSC should adopt new capital raising prospectus exemptions based on these concepts. We may decide not to introduce exemptions based on these concepts or that other alternatives are preferable.

6.2 Exploration of a prospectus exemption based on investment knowledge

Some stakeholders have submitted that having income or net worth of a certain minimum amount does not assure investment sophistication. Conversely, an investor may have investment sophistication but not meet the prescribed minimum income or net worth bright-line tests. A more appropriate test for investment sophistication is the investor's knowledge of an investment as a result of his/her education or work experience.

Concept idea

The following concept idea is for an exemption which would allow for distributions of securities to "sophisticated" investors who do not qualify as accredited investors.

Premise of the exemption

Given an investor's investment knowledge, the investor does not require the protections afforded by a prospectus offering, including the delivery of a prospectus that is subject to statutory liability for a misrepresentation and the involvement of a registrant.

As noted in Part 2, this concept is found in the UK's regulatory regime.

Investor qualification criteria

To qualify as a "sophisticated" investor, the investor would have to satisfy two conditions:

- **Relevant work experience.** The investor must have worked in the investment industry for at least one year in a position that requires knowledge of securities investments.
- **Relevant educational qualification.** The investor must have earned or received one of the following:
 - a Chartered Financial Analyst designation (**CFA Charter**),
 - a Chartered Investment Manager designation (**CIM designation**), or
 - a Master in Business Administration degree (**MBA**) from an accredited university.

We considered whether other educational qualifications or work experience would satisfy these conditions. For example, we considered whether a person who is a “qualified person” under National Instrument 43-101 *Standards of Disclosure for Mineral Projects* should be able to invest in an issuer in the mining industry. Such a person has familiarity with the industry and would arguably be in a position to assess an issuer’s prospects based on the issuer’s scientific and technical disclosure. However, there are many challenges associated with creating qualification criteria on an industry-by-industry basis because not all industries have clearly defined qualification standards. As a result, we focused more broadly on general investment knowledge and expertise.

We also considered whether the size of an investor’s portfolio and/or the frequency and size of the investor’s investment transactions are relevant for measuring sophistication. As noted above, several stakeholders do not agree that net worth is an adequate proxy for investment sophistication. An investor may have a sizeable investment portfolio as a result of an inheritance or as a result of investment decisions previously made on his/her behalf by a registrant. We also do not believe that transaction size and frequency are indicators of investment sophistication and, in fact, such criteria could provide an incentive for an investor to make larger and more frequent investments than would make sense for his/her personal circumstances.

Other conditions

Similar to 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, or
- the size of the offering.

However, additional conditions would apply to provide greater investor protection. They include:

- the investor must be provided with basic information about the offering, such as the information typically found in a term sheet, and
- the investor must sign a risk acknowledgement form.

A more detailed summary of this concept idea, along with explanatory commentary, is set out in Appendix B.

Benefits and challenges of this concept idea

This concept idea may provide greater investment opportunities for “sophisticated investors” and may increase the investor pool for issuers. While we recognize that “sophisticated investors” may not need the protections afforded by a prospectus offering, there are a number of challenges associated with this concept idea.

Potentially small impact

We do not expect that the number of investors who will qualify under this exemption will be significant and we note that there is already a prospectus exemption for distributions to registrants. As a result, the introduction of this type of exemption may not have a significant impact on capital raising by issuers and, in particular, SMEs.

Implementation and compliance issues

This concept idea is principles-based and refers to terms such as “investment industry” and “knowledge of securities investments” which are not readily defined. As a result, assessing whether an investor satisfies the qualification criteria will involve subjective determinations, which may be more challenging than applying

quantitative bright-line tests.

Appropriate framing of qualification criteria

It is challenging to define relevant work experience and educational qualifications in a manner that is neither over-inclusive nor under-inclusive.

Implications for registration regime

This concept idea is a prospectus exemption and is not an exemption from ordinary dealer registration or adviser registration requirements under NI 31-103. To the extent an issuer or intermediary may be considered to be “in the business” of trading securities or advising with respect to securities, ordinary registration requirements will continue to apply.

This concept idea, if implemented, will have implications for the registration regime since it will expand the class of investors with whom EMDs may deal. Through our compliance reviews, we have recently identified significant compliance issues and concerning trends with certain types of EMDs, particularly EMDs that distribute securities of “related issuers” and “connected issuers”. Although these concerns may also apply to other classes of registrants, we have highlighted these concerns in relation to EMDs since the concept idea will expand the class of investors with whom an EMD may deal. Broadening the prospectus exemption regime may heighten these current issues with these types of EMDs.

Consultation questions

General questions

- Would this exemption be useful for issuers, particularly SMEs, in raising capital?
- Are there sufficient investor protections built into this exemption?

Questions on the specific terms of the concept idea

- Should we require an investor to satisfy both a relevant work experience condition and an educational qualification condition or would one suffice?
- How should we define the relevant work experience criteria?
- What educational qualifications should be met? Should we broaden the relevant educational qualifications?
- Are there other proxies for sophistication that we should consider?

6.3 Exploration of a prospectus exemption based on registrant advice

We heard from stakeholders that we should consider adopting a prospectus exemption for distributions to an investor where the investor has received appropriate advice from a registrant. The investor would not need to satisfy any sophistication criteria or have an income or net worth of a minimum amount.

Managed account exemption

A prospectus exemption based on registrant involvement already exists under Ontario securities law. A portfolio manager acting on behalf of a “fully managed account” managed by the portfolio manager is an “accredited investor” under clause (q) of the definition of “accredited investor” in section 1.1 of NI 45-106. As a result, the

portfolio manager is able to acquire securities (other than, in Ontario, investment fund securities) of non-reporting issuers on a prospectus-exempt basis on behalf of accounts for retail clients.

The existing exemption is premised on the portfolio manager:

- having satisfied the requisite proficiency requirements required for registration in that category,
- having an ongoing relationship with its client, and
- being in a fiduciary relationship with its client.

Concept idea for broader exemption based on the provision of advice

In order to explore the possibility of an exemption based on registrant advice, we have developed a concept idea for this type of exemption. It contemplates a prospectus exemption for a distribution to an investor where:

- an investment dealer is providing advice to the investor in connection with the distribution,
- the investment dealer has an ongoing relationship with the investor,
- the investment dealer has contractually agreed that it has a fiduciary duty to act in the best interests of the investor, and
- the investment dealer is not providing advice in connection with a distribution of securities of a "related issuer" or a "connected issuer" of the investment dealer. Accordingly, the investment dealer must not be otherwise acting for the issuer or in connection with the distribution.

Only dealing representatives within the investment dealer who are qualified to provide advice can do so. Investment dealers do not include other types of registrants, such as EMDs.

Concerns with extending exemption to EMDs

EMDs would not be permitted to provide advice under this exemption. We have excluded EMDs because there are important differences in terms of the duties owed to a client and the proficiency, solvency and other requirements applicable to an EMD as compared with a portfolio manager managing a fully managed account or an investment dealer who is qualified to provide advice. Based on our experience with recent compliance reviews, we have concerns about the ability and willingness of *some* EMDs to comply with their KYC, KYP and suitability obligations, and other registrant obligations when dealing with accredited investors. These concerns are particularly apparent when the EMD is dealing in products of a "related issuer" or "connected issuer". We believe these concerns may be exacerbated if EMDs were able to deal with retail clients under this concept idea.

Consultation questions

- Should we consider a new prospectus exemption that is based on advice provided by a registrant? 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?
 - 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)?
 - 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)? If so, would this be consistent with the registrant being subject to a fiduciary duty to the client?
 - Would exempting the issuer from a disclosure obligation have implications for a registrant's ability to conduct a meaningful KYP and suitability review?
 - Do you agree that a registrant should be required to have an ongoing relationship with the client?
 - Should there be any restrictions on the type of security that could be purchased? For example, should this exemption be available for purchases of securities of investment funds and/or complex products (including securitized products and derivatives)?
- Should the existing managed account exemption described above be expanded in Ontario to permit purchases of securities of investment funds?

7. NEED FOR ADDITIONAL EXEMPT MARKET DATA

7.1 Need for more data

Data on exempt market activity is necessary to inform decisions about regulatory changes to the exempt market.

Issuers or underwriters that sell securities under certain prospectus exemptions are required to file a report of exempt distribution on Form 45-106F1 *Report of Exempt Distribution* (the **report**) with securities regulators. The report includes some information about the issuer, the offering and the purchasers. The report is our primary source for information regarding activity in the exempt market.

While this information is useful, there are three challenges with the current reporting requirement:

- **Manner of collection.** The reports currently can be filed with the OSC in paper format. In Ontario, we receive thousands of reports each year. In order to properly analyze the data in the reports, we need to manually review and extract the key pieces of information from each form, which is extremely labour-intensive and time-consuming.
- **Information collected.** The information required to be included in the report is limited and is more focused on the details of the distribution, rather than the parties involved in the distribution (being the issuer, the investors and potentially a registrant).
- **Reporting trigger.** Not all prospectus exemptions trigger a reporting requirement. For example, a report is not required for a distribution under the private issuer exemption.

As a result, we do not have a complete picture of activity in the exempt market.

We are considering two means of addressing these issues:

- mandating electronic filing of the reports, and
- amending the reports to require additional information.

7.2 Electronic filing

In June 2012, the OSC launched an electronic version of the report (the **E-form**) which can be filed through the OSC's website. Our goal in providing an E-form is to both make it easier for filers to prepare and file the report and also to facilitate the OSC's ability to review the data contained in the report.

The information required to be included in the report did not change and no new reporting requirements were added at that time.

Issuers and underwriters that are required to prepare and file a report may now choose to prepare and file the report using the E-form, instead of in paper format. While filing the report electronically is voluntary, we anticipate moving towards mandatory electronic filings in the future.

Please see OSC Staff Notice 45-708 *Introduction of Electronic Report of Exempt Distribution on Form 45-106F1* (June 21, 2012) for further information.

Consultation question

- Are there any concerns with mandating use of the E-form?

7.3 Additional information required

Information currently collected

Currently, the report requires the reporting of the following types of information:

- basic information about the issuer, including its name, head office address, reporting issuer status and industry,
- if an underwriter is completing the form, the name and address of the underwriter,
- details of the distribution, including the date, the type of security distributed, the total number of securities distributed, the price of the securities and the prospectus exemptions relied on,
- information regarding commissions and finder’s fees, and
- basic information regarding the investors, including their names and addresses and the number and type of securities purchased by them.

The report must be certified by the issuer or underwriter.

Additional information required

As part of this policy review, we have identified additional information that would provide us with a better understanding of issuers, registrants and investors in the exempt market. This information includes:¹⁶

Party	Additional information sought
Issuer	<p>For non-investment fund issuers:</p> <ul style="list-style-type: none">• the issuer’s full legal name• the full legal name of the issuer’s parent• the industry of the issuer based on a more granular industry categorization than is currently set out in the report• the number of years that the issuer has been in operation• information regarding the issuer’s directors and executive officers <p>For investment fund issuers:</p> <ul style="list-style-type: none">• key service providers to the fund, including the fund’s manager, trustee, portfolio manager, sub-advisor, custodian, registrar and auditor• manager’s assets under management• type of fund by strategy• redemptions during the period• key financial information such as size of fund and management expense ratio (MER)• performance information

¹⁶ Any proposed changes to the report would be published for comment.

Party	Additional information sought
Registrant	<ul style="list-style-type: none"> • whether the distribution involves a registrant • if a registrant is involved: <ul style="list-style-type: none"> • the name of registrant • registrant’s contact information • information on the category of registrant • the registrant’s National Registration Database (NRD) number • information about whether the registrant is somehow related or connected to the issuer
Investor	<ul style="list-style-type: none"> • whether the investor is an individual • if the distribution was made to the investor under the accredited investor prospectus exemption, the category of accredited investor in which the investor qualifies • where the investor is an individual: <ul style="list-style-type: none"> • the investor’s age range • the investor’s work status (i.e. full-time, part-time, retired)

We also would like to obtain more specificity on the type of security distributed and whether an OM was provided to investors as part of the distribution.

In our view, collecting this additional information will enable the OSC to better understand its stakeholders (both issuers and investors) that access the exempt market and better enable the OSC to monitor exempt market activity and identify compliance issues.

Consultation questions

- Are there any concerns with requiring this additional information in the report? Please explain.
- Are there other types of information that we should require in the report?
- Should we require more frequent reporting for investment funds? If not, why not?

8. CONCLUSION

8.1 Implications for broadening access to the exempt market

Introducing new capital raising prospectus exemptions may provide issuers, particularly SMEs, with greater access to capital and may provide investors with greater investment opportunities. However, greater access does have significant implications for the regulation of the exempt market.

If we allow more issuers and registrants to actively participate in the exempt market, we will need to adjust our regulatory oversight of this market. In particular, if we introduce either a crowdfunding or OM exemption, we would need to consider developing new programs for the review of the disclosure provided to investors and for the oversight of funding portals and other registrants involved in these distributions.

Based on current research, there are concerns regarding the level of financial literacy of retail investors. These concerns will be heightened if retail investors are able to make investments in the exempt market without the benefit of expert advice.

The OSC's mandate is to provide protection to investors from unfair, improper or fraudulent practices and to foster fair and efficient capital markets. Any consideration of increasing access to capital raising in the exempt market should be consistent with the aim of aligning the interests of issuers and investors. As noted above, this paper is the initial step in soliciting comments from all interested stakeholders on these important issues. The OSC does not intend to make any decisions regarding new capital raising prospectus exemptions without:

- broad consultation with all interested stakeholders,
- obtaining the results of our further investor research, and
- consulting with the other members of the CSA on their review of their OM exemption.

Consultation question

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

8.2 Need for investor research to support review

Information about the investment knowledge, objectives and behaviour of individual investors is difficult to obtain and the feedback that we have received during our consultations to date has principally been from the investment industry. In order to ensure that any new prospectus exemptions introduced by the OSC include appropriate investor protections, we need to gain insight into individual investors' approaches when investing in start-ups and SMEs.

Concurrent with this consultation, we are conducting investor research to help us better understand:

- investors' desire to invest in start-ups and SMEs, including risk appetite and size of investment,
- investors' perceptions of the risks associated with investing in the exempt market,
- the specific information needs of investors investing in start-ups and SMEs,

- the experiences of those investors that do or have considered investing in securities in the exempt market, and
- the role of professional advisors in investors' investment decision-making process.

We are seeking investor feedback on the following general topics:

- **Access to investment opportunities.** We would like to better understand the level of individual investor interest in investing in the exempt market, including in start-ups and SMEs as an investment class. We are interested to learn if individual investors want access to investment opportunities in the exempt market, and if so, what investor protections they believe that they need. In particular, if new prospectus exemptions provide individual investors with more opportunities to invest in start-ups and SMEs, we want to understand the level of disclosure that individual investors need, the level of investment they are willing to make and who they would consult in making these decisions.
- **Information about investment decision making by individual investors.** We would like to better understand the current information relied on by individual investors. In particular, what information do investors want before making an investment decision in start-ups or SMEs? We also want to understand the reliance by individual investors on advisors in the decision making process.
- **Knowledge of investment products – investor sophistication.** We are interested in gaining a better understanding of individual investors' level of sophistication and knowledge.
- **Past experience with investments in the exempt market.** We are interested in learning more about the direct investing experience of individual investors who have invested in the exempt market. For example, we would like to know more about investors' experiences and whether they feel they understood the investments they made. We would also like to determine if investors understood the risks associated with the investment.

9. HOW TO PROVIDE FEEDBACK

9.1 Written comments

You must submit your comments in writing by **February 12, 2013**. If you are sending your comments by email, you should also send an electronic file containing the submissions in Microsoft Word.

Please address and send you comments to the address below.

John Stevenson

Secretary

Ontario Securities Commission

20 Queen Street West

19th Floor, Box 55

Toronto, Ontario M5H 3S8

Fax: 416-593-2318

Email: jstevenson@osc.gov.on.ca

Please note that all comments received during the comment period will be made publicly available. We will post all comments to the OSC website at www.osc.gov.on.ca to improve the transparency of the policy-making process.

9.2 Questions

If you have any questions, please contact:

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OSC EXEMPT MARKET REVIEW

**APPENDICES TO OSC STAFF CONSULTATION PAPER 45-710
CONSIDERATIONS FOR NEW CAPITAL RAISING PROSPECTUS EXEMPTIONS**



APPENDIX A – CONCEPT IDEAS FOR A CROWDFUNDING AND OM PROSPECTUS EXEMPTION

1. Crowdfunding prospectus exemption

The key elements of this concept idea, along with explanatory commentary, are set out in the table below. This concept idea is being put forward solely for discussion purposes. We are requesting comments on each of the elements of this concept idea.

Key elements of the crowdfunding concept idea	Explanatory notes
<p>Type of issuer</p> <ul style="list-style-type: none"> The issuer of the security, its parent (if applicable) and its principal operating subsidiary (if applicable) must be incorporated or organized under Canadian federal laws or the legislation of a Canadian jurisdiction, and the issuer must have its head office located in Canada. This exemption is not available for distributions of securities of investment funds. 	<ul style="list-style-type: none"> We have proposed that the issuer of the security, its parent (if applicable) and its principal operating subsidiary (if applicable) must be incorporated or organized under Canadian federal laws or the legislation of a Canadian jurisdiction and have its head office located in Canada because one of our objectives is to facilitate capital raising for SMEs in Canada. We note that the JOBS Act has similarly limited the availability of the crowdfunding exemption to domestic US issuers. It remains unclear whether the crowdfunding exemption will be available to US subsidiaries of Canadian issuers or issuers domiciled in other foreign jurisdictions. However, we note that the accredited investor exemption, the minimum amount exemption and the OM exemption in NI 45-106 are not currently limited to distributions of securities of issuers based in Canada. We have suggested making this exemption available for distributions of both reporting and non-reporting issuers. That is consistent with the accredited investor exemption and the OM exemption available in other Canadian jurisdictions. We recognize that some SMEs are reporting issuers. The focus of this paper is to consider possible new prospectus exemptions that could facilitate capital raising for business enterprises. As a result, we have suggested limiting the use of this exemption to distributions of securities of issuers other than investment funds. This approach is consistent with the JOBS Act, which excludes investment fund companies from using the crowdfunding exemption. We note that an investment fund that is advised by a registered adviser or a person exempt from registration already qualifies (as a form of institutional investor) as an accredited investor to invest in all types of businesses, including SMEs, on an exempt basis.

Key elements of the crowdfunding concept idea	Explanatory notes
<p>Type of security</p> <ul style="list-style-type: none"> • The only securities that can be distributed under this exemption are: <ul style="list-style-type: none"> ○ common shares ○ non-convertible preferred shares ○ non-convertible debt securities that are linked only to a fixed or floating interest rate ○ securities convertible into common shares or non-convertible preferred shares 	<ul style="list-style-type: none"> • There are currently no restrictions on the type of security that can be sold under the accredited investor exemption or the OM exemption available in other Canadian jurisdictions. There similarly do not appear to be any restrictions on the type of security that can be sold under the crowdfunding exemption in the JOBS Act. • Only four classes of security can be issued under this exemption. Given that this exemption is intended to facilitate capital raising by SMEs, we do not think it is necessary or appropriate to allow certain complex products, such as derivatives and securitized products, to be distributed under this exemption. • For the reasons discussed above, we have carved out securities of investment funds.
<p>Type of purchaser</p> <ul style="list-style-type: none"> • There are no limitations on the purchaser of the security. However, the purchaser is subject to investment limitations, as discussed below. 	<ul style="list-style-type: none"> • We considered the approach taken in the JOBS Act and the OM exemption available in other Canadian jurisdictions regarding the type of purchaser. <p><u>US approach</u></p> <ul style="list-style-type: none"> • There are no restrictions on the purchaser under the crowdfunding exemption in the JOBS Act. <p><u>BC approach</u></p> <ul style="list-style-type: none"> • There are no restrictions on the purchaser under the BC model of the OM exemption. <p><u>Alberta approach</u></p> <ul style="list-style-type: none"> • Under the Alberta model of the OM exemption, the purchaser must be an “eligible investor” or the acquisition cost to the purchaser cannot exceed \$10,000. We agree with the concept of an investment limit. However, we question whether the “eligible investor” criteria provides meaningful investor protection. • Consistent with these approaches, we are suggesting that any investor can buy securities under this exemption. The purchaser, however, would be subject to investment limits (discussed below).

Key elements of the crowdfunding concept idea	Explanatory notes
<p>Type of seller</p> <ul style="list-style-type: none"> This exemption is limited to distributions by an issuer in securities of its own issue. 	<ul style="list-style-type: none"> This approach is substantially consistent with the OM exemption available in other Canadian jurisdictions, which is limited to distributions by issuers of securities of their own issue. Consistent with the OM exemption, we have suggested not allowing selling security holders to use this exemption. This exemption is intended to facilitate capital raising and not necessarily the resale of securities. We do not believe selling security holders are necessarily as well positioned to provide the disclosure and other investor protection measures discussed below.
<p>Size of investment</p> <ul style="list-style-type: none"> A purchaser's investment in securities of a particular issuer cannot exceed \$2,500. In addition, a purchaser's investment under this exemption during a calendar year cannot exceed \$10,000. 	<ul style="list-style-type: none"> We believe investment limits are an important element of investor protection to limit an investor's exposure. An investment limit presents difficulties with compliance. A centralized system where funding portals are required to confirm the size of an investor's investment in its own and other registered portals has been suggested. Another alternative proposal would be to require the investor to self-certify that he/she is within the investment limits and has not exceeded the annual threshold. <p><u>US approach</u></p> <ul style="list-style-type: none"> Under the crowdfunding exemption in the JOBS Act, the aggregate amount of securities sold to any investor within the previous 12-month period in reliance on the exemption cannot exceed: <ul style="list-style-type: none"> the greater of US\$2,000 or 5% of the investor's annual income or net worth if either the annual income or the net worth of the investor is less than US\$100,000, and 10% of the investor's annual income or net worth, not to exceed a maximum aggregate amount sold of US\$100,000, if either the annual income or net worth of the investor is equal to or more than US\$100,000. We are concerned that investors may not wish to share their tax returns with issuers or registrants to establish that they are investing within the prescribed limits. As a result, a monetary cap may be easier to administer than an approach that requires calculations of an investor's net income or net worth.

Key elements of the crowdfunding concept idea	Explanatory notes
	<p><u>BC approach</u></p> <ul style="list-style-type: none"> • There are no limits on the size of the investment under the BC model of the OM exemption. We have concerns that this approach could result in too much of an investor’s assets being at risk. <p><u>Alberta approach</u></p> <ul style="list-style-type: none"> • As noted above, under the Alberta model of the OM exemption, a purchaser can purchase securities under the exemption if he/she is either an eligible investor or the acquisition cost to the purchaser does not exceed \$10,000. • A monetary cap of \$10,000 may be easier to apply than a limit based on a percentage of net income or net worth.
<p>Size of offerings</p> <ul style="list-style-type: none"> • An issuer cannot raise more than \$1.5 million in a 12-month period under this exemption. 	<p><u>BC and Alberta approach</u></p> <ul style="list-style-type: none"> • The OM exemption in other Canadian jurisdictions does not impose a limit on the amount of capital that can be raised under the exemption by an issuer. <p><u>US approach</u></p> <ul style="list-style-type: none"> • Under the crowdfunding exemption in the JOBS Act, an issuer can raise up to \$1 million in a 12-month period. Some commenters have expressed concern that the threshold is too low for the exemption to be a useful capital raising tool. Some commenters have suggested that a limit of \$5 to \$10 million may be more appropriate. • We acknowledge that not all SMEs’ capital requirements are the same. Issuers in different industry sectors may require different capital needs at different stages of growth. In looking at alternatives, we considered the following: <ul style="list-style-type: none"> ○ The prospectuses of 298 SMEs that raised capital between 2002 and 2006 were examined. The median offering size was \$6 million and nearly two-thirds of the offerings were for less than \$10 million. ○ The OSC’s former closely-held issuer exemption provided that an issuer could only raise \$3 million under that exemption in total (not just in a 12-month period). • We have suggested a limit of \$1.5 million in a 12-month period.

Key elements of the crowdfunding concept idea	Explanatory notes
<p>Disclosure provided to purchaser at the time of distribution</p> <ul style="list-style-type: none"> • A purchaser must be provided with an information statement at the time of the distribution. • The information statement must include “financing facts”, “issuer facts” and “registrant facts”. <p><u>“Financing facts”</u></p> <ul style="list-style-type: none"> • “Financing facts” (i.e. basic information about the offering) include: <ul style="list-style-type: none"> ○ the type/nature of the securities being offered ○ the price of the securities ○ the rights attached to the securities (including the impact on those rights if the issuer’s operations and/or assets are located outside of Canada) ○ whether there is a minimum and maximum subscription, and if so, the deadline to reach the minimum subscription ○ the use of the proceeds from the offering (including whether any directors, officers, promoters or related parties of the issuer will receive any of the proceeds) ○ resale restrictions ○ statutory rights in the event of a misrepresentation and a right of withdrawal (please see discussion below) <p><u>“Issuer facts”</u></p> <ul style="list-style-type: none"> • “Issuer facts” (i.e. basic information about the issuer) include: <ul style="list-style-type: none"> ○ a description of the issuer’s business or proposed business, and its anticipated business plan ○ one year of annual financial statements, if any ○ a description of the directors, officers and control persons of the issuer ○ limited executive compensation disclosure ○ principal risks of the issuer’s business 	<p><u>General comments on disclosure</u></p> <ul style="list-style-type: none"> • We believe that purchasers and any registrants advising them require a minimum level of disclosure on which to base an investment decision or recommendation. • Both the BC and Alberta models of the OM exemption require disclosure that is similar to the type of disclosure found in a long-form prospectus. We have heard two concerns with this approach: <ul style="list-style-type: none"> ○ Stakeholders have advised us that an offering memorandum prepared in accordance with the form requirements in NI 45-106 contains an overwhelming amount of information that is neither useful nor read by investors. ○ We have been advised that the OM exemption is not particularly useful to SMEs. The speculated reason is the cost associated with preparing an offering memorandum (and the cost of obtaining an audit of the financial statements). • In light of these concerns, we have suggested more streamlined disclosure in the information statement. The key items of disclosure are substantially derived from: <ul style="list-style-type: none"> ○ the requirements for the summary of a long-form prospectus, and ○ the disclosure requirements set out in the crowdfunding exemption in the JOBS Act (which remain subject to SEC rulemaking). <p><u>Financial statement disclosure</u></p> <ul style="list-style-type: none"> • This concept idea requires one year of audited annual financial statements of the issuer if the issuer has been in business. • The crowdfunding exemption in the JOBS Act has adopted a scaled approach to financial disclosure. Under that exemption, if the aggregate offering proceeds within a 12-month period are: <ul style="list-style-type: none"> ○ \$100,000 or less: the issuer must file income tax statements for the most recently completed year and have its financial statements certified by the principal executive officer to be true and complete in all material respects ○ more than \$100,000 but not more than \$500,000: the issuer must file financial statements reviewed by an independent public accountant, using professional standards and procedures for such review or standards and procedures established by the SEC ○ more than \$500,000: the issuer must file audited

Key elements of the crowdfunding concept idea	Explanatory notes
<p><u>“Registrant facts”</u></p> <ul style="list-style-type: none"> • “Registrant facts” (i.e. basic information about the registrant) include (where applicable): <ul style="list-style-type: none"> ○ the name of the funding portal ○ the name of any other registrant involved and the relationship between that registrant and the issuer, if any <p><u>Certification</u></p> <ul style="list-style-type: none"> • We believe that the issuer should take responsibility for the disclosure provided. Management of the issuer should certify the disclosure. <p><u>Marketing</u></p> <ul style="list-style-type: none"> • No other marketing materials may be provided. • In addition, no advertising by an issuer would be permitted except through the funding portal or the issuer’s website. The issuer would be able to use social media to direct investors to the funding portal or issuer’s website. 	<p>financial statements</p> <ul style="list-style-type: none"> • We are suggesting a similarly scaled approach: <ul style="list-style-type: none"> ○ If the proceeds of the offering are proposed to be at least \$500,000 or if the issuer is a reporting issuer, then audited annual financial statements must be included in the information statement. ○ If the proceeds of the offering are proposed to be less than \$500,000 and if the issuer is not a reporting issuer, then only management-certified financial statements need to be included. • We recognize that the cost of an audit could be an impediment for start-ups and SMEs using this exemption. <p><u>Risk factor disclosure</u></p> <ul style="list-style-type: none"> • The summary of a long-form prospectus requires disclosure of risk factors. Similarly, the crowdfunding exemption in the JOBS Act contemplates some level of risk factor disclosure. We are similarly suggesting that the information statement include a discussion of the <i>principal</i> risks facing the issuer’s business. • We have heard from stakeholders that risk factor disclosure is often not helpful as the issuer and its advisors include a lengthy list of risk factors, many of which are boilerplate. Some stakeholders have argued that having those risk factors protects the issuer from liability. • We have suggested that all purchasers sign a risk acknowledgement form. Please see the discussion below. <p><u>Marketing</u></p> <ul style="list-style-type: none"> • General solicitation and advertising would be prohibited other through the issuer’s or the funding portal’s website.
<p>Ongoing information available to investors</p> <p><u>Ongoing continuous disclosure</u></p> <ul style="list-style-type: none"> • The issuer must provide its security holders with annual financial statements within 120 days from its fiscal year end. <p><u>Books and records</u></p> <ul style="list-style-type: none"> • The issuer must maintain books and records that are available for inspection by purchasers and OSC staff. 	<p><u>Ongoing continuous disclosure</u></p> <ul style="list-style-type: none"> • As noted above, this exemption contemplates issuers providing one year of annual financial statements to potential investors, if any. • We believe that issuers who raise money under this exemption should provide <i>ongoing</i> financial statement disclosure to investors. For start-up issuers, in particular, the financial statements provided at the time of an offering may be of little value to investors if the issuer is in an early stage of development with little in the way of

Key elements of the crowdfunding concept idea	Explanatory notes
<ul style="list-style-type: none"> • The books and records must contain, at a minimum: <ul style="list-style-type: none"> ○ the securities issued by the issuer as well as the distribution price and date ○ the names of all security holders and the size of their holdings ○ the use of funds raised under this exemption 	<p>assets or earnings. In addition, requiring annual financial statements may reduce the risk of fraud.</p> <ul style="list-style-type: none"> • Under the terms of the crowdfunding exemption in the JOBS Act, issuers will be required to file with the SEC and provide to investors on an annual basis reports of the issuer's results of operations and financial statements, with the details to be determined by SEC rulemaking. • We note that it would be a novel approach in Ontario to require an issuer to provide ongoing continuous disclosure in the exempt market. <p><u>Books and records</u></p> <ul style="list-style-type: none"> • We also believe requiring the issuer to maintain books and records provides another measure of investor protection. This would enable security holders to assess whether the issuer has used the proceeds from the offering in the manner indicated in the information statement.
<p>Risk acknowledgement from purchaser</p> <ul style="list-style-type: none"> • A purchaser must sign a stand-alone risk acknowledgement form in which the purchaser confirms that he/she: <ul style="list-style-type: none"> ○ falls within the investment limitations ○ understands the risk of loss of the entire investment ○ can bear the loss of the entire investment ○ understands the illiquid nature of the investment 	<ul style="list-style-type: none"> • We believe that requiring the purchaser to sign a risk acknowledgement form provides another element of investor protection. It puts the investor on notice that he/she may lose all of his/her investment. • The OM exemption in other Canadian jurisdictions and the family, friends and business associates exemption in Saskatchewan require a risk acknowledgement form. Similarly, the crowdfunding exemption in the JOBS Act contemplates a form of risk acknowledgement.

Key elements of the crowdfunding concept idea	Explanatory notes
<p>Registrant involvement</p> <ul style="list-style-type: none"> • Distributions must be made through a registered funding portal. • The funding portal may be registered in an existing dealer or adviser category or in a restricted dealer or adviser category. • The funding portal must play a “gatekeeper” role and take reasonable measures to reduce the risk of fraud. That would include obtaining background and securities enforcement regulatory history checks on the issuer and each officer, director and significant shareholder of the issuer. 	<ul style="list-style-type: none"> • Use of an online funding portal is an important element of this exemption and is found in the crowdfunding exemption in the JOBS Act. • Under the JOBS Act, intermediaries involved in a crowdfunding transaction must be registered as a broker or funding portal under the <i>US Securities Exchange Act of 1934</i> and registered with a SRO. • A “funding portal” is defined in the JOBS Act to mean any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others pursuant to the exemption that meets certain conditions. • The funding portal cannot: <ul style="list-style-type: none"> ○ offer investment advice or recommendations ○ solicit purchases, sales or offers to buy securities offered or displayed on its website or portal ○ compensate employees and others for such solicitation or based on the sale of securities • The JOBS Act requires a person acting as a broker or funding portal intermediary to take certain actions, including to: <ul style="list-style-type: none"> ○ register with the SEC as a broker or funding portal and register with any applicable SRO ○ provide such disclosures, including those related to risks and other investor education materials, as the SEC by rule will determine appropriate, and ensure that investors review such disclosures, affirm risk of loss and answer various questions ○ take such measures to reduce risk of fraud, as will be established by the SEC, including background and regulatory checks on directors, officers and significant shareholders of issuers ○ make available to the SEC and to potential investors any information provided by the issuer to investors and intermediaries, not later than 21 days prior to the first day on which securities are sold to any investor ○ ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount and allow all investors to cancel their commitments to invest as determined by SEC rulemaking ○ make such efforts as the SEC determines appropriate by rule to ensure that no investor in a 12-month period has purchased securities offered pursuant to this exemption that, in the aggregate,

Key elements of the crowdfunding concept idea	Explanatory notes
	<p>from all issuers, exceed the investment limits set forth above</p> <ul style="list-style-type: none"> ○ take steps to protect privacy of information ○ not compensate promoters, finders, or lead generators for providing personal identifying information of personal investors ○ prohibit insiders from having any financial interest in an issuer using that intermediary’s services ○ meet any other requirements that the SEC may prescribe <ul style="list-style-type: none"> • Many details are not yet clear as they will be dealt with by the SEC in rulemaking. • We believe that requiring the funding portal to undertake a similar role would provide an important element of investor protection. We note that this may have the effect of enabling the funding portal to control what investment opportunities are available to investors and what capital raising opportunities are available to issuers. Under the JOBS Act, the funding portal is essentially acting as an “exchange” and its “listing process” involves background checks.
<p>Other conditions</p> <p><u>Rights if misrepresentation</u></p> <ul style="list-style-type: none"> • This exemption would specify that the information statement contemplated falls within the definition of offering memorandum set out in the Securities Act. • As a result, the statutory rights in the event of misrepresentation in the offering memorandum set out in section 130.1 of the Securities Act would apply. <p><u>Withdrawal right</u></p> <ul style="list-style-type: none"> • The purchaser must be provided with a right of withdrawal that is to be exercised within two-business days of the distribution. 	<p><u>Rights if misrepresentation</u></p> <ul style="list-style-type: none"> • We believe the purchaser’s rights contemplated by section 130.1 of the Securities Act provide an important element of investor protection. <p><u>Withdrawal right</u></p> <ul style="list-style-type: none"> • We believe a right of withdrawal provides another element of investor protection. It allows the purchaser a “cooling off” period to consider the disclosure provided and reflect on the investment decision. • This type of consumer protection is available in other legislation. For example, an individual who purchases a condo in pre-construction is provided with a 10-day rescission period where the individual can withdraw the offer to purchase. • We have suggested a two-business day period in which to exercise the right in order to be consistent with the right of withdrawal period applicable in prospectus offerings.

Key elements of the crowdfunding concept idea	Explanatory notes
<p>Reporting requirement</p> <ul style="list-style-type: none"> A distribution by an issuer or underwriter under this exemption triggers a requirement to file a report of exempt distribution. 	<ul style="list-style-type: none"> Requiring a report of exempt distribution would be consistent with the approach taken for other capital raising exemptions.
<p>Resale restrictions</p> <ul style="list-style-type: none"> Securities distributed under this exemption are subject to a restricted resale period. 	<ul style="list-style-type: none"> This resale treatment is consistent with the resale treatment of securities distributed under other capital raising exemptions. The resale restriction is indefinite where the issuer is not a reporting issuer.

2. OM prospectus exemption

The key elements of this concept idea, along with explanatory commentary, are set out in the table below. This concept idea is being put forward solely for discussion purposes. We are requesting comments on each of the elements of this concept idea.

Key elements of the OM concept idea	Explanatory notes
<p>Type of issuer</p> <ul style="list-style-type: none"> • The issuer of the security, its parent (if applicable) and its principal operating subsidiary (if applicable) must be incorporated or organized under Canadian federal laws or the legislation of a Canadian jurisdiction, and the issuer must have its head office located in Canada. • This exemption is not available for distributions of securities of investment funds. 	<ul style="list-style-type: none"> • We have proposed that the issuer of the security, its parent and principal operating subsidiary must be incorporated or organized under Canadian federal laws or the legislation of a Canadian jurisdiction and have its head office located in Canada because one of our objectives is to facilitate capital raising for SMEs in Canada. However, we note that the accredited investor exemption, the minimum amount exemption and the OM exemption in NI 45-106 are not currently limited to distributions of securities of issuers based in Canada. • We have suggested making this exemption available for distributions of both reporting and non-reporting issuers. That is consistent with the accredited investor exemption available in other Canadian jurisdictions. We recognize that some SMEs are reporting issuers. • The focus of this paper is to consider possible new prospectus exemptions that could facilitate capital raising for business enterprises. As a result, we have currently suggested limiting the use of this exemption to distributions of securities of issuers other than investment funds. We note that an investment fund that is advised by a registered adviser or a person exempt from registration already qualifies (as a form of institutional investor) as an accredited investor to invest in all types of businesses, including SMEs, on an exempt basis.
<p>Type of security</p> <ul style="list-style-type: none"> • The only securities that can be distributed under this exemption are: <ul style="list-style-type: none"> ○ common shares ○ non-convertible preferred shares ○ non-convertible debt securities that are linked only to a fixed or floating interest rate ○ securities convertible into common shares or non-convertible preferred shares 	<ul style="list-style-type: none"> • There are currently no restrictions on the type of security that can be sold under the accredited investor exemption or the OM exemption available in other Canadian jurisdictions. • Only four classes of security can be issued under this exemption. Given that this exemption is intended to facilitate capital raising by SMEs, we do not think it is necessary or appropriate to allow certain complex products, such as derivatives and securitized products, to be distributed under this exemption. • For the reasons discussed above, we have carved out securities of investment funds.

Key elements of the OM concept idea	Explanatory notes
<p>Type of purchaser</p> <ul style="list-style-type: none"> There are no limitations on the purchaser of the security. However, the purchaser is subject to investment limitations, as discussed below. 	<ul style="list-style-type: none"> We considered the approach taken in the JOBS Act and the OM exemption available in other Canadian jurisdictions regarding the type of purchaser. <p><u>US approach</u></p> <ul style="list-style-type: none"> There are no restrictions on the purchaser under the crowdfunding exemption in the JOBS Act. <p><u>BC approach</u></p> <ul style="list-style-type: none"> There are no restrictions on the purchaser under the BC model of the OM exemption. <p><u>Alberta approach</u></p> <ul style="list-style-type: none"> Under the Alberta model of the OM exemption, the purchaser must be an “eligible investor” or the acquisition cost to the purchaser cannot exceed \$10,000. We agree with the concept of an investment limit. However, we question whether the “eligible investor” criteria provides meaningful investor protection. Consistent with these approaches, we are suggesting that any investor can buy securities under this exemption. The purchaser, however, would be subject to investment limits (discussed below).
<p>Type of seller</p> <ul style="list-style-type: none"> This exemption is limited to distributions by an issuer in securities of its own issue. 	<ul style="list-style-type: none"> This approach is substantially consistent with the OM exemption available in other Canadian jurisdictions, which is limited to distributions by issuers of securities of their own issue. Consistent with the OM exemption, we have suggested not allowing selling security holders to use this exemption. This exemption is intended to facilitate capital raising and not necessarily the resale of securities. In addition, we do not believe selling security holders are necessarily as well positioned to provide the disclosure and other investor protection measures discussed below.

Key elements of the OM concept idea	Explanatory notes
<p>Size of investment</p> <ul style="list-style-type: none"> • A purchaser’s investment in securities of a particular issuer cannot exceed \$2,500. • In addition, a purchaser’s investment under this exemption during a calendar year cannot exceed \$10,000. 	<ul style="list-style-type: none"> • We believe investment limits are an important element of investor protection to limit an investor’s exposure. • We recognize that an investment limit presents difficulties with compliance. • Another alternative proposal would be to require the investor to self-certify that he/she is within the investment limits and has not exceeded the annual threshold. <p><u>US approach</u></p> <ul style="list-style-type: none"> • Under the crowdfunding exemption in the JOBS Act, the aggregate amount of securities sold to any investor within the previous 12-month period in reliance on the exemption cannot exceed: <ul style="list-style-type: none"> ○ the greater of US\$2,000 or 5% of the investor’s annual income or net worth if either the annual income or the net worth of the investor is less than US\$100,000, and ○ 10% of the investor’s annual income or net worth, not to exceed a maximum aggregate amount sold of US\$100,000, if either the annual income or net worth of the investor is equal to or more than US\$100,000. • We are concerned that investors may not wish to share their tax returns with issuers or registrants to establish that they are investing within the prescribed limits. As a result, a monetary cap may be easier to administer than an approach that requires calculations of an investor’s net income or net worth. <p><u>BC approach</u></p> <ul style="list-style-type: none"> • There are no limits on the size of the investment under the BC model of the OM exemption. We have concerns that this approach could result in too much of an investor’s assets being at risk. <p><u>Alberta approach</u></p> <ul style="list-style-type: none"> • As noted above, under the Alberta model of the OM exemption, a purchaser can purchase securities under the exemption if he/she is either an eligible investor or the acquisition cost to the purchaser does not exceed \$10,000. • A monetary cap of \$10,000 may be easier to implement than a limit based on a percentage of net income or net worth.

Key elements of the OM concept idea	Explanatory notes
<p>Size of offerings</p> <ul style="list-style-type: none"> An issuer cannot raise more than \$1.5 million in a 12-month period under this exemption. 	<p><u>BC and Alberta approach</u></p> <ul style="list-style-type: none"> The OM exemption in other Canadian jurisdictions does not impose a limit on the amount of capital that can be raised under the exemption by an issuer. <p><u>US approach</u></p> <ul style="list-style-type: none"> Under the crowdfunding exemption in the JOBS Act, an issuer can raise up to \$1 million in a 12-month period. Some commenters have expressed concern that the threshold is too low for the exemption to be a useful capital raising tool. Some commenters have suggested that a limit of \$5 to \$10 million may be more appropriate. We acknowledge that not all SMEs' capital requirements are the same. Issuers in different industry sectors may require different capital needs at different stages of growth. In looking at alternatives, we considered the following: <ul style="list-style-type: none"> The prospectuses of 298 SMEs that raised capital between 2002 and 2006 were examined. The median offering size was \$6 million and nearly two-thirds of the offerings were for less than \$10 million. The OSC's former closely-held issuer exemption provided that an issuer could only raise \$3 million under that exemption in total (not just in a 12-month period). We have suggested a limit of \$1.5 million in a 12-month period.
<p>Disclosure provided to purchaser at the time of distribution</p> <ul style="list-style-type: none"> A purchaser must be provided with an information statement at the time of the distribution. The information statement must include "financing facts", "issuer facts" and "registrant facts". <p><u>"Financing facts"</u></p> <ul style="list-style-type: none"> "Financing facts" (i.e. basic information about the offering) include: <ul style="list-style-type: none"> the type/nature of the securities being offered the price of the securities the rights attached to the securities (including the impact on those rights if the issuer's operations and/or assets 	<p><u>General comments on disclosure</u></p> <ul style="list-style-type: none"> We believe that purchasers and the registrants advising them require a minimum level of disclosure on which to base an investment decision or recommendation. Both the BC and Alberta models of the OM exemption require disclosure that is similar to the type of disclosure found in a long-form prospectus. We have heard two concerns with this approach: <ul style="list-style-type: none"> Stakeholders have advised us that an offering memorandum prepared in accordance with the form requirements in NI 45-106 contains an overwhelming amount of information that is neither useful nor read by investors. We have been advised that the OM exemption is not particularly useful to SMEs. The speculated reason is the cost associated with preparing an offering memorandum (and the cost of obtaining an audit of the financial statements).

Key elements of the OM concept idea	Explanatory notes
<p>are located outside of Canada)</p> <ul style="list-style-type: none"> ○ whether there is a minimum and maximum subscription, and if so, the deadline to reach the minimum subscription ○ the use of the proceeds from the offering (including whether any directors, officers, promoters or related parties of the issuer will receive any of the proceeds) ○ resale restrictions ○ statutory rights in the event of a misrepresentation and a right of withdrawal (please see discussion below) <p><u>“Issuer facts”</u></p> <ul style="list-style-type: none"> ● “Issuer facts” (i.e. basic information about the issuer) include: <ul style="list-style-type: none"> ○ a description of the issuer’s business or proposed business, and its anticipated business plan ○ one year of annual financial statements, if any ○ a description of the directors, officers and control persons of the issuer ○ limited executive compensation disclosure ○ principal risks of the issuer’s business <p><u>“Registrant facts”</u></p> <ul style="list-style-type: none"> ● “Registrant facts” (i.e. basic information about any registrant including the name of that registrant and the relationship between that registrant and the issuer, if any). <p><u>Certification</u></p> <ul style="list-style-type: none"> ● We believe that the issuer should take responsibility for the disclosure provided. Management of the issuer should certify the disclosure. <p><u>Marketing</u></p> <ul style="list-style-type: none"> ● No other marketing materials may be provided. ● In addition, no advertising by an issuer would be permitted except through the issuer’s website. 	<ul style="list-style-type: none"> ● In light of these concerns, we have suggested more streamlined disclosure in the information statement. The key items of disclosure are substantially derived from: <ul style="list-style-type: none"> ○ the requirements for the summary of a long-form prospectus, and ○ the disclosure requirements set out in the crowdfunding exemption in the JOBS Act (which remain subject to SEC rulemaking). <p><u>Financial statement disclosure</u></p> <ul style="list-style-type: none"> ● This concept idea requires one year of audited annual financial statements of the issuer if the issuer has been in business. ● The crowdfunding exemption in the JOBS Act has adopted a scaled approach to financial disclosure. Under the crowdfunding exemption, if the aggregate offering proceeds within a 12-month period are: <ul style="list-style-type: none"> ○ \$100,000 or less: the issuer must file income tax statements for the most recently completed year and have its financial statements certified by the principal executive officer to be true and complete in all material respects ○ more than \$100,000 but not more than \$500,000: the issuer must file financial statements reviewed by an independent public accountant, using professional standards and procedures for such review or standards and procedures established by the SEC ○ more than \$500,000: the issuer must file audited financial statements ● We are suggesting a similarly scaled approach: <ul style="list-style-type: none"> ○ If the proceeds of the offering are proposed to be at least \$500,000 or if the issuer is a reporting issuer, then audited annual financial statements must be included in the information statement. ○ If the proceeds of the offering are proposed to be less than \$500,000 and if the issuer is not a reporting issuer, then only management-certified financial statements need to be included. ● We recognize that the cost of an audit could be an impediment for start-ups and SMEs using this exemption. <p><u>Risk factor disclosure</u></p> <ul style="list-style-type: none"> ● The summary of a long-form prospectus requires disclosure of risk factors. Similarly, the crowdfunding

Key elements of the OM concept idea	Explanatory notes
	<p>exemption in the JOBS Act contemplates some level of risk factor disclosure. We are similarly suggesting that the information statement include a discussion of the <i>principal</i> risks facing the issuer’s business.</p> <ul style="list-style-type: none"> We have heard from stakeholders that risk factor disclosure is often not helpful as the issuer and its advisors include a lengthy list of risk factors, some of which are boilerplate. Some stakeholders have argued that having those risk factors protects the issuer from liability. We have suggested that all purchasers sign a risk acknowledgement form. Please see the discussion below. <p><u>Marketing</u></p> <ul style="list-style-type: none"> General solicitation and advertising would be prohibited other than through the issuer’s website.
<p>Ongoing information available to investors <u>Ongoing continuous disclosure</u></p> <ul style="list-style-type: none"> The issuer must provide its security holders with annual financial statements within 120 days from its fiscal year end. <p><u>Books and records</u></p> <ul style="list-style-type: none"> The issuer must maintain books and records that are available for inspection by purchasers and OSC staff. The books and records must contain, at a minimum: <ul style="list-style-type: none"> the securities issued by the issuer as well as the distribution price and date the names of all security holders and the size of their holdings the use of funds raised under this exemption 	<p><u>Ongoing continuous disclosure</u></p> <ul style="list-style-type: none"> As noted above, this exemption contemplates issuers providing one year of annual financial statements to potential investors. We believe that issuers who raise money under this exemption should provide <i>ongoing</i> financial statement disclosure to investors. For start-up issuers, in particular, the financial statements provided at the time of an offering may be of little value to investors if the issuer is in an early stage of development with little in the way of assets or earnings. In addition, requiring annual financial statements may reduce the risk of fraud. Under the terms of the crowdfunding exemption in the JOBS Act, issuers will be required to file with the SEC and provide to investors on an annual basis reports of the issuer’s results of operations and financial statements, with the details to be determined by SEC rulemaking. We note that it would be a novel approach in Ontario to require an issuer to provide ongoing continuous disclosure in the exempt market. <p><u>Books and records</u></p> <ul style="list-style-type: none"> We also believe requiring the issuer to maintain books and records provides another measure of investor protection. This would enable security holders to assess whether the issuer has used the proceeds from the

Key elements of the OM concept idea	Explanatory notes
	<p>offering in the manner indicated in the information statement.</p>
<p>Risk acknowledgement from purchaser</p> <ul style="list-style-type: none"> • A purchaser must sign a stand-alone risk acknowledgement form in which the purchaser confirms that he/she: <ul style="list-style-type: none"> ○ falls within the investment limitations ○ understands the risk of loss of the entire investment ○ can bear the loss of the entire investment ○ understands the illiquid nature of the investment 	<ul style="list-style-type: none"> • We believe that requiring the purchaser to sign a risk acknowledgement form provides another element of investor protection. It puts the investor on notice that he/she may lose all of his/her investment. • The OM exemption in other Canadian jurisdictions and the family, friends and business associates exemption in Saskatchewan require a risk acknowledgement form. Similarly, the crowdfunding exemption in the JOBS Act contemplates a form of risk acknowledgement.
<p>Registrant involvement</p> <ul style="list-style-type: none"> • Registrant involvement in the distribution would not be required as a condition to the prospectus exemption. • To the extent an issuer or intermediary may be considered to be "in the business" of trading securities or advising with respect to securities, ordinary registration requirements will continue to apply. 	<ul style="list-style-type: none"> • The OM exemption in the other Canadian jurisdictions does not require registrant involvement. • We believe registrant involvement can provide an important element of investor protection as the registrant is subject to KYC, KYP and suitability assessment obligations. This may be particularly important given that the purchasers may not be sophisticated investors. • However, we note that involvement of a registrant could prevent many issuers from accessing the exempt market through this exemption because registrants may not be prepared to participate in smaller distributions. Registrant involvement would also increase the costs of the distribution for issuers.
<p>Other conditions</p> <p><u>Rights if misrepresentation</u></p> <ul style="list-style-type: none"> • This exemption would specify that the information statement contemplated falls within the definition of offering memorandum set out in the Securities Act. • As a result, the statutory rights in the event of misrepresentation in the offering memorandum set out in section 130.1 of the Securities Act would apply. <p><u>Withdrawal right</u></p> <ul style="list-style-type: none"> • The purchaser must be provided with a right of withdrawal that is to be exercised within two-business days of the distribution. 	<p><u>Rights if misrepresentation</u></p> <ul style="list-style-type: none"> • We believe the purchaser's rights contemplated by section 130.1 of the Securities Act provide an important element of investor protection. <p><u>Withdrawal right</u></p> <ul style="list-style-type: none"> • We believe a right of withdrawal provides another element of investor protection. It allows the purchaser a "cooling off" period to consider the disclosure provided and reflect on the investment decision. • This type of consumer protection is available in other legislation. For example, an individual who purchases a condo in pre-construction is provided with a 10-day rescission period where the individual can withdraw the offer to purchase. • We have suggested a two-business day period in which to exercise the right in order to be consistent with the

Key elements of the OM concept idea	Explanatory notes
	right of withdrawal period applicable in prospectus offerings.
<p>Reporting requirement</p> <ul style="list-style-type: none"> A distribution by an issuer or underwriter under this exemption triggers a requirement to file a report of exempt distribution. 	<ul style="list-style-type: none"> Requiring a report of exempt distribution would be consistent with the approach taken for other capital raising exemptions.
<p>Resale restrictions</p> <ul style="list-style-type: none"> Securities distributed under this exemption are subject to a restricted resale period. 	<ul style="list-style-type: none"> This resale treatment is consistent with the resale treatment of securities distributed under other capital raising exemptions. The resale restriction is indefinite where the issuer is not a reporting issuer.

APPENDIX B – CONCEPT IDEA FOR A PROSPECTUS EXEMPTION BASED ON AN INVESTOR’S INVESTMENT KNOWLEDGE

The key elements of this concept idea, along with explanatory commentary, are set out in the table below. This concept idea is being put forward solely for discussion purposes. We are requesting comments on each of the elements of this concept idea.

Key elements of the investment knowledge concept idea	Explanatory notes
<p>Type of issuer</p> <ul style="list-style-type: none"> This exemption is available for distributions of securities of any issuer. 	<ul style="list-style-type: none"> We have suggested making this exemption available for distributions of securities of both reporting and non-reporting issuers. That is consistent with the accredited investor exemption.
<p>Type of security</p> <ul style="list-style-type: none"> There are no restrictions on the type of security that can be distributed under this exemption. 	<ul style="list-style-type: none"> There are no restrictions on the type of security that can be distributed under the accredited investor exemption. We suggest being consistent with that approach.
<p>Type of purchaser</p> <ul style="list-style-type: none"> The purchaser must meet a work experience condition <i>and</i> an educational qualification condition. <p><u>Work experience condition</u></p> <ul style="list-style-type: none"> The purchaser must have worked in the investment industry for at least one year in a position that requires knowledge of securities investments. <p><u>Educational qualification condition</u></p> <ul style="list-style-type: none"> One of the following must apply to the purchaser: <ul style="list-style-type: none"> the individual has earned a CFA Charter the individual has received the CIM designation the individual has received a MBA from an accredited university 	<ul style="list-style-type: none"> As the premise behind this exemption is that the purchaser is a sophisticated investor, we have identified relevant work experience and relevant educational qualifications that we believe could operate as proxies for investment sophistication. We note that registrants and former registrants (other than limited market dealers) qualify as accredited investors. This exemption is intended to extend the class of sophisticated investors beyond registrants. <p><u>Work experience condition</u></p> <ul style="list-style-type: none"> We suggest that the purchaser must have at least one year of relevant work experience. In the UK, there is an exemption for distributions to “qualified investors”. The investor must meet two of three criteria, one of which is that the investor is working, or has worked for at least one year, in the financial sector in a professional position which requires knowledge of securities transactions. We were concerned that this threshold for relevant work experience was too low as anyone currently working in the financial sector, regardless of how long, would meet this criteria. We also questioned whether one year of work experience is sufficient. We reviewed work experience requirements for other relevant Canadian designations. For example, to become a regular CFA member, an individual must have completed four years of qualifying work experience (in

Key elements of the investment knowledge concept idea	Explanatory notes
	<p>addition to completing the requisite examinations). The concept of “relevant work experience” also appears in NI 31-103. For example, portfolio managers must have gained 12, 24 or 48 months of relevant investment management experience (depending on their educational qualifications and type of registration).</p> <ul style="list-style-type: none"> • There are challenges with this condition as it is principles-based and refers to terms such as “investment industry”, “professional position” and “knowledge of securities investments” which are not readily defined. An issuer and/or a registrant would be responsible for determining whether a purchaser satisfies this work experience requirement, which may raise compliance concerns. <p><u>Educational qualification condition</u></p> <ul style="list-style-type: none"> • In assessing which educational qualifications would be appropriate, we considered the educational qualifications which would be needed to become registered as a dealing representative of an exempt market dealer (set out in section 3.9 of NI 31-103). In that circumstance, an individual must have obtained or completed one of the following: <ul style="list-style-type: none"> ○ Canadian Securities Course Exam ○ Exempt Market Products Exam ○ CFA Charter ○ CIM designation • While we are comfortable with a CFA Charter and the CIM designation as proxies for investment sophistication, we do not believe passing the Canadian Securities Course Exam or the Exempt Market Products Exam is sufficient. • In our view, an MBA is also an adequate proxy for investment sophistication given that that degree would provide an individual with the basic tools for assessing investments. • We also considered whether lawyers and/or Chartered Accountants should meet the educational qualification condition, but did not consider these educational backgrounds to necessarily be sufficiently relevant for investing.

Key elements of the investment knowledge concept idea	Explanatory notes
<p>Type of seller</p> <ul style="list-style-type: none"> Any seller may distribute securities under this exemption. This includes the issuer of the security, an underwriter or a selling security holder. 	<ul style="list-style-type: none"> This approach is consistent with the accredited investor exemption, which is available to any seller.
<p>Size of investment</p> <ul style="list-style-type: none"> There is no limit on the size of a purchaser's investment under this exemption. 	<ul style="list-style-type: none"> This approach is consistent with the accredited investor exemption, which similarly does not impose any limits on the size of the investment.
<p>Size of offerings</p> <ul style="list-style-type: none"> There is no limit on the size of an offering under this exemption. 	<ul style="list-style-type: none"> This approach is consistent with the accredited investor exemption, which similarly does not impose any limitations on the size of the offering.
<p>Registrant involvement</p> <ul style="list-style-type: none"> There is no requirement for a registrant to be involved in the distribution. Although registrant involvement is not required, to the extent an issuer or intermediary may be considered to be "in the business" of trading securities or advising with respect to securities, ordinary registration requirements will continue to apply. 	<ul style="list-style-type: none"> We acknowledge that registrant involvement provides an element of investor protection as the registrant is subject to KYC, KYP and suitability assessment obligations. However, the rationale for this exemption is that the purchaser is a sophisticated investor who is familiar with investments. As a result, involvement of a registrant is not necessary.
<p>Disclosure provided to purchaser</p> <p><u>Term sheet</u></p> <ul style="list-style-type: none"> A purchaser must be provided with a term sheet setting out basic information about the offering. This includes: <ul style="list-style-type: none"> For a non-investment fund: <ul style="list-style-type: none"> the type/nature of the securities being offered the price of the securities the rights attached to the securities (including the impact on those rights if the issuer's operations and/or assets are located outside of Canada) whether there is a minimum and maximum subscription, and if so, the deadline to reach the minimum subscription the use of the proceeds from the offering (including whether any directors, officers, promoters or related parties of the issuer will receive any of the proceeds) 	<p><u>Term sheet</u></p> <ul style="list-style-type: none"> We believe that purchasers require basic information about what they are buying in the exempt market in order to make an informed investment decision. The term sheet is intended to provide basic information about the security being sold, the offering price and the purchasers' rights. <p><u>Marketing materials</u></p> <ul style="list-style-type: none"> In our compliance reviews, we have seen misleading marketing materials that misstate the risks and safety of investments. To address this concern, we suggest requiring that all marketing materials be consistent with the term sheet and explicitly refer a purchaser to the term sheet and the risk acknowledgement form (discussed below).

Key elements of the investment knowledge concept idea	Explanatory notes
<ul style="list-style-type: none"> ○ resale restrictions <p>For an investment fund, information similar to that appearing in the Fund Facts for public mutual funds, including:</p> <ul style="list-style-type: none"> ○ the investment objective of the fund, ○ the manager, portfolio advisor, trustee, custodian and other key service providers to the fund, and ○ the fees and expenses associated with operating the fund and with distributing securities of the fund. <p><u>Marketing materials</u></p> <ul style="list-style-type: none"> ● Any marketing materials provided to a purchaser in addition to the term sheet must: <ul style="list-style-type: none"> ○ be consistent with the term sheet ○ explicitly refer a purchaser to the term sheet and the risk acknowledgement form (discussed below) 	
<p>Risk acknowledgement from purchaser</p> <ul style="list-style-type: none"> ● A purchaser must sign a stand-alone risk acknowledgement form in which the purchaser confirms that he/she: <ul style="list-style-type: none"> ○ meets the eligibility criteria (and explains how this criteria is met) ○ understands the risk of loss of the entire investment ○ can bear the loss of the entire investment ○ understands the potentially illiquid nature of the investment (in the case of a security of a non-reporting issuer) 	<ul style="list-style-type: none"> ● We believe that requiring the purchaser to sign a risk acknowledgement form provides another element of investor protection. It puts the purchaser on notice that he/she may lose all of his/her investment. ● The OM exemption in other Canadian jurisdictions and the family, friends and business associates exemption in Saskatchewan require a risk acknowledgement form. Similarly, the crowdfunding exemption under the JOBS Act contemplates a form of risk acknowledgement. We note, however, that the accredited investor exemption currently does not require such a form.

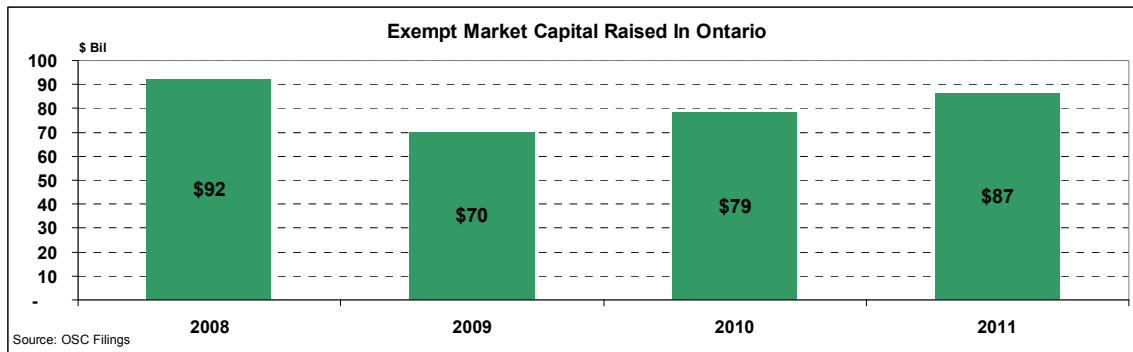
Key elements of the investment knowledge concept idea	Explanatory notes
<p>Rights if misrepresentation</p> <ul style="list-style-type: none"> The term sheet would not likely constitute an offering memorandum under the Securities Act because it does not describe the business and affairs of the issuer. As a result, the purchasers' rights set out in section 130.1 of the Securities Act would not be available. 	<ul style="list-style-type: none"> We could consider whether contractual rights of action should apply in the case of a misrepresentation in the term sheet. That would represent a departure from our current approach to term sheets provided to purchasers. We note that the term sheet would be subject to the prohibition on misleading or untrue statements in section 126.2 of the Securities Act. In addition, if an issuer or other seller voluntarily provides an offering memorandum to a purchaser, the rights set out in section 130.1 of the Securities Act would apply.
<p>Reporting requirement</p> <ul style="list-style-type: none"> A distribution by an issuer or underwriter under this exemption triggers a requirement to file a report of exempt distribution. 	<ul style="list-style-type: none"> Requiring a report of exempt distribution would be consistent with the approach taken for the accredited investor exemption.
<p>Resale restrictions</p> <ul style="list-style-type: none"> Securities distributed under this exemption are subject to a restricted resale period. 	<ul style="list-style-type: none"> This resale treatment is consistent with the resale treatment of securities distributed under the accredited investor exemption. The resale restriction is indefinite where the issuer is not a reporting issuer.

APPENDIX C – EXEMPT MARKET ACTIVITY IN ONTARIO

The following exempt market statistics are based on reports of exempt distribution filed with the OSC. Only specified prospectus exemptions trigger a requirement to file a report. As a result, these statistics do not capture all exempt market activity.

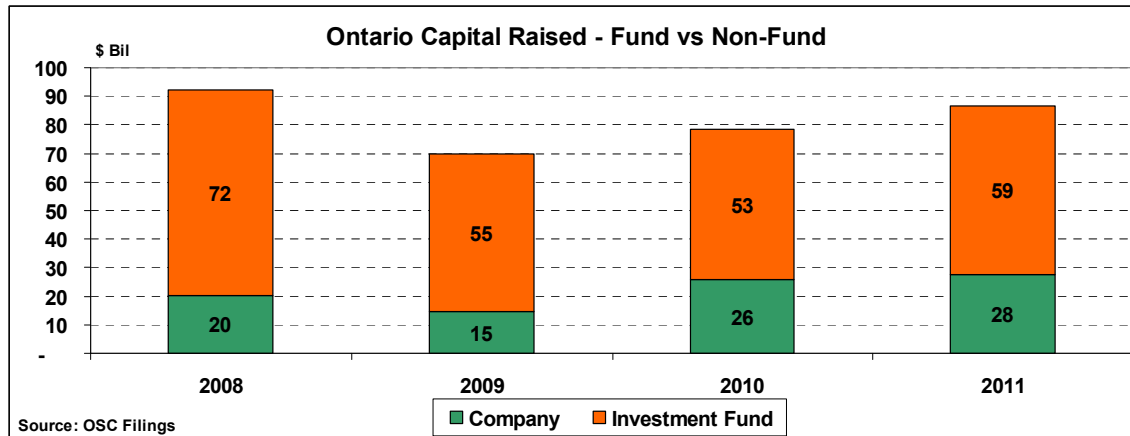
(1) Size of exempt market

Approximately \$86.5 billion was raised through the exempt market in Ontario in 2011.



(2) Exempt market activity by investment funds vs. non-investment funds

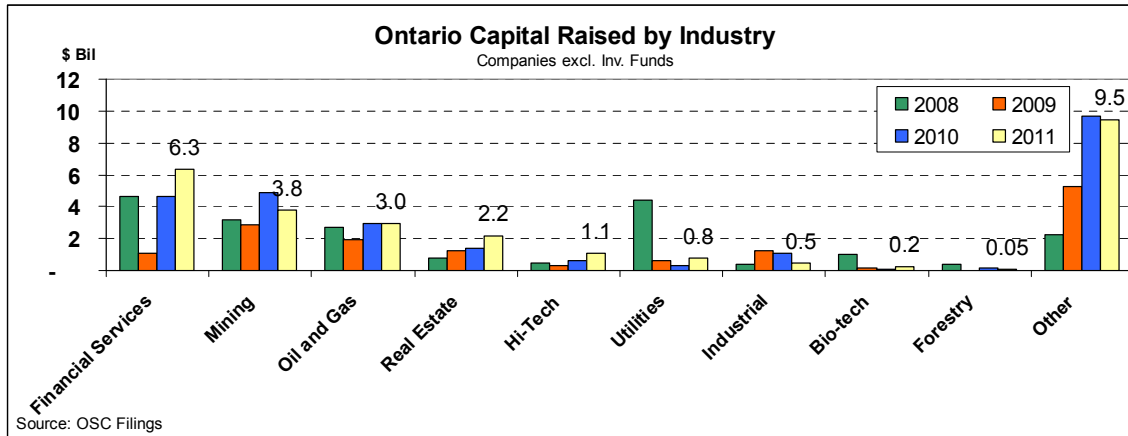
Investment funds¹⁷ accounted for approximately 68% of the capital raised in Ontario in 2011.



¹⁷ We note that the data for distributions of investment fund securities reflects distributions to both individual and institutional investors of both public and private investment fund securities. We also note that this data reflects purchases and not redemptions of investment fund securities.

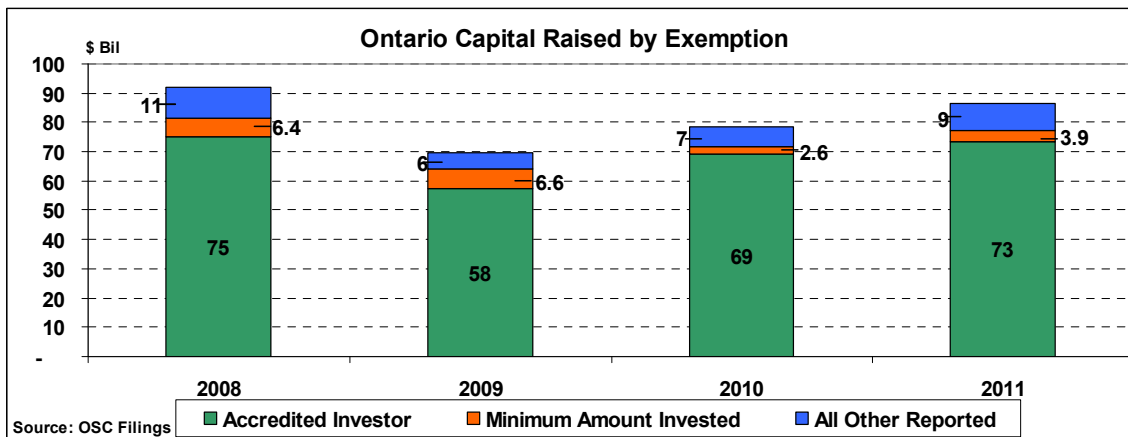
(3) Industries represented in the exempt market

Approximately 23% of the capital raised by non-investment funds was raised by issuers in the financial services industry. The mining and technology sectors represented approximately 14% and 5%, respectively, of this segment of the exempt market.



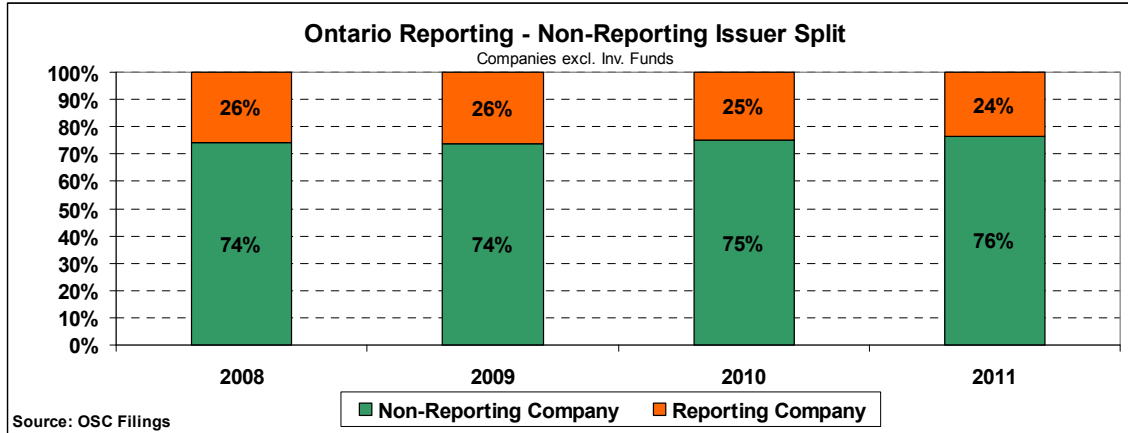
(4) Use of accredited investor and minimum amount exemptions

In 2011, approximately \$72.8 billion was raised under the accredited investor prospectus exemption in Ontario. In 2011, approximately \$3.9 billion was raised under the minimum amount prospectus exemption in Ontario.



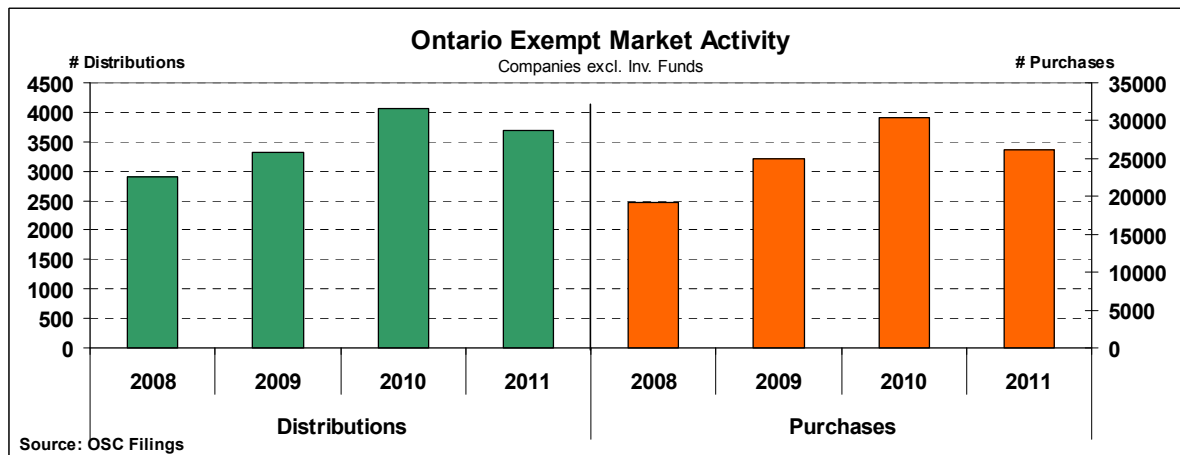
(5) Exempt market activity by reporting vs. non-reporting issuers

Approximately 76% of the capital raised in Ontario in 2011 by non-investment funds was raised by non-reporting issuers (such as private companies).



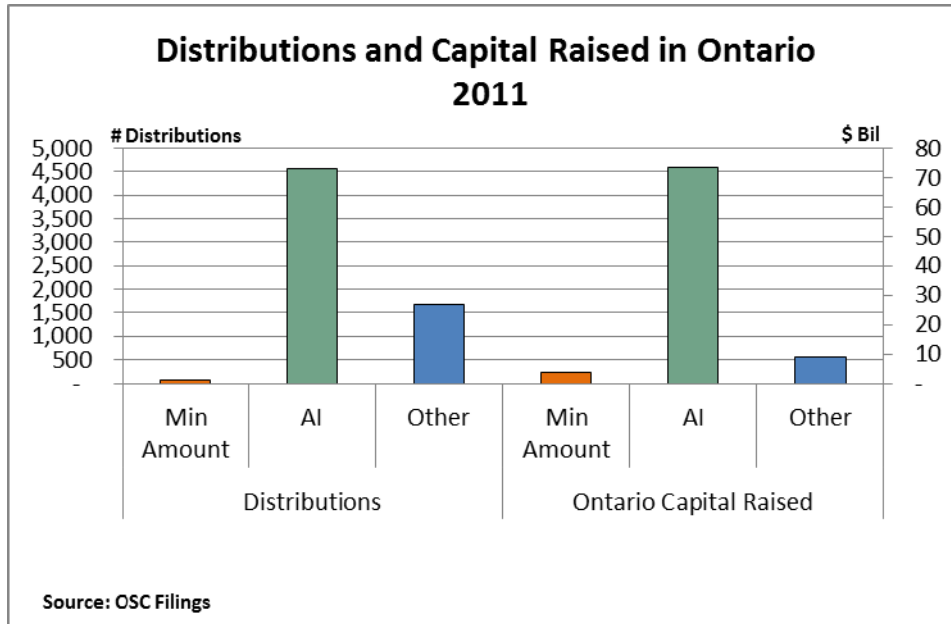
(6) Number of distributions and purchases

3,701 non-investment fund distributions were reported to the Commission in 2011 involving 26,156 purchases from Ontario investors.



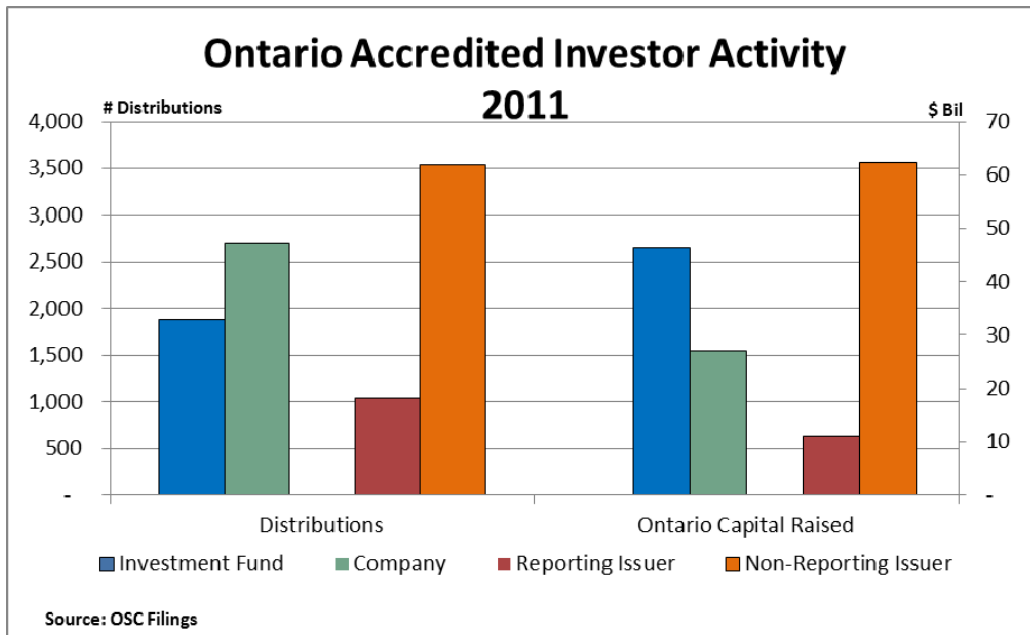
(7) Use of different prospectus exemptions

The accredited investor exemption is the most used capital raising exemption. The accredited investor exemption accounts for over 50% of purchases, over 70% of distributions, and over 80% of funds raised.



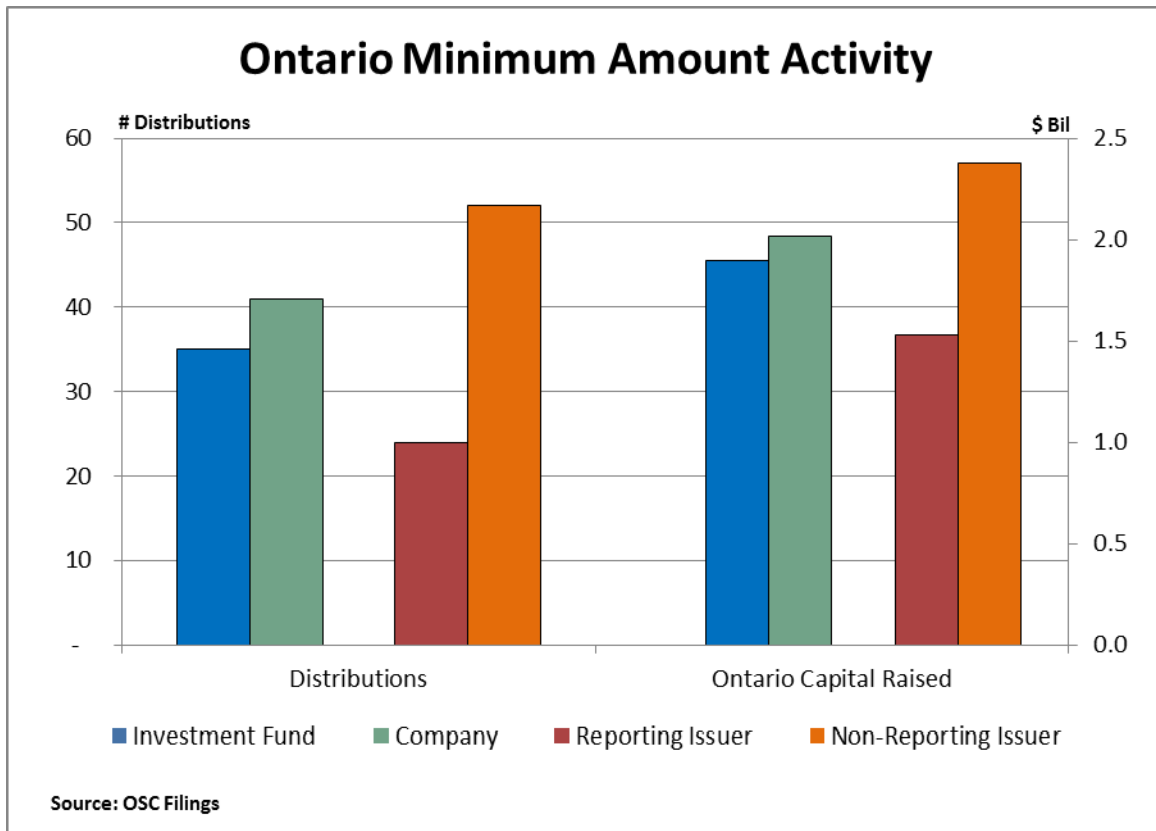
(8) Use of accredited investor exemption in 2011

Approximately 85% of the total amount raised under this exemption was raised by non-reporting issuers.



(9) Use of minimum amount exemption in 2011

Approximately 62% of the total amount raised under this exemption was raised by non-reporting issuers.



APPENDIX D – INCOME DATA

