

Via email

June 18, 2014

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**INTRODUCTION OF PROPOSED PROSPECTUS EXEMPTIONS AND
PROPOSED REPORTS OF EXEMPT DISTRIBUTION IN ONTARIO**

Supplement to the OSC Bulletin

**Investment Advisory Panel Commentary on proposed Equity Crowdfunding
Exemption**

We are pleased to provide Comments on the OSC Consultation on proposed exemptions related to equity crowdfunding. The Investment Advisory Panel (IAP) believes the Equity Crowdfunding exemption issue is critical for the retail investor. As proposed, for the first time, non-accredited investors will be allowed to purchase exempt securities without regard to the investor protection provided under the suitability requirement.

We understand that the OSC is proposing this exemption in order to facilitate capital raising for start ups and SMEs. The OSC seems to be reacting to fast moving developments in this market. We laud the OSC for the rapidity with which it is moving to consider this issue. The IAP is concerned that given the newness of this market, rules are being implemented without the usual and necessary research and careful analysis that is a fundamental prerequisite to effective rule making. It is not clear at this stage that equity crowdfunding will be a successful or appropriate capital raising tool for start ups and SMEs. Therefore, we urge the OSC to include an appropriate sunset clause for these rules. A sunset clause will ensure that this rapid response is reviewed both from a capital raising and an investor protection perspective while allowing time to conduct the necessary research and careful analysis. The OSC needs time to ensure, on an ongoing basis, that there is an appropriate balance between facilitating capital raising and investor protection.

The IAP shares the concern of the Chair of the OSC about ensuring the proper balance between access to capital and investor protection. In his recent comments on this subject, Mr. Wetston noted:

“We therefore need to create a regulatory framework for the exempt market that balances the interests of those investors that are willing, and able, to make high risk investments with the risks to those for whom such investments would be inappropriate. Obviously this is a difficult balance to achieve, but one that is essential to ensure that the needs of both companies and investors are met. The bottom line is we have to get it right. We cannot afford changes that backfire and lead to unsuspecting people suffering major losses. People who didn’t understand the risks, and were never advised of them.”

Given the potential pitfalls for retail investors that are inherent with an equity crowdfunding exemption, it is imperative that the OSC be able to monitor crowdfunding activity closely. Monitoring must include effective compliance and enforcement of OSC rules.

By their very nature, these crowdfunding investments are particularly risky. Retail investors will lose all of their money in a large share of these proposed crowdfunded investments.

Crowdfunding is predominantly the option of last resort for early stage companies. Investing in early stage companies requires business acumen, investment sophistication and substantive disclosure. Most retail investors do not have the skills, experience or time to effect adequate due diligence. Most retail investors will not understand key start up investing principles, e.g., implied valuation, liquidation preferences, minority protections, information rights, tagalong provisions, first refusal rights, anti-liquidation, reverse vesting, etc. which are all relevant to equity crowdfunding investing in start-ups and SMEs.

Some investor advocates fear that equity crowdfunding will focus on the least desirable and riskiest investments that cannot attract mainstream investor support. The effect of this will be to pass the riskiest investments to those who can least understand or afford the risk and those who may not have the ability to absorb the financial loss.

Because retail investors, as a group, are not knowledgeable about equity investing in early stage companies, the OSC must develop effective methods of warning investors about the risks associated with these investments prior to the implementation of a crowdfunding exemption. The proposed warnings are insufficient. Investors frequently do not read materials presented to them when they are in the process of making an investment. All potential investors need to read and understand the warnings as the first step in considering a specific equity crowdfunding investment. Warnings must be in clear, unambiguous language and must be forcefully brought to the attention of the potential investor. Font size and colour of the warnings also matter. The warning must be in keeping with the reading and numerical financial literacy levels as established by

the Investor Education Fund's empirical studies.

In addition to effective warnings, the OSC should provide self-assessment tools to help retail investors determine whether or not a crowdfunding investment is something they are comfortable with, knowing that there is a significant risk of loss of their capital.

Under the OSC proposal, there is:

- no test to ensure that the investor understands the risk acknowledgement;
- no suitability requirements or advisors acting on behalf of the investor.

As Mr. Wetston has stated:

"We all know there are weaknesses in financial knowledge among many investors in Canada. At the same time, the OSC's compliance exams have shown that procedures to address KYC and suitability of investments must be strengthened at some dealers...".

Given the new participants and retail investors involved in equity crowdfunding, it is reasonable for the OSC to develop monitoring and compliance verification tools to help it identify and promptly respond to issues as they develop.

The present OSC proposal does not require portals to belong to an SRO. That means that the OSC will remain responsible for ensuring that the portals comply with the rules. This will require the OSC to allocate sufficient staff to perform these duties. Mr. Wetston has acknowledged this need:

"... OSC plans to deliver sound supervision of the new private market mechanisms and the use of the new exemptions....We don't want anyone to ask later "Where were the regulators?""

Equity crowdfunding is rooted in the internet. The internet has been a boon to fraudsters. Using crowdfunding for fraudulent and other criminal activities, including money laundering, has already occurred and is likely to grow. The OSC will need to act expeditiously to minimize this specific risk to retail investors. Effective real-time warnings will be necessary as new scams are identified. This role is crucial and complex as investors are not limited to Canadian offerings of crowdfunding opportunities.

The OSC needs to ensure that portals are given sufficient powers to effectively fulfill their obligations under the rules.

The OSC must require portals to function as communication hubs for investors. This will ensure that investors have access to the "wisdom of the crowd" in a helpful way. This will also help identify fraudulent or criminal activity so that it can be acted upon by both

the portal and the OSC.

The OSC needs to find a way to ensure that the information portals collect is shared for compliance purposes.

Portals should be required to belong to OBSI. As investors start to lose money on these investments, there will undoubtedly be complaints, such as misleading representations, that should be dealt with by an independent third party. The courts are poorly structured to deal with equity crowdfunding disputes; OBSI is the best option for the retail investor.

The OSC should review the limits set for retail investors. They seem high relative to Canadians' average annual income. They are also high compared to many other jurisdictions.

Issuers should be required to provide investors or prospective investors with audited or reviewed financial statements. This will help protect investors from unscrupulous issuers.

The IAP is very concerned about the effects of this exemption on retail investors. We intend to regularly follow up with OSC staff to ensure that investors are well protected in this very risky environment.

Investor Advisory Panel

Connie Craddock
Chairperson