

**OSC EXEMPT MARKET REVIEW
OSC NOTICE 45-712
PROGRESS REPORT ON REVIEW OF PROSPECTUS EXEMPTIONS TO FACILITATE CAPITAL RAISING**

August 28, 2013

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EXECUTIVE SUMMARY

Background and purpose of notice

As a securities regulator, the Ontario Securities Commission has a responsibility to examine whether Ontario securities law contributes to the efficient functioning of capital markets, which in turn is necessary for Ontario's economic growth. The exempt market, in which securities are issued and acquired on a prospectus exempt basis, is an integral part of Ontario's capital markets. There is a widespread perception that the current exempt market regime in Ontario has not kept pace with global market developments, including changes in investor demographics and the use of the internet and social media. Issuers, dealers and their respective advisers have also told us that the exempt market regime could be enhanced to allow start-ups and small and medium-sized enterprises to raise capital more effectively and at a lower cost. While many investors have told us they would be interested in having greater access to investment opportunities in the exempt market, they cautioned that these opportunities should be accompanied by appropriate investor protections.

Staff therefore initiated a broad review of the exempt market to consider whether the Commission should propose any new prospectus exemptions that would facilitate capital raising for business enterprises, particularly start-ups and small and medium-sized enterprises, while protecting the interests of investors.

This notice provides an update on the progress of the review and also sets out the Commission's direction to staff on appropriate further work.

Work completed to date

Significant work has been completed in connection with the review, including:

- publication of a consultation paper that identified four concept ideas for new capital raising prospectus exemptions,
- extensive consultation with stakeholders, including commissioning an internet survey to gauge the interest of retail investors in investing in small and medium-sized enterprises through crowdfunding, and
- an update of our data on exempt market activity as well as collection of data on the capital raising environment for small and medium-sized enterprises.

In addition, other work related to the review has also been completed, including:

- the publication of a proposal to mandate electronic filing of reports of exempt distribution, and
- the granting of exemptive relief from certain dealer registration requirements for a not-for-profit online platform.

This work is discussed in Part 2 of this notice.

Key themes identified from the review

Through the review, and in particular through stakeholder consultations, we identified a number of key themes that fell into the following broad categories:

- the need to facilitate capital raising by small and medium-sized enterprises through expanded prospectus exemptions while maintaining investor protection,

- the importance of harmonizing prospectus exemptions across Canada,
- the emergence of crowdfunding as a new way for some start-ups and small and medium-sized enterprises to raise capital, and
- the importance of regulatory monitoring and oversight in the exempt market and the additional resources required to effectively monitor and oversee exempt market activity if new prospectus exemptions are adopted.

These themes are outlined in Part 3 of this notice.

Future work

After considering the feedback from stakeholder consultations, we have directed staff to undertake further work on four new capital raising prospectus exemptions for issuers other than investment funds. Our objective is to address the capital raising needs of small and medium-sized enterprises at different stages in their growth and business cycle, while maintaining an appropriate level of investor protection.

Decision-making principles

To provide direction to staff in this work, we have developed a set of decision-making principles outlined in Part 4 of this notice that reflect the Commission's dual mandate to:

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

These principles recognize the importance of:

- *adaptation and modernization* to address changes that impact the exempt market,
- *a robust exempt market regulatory regime* that:
 - recognizes the importance of the exempt market while recognizing its relationship to the public market,
 - contributes to the competitiveness of Ontario's capital markets, and
 - minimizes the opportunity for regulatory arbitrage,
- *coordination with the Canadian Securities Administrators* to:
 - work toward an appropriately harmonized exempt market regulatory regime, and
 - learn from the experiences of other jurisdictions with prospectus exemptions that are not currently available in Ontario,
- *access to the exempt market for issuers and investors* that facilitates issuer access to capital and investor access to direct investments in the exempt market, while taking into account the need for an appropriate level of investor protection,
- *investor protection and oversight* strategies to address investor protection and compliance issues associated with increased access to the exempt market by investors and market participants, and
- *increased transparency* about exempt market participants and transactions for regulators, investors and other stakeholders.

Capital raising prospectus exemptions we are considering

The following table summarizes the four new prospectus exemptions we have directed staff to further consider.

Type of exemption	High-level commentary
Crowdfunding exemption	<ul style="list-style-type: none"> • In a relatively short time, crowdfunding has become a new method of raising capital for a broad range of purposes using the internet. To date, it has mainly been used by people seeking to raise money for a specific project and does not generally involve the issuance of securities. However, in some jurisdictions, crowdfunding is emerging as a way for businesses, particularly start-ups and small and medium-sized enterprises, to raise capital by issuing securities. • The consultation paper included a concept idea for a crowdfunding prospectus exemption. Building on the concept idea in our consultation paper, staff will continue to work to develop a crowdfunding regulatory framework. We recognize that for crowdfunding to be a viable method of raising capital, the regulatory framework must provide investors with adequate protections, while at the same time not imposing excessive regulatory costs on issuers and funding portals. • We will focus on developing a regulatory framework for funding portals as well as further refining the parameters we outlined in our concept idea.
Family, friends, and business associates exemption	<ul style="list-style-type: none"> • Start-ups and early-stage companies could benefit from greater access to capital from their network of family, friends and business associates than is currently permitted under Ontario securities law. • There are two exemptions in National Instrument 45-106 <i>Prospectus and Registration Exemptions</i> that Ontario start-ups and early-stage companies can use to raise capital from family members without a prospectus: <ul style="list-style-type: none"> ○ the private issuer exemption in section 2.4 allows a non-reporting issuer to distribute its securities to a maximum of 50 people (excluding current and former employees) who have certain specified relationships with the issuer, including specified family members of its executive officers, directors or founders, and ○ the founder, control person and family exemption in section 2.7 allows an issuer to distribute its securities to specified family members of its executive officers, directors or founders. • Section 2.5 of National Instrument 45-106 <i>Prospectus and Registration Exemptions</i> includes a family, friends and business associates exemption that is available outside of Ontario and allows access to more types of family members, as well as close personal friends and close business associates. We have previously expressed concern that this exemption allows securities to be issued to an unlimited number of undefined “close personal friends” and “close business associates”. • We will consider adopting the broader family, friends and business associates exemption, with the goal of substantial harmonization of the exemption across Canada. We will consider if additional conditions could be added to the family, friends and business associates exemption to mitigate our concern regarding the scope of “close personal friends” and “close business associates”.

Type of exemption	High-level commentary
Offering memorandum exemption	<ul style="list-style-type: none"> • As issuers develop and their capital needs increase, they need to access investors who are able to invest larger amounts of money than would generally be available through crowdfunding or other prospectus exemptions relied on by early-stage businesses. An offering memorandum exemption similar to the one currently in National Instrument 45-106 <i>Prospectus and Registration Exemptions</i> could help issuers achieve this objective. Adopting an offering memorandum exemption in Ontario that is substantially harmonized with the existing offering memorandum exemption can also reduce investor and market participant confusion, simplify the capital raising process and reduce capital raising costs. • We intend to develop a proposal for an offering memorandum exemption in Ontario securities law that is substantially harmonized with the existing Alberta model of the offering memorandum exemption in National Instrument 45-106 <i>Prospectus and Registration Exemptions</i>. • In developing an offering memorandum exemption, we intend to consider whether there is a need for additional measures that would facilitate capital raising by issuers while protecting the interests of investors, including: <ul style="list-style-type: none"> ○ whether and how the form of offering memorandum could be streamlined so that it is more cost-effective for small and medium-sized enterprises and more user-friendly for investors, ○ possible limits on the types of securities offered, and ○ appropriate investment limits.
Streamlined rights offering exemption and possible exemption based on a reporting issuer's continuous disclosure and existing security holder base	<ul style="list-style-type: none"> • Small and medium-sized enterprises continue to face capital raising challenges after they have become reporting issuers and are listed on an exchange. • We will work with other Canadian Securities Administrators members to see if the existing rights offering exemption that is available across Canada could be streamlined to improve its efficiency and effectiveness for reporting issuers. • We will consider whether it would be appropriate to develop an exemption that would permit a reporting issuer to issue securities to its existing security holders on a private placement basis without an offering document and in reliance on the issuer's continuous disclosure.

Amend the accredited investor exemption to allow fully managed accounts to purchase investment fund securities

In addition to conducting further work on the four prospectus exemptions set out above, we intend to pursue amending the accredited investor exemption to permit fully managed accounts, where the adviser has a fiduciary relationship with the investor, to purchase any securities on an exempt basis, including investment fund securities. Currently, in Ontario only, investment funds are carved out of the managed account category of the accredited investor exemption. We intend to pursue removing the carve-out, which will harmonize this category of the exemption with other Canadian jurisdictions.

Prospectus exemptions we are not considering at this time

We are not at this time considering the following prospectus exemptions or amendments that we discussed in the consultation paper. We are not doing so because:

- we have received limited or mixed support for these exemptions expressed through the feedback, and
- we do not consider these proposals as important for capital raising as the exemptions we intend to further consider.

The following are the prospectus exemptions we are not considering at this time.

Type of exemption	High-level description
Investor sophistication exemption	<ul style="list-style-type: none">• This exemption was a concept idea in the consultation paper based on an investor satisfying certain work experience and educational criteria.
Registrant advice exemption	<ul style="list-style-type: none">• This exemption was a concept idea in the consultation paper based on an investment dealer providing advice to an investor where the investment dealer has an ongoing relationship with the investor and has contractually agreed that it has a fiduciary duty to act in the best interests of the investor.
Changes to the existing private issuer exemption	<ul style="list-style-type: none">• The private issuer exemption in section 2.4 of National Instrument 45-106 <i>Prospectus and Registration Exemptions</i> allows a non-reporting issuer to distribute its securities to a maximum of 50 people (excluding current and former employees) who have certain specified relationships with the issuer. The consultation paper sought comment on whether the 50 security holder limit was too restrictive and whether it should be increased.
Re-introduction of the closely-held issuer exemption	<ul style="list-style-type: none">• The closely-held issuer exemption was repealed in 2005. It permitted an issuer 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. The consultation paper sought comment on whether this exemption should be re-introduced in Ontario.

A more detailed discussion is found in Part 4 of this notice.

There are a number of issues that must be considered and steps that must occur before any new or amended prospectus exemptions can become part of Ontario securities law. In particular, the *Securities Act* requires that we:

- **publish any proposed new rules or amendments for a comment period of at least 90 days,**
- **consider the comments before making any final rules or amendments, and**
- **obtain Ministerial approval for any rules or amendments that we propose.**

There is no assurance that any new prospectus exemptions or amendments will be adopted in Ontario.

1. INTRODUCTION

1.1 Background and purpose of notice

As a securities regulator, the Ontario Securities Commission (the **Commission** or **we**) has a responsibility to examine whether Ontario securities law contributes to the efficient functioning of capital markets, which in turn is necessary for Ontario's economic growth. The exempt market, in which securities are issued and acquired on a prospectus exempt basis, is an integral part of Ontario's capital markets. There is a widespread perception that the current exempt market regime in Ontario has not kept pace with global market developments, including changes in investor demographics and the use of the internet and social media. Issuers, dealers and their respective advisers have also told us that the exempt market regime could be enhanced to allow start-ups and small and medium-sized enterprises (**SMEs**) to raise capital more effectively and at a lower cost. While many investors have told us they would be interested in having greater access to investment opportunities in the exempt market, they cautioned that these opportunities should be accompanied by appropriate investor protections.

Staff therefore initiated a broad review (the **Review**) of the exempt market to consider whether the Commission should propose any new prospectus exemptions that would facilitate capital raising for business enterprises, particularly start-ups and SMEs, while protecting the interests of investors.

Staff announced the Review and outlined specific steps that they would take during the 2013 fiscal year in OSC Staff Notice 45-707 *OSC Broadening Scope of Review of Prospectus Exemptions*, which was published on June 7, 2012. These steps were to:

- publish a consultation paper in which staff would seek further feedback on and explore whether the Commission should adopt any new prospectus exemptions,
- hold public consultation sessions and actively reach out to investors and other stakeholders to obtain their feedback,
- consider the experience of other jurisdictions that are members of the Canadian Securities Administrators (**CSA**) with prospectus exemptions not currently available in Ontario,
- consider developments in other jurisdictions relevant to capital raising in the exempt market, including the *Jumpstart Our Business Startups Act* (the **JOBS Act**) in the US, and
- establish an ad hoc advisory committee.

This notice provides an update on the progress of the Review and also sets out the Commission's direction to staff on appropriate further work.

1.2 Structure of notice

This notice is structured as follows:

- In Part 2, we discuss the work that has been completed in connection with the Review.
- In Part 3, we set out the key themes that we have identified from the Review.
- In Part 4, we outline future work that we have directed staff to undertake, including considering four new capital raising prospectus exemptions.

2. WORK COMPLETED TO DATE

The work completed to date in connection with the Review includes:

- publication of a consultation paper that identified four concept ideas for new capital raising prospectus exemptions,
- extensive consultation with stakeholders, including commissioning an internet survey to gauge the interest of retail investors in investing in SMEs through crowdfunding, and
- an update of our data on exempt market activity as well as collection of data on the capital raising environment for SMEs.

In addition, other work at the OSC related to the Review has also been completed, including:

- the publication of a proposal to mandate electronic filing of reports of exempt distribution and
- the granting of exemptive relief from certain dealer registration requirements for a not-for-profit online platform.

2.1 Consultation paper on new prospectus exemptions

On December 14, 2012, staff published OSC Staff Consultation Paper 45-710 *Considerations for New Capital Raising Prospectus Exemptions* (the **Consultation Paper**).

The Consultation Paper:

- provided background information on capital raising and investment activity on a prospectus-exempt basis,
- asked questions about possible enhancements to existing prospectus exemptions, specifically those based on existing relationships with the issuer, and
- outlined and sought feedback on four concept ideas for new capital raising prospectus exemptions in Ontario:
 - a crowdfunding exemption that contemplates investments being made through an online funding portal,
 - an offering memorandum (**OM**) exemption,
 - an investor sophistication exemption based on an investor's investment knowledge, and
 - an exemption based on an investor having received advice from a registrant.

The Consultation Paper also asked whether the restriction in the accredited investor exemption in Ontario against managed accounts purchasing securities of investment funds should be removed.

In addition, the Consultation Paper reviewed developments in other jurisdictions relevant to capital raising in the exempt market, including a discussion of crowdfunding under the JOBS Act as well as the Australian and UK securities law regimes on crowdfunding.

We received 102 comment letters on the Consultation Paper from a variety of stakeholders.

The following is a breakdown of the commenters.

Category of commenter	Number of commenters
Angel investors and venture capitalists	9
Crowdfunding organizations	2
Exchanges	2
Funding portals and other crowdfunding services	6
Individuals	18
Industry associations	11
Investor advocates	1
Issuers	11
Legal advisers	10
Registrants	18
Registrant support services	4
Other	10
Total	102

We thank everyone who commented. A detailed summary of the comments is attached as Appendix A to this notice. The comment letters are also available on the Commission's website at www.osc.gov.on.ca.

2.2 Stakeholder outreach

Between January and June 2013, staff conducted extensive public consultations and stakeholder outreach. We also commissioned a survey targeted at retail investors.

A. Targeted consultations

Staff held 46 one-on-one meetings with stakeholders, including:

- Commission and TMX Group Limited (the **TMX**) advisory committees,
- exchanges and other self-regulatory organizations,
- foreign regulators,
- investor advocates,
- industry associations,
- existing crowdfunding portals in other jurisdictions,

- crowdfunding associations, and
- academics.

B. Town halls

General town hall meetings

In January and February 2013, staff held four town hall meetings designed to solicit feedback on the concept ideas set out in the Consultation Paper. These meetings were attended by approximately 165 people in total. Attendees were primarily people who worked in the securities industry or were involved with small business, as well as legal and other advisers.

Staff also participated in a town hall meeting at the MaRS Discovery District (**MaRS**) in February 2013 and one at the Prospectors and Developers Association of Canada's annual conference in March 2013.

Town hall meeting with an investor focus

In June 2013, staff held a town hall meeting that was intended to solicit the investor perspective. The town hall meeting was attended by approximately 100 people. Although most attendees identified themselves as investors, we note that many of them also worked in the securities industry and/or were entrepreneurs or involved with small business.

C. Investor survey

We wanted to gain insight into retail investors' views on investing in start-ups and SMEs. More specifically, we wanted to explore whether retail investors would be interested in investing in start-ups and SMEs through crowdfunding. We therefore commissioned a retail investor survey (the **Investor Survey**). In December 2012, following the conclusion of a competitive process, we selected a third party service provider to conduct the Investor Survey. It was conducted in English and French over the internet in late March and early April 2013. A report on the Investor Survey is attached as Appendix B to this notice.

The following table summarizes the key attributes of the Investor Survey:

Attributes of the Investor Survey	Details
Who was surveyed?	<ul style="list-style-type: none"> Individuals who were neither currently nor formerly registered with a provincial securities commission
How many respondents?	<ul style="list-style-type: none"> 1,501 respondents across the country Broad cross-section of Canadians, nationally representative by age, gender and region
What types of questions were asked?	<p>The Investor Survey was divided into three substantive sections.</p> <ol style="list-style-type: none"> <p>1. Questions to gauge respondents' interest in investing in start-ups and SMEs</p> <p>Respondents were asked about:</p> <ul style="list-style-type: none"> their desire to invest in start-ups and SMEs, factors that would influence their decision to invest, and their interest in investing in start-ups and SMEs through crowdfunding. <p>2. Questions answered by those interested in crowdfunding</p> <p>Respondents who indicated some interest in investing in start-ups and SMEs through crowdfunding were asked additional questions on crowdfunding, including:</p> <ul style="list-style-type: none"> the possible risks of investing through crowdfunding, the type of information they would want to receive before deciding whether or not to invest, and how much they might be willing to invest. <p>3. Questions answered by those not interested in investing in start-ups and SMEs</p> <p>Respondents that were clearly not interested in investing in start-ups and SMEs, either directly or through crowdfunding, were requested to answer questions on:</p> <ul style="list-style-type: none"> why they were not interested, and whether they would like the opportunity to invest in unregulated mutual funds or investment funds.

We discuss the key findings of the Investor Survey and their implications for the Review in Part 3 of this notice.

2.3 Mandatory electronic filing of reports of exempt distribution

The Consultation Paper stated that staff was considering whether the Commission should mandate electronic filing of Form 45-106F1 *Report of Exempt Distribution (Form 45-106F1)*. Voluntary filing has been available since June 2012, when an electronic version of Form 45-106F1 (the **E-form**) was made available on the Commission's website. While some issuers and underwriters have filed E-forms, approximately 95% of reports continue to be filed in paper format.

We received some comments on the possible impact of mandatory electronic filing. In general, the commenters expressed support for such an initiative. The costs associated with filing E-forms were generally viewed as

acceptable and it was recognized that electronic filing would help the Commission in collecting exempt market data to formulate effective policies for capital raising and investor protection.

Since the Consultation Paper was published, we have taken steps to reduce the number of documents being filed with the Commission in paper format. On April 11, 2013, we published proposed OSC Rule 11-501 *Electronic Delivery of Documents to the Ontario Securities Commission* (**Proposed OSC Rule 11-501**) for a 90 day comment period. Proposed OSC Rule 11-501 would make electronic filing mandatory for a number of documents that may currently be filed with the Commission in paper format, including Form 45-106F1. As stated in the notice that accompanied publication of the proposed rule, electronic filing would facilitate the efficient collection and use of information by the Commission and would improve our data analysis, while also streamlining the submission process for market participants in Ontario.

The comment period expired on July 10, 2013. Two comment letters were received and are currently under consideration.

Commenters were generally supportive of the OSC's efforts to improve its data analysis capabilities and the move towards the electronic filing of documents. However, concerns were raised about potentially increased administrative burdens and costs that might result from the mandatory electronic filing of Form 45-106F1, particularly if the current E-form is required. Concerns were also expressed about the importance of maintaining the privacy of personal information collected in Form 45-106F1 and the need for a harmonized approach across the CSA.

2.4 Restricted dealer registration and limited exemptive relief for a not-for-profit online platform

The Consultation Paper discussed the role of funding portals in crowdfunding and stated staff's expectation that funding portals would be required to register in an appropriate dealer or adviser category. In our view, the registration requirement with respect to funding portals 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 through the internet.

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

Relief from certain registration requirements for MaRS platform

In June 2013, the Commission granted exemptive relief from certain dealer registration requirements, as described below, to a not-for-profit online platform (**MaRS VX** or the **MaRS platform**) that aims to facilitate "impact investing" by bringing together via an online platform accredited investors in Ontario (and potentially elsewhere) and issuers that aim to solve social or environmental challenges in Ontario. MaRS VX is a not-for-profit initiative of MaRS. MaRS is an innovation centre located in Toronto that works with entrepreneurs to grow their ventures in the healthcare, information technology, clean technology and social innovation sectors.

Although the MaRS platform has certain similarities with the crowdfunding concept idea described in the Consultation Paper, it is important to note that access to the MaRS platform will be limited to eligible issuers and investors who are accredited investors as defined in National Instrument 45-106 *Prospectus and Registration Requirements* (**NI 45-106**). Accordingly, the MaRS platform facilitates offerings of securities to a more limited range of investors than would be the case under the crowdfunding concept idea described in the Consultation Paper.

KYC and suitability exemptive relief

MaRS VX has advised that it intends to seek registration as a restricted dealer in Ontario (and potentially elsewhere). On June 17, 2013, MaRS VX obtained time-limited exemptive relief from certain know-your-client (**KYC**) and suitability requirements (**client-specific KYC and suitability requirements**) applicable to dealers contained in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103)*. The exemptive relief will expire on the earlier of (1) two years and (2) 90 days after any material change in MaRS VX's business, operations or capital. The decision may also be amended by the Commission on written notice to MaRS VX.

The exemptive relief decision provides that, subject to certain investment limits and other terms and conditions, MaRS VX is exempt from the obligation to determine that sales of securities by issuers to accredited investors who are matched to the issuers through the MaRS platform are suitable for the investors in light of the investor's investment needs and objectives, financial circumstances and risk tolerance. MaRS VX will continue to be required to comply with customary gatekeeper KYC requirements, such as establishing the identity of a client, confirming that the client is an accredited investor and complying with anti-money laundering requirements. MaRS VX will not issue securities or have related or connected issuers and no transactions will be executed, settled or cleared through the MaRS platform.

Decision should not necessarily be viewed as a precedent

The time-limited relief from the client-specific KYC and suitability requirements for the MaRS platform is based on the particular facts and circumstances of the application and on very specific, rigorous conditions including the criteria for selecting issuers and background checks. There is no assurance that a similar exemption from KYC and suitability requirements would be granted to others, including crowdfunding portals. As further discussed in Part 4, we continue to review registration issues relating to funding portals. For more information about the MaRS platform and the terms and conditions of the exemptive relief, please see the decision *In the Matter of MaRS VX* dated June 17, 2013.

2.5 Updated data on exempt market activity in Ontario and data on the Canadian SME capital raising environment

The Consultation Paper contained information on exempt market activity in Ontario in 2011. We have updated this information for 2012. We have also collected data on the environment for SME capital raising in Canada. Both sets of data will inform our future policy development.

Overall exempt market activity in Ontario

In 2012, the total amount of capital raised in Ontario increased by approximately 20% from 2011, to \$104 billion.¹ Similar to 2011, approximately one third of the capital raised in Ontario in the exempt market was raised by issuers other than investment funds.² Non-reporting issuers raised 69% of this latter amount and 74% of it was in the form of debt securities.

¹ 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.

² 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 funds securities. We also note that this data reflects purchases and not redemptions of investment fund securities.

The accredited investor exemption remained the most used prospectus exemption, accounting for approximately \$94 billion or 90% of the total amount of capital raised in the exempt market in Ontario in 2012. The minimum amount exemption accounted for \$7 billion or 7% of the total amount of capital that was raised.

The Canadian capital raising environment

SMEs rely heavily on personal finances to fund early-stage growth. Credit from banks and other financial institutions is the next most relied on source of funds for businesses at the start-up stage. For more established SMEs, the primary source of funding is credit from financial institutions.

Another source of business financing in Canada is venture capital. The total amount of venture capital investment in Canada has remained relatively constant over the last five years at approximately \$2 billion per year. From available data, it appears that venture capital firms have become more conservative, concentrating a larger proportion of investment dollars in later-stage deals which attracted approximately 73% of all venture capital investment dollars in 2012, as opposed to seed or early-stage deals. At the same time, they are investing less than \$1 million in an increasing number of deals.³

Start-ups and innovative businesses are more likely to face financing constraints than other SMEs. There is limited available data on financing for start-ups⁴ which makes it difficult to assess the magnitude of any funding gaps. However, based on feedback that we have received from our stakeholders together with available data, it appears that enhancing the capital raising options for SMEs, particularly those at the start-up and early stages of development, is warranted.

Appendix C contains a more detailed summary of the Canadian SME capital raising environment and the exempt market data reported to the OSC.

³ Data from Industry Canada's Venture Capital Monitor and Thomson Reuters Canada.

⁴ The available data that we have on financing for SMEs is limited to companies captured by Statistics Canada's Business Register. The Business Register includes a list of all active businesses in Canada that have been assigned a NAICS code and meet at least one of the following criteria:

- is an employer (i.e., has employees),
- is a corporate tax filer (T2),
- is a GST registrant with sales greater than \$0,
- an individual has filed a tax return (T1) showing business revenue greater than \$0, or
- shows evidence (obtained via profiling activities) of size.

3. KEY THEMES IDENTIFIED FROM THE REVIEW

Through the Review, and in particular through stakeholder consultations, we identified a number of key themes. We outline these themes in this Part of the notice.

3.1 Need to facilitate SMEs' capital raising through expanded prospectus exemptions while maintaining investor protection

Key themes

- SME access to capital should be broadened through new or expanded prospectus exemptions.
- New or expanded prospectus exemptions should address the capital needs of SMEs at different stages of their growth and business cycle, including after they have become reporting issuers and are listed on an exchange.
- Reporting issuers should be able to better leverage their continuous disclosure to raise capital on a prospectus-exempt basis.
- When deciding whether to invest in SMEs, investors need to be aware that start-ups have a high risk of failure. Investors in SMEs also need to be aware that there is a high likelihood of low or negative returns on their investment, and that their investment is highly illiquid. Investor awareness in this area should be enhanced, including through imposing appropriate conditions on any new or expanded prospectus exemptions.

A. Stakeholder feedback

We received significant feedback that SMEs encounter challenges in raising capital throughout their growth and business cycle, from the start-up or early stages, to after they become reporting issuers. Any new or expanded prospectus exemptions should assist SMEs with raising capital at different stages in their growth and business cycle. Some stakeholders also encouraged us to better leverage the continuous disclosure of reporting issuers in capital raising on a prospectus-exempt basis.

An investor advocacy group expressed a countervailing view. While recognizing that SMEs play an important role in Canada's economy, this commenter noted that there was little empirical evidence of the effects of regulatory constraints on the ability of SMEs to raise capital in a timely and efficient manner. It also expressed concern that expanding SME access to capital could result in a misallocation of capital, noting that empirical studies to date showed that, on average, investors in small issuers experience very low or significantly negative returns.

3.2 Importance of harmonizing capital raising prospectus exemptions across Canada

Key themes

- Harmonization with existing prospectus exemptions in other CSA jurisdictions, such as the OM exemption available in other jurisdictions, should be considered as a means of expanding SME access to capital.

A. Stakeholder feedback

We received significant feedback that the capital raising rules in the exempt market should be harmonized across Canada. Some of the benefits identified were:

- reduced confusion for investors and market participants,
- simplification of the capital raising process for issuers, and
- reduced capital raising costs.

In particular, we heard that we should adopt an OM exemption that is harmonized with the existing OM exemption in section 2.9 of NI 45-106. We also heard that we should adopt a harmonized family, friends and business associates exemption as found in section 2.5 of NI 45-106.

The existing OM exemption 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.

The prescribed OM disclosure, while not as extensive or detailed as that required in a prospectus, must provide a prospective purchaser of securities with sufficient information to make an informed investment decision.

There are two models of the existing OM exemption:

British Columbia (BC) model of OM exemption	Alberta model of OM exemption
Under the BC model, there is no restriction on the identity of the purchaser nor on the investment size.	<p>Under the Alberta model, a purchaser may not invest more than \$10,000 unless the purchaser is an “eligible investor”.</p> <p>“Eligible investors” include persons whose:</p> <ul style="list-style-type: none"> • 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

British Columbia (BC) model of OM exemption	Alberta model of OM exemption
	<p>who reasonably expect to exceed that income level in the current calendar year.</p> <p>A person who has obtained advice regarding the suitability of the investment from an eligibility adviser also qualifies as an eligible investor.</p> <p>The Alberta model limits the use of the exemption by investment funds. Only mutual funds that are reporting issuers and non-redeemable investment funds may rely on this exemption.</p>

Many stakeholders took the view that we should place a priority on harmonizing with one of the existing models of the OM exemption rather than introducing a new OM prospectus exemption or other capital raising exemptions.

Some stakeholders indicated, however, that the existing OM exemption is of limited use as a capital raising tool for SMEs because it is common market practice for an OM to contain extensive, prospectus-like disclosure which is cost-prohibitive for a typical SME that is not a reporting issuer. An investor advocacy group submitted that there was no demonstrated investor need for an OM exemption and that its introduction would reduce investor protection and undermine confidence in Ontario’s capital markets.

3.3 Emergence of crowdfunding as a new way for some start-ups and SMEs to raise capital

Key themes

- There is a need for securities regulators to address the emergence of crowdfunding as a new way for some start-ups and SMEs to raise capital.
- Regulators in other jurisdictions are actively considering crowdfunding.
- Based on the Investor Survey, investors generally understand that crowdfunding is high risk and would not invest large amounts, would want disclosure and would seek professional advice. However, there is a concern that a significant minority of investors may not fully understand the risks associated with crowdfunding.

A. Stakeholder feedback

In a relatively short time, crowdfunding has become a significant new method by which the internet is being used to raise funds for a range of purposes. To date, it has mainly been used by people seeking to raise money for a specific project and does not generally involve the issuance of securities. However, in some jurisdictions, crowdfunding is emerging as a way for businesses, particularly start-ups and SMEs, to raise capital by issuing securities.

There was significant stakeholder support from issuers and other securities industry participants for introducing a crowdfunding exemption in Ontario that would allow issuers to use the internet to access large numbers of investors in a cost-effective manner through the use of an online platform. Supporters of a crowdfunding exemption submitted that it would be particularly beneficial for start-ups and early-stage companies. They also cautioned that inappropriate or excessive regulation could detract from the viability of crowdfunding as an efficient and cost-effective means of raising capital.

In contrast, others were highly critical of allowing crowdfunding. An investor advocacy group expressed concern that the crowdfunding exemption outlined in the Consultation Paper would result in too large a degree of informational asymmetry and too great a risk of fraud and potential for investor harm.

Stakeholders who supported crowdfunding generally agreed that for crowdfunding to be an effective means of raising capital, the regulatory framework must provide investors with adequate protections, while at the same time not impose excessive regulatory costs on issuers and funding portals. These stakeholders disagreed, however, on how to achieve this objective. Many of the stakeholders who did not support crowdfunding did not believe that it was possible to achieve this balance.

B. Regulatory developments in other jurisdictions

The Consultation Paper outlined how crowdfunding is currently regulated in the US, the UK and Australia. At this time, regulators in these and other jurisdictions continue to develop and/or implement rules around crowdfunding. The following summary updates the discussion in the Consultation Paper of how crowdfunding is regulated in the US, the UK and Australia.

Jurisdiction	Developments
US	The JOBS Act introduced a new crowdfunding exemption that will only come into force when the US Securities and Exchange Commission (SEC) adopts rules. The SEC had 270 days from April 5, 2012 to issue these rules. To date, it has not issued any rules.
UK	The Financial Conduct Authority has authorized several equity crowdfunding platforms.
Australia	In June 2013, the Minister for Broadband, Communications and the Digital Economy and two other federal ministers announced a review of equity crowdfunding. The review will consider, in consultation with stakeholders, whether Australian corporations law appropriately facilitates and properly regulates equity crowdfunding. The review will consider whether international models can provide guidance and what would constitute a best practice framework for regulating equity crowdfunding in the event that legislative change is appropriate.

C. Key findings from the Investor Survey

We commissioned the Investor Survey with the goal of obtaining insight into the retail investor perspective on investments in start-ups and SMEs through crowdfunding. When considering the survey results, we have been careful not to over-interpret small differences in responses. This is because we recognize that the survey responses only provide an indication of what respondents thought they might do in a given situation but there is no certainty as to what they would actually do if faced with that situation. When a much larger group expresses interest in one alternative over another, we can be reasonably certain that the preferred alternative will remain so in practice.

With the above caveats in mind, below is a summary of some key findings from the Investor Survey that we think can help inform our work in developing a regulatory framework for crowdfunding, particularly with respect to appropriate investor protection measures.

Respondents showed significant interest in investing in start-ups and SMEs through crowdfunding.

- Approximately 47% of respondents expressed some interest in investing in start-ups and SMEs through crowdfunding.
- Of this group, 14% expressed strong interest in investing through crowdfunding while 33% showed weaker interest and were deemed “potential crowdfunding investors”.

Most respondents were interested in investing amounts less than \$5,000.

The survey asked those interested in investing through crowdfunding how much they would be willing to invest assuming they could get the information they identified as important to them:

Size of investment	Proportion of respondents
Under \$1,000	4 out of 10
Between \$1,000 and \$4,999	4 out of 10
\$5,000 or more	2 out of 10

Most respondents had concerns about the risks associated with crowdfunding.

Respondents interested in investing through crowdfunding were shown a list of nine potential risks and asked which ones concerned them.

- Roughly two-thirds were concerned about the potential for fraud and the risk of losing their money. These were the dominant risks cited by respondents.
- Lack of unbiased information and a lack of liquidity were identified by at least half as additional areas of concern.
- Younger investors had fewer concerns than older investors.
- Only 7% had no real concerns.

However, some respondents who identified themselves as having a low risk tolerance did not appear to understand the risks associated with crowdfunding.

- Approximately 12% of respondents who identified themselves as “low risk” investors also expressed a strong interest in crowdfunding.
- This raises concerns because this group appears to not fully appreciate the risks associated with crowdfunding.

Most respondents thought it was important to have information about the issuer.

When asked about the importance of having some seven different types of information, using a 1-5 scale, all types of information were rated as important (4 or 5 rating) by at least 60% of respondents.

Three types of information were considered important to 75% of respondents:

- financial information about the issuer,
- yearly information about how the issuer is doing, and
- how the issuer will use the money it gets from investors.

A majority of respondents would seek professional advice before investing.

- 58% of those interested in crowdfunding stated that they would seek professional advice before deciding to invest.
- The adviser most likely to be consulted was an adviser licensed to sell stocks, followed by a financial planner.

3.4 Importance of regulatory monitoring and compliance oversight in the exempt market

Key themes

- As we consider expanding investor access to the exempt market through new and amended prospectus exemptions, we will also consider enhancing monitoring and oversight of exempt market activity.

A. Experience of other CSA members with the OM exemption

As part of the Review, we considered the experiences of other CSA members with prospectus exemptions not currently available in Ontario. Last year, staff from the CSA members other than the OSC published CSA Multilateral Staff Notice 45-309 *Guidance for Preparing and Filing an Offering Memorandum under National Instrument 45-106 Prospectus and Registration Exemptions* (the **CSA OM Staff Notice**). The CSA OM Staff Notice provides insight into how OMs are currently being prepared and identifies areas of common weakness that need to be addressed.

The CSA OM Staff Notice identified a number of key deficiencies with the OMs that were reviewed by CSA staff. Most of these deficiencies related to problems with the information included in the OM. Examples include:

- **Inadequate disclosure relating to the issuer and the issuer's business**
 - Some issuers provided very little disclosure about their business and its development while others appeared to present an unrealistic or excessively promotional picture.
 - In some cases, the disclosure of management's experience was overly promotional or insufficient for a prospective purchaser to evaluate management's background and ability to operate the issuer's business.
- **Inadequate disclosure relating to use of funds**
 - Some issuers provided inadequate disclosure about available funds and the use of those funds.
 - Some issuers did not identify payments to be made to related parties.
 - There were cases where the OM did not clearly or completely disclose compensation paid to directors, officers and promoters, particularly indirect compensation paid through a related party.
- **Deficiencies related to financial statements**
 - Some issuers omitted key elements of required financial statements while others failed to prepare financial statements in accordance with applicable accounting principles.

- Certain issuers failed to obtain required audits, omitted required audit reports or included non-compliant audit reports.

The CSA OM Staff Notice also stated that a breach of securities law arising from non-compliance with the terms of the OM exemption could result in different types of regulatory action, including re-filings and the use of cease trade orders.

The CSA OM Staff Notice confirms that we need to address the following important areas as we move toward developing new and expanded prospectus exemptions that increase issuer and investor access to the exempt market:

- enhancing our compliance monitoring and oversight of exempt market activity,
- expanding our educational outreach to issuers and investors, and
- in the event of non-compliance, assessing the regulatory tools available to us, and when and how they should be deployed.

We intend to consult with the other CSA members as we further consider these issues.

4. FUTURE WORK

4.1 Decision-making principles

After considering the feedback from stakeholder consultations, we have directed staff to undertake further work on four new capital raising prospectus exemptions for issuers other than investment funds. Our objective is to address the capital raising needs of SMEs at different stages in their growth and business cycle, while maintaining an appropriate level of investor protection.

To provide direction to staff in this work, we have developed a set of decision-making principles that reflect the Commission's dual mandate to:

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

Concept	Guiding principle for decision-making
Adaptation and modernization	
Adaptation and modernization	Recognize and respond to the changes that have occurred since the exempt market regulatory framework was initially developed, including: <ul style="list-style-type: none"> • changes in the capital markets, • changes in investor composition, behaviour, needs and beliefs, • introduction of the internet and its role in investing, including the internet's potential to enhance investor access to information and investment opportunities, and • global developments regarding capital raising options.
Role of the exempt market and exempt market regulatory regime	
Positioning of exempt market	Facilitate a robust exempt market while recognizing its relationship to the public market and the importance of the public market.
Global competitive positioning	Be sensitive to the impact of our exempt market regulatory regime on the competitiveness of Ontario's capital markets in the global context.
Regulatory arbitrage	Be sensitive to the impact of our exempt market regulatory regime on opportunities for regulatory arbitrage.
CSA coordination	
CSA harmonization	Harmonize, where possible, the exempt market regulatory regime with other CSA jurisdictions while taking into account the differences between the Ontario market and the markets in other Canadian jurisdictions.

Concept	Guiding principle for decision-making
Experience	Incorporate the learnings from other CSA members regarding the OM and family, friends and business associates exemptions into any proposed new exemptions or changes to existing exemptions.
Access to the exempt market for issuers and investors	
Expansion of capital raising options	Facilitate access to capital raising by all issuers, particularly SMEs, by considering either expanding existing exemptions or implementing new exemptions.
Inclusion and democratization	Increase investors' access to direct investments in the exempt market while taking into account the need for an appropriate level of investor protection.
Investor protection and oversight	
Investor protections and integrity of our market	Mitigate where possible the risk of fraud and abuse and address other investor protection issues associated with increasing access by non-accredited investors to the exempt market. Possible investor protection measures include: <ul style="list-style-type: none"> • appropriate financial limitations, • registrants acting as gatekeepers, and • other measures such as investor risk acknowledgements and issuer certifications.
Oversight	Recognize the need to expand our compliance and oversight of the exempt market, as well as our handling of complaints and enforcement actions, to take into account the increased access to the exempt market by investors and market participants.
Education	If changes are made to the exempt market regulatory regime, recognize the need to expand our educational outreach to both issuers and investors, particularly for those that have not previously been permitted to participate in the exempt market.
Transparency	
Transparency	Increase transparency about exempt market participants and transactions for regulators, investors and other stakeholders.

4.2 Prospectus exemptions we are considering

We have directed staff to undertake further work on the following capital raising prospectus exemptions:

- a crowdfunding exemption,
- a family, friends and business associates exemption,
- an OM exemption, and
- a streamlined rights offering exemption and a possible exemption for distributions to a reporting issuer's existing security holders based on the issuer's continuous disclosure.

We also intend to pursue amending the accredited investor exemption to allow fully managed accounts to purchase investment fund securities.

There are a number of issues that must be considered and steps that must occur before any new or amended prospectus exemptions can become part of Ontario securities law. In particular, the *Securities Act* requires that we:

- publish any proposed new rules or amendments for a comment period of at least 90 days,
- consider the comments before making any final rules or amendments, and
- obtain Ministerial approval for any rules or amendments that we propose.

There is no assurance that any new prospectus exemptions or amendments will be adopted in Ontario.

A. Crowdfunding exemption

Crowdfunding exemption concept idea

The Consultation Paper outlined a concept idea for a crowdfunding exemption. The following is a high-level summary of the concept idea published for comment.

Element of concept idea	Details
Issuer restrictions	
Qualification criteria	<ul style="list-style-type: none"> • Incorporated in Canada • Head office located in Canada • Not available to investment funds
Limit on offerings	<ul style="list-style-type: none"> • Cannot raise more than \$1.5 million in reliance on the exemption in any 12 month period
Limit on advertising	<ul style="list-style-type: none"> • Not permitted to advertise an investment except through the issuer's website or on the portal. The use of social media would be permitted to direct investors to the funding portal or the issuer's website.
Limit on securities	<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
Investor protection measures	
Investment limits	<ul style="list-style-type: none"> • Cannot invest more than \$2,500 in a single investment under the exemption • Cannot invest more than \$10,000 in total under the exemption in a calendar year
Provision of disclosure at point of sale	<ul style="list-style-type: none"> • Limited disclosure document that includes basic information about the offering, the issuer, the funding portal and any other registrant • One year of financial statements certified by management, but audited if proceeds raised are greater than \$500,000 or if the issuer is a reporting issuer

Element of concept idea	Details
Risk acknowledgement	<ul style="list-style-type: none"> Investors must sign a risk acknowledgement confirming that: <ul style="list-style-type: none"> they fall within the investment limits they understand that they may lose their entire investment and they can bear that loss they understand the illiquid nature of the investment (in the case of securities of a non-reporting issuer)
Two business day “cooling off” period	<ul style="list-style-type: none"> Investors have two business days to withdraw from their investment decision
Provision of ongoing disclosure	<ul style="list-style-type: none"> Issuer must provide investors with annual financial statements Issuer must keep books and records which contain minimum information: <ul style="list-style-type: none"> information on the securities issued by the issuer as well as the distribution price and date names of all security holders and size of holdings use of funds raised
Funding portal	
Investments through portal	<ul style="list-style-type: none"> All investments under the exemption must be made through a registered funding portal registered in an appropriate dealer or adviser category in Ontario
Category of registration	<ul style="list-style-type: none"> Staff would consider registration either in an existing dealer or adviser category or in a restricted dealer or adviser category
Obligations of portal	<ul style="list-style-type: none"> Staff would consider exempting funding portals from specific dealer or adviser registration requirements after considering the particular features of the portal’s proposed business model

What we intend to do next

In light of the feedback from many stakeholders that a crowdfunding exemption would be beneficial for start-ups and early-stage companies, staff will continue to work to develop a crowdfunding regulatory framework. We recognize that for crowdfunding to be a viable method of raising capital, the regulatory framework must provide investors with adequate protections without imposing excessive regulatory costs on issuers and funding portals.

We will build on the concept idea in the Consultation Paper and focus on the following areas:

1. Develop a regulatory framework for funding portals

Capital raising through crowdfunding involves three primary actors:

- the issuer,
- the investor, and
- the funding portal that brings them together.

The funding portal is central to capital raising through crowdfunding. Several stakeholders noted that inappropriate or excessive regulation of the portal would detract from the viability of crowdfunding as an efficient and cost-effective means of raising capital.

Based on our continuing review of funding portals, including our consultations with stakeholders, our review of comment letters received in response to the Consultation Paper and staff pre-file discussions with a number of

entities seeking to establish funding portals in Ontario, we continue to take the view that it should be a condition of any crowdfunding prospectus exemption that investments be made through a registered funding portal.

We have identified several basic investor protection issues that we would expect a funding portal to address in any application to become registered. These would be relevant in determining both the threshold question of whether registration should be granted, as well as appropriate terms and conditions.

Issue	Areas for further consideration
What due diligence does the portal conduct on issuers and their management?	One of the major concerns with permitting crowdfunding as a method of capital raising is that it may become easier to perpetrate investment frauds on investors. We would want to ensure appropriate background checks are made by the portal on the issuer, its directors and key executives. For example, based on the Review, existing crowdfunding equity and consumer lending platforms typically conduct some form of basic background checks on the issuer and its principals.
What due diligence does the portal conduct on the business?	Funding portals may attract issuers that have been unable to access funds elsewhere and that have inexperienced management. We would want to understand the steps a funding portal would take to assess the viability of the issuer's business. For example, one equity crowdfunding portal requires a comprehensive business plan, historical financial information and financial forecasts that are reviewed by an accountant.
Does the portal conduct any type of investor screening?	As we have indicated earlier, we have concerns that there may be a significant percentage of retail or non-accredited investors who will not fully understand the risks associated with crowdfunding and investing in a SME. We would want to know whether the portal conducts any screening or vetting of investors before they invest (in addition to the risk acknowledgement that was referred to in the crowdfunding concept idea). For example, one equity crowdfunding portal requires that each potential retail investor answer a questionnaire to demonstrate that the investor understands the key risks associated with investing in a SME, including dilution, illiquidity and risk of loss. If they fail to answer the requisite number of questions correctly, the investor is not permitted to invest unless he or she successfully completes a tutorial.

Issue	Areas for further consideration
<p>Does the portal offer additional services to issuers and investors, particularly services that may enhance investor protection?</p>	<p>Some portals may provide additional services to issuers and investors. For example, the portal could:</p> <ul style="list-style-type: none"> • offer a service that enables an issuer to create an investor relations page hosted on the portal, where current and prospective investors could find out more information about the issuer and its business on an ongoing basis, • provide share register and other record keeping services, or • provide issuer or other notifications to shareholders. <p>We would be particularly interested to know if the portal offers any services that could enhance investor protection, e.g., if the portal requires model, standardized term sheets and other legal documents that address typical deal structure issues such as anti-dilution protection, tag-along rights and pre-emptive rights.⁵</p> <p>Another investor protection feature would be a process to hold funds in escrow through an appropriate third party custodian until any minimum amount is raised.</p>

2. Further refine the issuer restrictions and investor protection measures identified in the crowdfunding concept idea

Based on the Review, we think that the types of issuer restrictions and investor protection measures outlined in the crowdfunding concept idea generally are appropriate. In particular, many stakeholders agreed that an investment limit is an extremely important investor protection measure. Some commenters suggested that it would be the most important investor protection measure.

We think that the following measures are appropriate:

- limits of \$2,500 on a single investment and \$10,000 in a 12 month period, although we do note the suggestion that these limits could be re-evaluated after a certain period,
- mandatory risk acknowledgement, and
- a two business day cooling off period.

Based on stakeholder feedback, however, we intend to further refine some of the other measures, including:

Measure	Areas for further consideration
<p>Limits on offerings</p>	<p>There was generally support for an offering limit. However, some commenters were of the view that the cap of \$1.5 million in a 12 month period was potentially too low for meaningful capital raising, while others thought it was too high. We will consider further the appropriate limit. We clarify that this limit would not preclude an issuer from raising additional amounts in reliance on other exemptions, such as the accredited investor exemption.</p>

⁵ We note that the National Venture Capital Association has developed a set of model legal documents for venture capital investments.

Measure	Areas for further consideration
Provision of disclosure at point of sale	<p>There was also general support for disclosure at the point of sale. Stakeholders supported a streamlined disclosure document, with some variation of opinion as to what should be included. However, there were mixed views around whether or not financial statements and, in particular, audited financial statements, should be required. Some took the view that financial statements were of limited value for an early-stage company and detracted from the objective of expanded, cost-efficient capital access and suggested other types of disclosure. Others supported the proposals regarding financial statements in the concept idea, while an investor advocacy group recommended that audited financial statements be mandatory for all issuers raising funds through crowdfunding.</p> <p>Results from the Investor Survey showed that three-quarters of those interested in crowdfunding would want financial information about the issuer and a significant majority would prefer financial information that has been verified by an independent source (for example by an independent accounting firm or through tax returns).</p>

We are mindful of stakeholder concerns that if the costs associated with investor protection are excessive, crowdfunding may not be a cost-effective capital raising method. At the same time, the Investor Survey suggests that investors would be concerned about the risks of crowdfunding and might not be prepared to invest through crowdfunding if they do not think there are adequate protections in place. A recent paper on the economics of crowdfunding frames the issue in the following way:

In general, the most critical differences between equity and non-equity crowdfunding will arise due to the amplification of information asymmetries. Whereas the asymmetry problem [in non-equity crowdfunding] currently concerns the feasibility of and the creator’s ability to deliver the product, in the equity setting the asymmetry problem includes the above as well as the creator’s ability to generate equity value by building a company rather than just delivering a product...Will risk levels be so high that either the market fails (low volume of trading) or social welfare is reduced due to excessive harm to funders?

The paper specifically identified government regulation as one of the main ways in which information asymmetry risks could be addressed.⁶

B. Family, friends and business associates exemption

The Consultation Paper sought comment on whether the Commission should consider adopting a form of 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.

⁶ Ajay Agrawal, Cristian Catalini, Avi Goldfarb, “Some Simple Economics of Crowdfunding”, Chapter in forthcoming NBER book *Innovation Policy and the Economy, Volume 14*, Josh Lerner and Scott Stern, editors. Conference held April 23, 2013. Forthcoming from University of Chicago Press NBER Book Series Innovation Policy and the Economy. Version of June 13, 2013.

We did not receive a significant amount of feedback on this proposal. Stakeholders generally either:

- supported adopting a harmonized family, friends and business associates exemption as set out in section 2.5 of NI 45-106, or
- did not support either a family exemption or a harmonized family, friends and business associates exemption, on the basis that it would pose too great a risk to investors. There were also concerns that there is no clear definition of “close personal friend” or “close business associate”.

We think that start-ups and early-stage companies could benefit from greater access to capital from their network of family, friends and business associates than is currently permitted under Ontario securities law. There are two exemptions in NI 45-106 that Ontario start-ups and early-stage companies can use to raise capital from family members without a prospectus:

- the private issuer exemption in section 2.4 allows a non-reporting issuer to distribute its securities to a maximum of 50 people (excluding current and former employees) who have certain specified relationships with the issuer, including specified family members of its executive officers, directors or founders, and
- the founder, control person and family exemption in section 2.7 allows an issuer to distribute its securities to specified family members of its executive officers, directors or founders.

Section 2.5 of NI 45-106 includes a family, friends and business associates exemption that is available outside of Ontario and allows access to more types of family members, as well as close personal friends and close business associates. We have previously expressed concern that this exemption allows securities to be issued to an unlimited number of undefined “close personal friends” and “close business associates”.

We will consider adopting the broader family, friends and business associates exemption, with the goal of substantial harmonization of the exemption across Canada. We will consider if additional conditions could be added to the family, friends and business associates exemption to mitigate our concern regarding the scope of “close personal friends” and “close business associates”. Possible conditions could include:

- requiring the relevant executive officers, directors or founders of an issuer to certify the nature of their relationship with the investor, and
- requiring the investor to sign a risk acknowledgement.

C. OM exemption

OM exemption concept idea

The Consultation Paper sought comment on a concept idea for an OM exemption, which was in many respects similar to the concept idea for a crowdfunding exemption as discussed above. The following is a high-level summary of the concept idea published for comment.

Element of concept idea	Details
Issuer restrictions	
Qualification criteria	<ul style="list-style-type: none"> • Incorporated in Canada • Head office located in Canada • Not available to investment funds
Limit on offerings	<ul style="list-style-type: none"> • Cannot raise more than \$1.5 million in reliance on the exemption in any 12 month period
Limit on advertising	<ul style="list-style-type: none"> • Not permitted to advertise an investment except through the issuer’s website

Element of concept idea	Details
Limit on securities	<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
Investor protection measures	
Investment limits	<ul style="list-style-type: none"> • Cannot invest more than \$2,500 in a single investment under the exemption • Cannot invest more than \$10,000 in total under the exemption in a calendar year
Provision of disclosure at point of sale	<ul style="list-style-type: none"> • Limited disclosure document that includes basic information about the offering, the issuer and the registrant (if any) • One year of financial statements certified by management, but audited if proceeds raised are greater than \$500,000 or if the issuer is a reporting issuer
Risk acknowledgement	<ul style="list-style-type: none"> • Investors must sign a risk acknowledgement confirming that: <ul style="list-style-type: none"> ○ they fall within the investment limits ○ they understand that they may lose their entire investment and they can bear that loss ○ they understand the illiquid nature of the investment (in the case of securities of a non-reporting issuer)
Two business day “cooling off” period	<ul style="list-style-type: none"> • Investors have two business days to withdraw from their investment decision
Provision of ongoing disclosure	<ul style="list-style-type: none"> • Issuer must provide investors with annual financial statements • Issuer must keep books and records which contain minimum information: <ul style="list-style-type: none"> ○ information on the securities issued by the issuer as well as the distribution price and date ○ names of all security holders and size of holdings ○ use of funds raised

The key difference between the concept idea for an OM exemption and the one for a crowdfunding exemption was that, under the OM exemption, there would be no requirement that an investment be made through a registrant, unless the issuer or intermediary was in the business of trading in securities.

What we intend to do next

As issuers develop and their capital needs increase, they need to access investors who are able to invest larger amounts of money than would generally be available through crowdfunding or other prospectus exemptions relied on by early-stage businesses. An OM exemption similar to the one currently in NI 45-106 could help issuers achieve this objective. Adopting an OM exemption in Ontario that is substantially harmonized with the existing OM exemption can also reduce investor and market participant confusion, simplify the capital raising process and reduce capital raising costs.

We intend to develop a proposal for an OM exemption in Ontario securities law that is substantially harmonized with the existing Alberta model of the OM exemption in NI 45-106. In developing an OM exemption, we intend to consider whether there is a need for additional measures that would facilitate capital raising by issuers while protecting the interests of investors. We intend to focus on the following measures:

Measure	Areas for further consideration
Streamlined disclosure	We received stakeholder feedback that it is common market practice for an OM to contain extensive, prospectus-like disclosure and that preparing such an OM would be cost-prohibitive for a typical SME that is not a reporting issuer. We also heard concerns that such extensive disclosure makes it difficult for investors to easily identify the key pieces of information that they need to make an investment decision. We intend to consider whether and how OM disclosure could be streamlined to make it more cost-effective for SMEs and user-friendly for investors.
Qualification criteria	As noted above, the Alberta model does not permit private mutual funds to use the OM exemption. Only mutual funds that are reporting issuers and non-redeemable investment funds may rely on this exemption. Our view is that an OM exemption should not be available for investment funds. As separate policy initiatives, we are currently undertaking significant policy projects to modernize product regulation for investment funds, for point of sale disclosure for mutual funds and to review the cost of ownership of mutual funds.
Related and connected issuers	We intend to consider whether an OM exemption should not be available for a distribution by a registrant of securities of a “related issuer” or “connected issuer” in light of significant compliance and conflict of interest concerns.
Limits on securities	We intend to consider whether certain types of complex securities should not be permitted to be sold under an OM exemption. Examples would include securitized products (e.g., asset-backed securities) and derivatives.
Investment limits	We intend to consider whether we should impose limits on the investment size where an individual investor (other than an accredited investor) is purchasing securities of a non-reporting issuer, because there will be a more limited continuous disclosure record available than there would be for a reporting issuer.

Registration issues

The OM exemption in NI 45-106 is a prospectus exemption and is not an exemption from applicable dealer 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, applicable registration requirements continue to apply.

An OM exemption, if implemented in Ontario, would have important implications for the registration regime in Ontario since it would expand the class of investors with whom exempt market dealers (**EMDs**) may deal. This is because, under section 25 of the *Securities Act* and Part 7 of NI 31-103, the class of investors with whom an EMD may deal is defined by reference to prospectus exemptions in Ontario securities law. Consequently, EMDs (and prior to the introduction of NI 31-103 in September 2009, limited market dealers) have traditionally been limited in Ontario to dealing with clients who are “accredited investors” or investors who are able to make an investment of at least \$150,000. The introduction of an OM exemption, without any other rule changes, would allow EMDs to deal with any investor, including retail investors.

The EMD category has traditionally been viewed as an appropriate dealer category only for dealing with accredited investors and other types of sophisticated investors.

Staff have, through compliance reviews, recently identified significant compliance issues and concerning trends with certain types of EMDs, particularly EMDs that distribute securities of “related issuers” and “connected issuers”. In April 2013, Compliance and Registrant Regulation staff released the findings of a targeted review of portfolio managers and EMDs to assess their compliance with their KYC, know-your-product (**KYP**) and suitability obligations. Please refer to OSC Staff Notice 33-740 *Report on the results of the 2012 targeted review of portfolio managers and exempt market dealers to assess compliance with the know your client, know-your-product and suitability obligations*. Although these concerns may also apply to other categories of registrant, we have highlighted these concerns in relation to EMDs since any proposed OM exemption will expand the class of investors with whom an EMD may deal. Broadening the prospectus exemption regime may heighten these concerns.

Accordingly, while the introduction of new prospectus exemptions in Ontario may create new capital raising opportunities for issuers, dealers and other market participants in Ontario, it may also have resource implications for the Commission, particularly in the areas of compliance and enforcement.

D. Streamlined rights offering exemption and possible exemption based on a reporting issuer’s continuous disclosure and existing security holder base

We received significant feedback that SMEs continue to face capital raising challenges after they have become reporting issuers and are listed on an exchange. Stakeholders encouraged us to consider ways to better leverage the continuous disclosure of reporting issuers in capital raising. We received a submission from the TMX in response to our Consultation Paper in which the TMX asked us to consider two proposals. The following is a high-level summary of the proposals made by the TMX, which are set out in more detail in its comment letter.

Amendments to streamline the rights offering prospectus exemption

Section 2.1 of NI 45-106 provides for a rights offering exemption. It allows an issuer to distribute rights to acquire its securities to the issuer’s existing security holders subject to certain conditions. These conditions are set out in both NI 45-106 and in National Instrument 45-101 *Rights Offerings*.

In general terms:

- The issuer must send to its security holders a rights offering circular that complies with certain disclosure requirements.
- The exemption is subject to an anti-dilution provision. The issuer cannot issue more than 25% of the number of outstanding securities in the class of securities to be issued under the offering.
- Restrictions on the time period for the exercise of rights are prescribed.

The TMX has requested that we consider the following rights offering amendments (the **rights offering amendments**):

- reduce the CSA review period for a rights offering circular from 10 days to three business days,
- remove the 25% ceiling for dilution for a prospectus-exempt rights offering on the basis that prospectus-level disclosure is not necessary for existing security holders who are already familiar with the issuer and can access the issuer’s continuous disclosure on SEDAR,
- reduce the minimum period during which rights must be exercisable from 21 days to 10 business days on the basis that existing security holders do not need 21 days to make an informed investment decision as they are

already familiar with the issuer and the investment decision of a secondary market purchaser is not primarily based on receipt of a disclosure document, and

- allow for electronic delivery of documents to reduce time and cost.

Prospectus exemption for existing security holders of a listed issuer

The key elements of this proposal (the **existing security holder exemption**) are:

- an issuer listed on a recognized stock exchange would be permitted to issue its securities to its current security holders on a private placement basis subject to certain terms and conditions,
- a security holder would have to have held the issuer’s listed securities for at least 60 days prior to execution of a subscription,
- a security holder could purchase up to \$10,000 of the issuer’s securities in a 12 month period,
- eligible securities would include those of the class that were listed, securities that were convertible into listed securities, preferred shares and non-convertible debt securities,
- dilution would be limited as contemplated by the current exchange rules for private placements, which differ depending on whether the issuer is listed on the TSX or TSX Venture Exchange, and
- a listed issuer would have to be in good standing under securities laws.

What we intend to do next

We will work with other CSA members to see if the existing rights offering exemption available across Canada can be streamlined to improve its efficiency and effectiveness for reporting issuers. We will consider in more detail each element of the TMX’s proposal, including:

Element	Areas for further consideration for rights offering exemption
Reduce the CSA review period	We agree that it may be appropriate to reduce the review period for reporting issuers that are eligible to file a short form prospectus from 10 days to three business days. That would be the same review period as for a short form prospectus. We will also consider reducing the review period for foreign issuers with a de minimis presence in Canada.
Increase the dilution ceiling	We think this issue needs to be considered further with reference to existing exchange rules regarding dilution. We will consider if there may be situations where the dilution is associated with a material event or change involving the issuer such that the security holder would benefit from prospectus-level disclosure, e.g., where the dilution is caused because the issuer is raising funds for a significant acquisition.
Reduce the exercise period	We will consider whether a 10 business day exercise period provides adequate time for investors to exercise their rights and, specifically, whether it is operationally feasible for dealers to contact client security holders (including beneficial owners) and obtain instructions from them within that time frame.
Electronic delivery of documents	We are supportive in principle of making better use of technology to communicate with security holders, but will consider the specific methods of electronic delivery in more detail.

We also will consider, in consultation with other CSA members, whether it would be appropriate to develop a separate exemption for distributions to an issuer’s existing security holders. A threshold issue is whether adopting the proposed rights offering amendments or other amendments to the rights offering exemption would sufficiently streamline raising capital from an issuer’s existing security holders such that there would be minimal additional benefit to adopting an existing security holder exemption.

E. Amend the accredited investor exemption to allow fully managed accounts to purchase investment fund securities

A registered adviser of a fully managed account is an accredited investor under the definition of “accredited investor” in NI 45-106 and can buy all types of securities for the managed account on an exempt basis except, in Ontario, investment fund securities. Advisers of a fully managed account have a fiduciary duty to investors. The Consultation Paper sought comment on whether the accredited investor exemption should be amended in Ontario to allow fully managed accounts to purchase investment fund securities.

Several investment management industry commenters expressed support for removing the investment funds carve-out. Among the reasons they gave were that:

- a portfolio manager’s proficiency and fiduciary obligation to the investor serve as adequate investor protection, and
- managed account clients should have the benefit of the exemption whether investing in securities directly or through an investment fund.

They also noted that removing the carve-out would harmonize the managed account category of the accredited investor exemption in Canada, permitting Ontario investors to have the same investment opportunities based on the exemption as they would have in other Canadian jurisdictions.

We intend to pursue removing the carve-out which will permit fully managed accounts to purchase all securities on an exempt basis, including investment fund securities.

4.3 Prospectus exemptions we are not considering at this time

We are not at this time considering the following prospectus exemptions or amendments that we discussed in the Consultation Paper. We are not doing so because:

- we have received limited or mixed support for these exemptions expressed through the feedback, and
- we do not consider these proposals as important for capital raising as the exemptions we intend to further consider.

The following are the prospectus exemptions or amendments we are not considering:

- an investor sophistication exemption,
- a registrant advice exemption,
- changes to the existing private issuer exemption, and
- the re-introduction of the closely-held issuer exemption.

A. Investor sophistication exemption

The Consultation Paper sought comment on a concept idea for an investor sophistication exemption for investors who did not qualify as accredited investors, but had investment knowledge. This concept idea contemplated a prospectus exemption for a distribution to an investor where:

- the investor has worked in the investment industry for at least one year in a position that requires knowledge of securities investments,
- the investor has earned or received one of the following:
 - a Chartered Financial Analyst designation,

- a Chartered Investment Manager designation, or
- a Master in Business Administration degree from an accredited university,
- the issuer provides basic information to investors about the offering, such as the information typically found in a term sheet, and
- the investor signs a risk acknowledgement form.

A significant number of stakeholders supported the concept idea, noting that its basic premise – linking ability to invest on a prospectus-exempt basis with investment knowledge – was sound and that it would broaden the number of investors available to invest in SMEs. However, other stakeholders thought that the exemption would have a minimal impact on capital raising.

Among those who supported the concept idea, there was a difference of opinion as to what specific work experience and educational qualifications would be appropriate proxies for sophistication. In particular, there were different views as to the appropriate types of work and the length of time that a person should be required to work in order to qualify. Most stakeholders supported broadening the list of educational qualifications and suggested a wide variety of other possible educational designations and qualifications.

B. Registrant advice exemption

The Consultation Paper sought comment on a concept idea for a prospectus exemption based on registrant advice. The concept idea contemplated 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.

As explained in the Consultation Paper, the concept idea was developed by analogy to clause (q) of the definition of “accredited investor” in section 1.1 of NI 45-106.

We received only limited support for this concept idea. An investment dealer advocacy group commented that an exemption based on registrant advice had the potential to help SMEs more quickly and broadly access capital than the other concept ideas introduced in the Consultation Paper. Other commenters, however, provided more qualified support and several commenters did not think the concept idea would improve access to capital.

An investor advocacy group agreed that the exemption should be limited to certain types of registrants, due to the compliance issues and concerns identified with certain types of EMDs. However, a number of other commenters did not agree with the restrictions on the type of registrant or suggested that other independent third parties, such as accountants and lawyers, should also be permitted to be advisers. Another commenter was of the view that an exemption of this nature would be appropriate but not necessary if the managed account exemption were expanded and harmonized.

C. Changes to the existing private issuer exemption

The Consultation Paper sought comment as to whether the 50 security holder limit under the private issuer exemption is too restrictive and, if so, what limit would be appropriate.

The private issuer exemption in section 2.4 of NI 45-106 allows a non-reporting issuer to distribute securities to up to 50 people (excluding current and former employees of the issuer or affiliates) who fall within certain prescribed categories. The investors who fall within the prescribed categories are generally thought to have a relationship with 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.

We received only a limited number of comments in response to our questions. Slightly over half of those commenters were of the view that the 50 security holder limit is too restrictive. Broadly speaking, the underlying reasons for this view included the following:

- the limit is too restrictive to meaningfully contribute to addressing the capital raising needs of SMEs,
- there should be no limit on the number of people who fall within the prescribed categories, and
- the categories should be expanded or modified to include other stakeholders who have close relationships with an issuer.

One commenter suggested that the limit be increased to 75 or 100 security holders while another commenter suggested increasing it to 100 or 150 security holders. A third commenter recommended increasing the limit to 75 non-accredited investors, with no limit on the number of accredited investors.

D. Re-introduction of the closely-held issuer exemption

The Consultation Paper also sought comment on whether the Commission should consider re-introducing the closely-held issuer exemption in addition, or as an alternative, to the private issuer exemption and, if so, whether the conditions of the exemption should be changed.

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.⁷ It was designed to facilitate financings of issuers at early stages by allowing them to access a finite amount of capital from investors who did not meet the accredited investor requirements. The exemption was repealed in 2005 on the introduction of NI 45-106 and replaced with the private issuer exemption in the interest of harmonization.

While in place, 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 only available to issuers, other than investment funds, whose shares were subject to restrictions on transfer.

Few stakeholders provided feedback on the closely-held issuer exemption and there was limited support for re-introducing the exemption. Commenters that did support re-introducing the exemption offered the following reasons:

- the exemption would facilitate the financing efforts of issuers and help fill the funding gap that currently exists,
- the exemption would address the uncertainty and subjectivity of the private issuer exemption and would be helpful given the limited use of the private issuer exemption, and
- even if crowdfunding were introduced, it may not be appropriate for all small issuers and the closely-held issuer exemption (with certain modifications) could benefit these issuers.

⁷ Task Force on Small Business Financing, *Final Report* (published by the OSC: October 1996).

Some stakeholders who supported re-introducing the closely-held issuer exemption suggested that the Commission consider modifications to the exemption, including increasing the limits on the number of eligible investors and offering size, and potential additional disclosure requirements and investor protection measures.

Others were not in favour of re-introducing the closely-held issuer exemption, primarily for reasons relating to harmonization and lack of utility. With respect to the latter, commenters noted that, given the existing exemptions and the concept ideas under consideration, the closely-held issuer exemption would not constitute a significant additional means of capital raising. Some commenters also indicated that there are investor protection concerns associated with the exemption as well as practical difficulties in determining which investors would qualify to use the exemption.

4.4 Further work on reports of exempt distribution

We intend to pursue further improvements to our data collection on exempt market activity for all issuers, including investment funds.

The Consultation Paper highlighted the importance of obtaining data on exempt market activity when the Commission is considering regulatory changes to the exempt market. The Commission’s primary source of data on the exempt market comes from the reports on Form 45-106F1. These reports are required to be filed following distributions made in reliance on certain prospectus exemptions.

The Consultation Paper identified three challenges with the current reporting requirement:

Challenge	Concern
Format of filing	These reports are filed with the Commission in paper format, making it difficult to analyze the data contained in them.
Information provided	The information required to be included in the report is limited and is more focused on details of the distribution, rather than the parties involved.
Incomplete picture of exempt market	Not all prospectus exemptions trigger a reporting requirement.

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

Response to challenge #1 – electronic filing

As noted in section 2.3, we have proposed to mandate electronic filing of these reports.

Response to challenge #2 – obtaining additional information on exempt distributions

The Consultation Paper stated that we are considering amending Form 45-106F1 to gather additional information on exempt distributions. The Consultation Paper suggested that certain additional facts about the issuer, information on the involvement of a registrant and more detail on the investors that acquired the securities would be informative additions to the report. It also stated that we 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.

Many commenters supported our goal of requiring additional information to be collected in the report. For example, one commenter stated that this information would be useful in identifying which industries are benefiting from prospectus exemptions and that better information could help the Commission identify potential compliance issues.

Commenters that did not support adding disclosure requirements to the report mainly cited privacy concerns associated with gathering data on individuals. Others noted that if prospectus exemptions are expanded to allow for distributions to many individual investors, this could pose a significant administrative burden. Finally, some commenters submitted that, to the extent information was already provided in another public filing, it should not be duplicated in the report.

We continue to believe that additional data is needed to fully inform our understanding of exempt market activity. After taking into consideration the feedback received on this issue, we plan to publish proposed amendments to Form 45-106F1 for public comment.

Response to challenge #3 – considering amending the reporting trigger

As noted in the Consultation Paper, certain key prospectus exemptions, such as the private issuer exemption, do not require a report to be filed with the Commission. We did not receive significant comment on this issue. We are still considering whether it would be appropriate to require a report to be filed in relation to distributions under these exemptions. This would enable us to gain a more comprehensive understanding of total exempt market activity. Any changes to the reporting trigger would be published for public comment.

5. QUESTIONS

If you have any questions, please contact any of the following staff:

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