



Raising Money in Ontario

What's Up With Crowdfunding and Other Initiatives?



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With the recent release by the Ontario Securities Commission (the “OSC”) of a progress report on its ongoing exempt market review we now have a pretty good idea that the OSC is likely to implement four (4) new prospectus exemptions, including a ‘crowdfunding’ exemption, which will make it easier, particularly for start-ups and early-stage entities, to raise money through equity financing.

The OSC, citing its mandate to foster efficient capital markets and its desire alleviate funding gaps that exist for many businesses, has signalled that it will propose the following new prospectus exemptions:

- crowdfunding
- family, friends and business associates
- offering memorandum
- rights offering/existing security holders

The details of these exemptions remain to be settled however here’s what the OSC has said so far.

Equity Crowdfunding

As you may know, ‘crowdfunding’ refers to the process of raising money from the public (typically a small amount per person) through the Internet using social media. Crowdfunding has proven to be successful for raising considerable sums of money for social causes, charitable and political donations and for rewards but cannot be used to sell securities under current Canadian securities laws.

The OSC foresees that under an equity crowdfunding prospectus exemption investors would be permitted to purchase equity securities issued by entities

(“issuers”) only through an independent website called a ‘funding portal’ that would be regulated to the extent of meeting certain requirements including registration. Generally speaking, any member of the public could invest, regardless of his/her financial profile or investment sophistication. The purpose of the funding portal would be to ensure at least a minimum level of due diligence of issuers and their management so as to ensure that investors have the ability to understand the risks involved and have access to information about the issuers. Issuers may be required to provide summary information through the funding portal about the securities being offered and may be required to provide financial statements, although it is not known at this time whether such financial statements would have to be audited.

In order to limit the potential loss for investors, restrictions would likely be placed on the amount that any one individual could invest both in any one issuer (\$2,500 has been suggested) and as an aggregate amount in all issuers over a 12 month period (\$10,000). There may also be a limit placed on the aggregate amount of money that an issuer can raise in a 12 month period using the crowdfunding exemption.

Family, Friends and Business Associates

The OSC has acknowledged that issuers could benefit from access to a larger scope of family members, friends and business associates as investors than is currently permitted in Ontario under the ‘private issuer’ and ‘founder, control person and family’ exemptions in National Instrument 45-106 (“NI 45-106”). In this regard the OSC will consider adopting the ‘family, friends, and business associates’ exemption in section 2.5 of NI

45-106 which is currently available to investors outside of Ontario, perhaps with some conditions requiring that executive officers, directors and founders certify the relevant relationships and that investors sign a form of prescribed risk acknowledgment. Adoption of this exemption would increase the number of potential investors by expanding the number and types of family members who could invest and unlike the 'private issuer exemption', which has a 50 security holder limit, there would be no numerical limit under this exemption for family members, close personal friends and close business associates.

Offering Memorandum Exemption

The OSC has recognized that an 'offering memorandum' ("OM") exemption could benefit issuers in a stage of development in which increasing amounts of capital are needed. Accordingly the OSC intends to propose an OM exemption which is substantially harmonized with the OM exemption available in Alberta under section 2.9 of NI 45-106, however with some differences.

The proposed OM exemption would include a requirement that the investor receives an offering memorandum which includes prescribed information about the issuer and the securities offered. Investors would be required to sign a risk acknowledgement, qualify as an 'eligible investor' or if not an 'eligible investor' would be limited to investing a maximum of \$10,000. An 'eligible investor' would be one who meets certain financial requirements including, for example, for an individual, a person whose net assets (including spouse) exceeds \$400,000 or whose net income over last 2 years exceeded \$75,000 (alone) or \$125,000 (with spouse) with an expectation to exceed those income levels in the current year. There would be no limit on the aggregate amount of money that could be raised by an issuer under the OM exemption.

The OSC has indicated that it thinks that the new OM exemption may differ from the OM exemption currently available in Alberta in the following ways. Firstly, the specified information in the offering memorandum may be streamlined to make it more cost-effective for issuers and more user-friendly for investors. A limit may be imposed on the dollar amount of investment by an individual who is an eligible investor but who

is not an accredited investor where the issuer is not a reporting issuer (i.e. not a public issuer). The OM exemption will not likely be available to sell securities of an investment fund and may not be available to sell certain 'complex' securities such as securitized products (asset-backed securities) and derivatives. Finally, dealers and other registrants may not be able to use the OM exemption to sell securities of issuers who are related or connected to the dealer/registrant.

The OSC is also looking at whether it should impose restrictions on the ability of exempt market dealers ("EMDs") to act in trades under the new OM exemption because EMDs would be dealing with retail investors who may be unsophisticated. Previously EMDs have not been permitted to do so, having been restricted in dealing with accredited investors and those able to invest at least \$150,000.

Rights Offering/Existing Security Holders

Further to proposals made by the TMX, the OSC is likely to propose changes to the existing rights offering exemption that would make it easier for reporting issuers whose shares are already listed on an exchange to raise capital by leveraging their continuous disclosure. In this regard the OSC may reduce the period for regulatory review of rights offering circulars for certain reporting issuers that are eligible to file short form prospectuses from ten to three days and may remove the current 25% ceiling for dilution on a prospectus-exempt rights offering in certain circumstances. The OSC will also consider whether it is feasible to reduce to ten days the current twenty-one day minimum period during which rights may be eligible and whether it is feasible to allow documents to be delivered electronically.

Related to proposed changes to the existing rights offering exemption, the TMX also asked the OSC to consider a new prospectus exemption for the sale of a limited amount of securities on a private placement basis to existing security holders of issuers whose securities are listed on a recognized stock exchange. The OSC has indicated that it will continue to assess whether there would be sufficient incremental benefit in adopting such an exemption, given its proposed changes to the existing rights offering exemption.

Accredited Investor Exemption – Investment Funds and Fully-Managed Accounts

Although this is not a new exemption, the OSC also proposes a slight revision to the current definition of ‘accredited investor’ in NI 45-106 so as to allow portfolio managers of fully-managed accounts to purchase investment fund securities under the accredited investor exemption. Currently in Ontario such a portfolio manager would fall within the definition of an ‘accredited investor’ so long as it did not purchase securities of an investment fund for the fully-managed account.

Commentary

Each of the proposed new exemptions provides increased opportunities for issuers to raise equity capital and the OSC should be commended for its efforts to assist issuers, particularly start-ups and early-stage entities.

However such opportunities for issuers can also come with challenges. For example, consider how would an early-stage issuer which has little or no administrative

staff deal with the expectations of potentially hundreds of small shareholders following a crowdfunding. Would such shareholders have voting rights? Also, use of the crowdfunding exemption could inhibit future financing as venture capitalists, from whom many issuers may seek follow-on financing, historically have not been partial to funding issuers with a large number of small shareholders.

Under the crowdfunding exemption the regulations, including those relating to the funding portal, could prove to be too burdensome and costly; on the other hand the exemption is likely to be used by many early stage, inherently high-risk, issuers to sell securities to unsophisticated investors, many of whom may not be able to afford to lose their investment – the very people who are most in need of the protections of securities regulation. Striking the right balance will be a challenge.

Although the OSC has not given a timeline as to when they expect the proposed changes to be finalized and implemented, I would not expect to see any new rules in place before the end of 2013.

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