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Comment Period Closes on OSC's Consideration of a Crowdfunding Prospectus Exemption

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On December 14, 2012, the Ontario Securities Commission (OSC) released Staff Consultation Paper 45-710 requesting comments on proposed changes to rules regarding prospectus exemptions. Included in this report were considerations for a prospectus exemption to permit crowdfunding. The comment period closed on March 8, 2013. In Ontario, companies cannot offer securities to the public without complying with the costly disclosure requirements of a prospectus filing. The model described in the OSC Consultation Paper is proposed for discussion purposes only.

The paper considers the roles of three stakeholders in a model crowdfunding prospectus exemption regime: the Issuer, the Investor, and the Crowdfunding Portal.

The Issuer

Start-ups with limited access to venture capital or who have exhausted other sources of funding, and for whom issuing a prospectus would be too costly, could benefit from crowdfunding. A crowdfunding exemption would allow start-ups to access capital from a more diverse investor pool of individuals who might otherwise not invest in smaller, riskier ventures. Start-ups would have to attract a large number of small investments to raise significant amounts of capital. The OSC warns that "an issuer having a large number of potentially unsophisticated shareholders with relatively small interests in the issuer … [would] limit the issuer's future financing options" and may result in increased compliance and disclosure requirements under corporate law. Start-ups hoping to attract venture capital in the future should consider the consequences of a successful crowdfunding campaign.

The Investor

Investors who do not otherwise qualify under another prospectus exemption would be able to access a broader range of investment opportunities under a crowdfunding exemption. According to the OSC "[t]his would democratize the exempt market so that investment opportunities can be accessed by all investors, not just those with high income or net worth". However, less sophisticated investors, smaller amounts of investment, and limited disclosure requirements all contribute to the OSC's concern that a crowdfunding exemption will increase investors' exposure to fraud.

Under the proposed OSC model, the size of individual investments, the type of securities available, and the total amount of capital an issuer would be permitted to raise would be limited. Investors would be granted a two business day right of withdrawal from the date of their investment in order to review the disclosure provided.

The Funding Portal

Under the proposed OSC model, all investment under the crowdfunding exemption would be made through a registered funding portal. Funding portals under the proposed exemption would likely look similar to non-equity based crowdfunding portals such as Kickstarter or Indiegogo. The portal may negotiate terms with the issuer and would post only those issuers it finds acceptable to the portal website. Funding portals through which investors would obtain equity would be registered with the OSC under an appropriate dealer or adviser category, and may be obligated to perform some due diligence before allowing the issuer to accept funds through its site. The OSC expects that portals would act as curators and gatekeepers, listing only the most desirable issuers. In this role, funding portals could add another layer of investor protection as more reputable portals will perform more due diligence and only allow issuers who are less likely to commit fraud.

Consultation Paper 45-710 is the public's first comprehensive look at the possible approach the OSC may take to allow crowdfunding in the future. The model discussed in the paper reflects many of the rules and restrictions contained in the US JOBS Act which was signed into law on April 5, 2012, but have not yet taken effect. The US Securities Exchange Commission has not released its rules regarding the administration of crowdfunding permitted by the JOBS Act. Start-ups and investors should also keep in mind that the OSC's mandate is to protect investors from unfair, improper, or fraudulent practices. This mandate will play a substantive role in any crowdfunding exemption that may become available.

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