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Will Canada Make Room for Crowdfunding?

When the U.S. recently changed its securities laws to enable equity crowdfunding, advocates of the practice to the North started urging Canadian securities administrators to follow suit. What reforms are needed to enable equity crowdfunding in Canada? Taking a closer look at how crowdfunding fits (or more to the point, does not fit) with current Canadian securities law and comparing the experience of other countries should help answer this question.

The Crowdfunding Concept

Crowdfunding and crowdsourcing cover a range of activities – from charities soliciting donations on the Internet to "donation and reward" portals like the U.S.-based Kickstarter. On sites like Kickstarter, entrepreneurs can give rewards, such as pre-release products, to financial backers.[1] Kickstarter and its U.K. equivalent, CrowdFunder, are examples of how to successfully leverage "the crowd" to raise funds.

Equity crowdfunding takes things one step further. Like traditional ways of raising capital, equity crowdfunding involves giving investors shares or other securities in exchange for financing. The difference is that equity crowdfunding uses online platforms and the full reach of the Internet to source investors and automate transactions. Crowdfunding "portals" can even be seen as micro stock exchanges. This expansive reach is the real attraction of equity crowdfunding for fledgling enterprises, especially in the early stages. Unfortunately, equity

[1] http://newsroom.cisco.com/feature-content?type=webcontent&articleId=973468

crowdfunding also creates concerns and challenges for securities regulators.

Legal and deployed in Australia for years, equity funding portals also are being used in the U.K., although without express legal authority. And now, new legislation seems to be setting the stage for like opportunities in the U.S.. Then there is Canada, where equity crowdfunding is likely not practical or scalable within existing frameworks. Does Canada have a future in the equity crowdfundunding space?

U.S. JOBS Act

In the U.S., the real boost came in April 2012 when President Obama ratified the *Jumpstart Our Business Startups Act* (the *JOBS Act*), which was enacted in Congress with overwhelming bipartisan support. The *JOBS Act* brought a wave of deregulatory reforms designed to foster capital formation. The reforms also open the door to equity crowdfunding in the U.S.[2] by creating the "crowdfunding exemption" (otherwise know as the "4(6) exemption"), establishing a regulatory scheme for online funding portals, and easing up on private offering advertising and general solicitation prohibitions for accredited investors.

The Section 4 (6) Crowdfunding Exemption

The new 4(6) crowdfunding exemption will apply to offerings to any investor, regardless of accreditation. Because non-accredited investors are permitted to invest, this has been described as "Main Street" financing. Enabling investments by "unsophisticated" investors is controversial and has raised some serious investor protection concerns. The exemption will not take effect until the U.S. Securities and Exchange Commission (the SEC) determines just how the exemption will work, through a 270-day rule-making period set to expire December 31, 2012. Whether the SEC can meet this deadline is anyone's guess.

Under the exemption, issuers may sell investors an aggregate of up to US$1 million of securities in any 12-month period. To surpass this limit, issuers will have to rely on other exemptions and beware of integration issues.[3] Issuers trying to raise between US$100,000 and US$500,000 will have to provide financial statements that an independent public accountant has reviewed; those seeking to raise over US$500,000 will need audited financial statements.[4]

The *JOBS Act* does not control how many persons may invest in a crowdfunded issuer. However, it does cap how much any single investor may invest in a 12-month period. Investors whose net worth or annual income is under US$100,000 may invest no more than the greater of $2,000 or 5% of their net worth or annual income. For investors whose net worth or annual income is US$100,000 or more, the cap goes up to 10% of their net worth or annual income.[5] Even though investors may invest in many crowdfunded issuers in any year, these caps apply to all crowdfunding activity in a 12-month period. Under the law, intermediaries must take steps that the SEC deems appropriate to ensure that individual investors keep within these investment limits. Exactly how this will work with issuers, intermediaries, and investors all acting independently remains to be seen.[6]

Issuers will not be able to build their own crowdfunding sites, or use conventional social media for crowdfunding, as all transactions

[2] https://www.secondmarket.com/discover/wp-content/uploads/2012/01/Stay-Current-Demystifying-the-Recently-Enacted-Reforms-Paul-Hastings.pdf

[3] Integration requires an issuer's entire offering to fall within a single registration exemption.

[4] Section 4(6)(B) of the Securities Act.

[5] Section 4(6) (A) of the Securities Act. Some commentators interpret the cap as the lesser of the two amounts.

[6] https://www.secondmarket.com/discover/wp-content/uploads/2012/01/Stay-Current-Demystifying-the-Recently-Enacted-Reforms-Paul-Hastings.pdf

relying on the new exemption must be through a broker or registered funding portal.[7]

The new exemption is available only to issuers incorporated in the U.S., reflecting Congress' intent to benefit community based fundraising, and to help ensure the SEC has the necessary reach to enforce the rules. This limitation has some in Canada concerned that start-up companies will choose to incorporate in the U.S. for access to equity crowdfunding.

Registered Funding Portals under the *JOBS Act*

The *JOBS Act* creates the concept of a funding portal, defined as any intermediary involved in a transaction offering or selling securities on account of others, solely under the new 4(6) crowdfunding exemption.[8] These online funding portals may market private placements, facilitate buying and selling securities, and offer related services like, for instance, providing due diligence and standardized documents for issuers and investors. On the other hand, the portals may not advise on or recommend investments, solicit offers or transactions, compensate employees and others for soliciting or selling securities, or hold, manage, or possess investor funds or securities. More still, every funding portal will need to register with the SEC, become a member of FINRA or another national securities association, remain subject to SEC authority, and meet other requirements the SEC may impose. Under this framework, registered funding portals are expected to become the chief crowdfunding vehicle in the non-accredited investor arena.

Rule 506 Crowdfunding

One of the intriguing *JOBS Act* reforms changes the Rule 506 exemption (under Regulation D of the 1933 Act). Rule 506 allows issuers to raise unlimited funds from an unlimited number of accredited investors. Under the *JOBS Act*, Rule 506 is modified to permit general solicitation and advertising as long as everyone buying the offered securities is an accredited investor. Eliminating the general solicitation restriction makes advertising Rule 506 offerings on the Internet possible – a major change to the fundraising landscape.

The SEC's recently proposed new subsection (c) to Rule 506 also would allow general solicitation when offering and selling securities if:

- the issuer takes reasonable steps to verify that buyers are accredited investors;
- all buyers are accredited because they fall within one of the enumerated categories that qualify as an accredited investor, or the issuer reasonably believes all investors to be accredited investors at the time of sale; and,
- all terms and conditions of Rules 501, 502 (a) and 502 (d) of the 1933 Act are satisfied.

The SEC has confirmed that the same reasonable belief standard in the current U.S. accredited investor definition applies. So, as long as issuers take reasonable steps to verify and do reasonably believe that their purchasers are accredited investors, issuers will not lose the ability to rely on proposed Rule 506 (c), even if the purchaser ends up not meeting the accredited investor standard.

Modified Rule 506 opens channels for new online matchmaking platforms that connect accredited investors with start-ups. Section 201(1) of the *JOBS Act* confirms that those selling securities under the Rule 506 exemption will not be subject to broker-dealer registration simply because the seller:

- maintains a platform or mechanism for offering, selling, buying, negotiating, generally soliciting, advertising, or conducting associated activities online or through other means;

[7] Section 4(6)(C) of the Securities Act.

[8] Section 3(a)(80)of the Securities Exchange Act of 1934 http://www.sec.gov/about/laws/sea34.pdf; See also page 2: http://www.sec.gov/about/laws/sea34.pdf

- co-invests in the offering; and,
- provides ancillary services connected with the offering.

This registration exemption applies only if the intermediary neither receives compensation nor controls investor funds or securities associated with a Rule 506 distribution.

Legality of Equity Crowdfunding in Canada

No specific rule or law prohibits equity crowdfunding in Canada. However, Canadian issuers may raise capital only by filing a prospectus (a costly proposition) or relying on an exemption from prospectus requirements. What is more, funding portals must register under Canada's dealer and investment advisor registration regime. Prospectus and registration requirements in their current form have proved to be a practical barrier to introducing equity crowdfunding in Canada.

Registration of Funding Portals

Why are crowdfunding portals and the issuers using them subject to Canada's dealer and investment advisor registration regime? After all, low value transactions in high risk, start-up issuers don't seem to fit with the laborious know-your-client, know-your-product, suitability, and other exercises registrants are obliged to carry out.

In Canada, anyone "in the business" of trading securities must register with securities regulators in the interest of protecting investors and ensuring Canadian capital markets' integrity. Because operating a portal touches on many of the criteria indicating a "business purpose" – the trigger for registration requirements under National Instrument 31-103 (NI 31-103) – online crowdfunding portals are likely required to register. Indicia of having a business purpose include setting up a business to promote securities, intermediating in securities trades or making a market for them, taking compensation (whether transaction- or value-based) for these activities, and contacting anyone to solicit securities transactions. Given the breadth of these triggers, even the activities of passive portals that contain only user-generated content could require registration.

Registering as a dealer or investment advisor is no small task. Under NI 31-103, intermediaries must not only be accredited, but also have the education, training, and experience to act as a broker or advisor. Registrants are expected to understand their investment products' structure, features, and risks well enough to advise investors on suitability. Subject to "know your client" obligations, registrants need to learn their client's profile, investment goals, and risk tolerance[9] – a dealer-client relationship that seems to be completely at odds with online crowdfunding portals intended to automate securities placements and dramatically reduce costs for small transactions. (Just imagine having to clear all of your eBay purchases with a broker). Very few registrants would be eager to take on the potential liability associated with running a portal. No Canadian jurisdiction has established special rules for funding portals, so it comes as no surprise that no registered funding portals seem to exist in Canada.

In theory, the companies that use portals to raise funds might also need to register are dealers. Although issuers raising capital generally are not considered to be "in the business," this general rule may not apply if they trade in securities "frequently" or "solicit investors actively."[10] Might the registration requirement apply to companies that crowdfund for their own account? The answer is not clear.

More generally, online advertising or soliciting may itself cross the line into activity requiring registration. Take, for instance, Section 3.1 of 45-

[9] NI 31-103.

[10] Companion Policy 31-103CP Registration Requirements and Exemptions

106CP, which states that issuers may use registrants, finders, or any form of advertising (including Internet or e-mail) to solicit buyers under any of the 45-106 prospectus exemptions. At the same time, National Policy 47-201 suggests that Canadian securities regulatory authorities generally consider any person or company that posts on the Internet anything offering or soliciting securities trades to be trading in Canada if the post is accessible to persons or companies in Canada. The policy goes further, specifying that those who post offering documents on the Internet must register to trade in the local jurisdiction. Created in the Internet's early days of 1999, National Policy 47-201 has not been reconciled with NI 31-103. Combined with 45-106CP, while advertising and soliciting may be allowed for prospectus-exempt offerings, systematically doing so over the Internet could, somewhat circuitously, bump the activity up to trading and trigger the dealer registration requirements.

Not surprisingly, many key players in the start-up ecosystem have no interest in becoming registrants and few registrants are interested in the low-fee, high-liability stakes of raising funds for start-ups. In parts of Canada – namely Alberta, British Columbia, Saskatchewan, Manitoba, the Northwest and Yukon Territories, and Nunavut – the Northwest Exemption theoretically could help non-registrants operate funding portals. These jurisdictions passed blanket exemption orders (together called the Northwest Exemption) relieving intermediaries trading in the exempt market from 31-103 registration requirements if they meet these conditions: the individual is neither currently registered nor required to register,[11] provides no suitability advice or financial services to purchasers, has no access to investor assets, and complies with mandated risk disclosure and regulatory filings. Intermediaries relying on the Northwest Exemption also must restrict their trading activities to their own or other jurisdictions in the north-western block and trades falling within specified capital-raising exemptions. But, the Northwest Exemption probably never was intended for systematic trading through portals. At any rate, the territorial limitations alone pose practical problems in the Internet age.

Prospectus Exemptions

National Instrument 45-106 (NI 45-106) sets out most of the available prospectus exemptions. Start-ups typically use the "private issuer" and "accredited investor" exemptions. To qualify as a "private issuer", the company may have no more than 50 non-employee shareholders, who all have a relationship with the issuer, its founders, or its management. Equity crowdfunding envisions far more investors, many of whom would have no pre-existing relationship with the company, and who may or may not be accredited investors.

The offering memorandum (OM) exemption has been advanced as a potential vehicle for crowdfunding. Issuers can use the OM exemption everywhere in Canada except Ontario. An OM is a detailed disclosure document designed to help investors evaluate investments. OMs are intended to be less onerous to prepare than prospectuses. A closer look suggests that the OM exemption is an imperfect solution because the exemption is not available in Ontario and not uniform where it is available. For instance, British Columbia's broad exemption allows any number of buyers to invest any amount of money, so long as they execute a risk acknowledgement and receive the proper OM document from the issuer (different forms are prescribed for "qualifying" and "non-qualifying" issuers). Alberta applies more restrictions, such as capping investments at $10,000 for all but "eligible investors." Some provinces follow British Columbia's model and others follow Alberta's (again, except for Ontario).

Another problem with OMs is their requirement for audited financial statements from issuers,

[11] As per ASC Blanket Order 31-505 s.6(b), the exemption precludes foreign registrants.

even those with no history of operations. Audited statements can cost upwards of $25,000 – unrealistically steep for most start-ups, especially if investors end up with no meaningful information. OM forms have also been criticized for presenting information in a way unsophisticated investors would not likely understand.[12] The forms have also been criticized as unwieldy, with some reading like (and costing as much as) prospectuses prepared by highly-paid advisers, making "DIY" efforts look bad by contrast.

Regulating Later Transactions

A primary concern for equity crowdfunding is the creation of large numbers of small shareholders. Unlike the U.S., Canada does not deem an issuer to become a public company once it exceeds a certain number of shareholders. However, Canada's securities regulations include several exemptions geared to non-reporting issuers that are lost to issuers with many shareholders. The "private issuer" exemption, for instance, is no longer available after an issuer has over 50 non-employee shareholders. Because the "private issuer" exemption also covers resale, investors in private companies could find selling their shares difficult when the company no longer falls within the exemption. Similarly, Ontario's OSC Rule 62-504 restricts the "non-reporting issuer" exemption for take-over and issuer bids to issuers with fewer than 50 non-employee shareholders, meaning that sales and buy-backs of shares must comply with the full formal take-over or issuer bid regime applicable to true public companies.

Having large numbers of small shareholders can also be a headache under corporate law. In Canada, 100% of shareholders must sign a written resolution to conduct shareholder business, or else hold a duly-constituted meeting. This can mean that early-stage companies with lots of investors will find it difficult and expensive to make fundamental changes or even carry out regular housekeeping. For these and other reasons, some commentators suggest that crowdfunding investors should be pooled under a single corporation or trustee. But, at least in Canada, pooling within a single corporation probably is not tax-effective. (On the other hand, the trustee model just might work.)

Jurisdictional Issues for U.S. Portals

The Internet's nature raises complex jurisdictional issues for crowdfunding regulation. By introducing Rule 506 crowdfunding in particular, the U.S. may make it possible for Canadian issuers to use U.S. portals to solicit investment from U.S. accredited investors, surfacing some serious questions as follows:

- National Policy 47-201 (47-201) warns that Canadian authorities generally consider entities to be trading in securities in a Canadian jurisdiction when they post documents offering or soliciting securities trades on the Internet if individuals or companies in Canada have access to the documents. Canadian issuers not wanting to run afoul of 47-201 may need U.S. matching services to block Canadian IP addresses or somehow fence offerings by, for example, requiring users to enter a valid U.S. address to prove residency (consider online travel booked through U.S. websites accessed from Canada).
- By contrast, the Interpretation Note replacing repealed OSC Policy 1.5 describes the Ontario Securities Commission's view that Ontario or non-Ontario issuers' distributions outside of Ontario might be considered distributions within Ontario if "connecting factors with Ontario" exist. Though which "connecting factors" would act as triggers is unclear, the Commission has

[12] In the mutual fund area, this particular concern has been nicely addressed by the new "Fund Facts" requirement. As of January 1, 2011, mutual fund companies are required to provide a Fund Facts disclosure document to investors at the point of sale (free of charge) that describes its offerings in plain and understandable language.

said a prospectus or other exemption is not needed where reasonable steps are taken to ensure that the securities connected with the extra-provincial distribution will remain outside of Ontario. According to the Interpretation Note, the issuer's measures to stop foreign issued securities from entering the Ontario market should be stringent enough to ensure that non-residents ultimately hold the securities and intermediaries cannot acquire securities for resale in Ontario.

- Provincial deeming rules further cloud questions of jurisdiction. Section 2.3 of 47-201 is a case in point: the section considers an online extra-provincial distribution by a company incorporated in British Columbia, Alberta or Quebec to be a distribution within that province as well.

U.S. funding portals wishing to serve Canadian issuers need to carefully consider their distribution model and whether they must register as dealers in Canada.

Building a Canadian Crowdfunding Model?

Will Canada lose entrepreneurs and innovators to crowdfunding-friendly neighbours, including the U.S.? On the other hand, would introducing crowdfunding into Canada put unsophisticated investors at risk?

Critics have pointed to crowdfunding as impossible-to-police "fraudfunding". Given that the U.S. experiment with crowdfunding remains in the early stages, looking to other jurisdictions may be instructive.

Crowdfunding is legal in Australia, where registered funding portals serve as a hub for investors to find investment data and buy securities. The Australian Securities and Investments Commission's Class Order 02/273 permits funding portals to act as "introduction services" and market securities on an issuer's behalf as long as they warn about the risky nature of early-stage investment.[13] Section 708(1) of the *Corporations Act 2001* (the enabling legislation in Australia) limits issuers to raising capital from no more than 20 unaccredited investors in any 12-month period and a maximum amount of $2,000,000.[14]

In the U.K., Crowdcube and others manage "equity funding portals" seemingly with the authorities' acceptance, even though crowdfunding legislation has yet to be enacted. Crowdcube is an interesting model given that the crowd does not invest directly into the fundraising issuer (as in Australian crowdfunding), but rather aggregates the funds in a holding entity that in turn invests as a single investor.

Most likely in response to the 108 letters from over 300 participants CSA staff received during consultation over CSA Staff Consultation Note *Review of Minimum Amount and Accredited Investor Exemptions*, the Ontario Securities Commission has convened the Exempt Market Advisory Committee (EMAC). EMAC will advise on matters concerning regulating the capital-raising segment of the exempt market, including the *JOBS Act*. The earlier exempt market consultation yielded mixed feedback. While some advocated for more liberal accredited investor and minimum amount exemptions, others supported narrowing the exemptions in the name of investor protection. Others still supported the status quo, while some encouraged modifying the accredited investor exemption or adopting other prospectus exemptions to specifically support capital formation by small and medium-sized companies. Crowdfunding represents a new factor in this debate.

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[13] ASIC Class Order 02/273: http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/co02-273.pdf/$file/co02-273.pdf

[14] http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s708.html

Investor Protection

Securities regulators have two priorities: protect investors from unfair, improper, and fraudulent activities and foster fair and efficient capital markets that inspire confidence. Regulators are often particularly concerned about the potential for fraud and abuse, especially against unsophisticated investors who seem more susceptible and more vulnerable to financial loss. Some members of the CSA have launched public awareness initiatives, such as the "Blue Hedge" campaign,[15] to tackle concern over online investment fraud.

Yet crowdfunding advocates assert that Australian and U.S. measures for combating fraud from funding portals should suffice in Canada as well. Today, early-stage capital-raising in Canada is cobbled together informally, at times with help from unregistered "finders". A regulated crowdfunding portal may actually enhance investor protection by moving these activities under a spotlight. Kickstarter, Indiegogo and other crowdfunding sites have invested in sophisticated algorithms to detect fraud and are sensitive to public criticisms of misuse. This promises that portals could become an important fraud prevention ally to securities regulators.

Some even wonder if the securities laws regime is in fact the correct framework for crowdfunding. Investments in start-up companies are extremely high-risk. Even so, non-financial incentives for investing in them have always existed, including intrigue with a concept and wanting to help bring to market socially useful products and services; some investors simply want to support a beloved local business. Kickstarter's success shows just how large the community of willing contributors can be, even without the promise of income or profit. Through this lens, perhaps small crowdfunded investments are best seen not as securities, but as lottery tickets or donations (or both).

The Crowdfunding Impact

In the final analysis, if permitted in Canada, crowdfunding could have a real impact on the early-stage financing landscape, particularly for companies that have traditionally had difficulty securing capital. Crowdfunding has fast become a billion dollar industry with the potential to fill the funding gap many small issuers face.[16]

Because angel investors and venture capitalists do invest at the concept stage, they could find themselves competing with the crowd for early, inexpensive capital. However, the small investment amounts characteristic of crowd contributions stand in stark contrast to typical venture capital investments. In Australia, where crowdfunding has been legal for years, the mean crowdfunding investment is about $300,000.[17]

If Canada does embrace equity crowdfunding, market regulators will need to strike the right balance between protecting investors and allowing capital to flow through new online channels. If they succeed, Canada may be better positioned to compete, spark innovation, and hold onto talent.

Contact Us

For further information, please contact a member of our National Securities | Corporate Finance Group.

[15] The "Blue Hedge" campaign was organized by the Canadian Securities Administrators and the Securities Commissions to education the public about online scams. The campaign featured a fake investment website, promoted by email blasts, social media and advertisements on prominent web pages, that encouraged visitors to invest immediately in a fictitious fund.

[16] The New Federal Crowdfunding Exemption: Promise Unfulfilled, C. Steven Bradford , University of Nebraska College of Law, May 24, 2012, Securities Regulation Law Journal, Vol. 40, No. 3, Fall 2012

[17] Australia Small Scale Offerings Board