

Ontario Bar Association

Regulatory Challenges in a Technological Age

**CROWDFUNDING: A BRAVE NEW WORLD FOR
INVESTORS?**

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CROWDFUNDING: A BRAVE NEW WORLD FOR INVESTORS?

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I have travelled the length and breadth of this country, and have talked with the best people in business administration. I can assure you on the highest authority that data processing is a fad and won't last out the year.

Editor in charge of business books at Prentice-Hall publishers, responding to Karl V. Karlstrom (a junior editor who had recommended a manuscript on the new science of data processing), c. 1957

I. Introduction

Technological advances have made radical changes to nearly every daily activity; sometimes making them more convenient and accessible. However, from a regulator's perspective, the opposite can also often be said; technology creates new risks and concerns. The issue is the trade-off between "[regulating] too early and risk stymieing innovators, [or waiting] too long and risk losing the opportunity to regulate a technology or service before it becomes widespread, potentially harming consumers or markets in the interim".³ Recent advancements in technology in the financial industry have prompted a need for changes to modernize securities regulation, and the challenges that regulators are currently facing are daunting.

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³ Shrupti Shah, Rachel Brody and Nick Olson, *The Regulator of Tomorrow*, online: Deloitte University Press <<http://dupress.com/articles/us-regulatory-agencies-and-technology>>.

We considered a number of topics for this brief paper before choosing crowdfunding. For example, online “robo” advisors are extremely topical – but in our view it is one of the few examples where regulators seem to have been able to keep up with technological changes in the capital markets. Within a year, both the Canadian Securities Administrators (“CSA”) and the Ontario Securities Commission (“OSC”) released substantially similar reports dealing with the regulation of online advisors.⁴ Despite the increased interest in advisors delivering their services through online platforms, “the Know-Your-Client (“KYC”) and suitability obligations of portfolio managers (“PMs”) [who] provide services through online platforms remain the same as for any other PM”.⁵ Accordingly, “a PM’s obligations under securities law [has] not [changed] as a result of the [changes in the] delivery method[s] of providing services to a client”.⁶ Although an interactive “robo” advisor website may be used to collect KYC information, this information must be reviewed by an advisory representative (“AR”).⁷ The AR must then “ensure that sufficient KYC information has been gathered to support the PM firm’s obligation to make suitability determinations for the client”.⁸

This is to be contrasted with the United States’ model of “robo-advice”, whereby little human interaction is required. In Canada, online advisors are required to maintain a minimum level of personal relations with their clients.⁹ As such, it can be characterized as a hybrid model “that [utilizes] an online platform for the efficiencies it offers, while ARs remain actively involved in (and responsible for) the decision making”.¹⁰ This entire concept demonstrates that, despite technological advancements in the financial industry, it is possible for regulators to ensure that their regulations are “technology neutral”.¹¹

But a detailed discussion of “robo” advising is for another day.

We chose crowdfunding because although some small advances have been made, rapidly approaching challenges still lie ahead as regulators strive to balance the efficiency of the market with the interests of investors.

⁴ Michael Sharp, Kevin Rusli and Pamela Hughes, *CSA Provides Guidance on Canadian “Robo-Advisers”*, online: Blakes, Cassels & Graydon LLP <<http://www.blakes.com/English/Resources/Bulletins/Pages/Details.aspx?BulletinID=2202>>.

⁵ *Ibid.*

⁶ *Ibid.*

⁷ *CSA Staff Notice 31-342*, online: OSC <http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20150924_31-342_portfolio-managers-online-advice.htm>.

⁸ Sharp, Rusli and Hughes, *supra* note 4.

⁹ *Ibid.*

¹⁰ *CSA Staff Notice 31-342*, *supra* note 7.

¹¹ *Ibid.*

Crowdfunding is an already well-established way to obtain capital on a “charitable” donation basis. Equity capital crowdfunding, however, is a much more recent trend, whereby people make investments, as opposed to donations, with the expectation of a financial return.¹² In response to the market’s new direction, “securities regulators in Canada [claim to] have now established legal frameworks to permit crowdfunding via [the] sales of securities”.¹³ According to the OSC, “accredited investors make up only about 4 per cent of the [country’s] population”, which results in a limited pool of available capital.¹⁴ As such, the provinces have created exemptions to widen the pool of available of resources, with the objective of “[facilitating] capital-raising by start-ups and other small companies, who often face difficulties using traditional financing models, while at the same time creating new investment opportunities for small investors”.¹⁵

This paper will begin by defining the current crowdfunding regulatory framework in Ontario, followed by an analysis of the opportunities and challenges equity crowdfunding presents to the market and regulators alike, concluding with our small and respectful views on potential opportunities and challenges for the future.

II. The Regulatory Framework in Ontario

Currently, equity crowdfunding is primarily regulated by the CSA and the OSC.

CSA

Under the National Instrument 45-106, “issuers and underwriters who rely on certain prospectus exemptions to distribute securities are required to file a report of exempt distribution within a prescribed timeframe”.¹⁶ This provides issuers with general exempt market regime rules, however, the OSC has released more detailed and specific requirements that pertain to equity crowdfunding.

¹² Peter-Paul Van Hoeken, *Canadians Should Give Equity Crowdfunding a Warm Welcome*, online: LinkedIn <<https://www.linkedin.com/pulse/canadians-should-give-equity-crowdfunding-warm-peter-paul-van-hoeken?forceNoSplash=true>>.

¹³ Matthew Atkey, Eric L. Foster and Eme L. Baack, *Crowdfunding in Canada and the United States*, online: Torys LLP <<http://www.torys.com/insights/publications/2015/11/crowdfunding-in-canada-and-the-united-states>>.

¹⁴ Clare O’Hara, *New Crowdfunding Rules Widen Pool for Canada’s Private Capital Markets*, online: the Globe and Mail <<http://www.theglobeandmail.com/globe-investor/investor-education/new-crowdfunding-rules-widen-pool-for-canadas-private-capital-markets/article28660189>>.

¹⁵ Atkey, Foster and Baack, *supra* note 13.

¹⁶ *Guidance for Preparing and Filing Reports of Exempt Distribution under NI 45-106 Prospectus Exemptions*, online: OSC <http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20160407_45-308_revised-guide-exempt-distribution.htm>.

OSC

In 2014, the OSC conducted a review “of the existing exempt market regime to determine if changes [should] be made that would facilitate the raising of private equity for small- and medium-sized enterprises (“SMEs”)”.¹⁷ The four available OSC prospectus exemptions included:

1. Distributions by a reporting issuer (other than an investment fund) listed on a specified exchange to its existing security holders

This exemption came into force on February 11, 2015. It has permitted “publicly listed issuers on specified Canadian exchanges to cost-effectively raise capital from their existing investors in reliance on the issuer’s continuous disclosure record”.¹⁸

2. Family, friends and business associates exemption

This exemption came into force on May 5, 2015, and has allowed issuers to sell certain types of securities to family, friends and business associates in Ontario.¹⁹

3. Offering Memorandum (“OM”) prospectus exemption

This exemption came into force January 13, 2016. This exemption grants a release from the strict requirements of filing a detailed prospectus “to a wide range of businesses at different stages of development”.²⁰ It is under this exemption that Canadian companies raising capital through crowdfunding are required to provide financial statements.²¹

¹⁷ David Woolford, *TSX Private Markets – A New Platform in Canada’s Exempt Markets*, online: Miller Thomson Lawyers <<http://www.millerthomson.com/health-portal/our-publications/other-miller-thomson-publications/securities-practice-notes/january-2015/tsx-private-markets-a-new-platform-in>>.

¹⁸ *Backgrounder - Exempt Market Review (“Backgrounder #1”)*, online: Ontario Securities Commission <http://www.osc.gov.on.ca/documents/en/Securities-Category4/nr_20151105_osc-proposes-four-capital-raising-backgrounder.pdf>.

¹⁹ *Ibid.*

²⁰ *Backgrounder – Exempt Market Review (“Backgrounder #2”)*, online: Ontario Securities Commission <http://www.osc.gov.on.ca/documents/en/News/nr_20150219_family-friends-business-backgrounder.pdf>.

²¹ *Backgrounder #1*, *supra* note 18.

4. Crowdfunding prospectus exemptions

These exemptions came into force on January 25, 2016. They allow online portals to connect with both accredited and “non-accredited investors to participate in early-stage companies, traditionally limited to accredited and institutional investors”.²²

This exemption led to the creation of the Multilateral Instrument (“MI”) 45-108, which includes measures intended to provide effective protection of investors. The measures and restrictions applicable to crowdfunding transactions are as follows:

Type of Security

Under MI 45-108, issuers can only offer “non-complex securities, [...] such as common shares, non-convertible preference shares and limited partnership units”.²³

Eligible Companies

MI 45-108 applies to both “Canadian private and public companies with (i) a majority of the board residing in Canada, (ii) [a] head office in Canada and (iii) [a] principal operating subsidiary, if any, in the U.S. or in Canada. Special Purpose Acquisition Companies (“SPACs”) are not eligible”.²⁴

Investment Limits

An investor who does not qualify as an ‘accredited investor’ has a limit of \$2,500 per investment and a total of \$10,000 per calendar year.²⁵ An accredited investor, other than a permitted client, has a limit of \$25,000 per investment and a total of \$50,000 per calendar year.²⁶ A permitted client, one who has net financial assets above \$5-million, has no investment limit.²⁷

²² Darin Renton and Matei Olaru, *Crowdfunding Exemption Launched*, online: Stikeman Elliott LLP <<http://www.canadiansecuritieslaw.com/2016/01/articles/securities-law-compliance/crowdfunding-exemption-launched>>.

²³ *Ibid.*

²⁴ Atkey, Foster and Baack, *supra* note 13.

²⁵ Claire Gowdy, Omar Soliman and Andrew Parker, *Final Crowdfunding Rules to Come into Force in Five Provinces, including Ontario*, online: Securities Regulations Canada <<http://www.securitiesregulationcanada.com/2015/12/final-crowdfunding-rules-to-come-into-force-in-five-provinces-including-ontario-in-january-2016>>.

²⁶ *Ibid.*

²⁷ Brenda Bouw, *Despite New Rules, Equity Crowdfunding is No Picnic*, online: the Globe and Mail <<http://www.theglobeandmail.com/report-on-business/small-business/sb-money/crowdfunding-could-cause-headaches-for-companies-down-the-road/article27212620>>.

Companies also have a limit, whereby they are permitted to raise up to \$1.5 million in aggregate proceeds in a 12-month period.²⁸

Offering Document

Under MI 45-108, issuers are required “to prepare an offering document that contains all of the information about the issuer and its business that an investor should know before purchasing the issuer’s securities”, such as the issuer’s business, directors, officers and major shareholders; related party transactions; planned use of proceeds; risk factors; and financial statements.²⁹ The crowdfunding offering document must also contain “a contractual right of action against the issuer for rescission and damages if any disclosure materials contain an untrue statement of a material fact”.³⁰

Risk Acknowledgment Form (“RAF”)

Investors are required to complete a “RAF [which] highlight[s] the key risks associated with the investment”.³¹ By signing the RAF, the investor positively confirms that he or she has “read and understood the risk warnings and information in the crowdfunding offering document, before entering into an agreement to purchase securities”.³²

Liability for Materials

As previously mentioned, issuers are held “accountable for, and are subject to, a standard of liability on the crowdfunding offering document and other permitted materials”, and as such, “investors are provided with a related right of action”.³³

Distribution Period

The distribution period cannot exceed 90 days following the securities offerings by the issuer, and the “closing must take place within 30 days of the end of the distribution period”.³⁴

²⁸ Gowdy, Soliman and Parker, *supra* note 25.

²⁹ Lucy Durocher and Demyan Vlaev, *20 Questions on Crowdfunding*, online: PwC <<https://www.pwc.com/ca/en/financial-reporting/ifrs-and-other-accounting-developments/publications/pwc-2015-12-15-20-questions-on-crowdfunding-en.pdf>>; Atkey, Foster and Baack, *supra* note 13.

³⁰ Gowdy, Soliman and Parker, *supra* note 25.

³¹ *Background #1*, *supra* note 18.

³² Barbara Hendrickson, *Crowdfunding Exemption in Effect in Ontario on January 25th, 2016*, online: BAX Securities Law <<http://www.baxsecuritieslaw.com/blog/2015/11/17/crowdfunding-exemption-in-effect-in-ontario-on-january-25th-2015>>.

³³ *Ibid.*

³⁴ Renton and Olaru, *supra* note 22.

Advertising and Solicitation

Issuers are prohibited from advertising and engaging in general solicitation. However, it is not prohibited to inform the public of a contemplated distribution and the portal contemplated for such a distribution.³⁵

Ongoing Disclosure

Regarding non-reporting issuers, investors must have access to annual financial statements, a notice of the use of proceeds, and if applicable, a notice of discontinuation of the issuer's business or a change in the issuer's industry or control of the issuer.³⁶ Reporting issuers "must continue to comply with all of their previous disclosure requirements".³⁷

Registered Funding Portal

Issuers may only distribute securities through a single funding portal that is registered as an investment dealer, exempt market dealer or restricted dealer and "must post the offering document and other permitted materials solely on that funding portal's online platform".³⁸ Companies "cannot issue equity to investors through other general crowdfunding web sites that are not registered with securities regulators".³⁹

Funding Portal Requirements

Funding portals are prohibited from offering securities of a related issuer.⁴⁰ In addition, the funding portal "must obtain an issuer access agreement and perform background checks on both the issuer and its principals and review all of the issuer's disclosure materials to confirm that the issuer is meeting its obligations and has not made any misrepresentations".⁴¹

Risk Assessment Questionnaire

In addition to these measures, on May 18, 2016, the OSC sent Ontario registrants a Risk Assessment Questionnaire ("RAQ"), to be completed "by portfolio managers, investment fund managers, exempt market dealers, restricted portfolio managers and restricted dealers in

³⁵ *Ibid.*

³⁶ Hendrickson, *supra* note 32.

³⁷ *Ibid.*

³⁸ Renton and Olaru, *supra* note 22.

³⁹ Janet McFarland, *Regulators OK New Crowdfunding Rules for Firms in Five Provinces*, online: the Globe and Mail <<http://www.theglobeandmail.com/report-on-business/regulators-ok-new-crowdfunding-rules-for-firms-in-ontario-other-provinces/article27117232>>.

⁴⁰ Renton and Olaru, *supra* note 22.

⁴¹ Gowdy, Soliman and Parker, *supra* note 25; Renton and Olaru, *supra* note 22.

Ontario”.⁴² Although the RAQ is similar to the 2014 version, it also includes “questions intended to assess how registrants, issuers and portals are using newly developed capital-raising prospectus exemptions, such as the crowdfunding exemption and the OM exemption”.⁴³ The OSC will use the data gathered to apply a risk ranking to firms, whereby “firms with higher risk rankings are more likely to be targeted by the OSC for compliance reviews”.⁴⁴

III. Opportunities and Challenges

Crowdfunding Opportunities for the Market

As equity crowdfunding is primarily tailored to SMEs, this form of financing can be extremely beneficial to companies that tend to fail due to a lack of available capital.⁴⁵ In fact, “crowdfunding is best suited for companies that are beyond the ‘idea stage’ but far from going public”.⁴⁶ Crowdfunding benefits companies that are “too small to interest institutional investors” and that also lack the assets to obtain debt financing.⁴⁷ Even if a company was in a position to obtain a loan, crowdfunding provides the SME with a much more flexible alternative.⁴⁸

Crowdfunding also allows smaller companies to “leverage the power of social media and their supporters and existing customer base to sell securities online”, thereby providing such companies with a much broader exposure to investors than in the past.⁴⁹ Such companies are no longer constricted by boundary lines, since “a business resident outside of a participating jurisdiction can raise funding under the Integrated Crowdfunding Exemption, as long as the business is

⁴² Cristian Blidariu et al., *Tomorrow, May 18, Registrants Will Receive the OSC’s 2016 Risk Assessment Questionnaire – What will your Firm’s Risk Rating be?*, online: Securities Regulation Canada <<http://www.securitiesregulationcanada.com/2016/05/tomorrow-may-18-registrants-will-receive-the-oscs-2016-risk-assessment-questionnaire-what-will-your-firms-risk-rating-be>>.

⁴³ *Ibid.*

⁴⁴ *Ibid.*

⁴⁵ Peter Henderson, *Provincial Changes Lead Entrepreneurs to Equity Crowdfunding*, online: the Globe and Mail <<http://www.theglobeandmail.com/report-on-business/small-business/entrepreneurs-turn-to-equity-crowdfunding-as-provinces-loosen-rules/article27266861>>.

⁴⁶ *Ibid.*

⁴⁷ Marjukka Sippola, *Crowdfunding in the Context of Securities Offerings in the US and Europe: an Overview of the Regulatory Framework*, online: Krogerus <http://www.krogerus.com/images/uploads/pdf/Securities_Law_Feb2013.pdf>.

⁴⁸ Henderson, *supra* note 45.

⁴⁹ JD Alois, *OTC Markets CEO Cromwell Coulson: “Online Securities Offerings are Completely Disruptive”*, online: Crowdfund Insider <<http://www.crowdfundinsider.com/2016/03/82765-otc-markets-ceo-cromwell-coulson-online-securities-offerings-are-completely-disruptive>>.

incorporated or organized under the laws of a jurisdiction in Canada and has its head office and the majority of its directors are in Canada”.⁵⁰

It also provides first-time investors with an opportunity to gain experience in the market with a relatively low-risk method, compared to investing on a much larger scale, “making it attractive to millennials looking for more control and connection to their portfolio[s]”.⁵¹ Not only does crowdfunding offer financial benefits to both SMEs and investors, but it also provides companies with a resource pool that can offer “valuable insights into product development”, act as a link in developing resource networks and, in turn, allow these investors to become powerful product promoters.⁵²

The Regulatory Challenges of Crowdfunding

From the company’s perspective, “having [a large number] of investors [can] be difficult for a start-up to manage, especially if many of the investors are inexperienced with this type of investment”.⁵³ For contextual purposes, in order to raise \$1.5 million under this regime, it would require [at least] 600 non-accredited investors or 60 accredited investors, which demonstrates the regulator’s necessary role in ensuring investor protection.⁵⁴ Furthermore, the reality is that start-up businesses are generally considered to be “high-risk, even under the best of circumstances”.⁵⁵ For investors, “crowdfunding increases this risk, [as it is simpler] to make a pitch for support online”.⁵⁶ It is, indeed, a “crazy way to invest”.⁵⁷

Further complicating matters is the fact that “the intended primary audience for disclosures made in a crowdfund investment setting is the ‘crowd’, an ill-defined group of potential and actual investors”.⁵⁸ In fact, “the touchstone of disclosure policy in securities regulation is the ‘reasonable

⁵⁰ Alixe Cormick, *Equity Crowdfunding Regulations*, online: National Crowdfunding Association of Canada <<http://ncfacanada.org/equity-crowdfunding-regulations>>.

⁵¹ Henderson, *supra* note 48.

⁵² Craig Asano, *Crowdfunding is Essential for SME Innovation and Job Creation*, online: National Crowdfunding Association of Canada <<http://ncfacanada.org/crowdfunding-is-essential-for-sme-innovation-and-job-creation>>.

⁵³ Bouw, *supra* note 27.

⁵⁴ *Ibid.*

⁵⁵ Neil Gross, *Crowdfunding Has a Place, But It’s a Crazy Way to Invest*, online: the Globe and Mail <<http://www.theglobeandmail.com/report-on-business/rob-commentary/crowdfunding-has-a-place-but-its-a-crazy-way-to-invest/article24715364>>.

⁵⁶ *Ibid.*

⁵⁷ *Ibid.*

⁵⁸ Joan MacLeod Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing To and For the “Crowd”*, online: Crowdcheck <<http://www.crowdcheck.com/sites/default/files/Investor%20and%20Market%20Protection%20in%20the%20Crowdfunding%20Era.pdf>>.

investor’ [and] it is this investor that regulation strives to protect”.⁵⁹ It is therefore possible that a crowdfund investor does not have the attributes of the reasonable investor, further emphasizing the regulator’s important role in protecting these individuals.⁶⁰ There is also the added risk that fraudsters will eventually and inevitably target inexperienced investors through crowdfunding schemes, whereby money is invested in what appears to be a legitimate company.⁶¹ Similarly, another problem with targeting the ‘crowd’ is that crowds are “easily excited about novel things [and] in turn, the crowd might not be so wise after all, when it comes to what the market wants”.⁶²

A final challenge that regulators will have to consider is the need to maintain reasonable compliance costs, as lower costs are one of the primary reasons that crowdfunding is such a desirable alternative to raising capital. The OSC has recognized “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 impose excessive regulatory costs on issuers and funding portals”.⁶³ As equity crowdfunding is a relatively new way of doing business, only time will tell if regulators can maintain a reasonable balance between the two.

IV. Concluding Remarks

As a relatively new trading platform, regulators have begun to take steps in order to identify and try to minimize the potential risks to investors. There is still room for substantial improvement. In the face of an ever-growing reliance on technology to create new delivery channels for securities products, regulators will have to take a pre-emptive stance to avoid finding themselves in their current, reactionary position. As raising capital will continue to become progressively computerized, we believe that it is only a matter of time before the entire market becomes automated. That is a cause of real concern to us. While there is also the possibility that crowdfunding could become a viable alternative for not only SMEs, but for larger enterprises as well, we believe considerable thought needs to be given to issues of suitability, market integrity and investor protection. In the face of these potential changes, provincial regulators will inevitably have to take a more cooperative approach with each other to embrace the rapid shift towards a technologically centered market. Do we hear another cry for a national securities enforcement regulator?

⁵⁹ *Ibid.*

⁶⁰ *Ibid.*

⁶¹ McFarland, *supra* note 39.

⁶² *Special Report*, online: TD Economics
<<https://www.td.com/document/PDF/economics/special/Crowdfunding.pdf>>.

⁶³ *Ibid.*

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