The Democratization of Financing

by

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Abstract

This thesis seeks to contribute to the existing literature on equity crowd funding in Canada by putting forward the proposal that effective regulation of equity crowd funding offers a solution to counter Canada’s poor track record of productivity and innovation vis-à-vis other developed nations. The equity crowd funding market is the future of early stage financing for start-ups. This emerging market presents an opportunity for the Canadian securities regulators to expand the exempt market in a cost-effective manner. For this market to succeed it is vital that a workable model is established, which is compelling to both investors and entrepreneurs, to realize significant benefits to the Canadian economy.
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# Table of Contents

Introduction ........................................................................................................................................... 1

Chapter One: Crowd funding & Securities Laws ................................................................................. 2

Introduction ........................................................................................................................................... 2

Crowd funding ........................................................................................................................................ 2

Equity Crowd Funding ........................................................................................................................... 6

Canadian Securities Regulation ............................................................................................................. 8

Conclusion ............................................................................................................................................. 14

Chapter Two: Start-up Financing in Canada ......................................................................................... 15

Introduction ........................................................................................................................................... 15

Innovation .............................................................................................................................................. 15

The “Gap” in the Informal Risk Capital Market ...................................................................................... 16

The Equity Crowd Funding Solution .................................................................................................... 19

Conclusion ............................................................................................................................................. 21

Chapter Three: Comparative Country Experiences .............................................................................. 23

Introduction ........................................................................................................................................... 23

Australia ................................................................................................................................................. 23

The United Kingdom ............................................................................................................................ 25

The United States ................................................................................................................................. 28

Conclusion ............................................................................................................................................. 31

Chapter Four: Aspects of Successful Regulation .................................................................................. 32

Introduction ........................................................................................................................................... 32
The Investor Perspective .................................................................................................................. 32
The Creator Perspective .................................................................................................................. 36
The Portal Perspective .................................................................................................................... 39
The Business Perspective ............................................................................................................... 41
A Sectoral Approach ...................................................................................................................... 41
Conclusion ....................................................................................................................................... 43
Conclusion ....................................................................................................................................... 45
Introduction

This thesis will contribute to the existing literature on equity crowd funding in Canada. The aim of this thesis is to put equity crowd funding into the broader context of filling existing funding gaps for start-ups and supporting innovation to drive productivity growth in Canada. My focus is on discussing the role that equity crowd funding plays in reaching this wider objective and how the regulation of equity crowd funding should be structured to best achieve this goal of promoting innovation.

I will begin by providing background information on crowd funding in general and explaining how equity crowd funding can contribute to existing securities legislation. This emerging market presents an opportunity for the Canadian securities regulators to be market leaders in offering an equity crowd funding platform that is compelling to both investors and entrepreneurs. I will highlight Canada’s poor productivity performance and explain how it is lagging in the innovation race. I will discuss current modes of financing that are available for start-ups and then explain how equity crowd funding can fit into this and improve innovation.

I will profile a number of other jurisdictions where equity crowd funding is already operating. I will discuss the experiences of those jurisdictions that may inform the regulatory approach to be pursued in Canada. I will then put forward the key aspects of a regulatory structure for equity crowd funding that will ensure the utility of this new mode of financing in filling the funding gap for start-ups by ensuring that the right companies get funded. By creating a set of regulations that is forward thinking and cost-efficient, this will ultimately open up the equity crowd funding market with significant benefits to the Canadian economy.

Finally I will recommend that the regulations develop in a sector-specific manner to allow this new market the greatest possible flexibility. My focus is primarily on the legislative approach to the portals as they will be the fundamental driver in the success of this new financing method.
Chapter One: Crowd funding & Securities Laws

Introduction

In this chapter I will begin with a definition of crowd funding and a brief background on the concept of crowd funding. I will then provide a brief history of crowd funding and an introduction to the traditional modes of crowd funding. The three most well-established modes of crowd funding are donation-based, rewards-based and loan-based crowd funding. I will then explain how equity crowd funding has developed from these traditional methods. After setting out some key issues associated with equity crowd funding, I will then describe the existing parameters of securities regulations in Canada. It is important to understand how Canadian securities law operates because, if equity crowd funding is to emerge in Canada at all, this is the context within which it must operate. I will explain the two options that any company has when trying to raise funds by issuing securities; the prospectus process and the exempt market. I will then illustrate how equity crowd funding can fit into this regulatory structure. This chapter aims to present the case for the expansion of the exempt market into equity crowd funding.

Crowd funding

Although lacking a precise definition, crowd funding is generally understood as “the practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet.” The predecessor to crowd funding is crowdsourcing. Crowdsourcing involved “collecting contributions from many individuals to achieve a goal.” Crowdfunding was a natural evolution of this, the step from sourcing information to sourcing financing from many individuals. Belleflamme, Lambert and Schwienbacher stated that crowd funding involves an open call, mostly through the Internet, for the provision of financial resources either in form of donation or in exchange

for the future product or some form of reward to support initiatives for specific purposes.² Although this mode of fundraising has only recently caught the attention of the media and policymakers, its roots can be traced back deep into history. An oft-cited historical example was the Statue of Liberty. It was partly funded by small contributions from the general public after the renowned Joseph Pulitzer advertised in a national newspaper in 1885.³

The key difference between that form of crowd funding and today’s method and the reason for its rapid development can be attributed to the Internet. As Fraunhofer explains, “what is new in crowd funding is that it exploits the capabilities of social networks and other new features of web 2.0, especially the function of ‘viral networking and marketing,’” which enabled the mobilization of a large number of users in specific Web communities within a relatively short period of time.”⁴ The operation of these online platforms was succinctly explained by Cumming as follows “The funding process on most crowd funding platforms is similar, regardless of the type of crowd funding used. It begins with a fundraiser initiating a request for funding, typically by indicating what the money is needed for, and what, if anything, is offered in exchange. Potential investors can browse the offers, and, if interested, invest a small amount (generally a few dollars) toward the target amount. The crowd funding website provides the technical platform for the exchange of funds, voting rights, etc.”⁵

There are four categories of crowd funding. The parameters of these different modes of crowd funding are defined based on “returns” to investors. However, the degree of

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information asymmetry between the funder and the company varies largely depending on the type of crowd funding that is being used and in general increases as you go down the spectrum from donation-based crowd funding to equity-based crowd funding.\(^6\) That is, the investors generally have inferior information about the ventures than the creators and that can lead to problems where the party with the superior knowledge can take advantage of the other player’s lack of information. This information asymmetry is a key critique put forward by those who oppose equity crowd funding and will be discussed further in chapter four, below.

1. Donation-based

The donation-based crowd funding model is where funders donate to causes that they want to support, with no expectation of a return from that donation. These ventures are primarily philanthropic or sponsorship initiatives. Investors are generally incentivized not by expected returns, but because they believe in the cause the venture represents. Indiegogo is one of the most popular platforms for fundraising through crowd funding.\(^7\) They approve fundraising campaigns for anything from music and films to hobbyists and charities. Indiegogo also offers more flexibility for nonprofits in that it allows you to choose a funding model that allows you to keep your pledges even if you don’t reach your goal.

2. Rewards-based

The rewards-based model is the largest crowd funding category in terms of the number of platforms. Investors receive rewards or incentives in return for their financial support. These non-financial rewards can quite literally involve anything. The Veronica Mars movie rewards ranged from a movie script for a $10 pledge, all the way up to one $10,000 pledge in return for a speaking role.\(^8\) In the case of products, the reward is typically a first edition of the product. One of the most well-known crowd funding

\(^6\) Cumming, “Signaling” supra, note 5.
\(^7\) Online: <https://www.indiegogo.com/>
\(^8\) Rob Thomas, “The Veronica Mars Movie Project”, online: <https://www.kickstarter.com/projects/559914737/the-veronica-mars-movie-project>
platforms, Kickstarter, operates off this rewards-based model. This financing model offers less flexibility because the pledges are only made available if you reach your funding goal.

3. Loan-based

This model operates as any other loan would; investors receive a fixed periodic income equivalent to interest and expect full repayment of the principal amount. Typically the platforms involved in this model facilitate peer-to-peer lending, that is, the venture receives a loan directly from another individual. SoMoLend is one example of a loan-based platform that sources funding from individuals and banks to facilitate start-ups and small businesses and focuses on local fundraising.9

4. Equity-based

Equity-based crowd funding is the fastest growing category in terms of the number of platforms and on a per-project basis it raises the largest amount of funds. It has been defined by Cumming as “a method of financing whereby an entrepreneur sells equity or equity-like shares in a company to a group of (small) investors through an open call for funding on Internet-based platforms.”10 Investors receive equity, revenue or profit-sharing arrangements in return for their financial support. One of the largest platforms globally is the Australian Small Scale Offerings Board, known as ASSOB. It enables small businesses to sell equity shares to individual investors. The key difference between the equity-based model and the other categories is the information asymmetry that was previously mentioned. The imminent risk in equity crowd funding is that there could be a total loss of investment. Thus, although proponents of equity crowd funding see it as an effective mechanism for increasing small business growth, the existence of this risk indicates that there is a clear role for legislative intervention.

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9 Online: <https://www.somolend.com/> .
10 Cumming, “Signaling”, supra, note 5.
Equity Crowd Funding

A threshold issue that is crucial to understand is that crowd funding will not trigger securities laws unless there is a sale of securities. That is, donation-based and reward-based crowd funding will not fall within the ambit of securities regulation. Where however, there is an actual offering of securities, the regulation then comes to the forefront. That is why equity crowd funding is provoking controversy. As will be explained in further detail, the core of securities laws has developed from an investor protection standpoint, and thus there is a concern that opening up capital-raising in such a manner as is envisaged with equity crowd funding will result in a free-for-all. Although acknowledging that there is a real risk involved in this manner of online fundraising, the right legal tools can quite easily be put in place to assuage these fears.

At this juncture it is necessary to distinguish between equity crowd funding and another form of cost-effective capital raising for small medium enterprises called a direct public offering. Equity crowd funding involves the selling of securities to a large number of investors and utilizes the Internet to reduce costs. The purpose of this market however is to remain within the private exempt market, thus avoiding the continuous disclosure obligations associated with public companies. In contrast, a direct public offering is simply a public offering that is conducted without an underwriter. Cutting out the underwriter can also be highly cost-effective; however the result of this process is that the company goes public. Where confusion may arise is in the fact that the Internet has of course made direct public offering far cheaper and more feasible. The pre-Internet issue of finding investors and advertising to them has essentially disappeared with the advent of the World Wide Web. The benefit of a direct public offering is that, similar to equity crowd funding, it leverages the Internet to reduce costs and cut out the middlemen; the traditional underwriting process is removed completely. However, as a direct public offering is still a public offering, there are far more extensive disclosure requirements than would be associated with capital raising in the exempt market.

An oft-cited example of a successful direct public offering was Ben & Jerry’s ice cream which, in 1984 raised $750,000 to expand operations. With the advent of the Internet
however, direct public offerings were made much more accessible. The first Internet
direct public offering was completed in 1996 by Spring Street Brewery.¹¹ Spring Street
Brewery uploaded their offering documents to a website and raised almost $2 million
from thirty-five hundred investors.¹² Although this process is very different from equity
crowd funding, similar adverse selection problems arise, as will be discussed further in
chapter four. These concerns stem from the fact that there is no intermediary with an
established reputation upon which investors can rely. This is the vital role that the portals
will have to fulfill in the equity crowd funding market, to ensure its success.

An issue that many critics consider is problematic to the success of equity crowd funding
is the matter of information asymmetry. Asymmetric information, in simple terms, is a
situation where one party to a transaction has superior information in comparison to
another party and thus is in a position to use that superior knowledge to take advantage of
the other party. The concern is that this information imbalance could allow creators to
take advantage of investors and engage in self-dealing amongst other abuses. It is my
position that the risk of this occurring in equity crowd funding is grossly overstated for a
number of reasons. Firstly, the Internet has vastly reduced information asymmetries in
recent years. Everyone is able to access much more information. This has “reduced the
knowledge gap that once separated professionals from laypersons by making information
more readily accessible.”¹³ These technology advancements have diminished the adverse
selection problems associated with information asymmetry. With the creation of effective
communication networks between interested investors, the ability of a company to “sell
lies” is reduced. The communication forums that investors can and do use in existing
crowd funding portals can easily be put in place for equity crowd funding portals. These
forums enable investors to engage in a verification of facts.

¹² Ibid
¹³ 10 Hastings Bus. L.J. 183 2013-2014 “To Be or Not to Be a Funding Portal: Why
Crowdfunding Platforms will Become Broker-Dealers”, Shekhar Darke, Hastings Business Law
Journal.
Social media acts as a similar deterrent to prevent creators from utilizing their informational advantage to an investor’s detriment. Any start-up or small medium enterprise cannot afford to have their reputation destroyed by the spreading of negative stories about them. The “viral” nature of the Internet operates as a highly effective safeguard against this. Secondly, experience has proven that a diverse non-expert group can oftentimes make better decisions than individual experts. The conclusion from crowdsourcing has been that “even if most of the people within a group are not especially well informed or rational, the group can still reach a collectively wise decision.” The hypothesis that the uneducated masses could not possibly be better at selecting successful startups than experienced investors and financial experts is easily disputed and crowdsourcing is proof of that.

**Canadian Securities Regulation**

In my discussion of the Canadian securities regulation I will focus primarily on the Ontario securities legislation. Although there are some differences between Ontario and the other provinces, there has been a movement towards unification in recent times and the broad principles and processes are the same. The securities regulatory regime in Ontario operates within what is described as a “closed” system. That is, no one can buy or sell securities without falling within the parameters of the legislation. In general terms when deciding to sell securities a company has two main options, to go public by following extensive procedural steps and filing a long and detailed document known as a prospectus; or to sell securities privately by coming within one of the exemptions to the prospectus process. These options are referred to generically as the “public market” and the “exempt market”.

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The Ontario Securities Commission monitors both public and exempt market activity to ensure that everyone is operating within the parameters set by the legislation. The process of going public is both extremely expensive and can take a very long time. The process involves many stages, from hiring legal counsel to assist in filing an initial prospectus with the Ontario Securities Commission and receiving a receipt, to employing investment bankers to market your securities, before finally reaching a final prospectus. For start-ups and small businesses the going public process is generally too expensive and time consuming for them to engage in, so instead they will want to sell securities in the exempt market.

Within the exempt market there are a variety of different exemptions that can facilitate low cost and fast access to capital for start-ups and small businesses. The number and variety of exemptions is quite extensive so I will focus only on the four that are most utilized by small medium enterprises. These are known as: the accredited investor exemption, the family and friends exemptions, the private issuer exemption and the offering memorandum exemption.

1. Accredited investor exemption

This exemption is used by small businesses to raise funds from high net worth individuals. It can be used to raise any amount of money, at any time, from any individual who qualifies as an accredited investor. To qualify as an accredited investor one of the following criteria must be met: an individual who, alone or together with a spouse, owns financial assets worth more than $1 million before taxes but net of related liabilities; or an individual, who alone or together with a spouse, has net assets of at least $5,000,000; or an individual whose net income before taxes exceeded $200,000 in both of the last two years and who expects to maintain at least the same level of income this year. The regulators view this specified level of income as a proxy for sophistication to enable accredited investors to make good investment decisions without a high level of disclosure.

2. Family, friends and business associates exemption
In Ontario this exemption is available only to close family and friends, whereas in all other jurisdictions sale of securities to close business associates are also included. It has been noted that this exemption “appears to require a level of qualitative assessment as to the nature of personal relationships.”16 However, an exhaustive list is contained in the legislation that defines the persons who are exempt if they purchase securities as principal. In Ontario those exempt persons are: a promoter of the issuer or of any affiliated entity; a spouse, parent, grandparent or child of an officer director or promoter; a person or company that is an affiliated entity or control person of the issuer. In other jurisdictions, the exemption extends to a broader list of family members and also close business associates of a director, senior officer, founder or control person of the issuer or an affiliate of the issuer and to a person or company that is wholly owned by any combination of the persons or companies described.

3. Private Issuer Exemptions

The private issuer exemption is available to a company that is: not a reporting issuer, mutual fund or pooled investment fund; has less than fifty security holders; has provisions in its articles of association, by-laws or a shareholders agreement that restrict the transfer of its securities; and has sold securities only to directors, officers, employees or control persons of the issuer, or family members / close personal friends / close business associates of the directors, senior officers or control persons, or current security holders or family members of the selling security holder, or accredited investors.17

4. Offering memorandum exemption

The offering memorandum exemption allows an issuer to sell its securities to anyone, regardless of their relationship, wealth or the amount of securities purchased.18 The offering memorandum exemption is available in all jurisdictions except Ontario. Under

17 “Private & Early Stage Businesses” online: <http://www.bcsc.bc.ca/For_Companies/Private_Placements/Private_and_early_stage_businesses/>.
18 Ibid
this exemption, the issuer can sell securities in any amount to anyone provided that, before the securities are purchased, the issuer: 1) obtains a signed risk acknowledgement form from the purchaser; and 2) delivers an offering memorandum, prepared in the required form, to the purchaser. This offering memorandum must then be filed with the securities commission within 10 days of selling the securities.

The exempt market has been established to meet the policies of securities legislation. The Ontario Securities Act sets out with two broad objectives: (1) investor protection and (2) market efficiency. The exempt market is considered to be an effective balance of these two objectives that is, supporting market efficiency by reducing disclosure without sacrificing investor protection. I believe that the legislation does not currently achieve this balance, but rather places too much emphasis on investor protection and fails to adequately account for market efficiency. The securities legislation keeps mounting, as do disclosure requirements, with no corresponding increase in investor remedies. This expansion of the exempt market presents the perfect opportunity for securities regulators to reduce levels of disclosure and switch their focus to the needs of start-ups in Canada. A new exemption for equity crowd funding presents the perfect opportunity to remedy this problem.

An important element of securities law that has been implemented for investor protection is the liability that companies have to investors in the event of misrepresentations or fraud. The Ontario Securities Commission has broad enforcement powers to investigate any misconduct in capital markets and to impose sanctions on those individuals and companies. It is my position that such investor remedies must be equally applicable for those who invest in equity crowd funding. It will be essential for the integrity of this market that investors can seek substantive recourse in the event of abuse by corporations or their directors or officers.

I mentioned briefly at the beginning of this discussion about Canadian securities law that, although securities law is provincially regulated in Canada, there has been some movement towards unification in recent times. This point requires further discussion in the equity crowd funding context. Due to the global nature of this market, the negative
effects of not having a national securities regulator become markedly more apparent. The value of this internet-based fundraising is that investors do not need to be in geographical proximity to each other or to the companies they invest in for the market to succeed. All of these benefits are largely lost when regulation marches forward provincially. For example, in December 2013 Saskatchewan was the first province in Canada to implement rules that allow equity crowd funding. However, due to the provincial nature of securities regulation, these rules only allow Saskatchewan-based businesses and investors who have an address in Saskatchewan to invest in these markets. They have also set their own caps and limitations: a business cannot raise more than $150,000 and no person can invest more than $1,500 in any one offering. Without disputing or agreeing with the levels that have been set, the point to be made is that if every province proceeds with different regulations in this area, it prevents this market from developing into an international one and acts as a deterrent for people to invest here.

Currently, every jurisdiction in Canada operates its own securities legislation; there is no national securities regulator. This can be contrasted with the opposite system in the United States, where the Securities and Exchange Commission oversees securities regulation at a Federal level. The attempts that have been made to create a national securities regulator in Canada have been fraught with legal difficulties and complications. The consequences of provincial legislation are that Canada has a disparate and fragmented system of regulation. The Wise Persons’ Committee Report, released in 2009 recommended a single national regulator in Canada, where the provinces could still have a role to play. More than five years later, however, it has still not come to fruition. There have been some attempts to harmonize securities regulation through the establishment of the Canadian Securities Administrators (the “CSA”). The CSA has developed a number of national and multi-lateral instruments to create uniformity on certain issues, but each province will still interpret and enforce these differently. Such problems cannot be adequately addressed in the absence of a national regulator.

Some progress was made in September 2013 to move forward with a body that has a national oversight function, despite the issues that have arisen. The provinces of British Columbia and Ontario, and the federal government signed an agreement that will see the establishment of a Cooperative Capital Markets Regulator by July 1, 2015. This one regulator’s role will be to oversee uniform provincial securities legislation in those provinces. This is a positive move forward and creates a structure different from the United States that, although not as beneficial as a national regulator, accommodates those in Canada who do not want to take power from the provinces and hand it over to the federal government. Canada will have unified legislation without the provinces losing all control and revenue from the operation of securities law. Canada’s inability to put forward a unified position on equity crowd funding on a national level results in the international community being uncertain as to what is or is not permissible. With the global communication network that operates this disconnect places Canada at a disadvantage. People will be deterred from investing capital into this market when they can simply give it to our neighbors in the United States where there is one uniform and streamlined process. It remains to be seen whether all other provinces will sign the agreement, but it would be a huge step forward.

It is crucial for securities legislation to facilitate the opening up of innovative Canadian companies to investment, whether that comes from domestic or international sources, and whether in the form of financing, strategic partnerships, or advisory services. The legal structure must harness the Internet to achieve this objective at a much lower cost to both companies and investors, than that which is currently feasible under existing legislation. The existence of the current exempt market is proof that there are many situations in which prospectus-level disclosure is not warranted. Undoubtedly a certain level of disclosure is required to assess a business venture and weigh up the investment risks. However, reducing the level of disclosure required for growth companies at the early stage financing level can have far reaching positive economic effects.

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Conclusion

The expansion of the crowd funding industry into equity crowd funding presents an important opportunity to increase access to much-needed financing for small businesses. Unfortunately, within the existing securities legislation in Canada such a movement is not currently possible. The natural expansion of crowd funding from donation-based models into equity-based models has already occurred and the law must catch up. The expansion of the exempt market to allow for equity crowd funding is a necessary legislative step in order to effectively harness the benefits of this new financing market.
Chapter Two: Start-up Financing in Canada

Introduction

In this chapter I will put equity crowd funding into the broader context of filling the existing funding gap for start-ups and supporting innovation to drive productivity growth in Canada. I will begin by highlighting the already well accepted fact, that Canada has poor productivity performance. It is largely undisputed that this performance needs to change. The problem that exists is in identifying the best method to stimulate that change. I will then discuss the landscape that currently exists for start-up ventures to obtain seed and early-stage financing in Canada. This financing is colloquially referred to as the market for risk capital. This chapter aims to put forward the proposition that equity crowd funding can offer, at least in part, a solution to both extending the funding available for start-ups and to contributing to the objective of promoting innovation to close the funding gap.

Innovation

Canada is lagging in the innovation race. The Organization for Economic Co-operation and Development ("OECD") defines innovation as “the implementation of a new or significantly improved product (good or service), or process, a new marketing method, or a new organizational method in business practices, workplace organization or external relations.” Innovation is crucial to productivity and productivity is key to economic growth. Therefore, innovation is a vital prerequisite to an expanding economy. One feature of successful innovation is the ability to have processes in place that allow for the commercialization of an idea. This can be described as “the means by which an idea or

21 Online: <https://www.innovationpolicyplatform.org/content/innovation-definitions-and-fundamentals?topic-filters=11377>.
prototype is transformed into a market-ready product.”22 A key factor that such commercialization is dependent upon is access to finance.

Industry Canada is the government department tasked with “fostering a growing, competitive, knowledge-based Canadian economy.”23 The policy approach it has taken to achieve this mandate has been to “encourage innovation as the engine of growth for productivity and competitiveness in the globalized knowledge-based economy.”24 A number of reports that have been commissioned by Industry Canada have emphasized this inefficiency issue. In 2010, the Jenkins Report noted Canada’s innovation problem where it explained that Canada’s productivity growth has averaged only 0.6 percent from 2000 – 2009, a figure that is less than half the average of all OECD countries.25 The panel traced this poor performance to a lack of investment in innovation and reached the conclusion that the remedy required to improve the country’s innovation was to support the growth of innovative firms.26

The primary problem highlighted in the Jenkins Report was the inability for start-up firms to access much-needed risk capital at the key commercialization stage of their business. An earlier report in 2008 similarly emphasized the critical importance for start-up businesses to access financing at the “angel” or “seed” stage.27 Thus it is clear that many start-up firms are unable to access financing in Canada in the early stages of their business’ life cycle.

The “Gap” in the Informal Risk Capital Market

To identify why these start-up businesses are not getting financing when they need it, it is necessary to understand how the existing market for risk capital operates and who the key

players are within it. To finance the very early stages of a company’s development, funding usually comes, first from the founders’ personal savings, secondly from friends and family, (collectively referred to as “love money”) and then from angel investors. This funding market is generally referred to as the informal risk capital market and is, by its nature, poorly documented.

Another potential source of funding for start-ups is conventional bank financing. While it is common for founders to utilize personal credit facilities and loans in the early stages of their business development, the availability of such financial products for the company itself is very limited. An Industry Canada report confirmed this finding that there is a gap in the debt market, as “financial institutions do not understand knowledge-based businesses.” In theory bank financing in the form of credit facilities, term loans and operating lines are another source of financing for start-ups. However, for a company in what financial institutions generally describe as the “infancy period” (in its first two years), any lending or credit facility is challenging to advance and therefore must be secured by collateral or a personal guarantee. Thus, as start-ups generally do not have sufficient collateral to secure the loan, bank financing is largely ineffective and unavailable to these small businesses, particularly in high-tech and knowledge based industries, where it’s challenging to collateralize physical assets.

In addition, the repayment of bank financing generally begins anywhere from thirty to one hundred and twenty days after such funds have been provided and this short timeframe is generally not viable for start-ups. It is unlikely that start-ups will have sufficiently commercialized their idea to realize other income sources within this short space of time to begin repayment of these facilities. In another Industry Canada report, statistics highlighted that the three main reasons start-ups were denied debt financing in 2013 were as a result of insufficient collateral, project riskiness and insufficient sales or cash flow. Thus, it is clear that for most start-ups bank financing cannot assist them.

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Since these companies generally won’t be income producing fast enough, debt servicing is problematic and therefore even government-sponsored loan programs are largely unavailable at the early financing stage.

A discussion of start-up financing would be incomplete without a reference to venture capital and private equity funding. However, this is not of primary importance in my discussion as such firms generally get involved at a later stage in a business’ life cycle. As is the case in Australia, where “private equity and venture capital is essentially an avenue for companies to secure funding for expansion capital rather than start-up capital”; usually in Canada venture capitalists come into the picture after the firm has survived the seed and angel-financed stages of development and has begun to establish sales and a track record.30

It is clear therefore that unless a start-up’s founder has a high net worth or willing friends and family members with deep pockets, the founders will fail to obtain funding at this crucial time, unless they can develop strong connections with an angel or a group of angel investors. So, here we can see the emergence of what is referred to as a “funding gap”. A gap in a capital market may be implied when “particular categories of firms that ought to receive financing are systematically unable to obtain it.”31 An Industry Canada report analyzing potential funding gaps in small medium enterprises highlighted the fact that some firms will be, and should be, denied financing.32 This true gap within the start-up sector was found to exist specifically for high-tech ventures. This is of the utmost importance in my discussion as those are primarily the companies that will spur innovation. The implication of this report’s findings are that it is vital that equity crowd funding regulation is structured in such a way to ensure, not that all start-ups are being funded, but that the right ones are being funded. At least in the early stages of equity

crowd funding, it should be focused only on financing these high-tech ventures that struggle to secure early stage financing.

**The Equity Crowd Funding Solution**

Once it is accepted that a funding gap exists for high-tech start-ups in Canada, the question then becomes whether equity crowd funding is the best approach to fill this funding gap. I am putting forward the proposition that, if structured correctly, equity crowd funding can be a highly effective tool to address this gap. A German research paper on the topic found that “crowd funding should function well in the pre-seed or seed phase when a relatively small amount of seed money (some thousands of euros) is sufficient to spur on the project and get it off the ground.” Further, it promulgated the idea that crowd funding be “promoted and supported, as it is one of the few instruments that can mobilize private capital in the early stages. It is no longer a minor issue belonging exclusively to the creative scene; it deserves greater attention, both in politics and in science.”

Equity crowd funding will not eliminate the need for bank financing and early-stage equity financing from angel investors. However, the formalization of equity crowd funding into a legitimate tool of the financial services industry will lay the foundation for a market that can complement other existing early stage funding sources.

Equity crowd funding need not be implemented in isolation; in fact it may prove most effective when operated in tandem with other policy tools. An example of such an approach will be discussed further below in relation to equity crowd funding in the United Kingdom where tax incentives for investors play an important role.

Proponents of equity crowd funding are of the belief that equity crowd funding will support and assist Canadian start-ups in accessing much needed financing. While this is undoubtedly true, there will only be a net benefit to the economy if the right start-ups are receiving funding. Equity crowd funding will only increase small business growth and

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35 European Crowdfunding Network, “Regulation of Crowdfunding in Germany, the UK, Spain and Italy and the Impact of the European Single Market (June 2013).
stimulate the start-up market in Canada if the right companies get this funding. As Gompers and Lerner argue, “encouraging individuals to make such small investments may be counter-productive and socially wasteful if the financial returns are unsatisfactory and the companies financed are not viable.”\(^{36}\) The regulation must not be focused on allowing every individual to invest in any kind of start-up that seems appealing; the focus must be on structuring legislation to promote innovation in Canada. Under the right approach, equity crowd funding can achieve this outcome and assist in driving productivity and filling the funding gap for start-ups.

Riding has conducted a number of analyses of the informal market for risk capital in Canada that are relevant to this discussion. He has highlighted the important “non-financial inputs” that angel investors provide.\(^{37}\) The value that angels contribute to start-ups through mentoring and business advice cannot be understated. In another 2005 analysis, Riding found that “friends and family are known to lose their investments comparatively often and make high rates of return relatively rarely;” whereas, “business angels are associated with successful entrepreneurial firms that achieve relatively high rates of return.”\(^{38}\) Both of these conclusions suggest that equity crowd funding should be supporting the business angels’ market for risk capital.

A key concern of equity crowd funding opponents, as expressed by Freear, Sohl and Wetzel is that “small investors are likely to lack the financial sophistication and experience of angel investors or venture capitalists, which are generally highly knowledgeable about valuing start-ups and assessing founding teams.”\(^{39}\) However, by creating the right incentive for platforms to conduct a suitable level of due diligence, this issue can be minimized. This is already happening in other jurisdictions where platforms, such as Crowdcube in the United Kingdom, which will be discussed later, have become

\(^{39}\) Cumming, “Signaling”, supra, note 5.
very effective at self-regulating within the equity crowd funding market. The limitations placed on the regulatory structure in Canada must facilitate a process whereby the portal is conducting a due diligence comparable to that of an angel. A recommendation of the Jenkins report suggested the creation of a “sidecar” fund for the government to invest following the lead of an experienced investment group.\textsuperscript{40} In a similar manner, the public money of the crowd can be put to effective use with this minimal level of due diligence.

Another significant finding of the Industry Canada report referred to above, was that there is a disconnect between investors and investment-ready opportunities.\textsuperscript{41} That is, there is no lack of available funds for these businesses; rather the firms are unable to tap into those funds. This is a fundamental problem that equity crowd funding can quickly resolve. The Internet has the power to open up the communication channels between investors and creators and facilitate development of these key relationships. The Internet can be deployed as a cost-efficient medium for communication of information between those companies in need of early-stage funding and advice, with the investors who can best provide those services. As will be discussed in more detail in chapter four, the online portals can create a highly cost-effective network to establish these much needed linkages for investors to efficiently and quickly locate investment-ready opportunities and even limit their search to relevant sectors.

**Conclusion**

The poor productivity performance that Canada has been experiencing needs to be addressed. Paired with other governmental initiatives, equity crowd funding can be used as a key tool to propel innovation forward. Modern technologies must be used and embraced by securities regulators to allow for more active and engaged communication and connections between those who need funding and those who can provide it. Equity crowd funding, if properly framed, will at the very least complement and at best develop into a viable alternative to traditional early-stage financing methods.

\textsuperscript{40} Industry Canada, “Innovation”, supra note 22.

\textsuperscript{41} Ibid.
Chapter Three: Comparative Country Experiences

Introduction

This chapter will conduct a comparative analysis of the law on equity crowd funding in other countries. It will analyze the experience of equity crowd funding regulation and practice in Australia, in the United Kingdom and in the United States. Lessons can be drawn from this comparative analysis that can assist with the development of a competitive market for equity crowd funding in Canada. I will not engage in a general comparison of the regulatory structures in each jurisdiction, however I will provide an overview of securities regulation in each jurisdiction to add context. The goal of this chapter is to focus, not on the differences in how these systems operate, but rather on key aspects of approaches taken and issues highlighted in these jurisdictions that can be applied in the Canadian context.

Australia

The Australian Securities and Investments Commission regulates securities laws generally in Australia. Offers of securities require a disclosure document containing detailed information about the offering. There are two primary situations where an exemption exists and the production of this disclosure document is not required. That is, first when offers are made to sophisticated investors and secondly, for small-scale offerings. Crowd funding cannot easily fit within either of these existing exemptions. However, further legislation has been enacted that provides relief from the disclosure requirements for “business introduction or matching services”. The largest online platform in Australia operates within these provisions.

In effect, therefore, equity crowd funding is already operating in Australia under certain exceptions that exist under the current regulatory structure. Although legally it operates

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42 “Crowd funding and Securities Laws: What the Americans are Doing and the Case for an Australian Crowd funding Exemption”, Matt Vitins, 22 J.L. Inf. & Sci. 92 2012-2013 [Vitins, “Americans”].
43 Ibid.
as a matching service between investors and small businesses, functionally it is structured in the normal crowd funding style. ASSOB, the largest online platform in Australia operates under this exemption from the provisions of the Corporations Act for persons involved in making or calling attention to offers or securities through a business introduction service.\textsuperscript{44}

The Corporations and Markets Advisory Committee is considering how best to regulate for equity crowd funding going forward. In their discussion paper that is still under review, the Committee considered whether to amend existing legislation to expand the existing exceptions or to enact new legislation specifically designed to accommodate and legalize equity crowd funding.\textsuperscript{45} That paper sets out the findings of the Committee’s independent review of equity crowd funding in Australia. A key aspect of that discussion paper was the emphasis it placed on effective regulation of the equity crowd funding platforms. It highlighted the value that a well-run intermediary that exercises due diligence can provide for less knowledgeable investors.

In Australia, the proponents of equity crowd funding fall into two camps in terms of how to legislate going forward. There are those who believe that equity crowd funding requires an over-haul of the existing regulations to create an entirely new structural framework. The logic behind this is simple; much current legislation was enacted without the Internet and the global marketplace in mind. This flaw means that the law is constantly scrambling to catch up. The benefit of a new legislative framework is that it could be developed in a forward-thinking way to envisage rapid change. A similar argument can be made in the Canadian context. Securities laws were in place long before the global market became a dominant force for corporations. Although these laws have not been static, there is still much more needs to be changed to account for recent

\textsuperscript{44} Tompkins, “White Paper”, supra, note 30.

technological advancements. A more extensive discussion on this point is outside the scope of this thesis. However, suffice it to say that perhaps the regulation of equity crowd funding within securities law is not even the right forum within which it should be contemplated.

On the other side of the line in Australia are those who think that a total over-haul is unnecessary and a waste of resources. They are of the opinion that the matching exemption, with a few tweaks will be an effective method of regulating equity crowd funding. These advocates for maintaining the status quo with minor amendments argue that to legislate for something that has not yet been fully understood or explored would be counter-productive. Additional suggestions were put forward by market participants in response to the release of the discussion paper. A number of these recommendations would be well applied in the Canadian context. Firstly, the accreditation of investors via a risk awareness workshop is a very effective way to manage investor expectations and ensure that investors actually read and fully understand the risks of investing in these ventures prior to investment. Another risk management tool that was suggested was for the accreditation of directors of issuers via formal training. This training would aim ensure that entrepreneurs fully understand the consequences of having a large investor base.

The United Kingdom

Similarly to Canadian securities laws, securities regulation in the United Kingdom is underpinned by two primary policy objectives. The first objective is the development of efficient capital markets and the second objective is to safeguard the protection of investors in these markets. The provision of accurate and reliable information is an important aspect of investor protection. For this reason there is an obligation to publish a prospectus when there is an offer of transferable securities to the public, or where an application is made to have securities admitted to trading on a regulated market, or otherwise where the issuer of securities elects to have a prospectus in the regulated

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47 Ibid.
form.\textsuperscript{48} When there is a communication to any person that presents detailed information about offered securities, this constitutes an offer of transferable securities to the public, and the obligation to prepare and file a prospectus is triggered, unless an exemption applies. The principal exemptions are as follows: first, offers to qualified investors; secondly, restricted offers to a small group of intended investors; thirdly, certain offers that are of a sufficient size; fourthly, certain large denominations of securities; and finally, for issues of small amounts with a maximum total consideration of 100,000 euro.\textsuperscript{49} In the United Kingdom, the Financial Conduct Authority regulates the financial services industry, including securities law.

The Financial Conduct Authority is currently developing the regulation of equity crowd funding in the United Kingdom. There was an initial consultation paper released in October 2013, followed by a policy statement which was released in March 2014 that regulated both loan-based and equity-based crowd funding and contained rules that came into effect on 1 April 2014.\textsuperscript{50} I will discuss only the aspects relevant to equity crowd funding. Similarly to Australia, equity crowd funding has been operating in the United Kingdom within existing exemptions and under some authorization from the Financial Conduct Authority. However, prior to the new rules being released in 2014, participation in this market was limited for retail clients to high net-worth individuals and self-certified sophisticated investors.

This self-certification process is worth considering for its potential applicability in Canada. One can self-certify in the United Kingdom by virtue of any of the following: being a member of a network or syndicate of business angels for at least six months prior to certification; making more than one investment in an unlisted company in the two years prior to certification; working or having worked in the two years prior, in a


\textsuperscript{49} Ibid.

\textsuperscript{50} UK, Financial Conduct Authority, \textit{The FCA’s regulatory approach to crowdfunding over the internet, and the promotion of non-readily realizable securities by other media} (Policy Statement PS14/4) (2014).
professional capacity in the private equity sector, or in the provision of finance for small medium enterprises; currently, or in the two years prior been a director of a company with an annual turnover of at least one million pounds sterling. This self-certification process is comparable to the signing of a risk acknowledgement form and shifts the liability from the regulatory authority to the individual who is asserting a level of sophistication and therefore an understanding of and willingness to take on the inherent risk of the investment.

The recent rules were aimed at making the equity crowd funding market more accessible to retail clients while still ensuring a high level of consumer protection. To achieve this, the rules allow retail investors, who don’t self-certify or qualify as high net worth, to invest up to a maximum of ten per cent of their net investible assets (excluding their primary residence, pensions and life cover). For retail clients who have not received professional advice, platforms will be required to assess appropriateness before allowing them to invest through the platform. This “appropriateness test” will require platforms to confirm that the clients are not investing more than the ten percent limit. In addition, platforms must be careful when offering any information about the available investments to ensure that it doesn’t amount to advice. Platforms will need specific approval from the Financial Conduct Authority prior to providing advice on investments.

Another important aspect of the regulatory structure in the United Kingdom is the tax incentives that are available for investors who invest in start-ups. The Enterprise Investment Scheme and the Seed Enterprise Investment Scheme, offer significant tax relief to qualifying investments, intended to compensate for some of the high risk associated with such investments. Similar benefits could be offered in Canada through effective consultation of the securities regulators with other regulatory bodies.

53 Ibid.
As equity crowd funding has been operating within somewhat of a regulatory vacuum in the United Kingdom for a number of years, it is worth looking at a couple of the most successful platforms to note how they have effectively self-regulated to achieve this success. Seedrs takes a unique approach. Seedrs pools funds invested into a new business together and then acts as a sole intermediary between the investors and businesses, giving entrepreneurs’ one stakeholder to deal with and eliminating the risk of dilution for investors. This is another potential approach for the Canadian authorities to consider, with the dual aims of limiting the difficulties for entrepreneurs in managing a broad investor base and providing a unified voice for investors if problems do occur.

Crowdcube, which was approved by the Financial Conduct Authority in February 2013, performs rigorous due diligence on potential ventures. They have estimated that they only accept approximately twenty five percent of all applications that are received. They explain the decision process as follows: “whilst we don’t typically judge if a business should receive funding – that’s for the crowd – we always ask the top-level questions investors typically ask to analyze whether a business is “investment ready”. If they can’t be answered effectively, the pitch doesn’t make it onto the site.” This type of vetting could potentially play a key role in the Canadian context to ensure that the right companies are getting funded.

The United States

The Securities and Exchange Commission federally regulates securities law and capital-raising transactions in the United States. Companies that wish to go public in the United States must register with the Securities and Exchange Commission. There are four important parts to this registration: (1) mandatory disclosure to investors; (2) review of this disclosure by the Securities and Exchange Commission; (3) restrictions on the selling process to ensure that investors make informed decisions; and (4) the threat of liability to

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ensure strict compliance with these high standards.\textsuperscript{57} These standards were set after the Great Depression in an aim to respond to fraud allegations at that time and to regenerate public confidence in the capital markets. Bearing much resemblance to Canadian securities law, the focus is on a high level of disclosure to ensure investor protection. An offer to sell securities must be registered unless it is exempt. There are many different exemptions to this registration requirement, the most highly utilized one being the private placement exemption.\textsuperscript{58} However, none of the existing exemptions currently operate in such a way as to allow crowd funding.

The coming into force of the Title III of the Jumpstart Our Business Startups Act will create a new exemption from registration for crowd funding under Section 4(6) of the Securities Act of 1933.\textsuperscript{59} This will pave the way for equity crowd funding to develop in the United States as a new market for risk capital. The purpose behind these provisions is a recognition that small businesses contribute highly to the creation of jobs. The idea is that by allowing small businesses to access a wider pool of investors online, this capital raising will have positive knock-on effects for the whole economy.

The structure of the regulation allows unaccredited investors to buy stock directly in a company through a crowd funding exchange. The Securities and Exchange Commission has retained an oversight function in that the portals must be registered. This oversight function is important to ensure the integrity of the portals. The provincial securities commissions in Canada could similarly administer a supervision responsibility. There are also limitations and caps on the total amount that companies can raise and the total amount that investors can invest. These provisions could also be well applied in Canada. An important limitation is that companies can only raise up to $1,000,000 in any twelve month period. The limits on the amounts that investors can advance are one of the primary investor protection measures. If an investor’s annual income is less than $100,000, the investor is allowed to invest up to $2,000 or 5% of their annual income or

\textsuperscript{57} “Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising,” Robert B. Thompson & Donald C. Langevoort 98 Cornell L. Rev. 1573 2012-2013

\textsuperscript{58} Vitins, “Americans”, \textit{supra}, note 42.

net worth (whichever is higher) in a twelve-month period. If an investor’s annual income is greater than $100,000, the investor is allowed to invest up to 10% of their annual income in a twelve-month period.

The additional protective measure that was put in place was that the transactions must be conducted through a registered crowd funding portal. I will engage in a more detailed discussion of intermediaries in the next chapter, but it must be noted that this oversight function that the Securities and Exchange Commission has maintained is likely to be the key to the success of equity crowdfunding in the United States. It adds a level of legitimacy to this new market and serves to curtail fears of fraud. These third-party intermediaries may register under either the funding portal registration, or the broker-dealer registration. Experience thus far indicates that crowd funding platforms are in fact registering as broker-dealers and are likely to continue to do so. This registration provides more extensive investor protection and will bolster this emerging market’s credibility. On top of the registration of intermediaries the companies themselves must also comply with specified disclosure obligations.

Depending on the size of the company’s offering amount, there are certain reporting requirements. Companies with a total target offering of $100,000 or less in the previous twelve-month period have to provide income tax returns and financial statements certified by an executive officer as true and complete. Where the target offering was between $100,000 and $500,000 in the previous twelve-month period, the company must provide financial statements that have been reviewed by an independent public accountant. If the company has had a target offering of greater than $500,000 in the previous twelve-month period, then they must produce audited financial statements. In addition, the securities have to be held for a year before they can be sold, to address liquidity concerns that many opponents see as an obstacle to this market’s success.

61 Securities Act (Ontario), RSO 1990, c 5, s. 4(6)
**Conclusion**

Although the regulatory structures of Australia, the United Kingdom and the United States differ significantly in some respects from Canadian securities regulations, much can be gained from a review of each of their experiences and approaches to equity crowd funding. The key takeaways from each jurisdiction that can and should be incorporated into an equity crowd funding exemption in Canada are as follows: an investor risk assessment workshop; formal training for directors; a self-certification process for investors who want to invest in this market; tax incentives for investors, to encourage early stage financing; a high level of due diligence performed by the platforms; the retention of an oversight function for the securities commissions and clear caps and limitations on the amount investors can invest and the amount that companies can raise via equity crowd funding.
Chapter Four: Aspects of Successful Regulation

Introduction

Now that I have canvassed the regulatory structure of equity crowd funding in other jurisdictions, this chapter will aim to put forward a number of features that should be incorporated into the equity crowd funding legislation in Canada. Note that I will not attempt to outline every aspect that must be encompassed in such regulation. There are many necessary factors that I will not consider, such as the types of shares, the share class structures, or tag along rights as they are beyond the scope of this thesis. My aim is to simply put forward a few major recommendations that I believe should form part of the regulatory structure if the equity crowd funding exemption is to succeed in Canada. These recommendations will initially be discussed from the perspective of investors, entrepreneurs and the portals, respectively. I will then delve further into a more detailed examination of how exactly the portal should be structured. It is my belief that there will be a direct correlation between the structure of the portal and the success of the equity crowd funding market in Canada. The portal is the crux through which all participants will engage and all funds will flow. I will look at the portal’s role from a business perspective and also with regard to structural and regulatory considerations. This chapter aims to recommend a sectoral approach to the development of equity crowd funding regulations.

The Investor Perspective

In simple terms, the regulatory structure of this market must be focused on what investors want. Cumming made a key finding in support of this that, “capital will flow to better regulated markets that appropriately protect investors and enable entrepreneurs to operate in an environment which facilitates capital raising.”63 In structuring equity crowd funding regulation to accommodate investor requirements, there are two key issues that must be

accounted for. The first factor is to ensure that investors precisely comprehend the risk that they are undertaking. Once investors have certified that they understand the high risk of loss associated with investing in start-ups, the second key factor is to ensure that investors are adequately protected in circumstances where their funds are misused or abused. I will deal with each of these issues in turn.

The first element that successful equity crowd funding regulations must encompass is something to ensure that those who choose to invest in early-stage financing are aware and willing to take on the inherent risk of such an investment. There is no guaranteed return. It is essential for investors to understand the strong likelihood of losing all of their investment. According to reports from Industry Canada, almost half of all small businesses fail within five years. As Allan Riding has highlighted, “the key thing is that everybody has to go into this understanding that losing the investment is often going to happen.”

There are a number of ways that the regulation can be structured to affirm this risk acknowledgement by investors. The most effective method is to require that each investor conduct a risk assessment workshop, an idea that was highlighted in the previous chapter in relation to discussions about how legislators should proceed in Australia. There are a number of jurisdictions in Canada that have, or are considering implementing a risk acknowledgment form for certain exempt purchasers. This is essentially a signed acknowledgment that the investor understands that he or she may potentially lose the entire investment. Although helpful, I think that in the riskier environment of equity crowd funding, something more is necessary. The risk assessment workshop should encompass a clear explanation of both the likelihood of loss of investment due to the high-risk nature of early stage businesses and also the possibility of dilution if the venture does prove successful. An online training module is one of the most convenient and cost-effective ways in which to ensure this investor education. At an early stage, when for example an investor is signing on to the portal, the investor, affirming his or her understanding of these risks, can be required to watch a short video and / or a power point

presentation, and then complete a straightforward questionnaire and acknowledgment. This approach will strike the right balance between ensuring that investors understand the risk that they are taking on, without making this assessment too prohibitive, thereby deterring people from investing.

The reality is that shareholders invest in companies because they want a return, they do not invest to promote innovation. Investors want to ensure the best return and to make certain that if their funds are mismanaged, they have clear recourse and effective remedies available to them. When a company has too many shareholders, this leads to collective action problems. A collective action problem describes a situation where every individual in a group would benefit from taking a certain course of action, but the cost of taking that action is prohibitively high for any one individual acting alone. Therefore, the result is that no one will act, even though as a group they would all be better off. For example, all of the shareholders of a large public company may benefit from forcing that company to appoint new members to the board of directors, by forcing out the old directors. However, the cost to any one shareholder of doing this is so high that no one will do this, although any individual shareholder can sell his or her shares and invest in a different company. This demonstrates that, in large public markets, the liquidity available in public markets alleviates the collective action problem to an extent, since, if investors are unhappy they can simply exit the corporation and sell their shares. In the long run, if this continues to happen, the share price of that company will diminish to such an extent that the company will be forced to take action. In addition, in Canada these issues have been mitigated in the last twenty-five years as a result of the exponential growth in the number of institutional investors. Such institutional investors have proved willing both to actively participate in and to question corporate decision-making.

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In the equity crowd funding context, these options are not available to investors. There is no public market for the shares as the company is still privately held, but the shares are widely held thus no one individual is incentivized to incur the costs necessary to force change when necessary. Thus these problems again become pronounced due to the broad range of individuals without geographical proximity who invest in companies that they may know little about. If shareholders do not have clear-cut recourse available to them in the event that a misuse of funds does occur, then from the outset they will be deterred from investing in this market. Cumming highlighted this fact in his analysis of a National Crowd funding Association of Canada survey that suggests that the equity crowd funding market in Canada requires a highly regulated approach. Investors in this market must be granted the full range of remedies open to all other purchasers of securities. Although beyond the scope of this thesis, suffice it to say that all of the broad remedial options that are currently available to investors in the exempt market must equally be open to those who invest in equity crowd funding.

The second element that successful equity crowd funding regulations must encompass, from an investor’s perspective, is some form of tax incentives. In chapter two it was noted that there are numerous different policy options at the government’s disposal when they consider the most effective way to address the existing funding gap. I concluded that equity crowd funding was one of the best options in that context, but this does not have to occur in isolation. Equity crowd funding could operate even more effectively if it is implemented in conjunction with other policy tools, such as tax incentives. I draw this idea from the Enterprise Investment Scheme and the Seed Enterprise Investment Scheme that are operated in the United Kingdom. The current approach in Canada has been to offer tax credits to creators and start-up companies, particularly those in the research and development and technology fields. For example, one of the largest government programs is the Scientific Research and Experimental Development tax incentive program, which offers large tax credits to all sizes of companies who conduct research.

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67 Cumming, “Demand”, supra, note 63.
and development in Canada.\textsuperscript{68} However, there has been little focus on establishing any comparable incentives for investors in the start-up and small medium enterprise markets.

There have been some provincial programs that have offered tax incentives to investors on a small scale. For example, the Ontario Community Small Business Investment Fund Program, the British Columbia Small Business Venture Capital Tax credit, and the New Brunswick Investor Tax Credit. However, something more is needed at the Federal level. It would be beneficial to introduce a similar program to the Seed Enterprise Investment Scheme in the United Kingdom. That program is designed for investing in small companies and offers very large tax breaks. For the investment to be eligible, the company must be less than two years old, have a maximum of 50 staff, with gross assets of not more than 200,000 pounds sterling. For the investors, the tax relief is 50\% and there is no capital gains tax payable on profits. If a similar investor tax incentive was introduced in Canada this would make equity crowd funding a far more compelling proposition for investors. It would signal to investors that this is a legitimate and worthwhile investment and would enable equity crowd funding to be seen as a viable option for all investors as part of a diversified portfolio, whatever size that portfolio might be. Additionally, if a company has to go through a certification stage with the Canada Revenue Agency before investors can benefit from this tax incentive that would create another level of verification for the company.

\textbf{The Creator Perspective}

I will now look at some important aspects of the equity crowd funding legislation from the perspective of the creators. When referring to creators this is intended to encompass all types of entrepreneurs, start-ups, and small medium enterprises. Much empirical data has suggested that a lack of managerial competence is a primary defect in preventing many early stage companies from accessing the financing that they seek.\textsuperscript{69} As Newton highlighted, “management is central to the innovation process” and “there is clearly a

\textsuperscript{69} Small Business, “Gaps” supra, note 28.
“public good” dimension to management skills development in the small business sector – its enhancement can do much for the rate quality and diffusion of innovation and therefore aggregate productivity.”⁷⁰ The implication of this is that there is a need for experts to be engaged at an early stage in the equity crowd funding process to provide guidance and mentorship to these companies. This suggestion came from the Australian discussion of possible risk management strategies that could be effective. The provision of this expertise can occur in two main ways. Firstly, directors of the companies seeking funding should participate in educational workshops, as discussed earlier, to ensure that they understand the business and legal ramifications of having a potentially large number of shareholders. They can be educated about their fiduciary and other duties towards their shareholders in addition to ensuring that they understand the logistics of managing a broad and likely dispersed investor base. These workshops can be conducted in an online seminar format at minimal cost. Since the sophistication of directors will vary hugely as between the different creators, this need not be a mandatory requirement. Although there may be concerns that if this is made optional most directors will choose not to participate, there are many directors who will welcome this source of information. There can also be a role for the portals here in using their expertise to create appropriate content and to encourage certain directors to participate in the workshop if they think it would be beneficial. If participation does become an issue, the portals could exercise some discretion in deciding who is or is not required to complete the workshop.

The second element of the expertise that should be offered to directors to provide guidance to creators; is for the platforms to engage with professional experts to assist them with the preparation of disclosure documents. This practice of engaging with experts has in fact already developed in other jurisdictions where platforms became self-regulating very fast. For example, ASSOB in Australia requires companies to engage an approved “Partner” to assist with initial disclosure and ongoing compliance. These partners, typically accountants, lawyers, financial advisors or business consultants, assist

in the preparation of the requisite offering documents. Similarly, Crowdcube in the United Kingdom recommends a number of financial forecasting professionals to guide companies in ensuring that their pitch meets the disclosure standards set by the platform. For equity crowd funding in Canada, the necessary disclosure documents will vary depending on the firm and industry, and legislation should allow for this level of flexibility. However, at a minimum, the disclosure documents should include: 1) a description of the product / service / technology; 2) relevant support documents such as patent applications; 3) market research and analysis; 4) a business plan; 5) financial projections; 6) financial statements if the business is established; 7) proposed use of funds; 8) existing share ownership structure; 9) details of the offering; and 10) descriptions and resumes of the management team, promoters and board members. A key concern of entrepreneurs at this early stage is to protect any proprietary aspects of their business model. This can be achieved quite easily in equity crowd funding. These disclosure documents are primarily to allow the platform to perform its due diligence, and potential investors should not be allowed access to the documents until they have been vetted and registered, and expressed a sufficient level of interest in the company.

As mentioned previously, the regulations need to be primarily investor-focused to ensure the entire market’s success. This focus requires some level of disclosure. It has been shown, theoretically, that funders will infer from entrepreneurs who fail to provide information that their start-ups are of below-average quality. As Cumming discovered, a key aspect of firms successfully receiving financing is through the provision of financial forecasts and disclaimers. Therefore, without reaching anywhere close to prospectus-level disclosure, a certain level of legislated disclosure must be required. The balance must be struck at the correct point where costs are minimized, to ensure that entrepreneurs are not discouraged from participating in this market.

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71 Cumming, “Signaling”, supra, note 5.
72 Ibid.
73 Ibid.
The Portal Perspective

The gate-keeping role that the portal must play in legitimizing this market cannot be overstated. As a European research paper found, “crowd funding platforms act as neutral facilitators both for the project initiators and the crowd funders” and “the rapid emergence of such platforms is logical and crucial for this new market to function properly.”\(^74\) The key to the success of equity crowd funding in Canada is the reputation of the portals.\(^75\) Again the approach can be informed by best practices that have developed in the United Kingdom and in Australia. From an investor protection standpoint, in Australia, ASSOB only permits investors to obtain very limited information prior to registration. Investors are required to certify that they understand and are willing to take on the high risk of investing prior to any access to viewing potential investee companies. From the perspective of assisting creators, in addition to the expert referrals discussed above, in the United Kingdom, Crowdcube provides extensive guidelines to assist entrepreneurs in the preparation of their pitches and disclosure documents.

An important protectionist role that the portals will have to undertake will be to ensure that neither investors nor creators are exceeding their annual limits as prescribed by the regulations. As previously mentioned these limits can be established based on the levels that have been set in the United States. This will be particularly important if the legislation involves a self-certification process for investors, similar to the procedure in the United Kingdom. If the correct limitations are set on the amount that investors can invest in any twelve-month period there is no reason why self-certification should not be an option. Although investors must be protected, as long as people are only risking small amounts (relative to their personal net worth) there is no reason why people should not be able to choose where they can invest their money. Thus it will be vital that these limitations are strictly monitored and adhered to by all investors.

\(^{75}\) CAMAC, “Discussion Paper”, \textit{supra}, note 45.
Thus the primary focus must be to address the portal’s registration requirements, and its responsibilities vis-à-vis both creators and investors. Without engaging in a detailed discussion from a securities law perspective about the current registration requirements, any person or company who provides services related to investment advice, fund management or is a dealer, must be registered with the relevant securities commissions unless an exemption is available. The requirement for equity crowd funding portals to be subject to these registration obligations is absolutely necessary to ensure the legitimacy of this new market. The Ontario Securities Commission has recommended that portals must be registered in the category of restricted dealer. This means that the portal will be restricted to only performing certain activities. Although the selection of this registration category was likely reached at with an investor protection purpose in mind, I believe that this is too restrictive as it does not allow an adequate level of flexibility to ensure that business models can be adjusted and tweaked to best suit this market. A more appropriate approach would be to develop, as the United States has done, a new registration requirement for equity crowd funding portals. This will ensure that the legislation is designed with the specific problems and needs of these portals in mind.

The portals must be under a responsibility to vet both the investors and the creators. The verification of investors has two components: to ensure that investors have been properly advised as to the risks of their investment through the risk acknowledgment workshop and to require income disclosure at the registration stage to ensure that investors are not exceeding their allowable investment limits as set by the legislation. The verification of creators must encompass the rigorous due diligence of disclosure documents; a background check on founders, officers, directors and significant shareholders and the educational workshops for entrepreneurs. This check on the companies is not intended to shift liability to the portals. The portals must have a clear neutral, investigatory role to guard against fraud. Liability for the contents of the documents should remain with the company who prepared them. This must be made clear to investors at the registration

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76 Registration Requirements, Exemptions and Ongoing Registrant Obligations, OSC NI 31-103.
stage to ensure that they know with certainty to whom they do and do not have recourse in the event of any default or misrepresentation.

**The Business Perspective**

Setting aside the purely regulatory aspects of the portal for a moment, it is necessary to consider the broader role that these portals will perform, from a business perspective. The Internet has the ability, as it has done with many other industries, to revolutionize the early-stage financing industry for start-ups and small medium enterprises. The portals have a vital function to perform in acting as a medium of communication between the key players in this market. The portal can establish, using the world-wide web as a medium for communication of information, a connection between those companies in need of early-stage funding and advice, with the investors and strategic partners who can provide that funding and those consultation services. Early-stage financing should not be the exclusive domain of those individuals who have, or who can forge the best “connections”. By developing clusters of expertise, the portal can begin to forge linkages for Canada on an international scale. The online model opens up Canadian companies to a global investor base and can attract “smart money” into Canada. The role that the Internet and social media can play in creating these partnerships in a cost-effective manner cannot be overemphasized. The ease of access and visibility that investors, creators and all potential strategic partners can achieve through online mechanisms presents a highly efficient option to all players in this market to connect funding and industry experts with new enterprises.

**A Sectoral Approach**

As previously noted, the securities regulators will provide an initial oversight of the portals through the registration requirements. However, I believe that the regulatory structure needs to become involved on a much deeper level than this basic function. The framework within which the portals will operate must be approached on a sectoral basis. The economic analysis discussed in chapter two, has revealed where exactly funding gaps exist for Canadian start-ups and small medium enterprises. The starting point for the model is to develop rules around the sector identified in this funding gap. Equity crowd
funding should begin with focusing on the high-tech ventures that struggle to secure early stage financing. This is easily done and SeedUps, one of the most successful equity crowd funding platforms, currently only for accredited investors, only invests in high-growth technology start-ups. The correct limits on the regulation should, at least in the beginning, be focused only on addressing this high-tech sector. Starting small will ensure that investors actually invest.  

There is a great benefit in starting small as this allows for greater flexibility and the ability to adapt to market changes. As the market develops and more data becomes available on what aspects of the model are or are not working these can be implemented and the sectors can subsequently be expanded.

In order to ensure the development of a successful equity crowd funding market, the model in Canada has to account for the concerns that many people have of an equity crowd funding exemption being unjustifiably risky. Establishing sector-specific rules from the outset and then rolling out those rules, sector by sector, on an incremental basis, can act as an effective risk limitation. This segmentation can occur along a number of different criteria such as sector, type of project, stage of development, size of venture etc. For example, sectors could include: community-based ventures with a strong social element, high-tech ventures, media, arts, etc. The model can start with just accommodating the high-tech funding gap sector, and then subsequently be modified and expanded into other sectors at a point in time when further information and analysis on this market has been generated.

This sectoral approach will facilitate a number of things. Firstly, the primary benefit of this segmentation is that it will allow for the development of expertise in specific areas. This sector-specific focus can assist the portals in developing into industry experts. This will provide a critical value-add for Canadian start-ups going forward. If the portals become established as industry experts, this reputational experience will mitigate some of the high risks that critics are wary of in this emerging market. The advantage of portals enhancing their reputation is that it will allow them to provide to creators some advantages that are associated with underwriters in the traditional initial public offering

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79 Cumming, “Signaling”, supra, note 5.
context. The key difference is that this reputational value will come at a very low cost to the investors and creators. This emphasizes the ability that equity crowd funding has to cut out the middle men in traditional fundraising and channel much needed funding almost directly from the investors to the creators. The second benefit of the sectoral approach is this will allow for the development of sought-after expertise in each market segment. A pool of industry experts can be nominated and approved by portals to act as a committee to review and assess new proposals. This can allow experts to provide opinions on the merits of technology or an idea and can answer questions through blogs linked to each specific venture. These experts should be compensated on a fees basis with requirements that they have no vested interest in the ventures. These independent experts will add another level of legitimacy to this developing marketplace.

Thirdly, the disclosure documents can be tailored for each sector. This will allow for the development of a set of sector-specific standard templates for disclosure that are appropriate to those ventures. Finally, the separation of these sectors can allow for more vigorous empirical analysis to be conducted by both market watchdogs and interested academics. For example, umbrella reports can be commissioned by Industry Canada for specific sectors, and can then be posted online and made available to potential investors who have signed up to receive such information. These reports can then be extrapolated and studied for the purpose of improving the crowd funding model and process. The regulation of the portal must be aimed at facilitating investment and partnerships for innovative Canadian companies, with complementary companies and investors on an international scale.

**Conclusion**

The key to the success of the equity crowd funding market in Canada will be the establishment of highly reputable portals. The most effective structure to achieve this is to increase the level of disclosure from the current nil level in the existing exempt market, harnessing technology to ensure cost efficiency, without reaching anywhere close to the

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high level of disclosure that is required in the public market. Entrepreneurs should engage with experts to get advice on the preparation of these disclosure documents that can then be approved or rejected by the platform in conducting its due diligence. Strategically, the portals will play a key role in expanding the future of early-stage financing in Canada. From a legislative perspective, the sectoral approach will alleviate some concerns of those opposed to the expansion of the market by ensuring that it develops on a slow and incremental basis. In addition, the sector-specific method will ensure that expertise is developed and sufficient empirical analysis of the market can be conducted on an ongoing basis.
Conclusion

In this thesis I have looked at the development of equity crowd funding as a viable new market for early-stage financing in Canada. I began with an introduction to crowd funding and Canadian securities law. I have discussed the benefits of expanding the exempt market to ensure that this market is appropriately regulated to account for sufficient investor protection. The key critique of equity crowd funding that has been put forward by opponents is that the extent of the information asymmetry that exists between investors and creators is such that self-dealing on the part of creators is highly likely. In the Internet age these concerns are grossly over-stated. With the benefit of open communication forums and some small risk management tools to ensure that investors and creators are sufficiently well educated, these concerns can be virtually eliminated, and in a highly cost efficient manner. The global nature of this market highlights the imperative need for a national securities regulator in Canada. If Canada does not develop a national framework for this market the investors’ funds will simply migrate to another jurisdiction. The result will be that Canadian entrepreneurs, start-ups and small medium enterprises will again be left lacking the funding they need.

I have shown where the funding gap exists in Canada and how effective equity crowd funding could be in addressing this gap. That Canada has lagging productivity is not new information, similarly, that innovation drives productivity is a well-established fact. Where the problem lies is in determining how best to boost innovation and drive productivity growth. Entrepreneurs are vital to creating this innovative economy, but if good ideas are not receiving adequate financial support then they are immediately dead in the water. The lack of suitable sources of financing for these innovators has equally generated much discussion. The approach that the Canadian government has taken to date has been to use public money to support these ideas, through government grants and tax credits. A better approach would be to put a framework into place that will allow private money to flow to these ventures more easily. Equity crowd funding, if properly structured can be this essential tool. As long as the portals are required to do a minimum level of due diligence, the right companies will get funded and as long as the right limitations are placed on investors, their interests will still be adequately protected.
I have canvassed the approaches being taken in other comparable jurisdictions and compiled key aspects of those methods that should be implemented in the Canadian legislative framework. The securities laws in each of these jurisdictions are different in many aspects to Canadian regulations, particularly in terms of the changes that need to be made in those regulatory structures to support equity crowdfunding. However, there are still many elements of those approaches to change that can be well incorporated in the Canadian context. The key takeaways from the discussions in Australia relate to the education of some of the key players in this market. The portal has a crucial role to play in ensuring that investors understand the risk that they are taking on by investing in this early-stage financing market. Equally, directors of these innovative companies must ensure that they understand the new role that they will have to take on when signing up for a large and broadly dispersed investor base. In the United Kingdom, the tax incentives that exist for investors who invest into the seed market there, could prove similarly successful in Canada to encourage participation in this emerging market. In addition, the due diligence that established portals in Australia and the United Kingdom, such as Crowdcube and the Australian Small Scales Offering Board, conduct on their projects can guide the way for portal regulation in Canada. In the United States, the caps and limitations that the Securities and Exchange Commission has placed on the amount that investors can invest on an annual basis, and the amount that companies can raise on an annual basis, provide good parameters around which the Canadian structure can also operate.

The primary recommendations that the legislative framework must encompass for equity crowdfunding to succeed in Canada, from the viewpoint of investors and creators, must include: a risk acknowledgment workshop for investors to ensure that they fully understand the risk of loss in this industry; tax incentives to encourage broad participation by investors; educational workshops for directors who are inexperienced in understanding and managing a shareholder base; and the involvement of experts to assist in the preparation of disclosure documents. I have noted that the legislative emphasis must be on the portals and the role they will play is crucial to the success of equity crowdfunding in Canada. The portals need to go through a registration process with the applicable securities commission to ensure the legitimacy of these platforms and to
prevent fraud at that level. The legislation should develop on a sector-by-sector basis. This will ensure that this new market is adequately monitored and can adapt to unforeseen problems and critiques. The Internet and technology is changing at a fast pace and the legislation in this area must be equally flexible. The other primary benefit of a sectoral approach is the development of expertise in these areas. Different portals can become experts in specific market segments thus adding reputational value to companies that they allow on their sites.

In any competitive global market, whatever jurisdiction adopts the best set of regulations that balance the interests of all stakeholders will attract the largest portion of market share. The market for equity crowd funding is no different. In this context, the key stakeholders are the investors, the entrepreneurs and the platforms. Any legislative attempt that places an unjustifiable emphasis on investor protection at the expense of cost-effective fundraising procedures for entrepreneurs, or vice-versa, will be left behind. It is vital in today’s knowledge-based economy, that equity crowd funding be embraced to ensure Canada’s future as a leading innovator.