IS CROWDFUNDING BAD FOR INVESTORS?

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With the passing of the Jumpstart Our Business Startups (JOBS) Act, U.S. companies and their investors will soon be able to participate in “equity crowdfunding” (ECF), a process that allows individuals to buy equity securities in a company over the Internet. After assessing arguments both for and against ECF, this article concludes that the benefits of ECF, on the whole, outweigh its disadvantages. ECF provides small and mid-size companies with an economical system for raising capital, decreases costs incurred to invest in these companies, offers investment opportunities to a greater population, and pairs companies with interested investors. The article makes some proposals for the regulation of ECF, such as requiring the distribution of securities to occur through portals that are registered with the securities regulator and it briefly addresses the Ontario Securities Commission’s recently proposed crowdfunding prospectus exemption.

I. INTRODUCTION

A trend known as “equity crowdfunding” (ECF) is becoming popular as a means by which firms and individuals raise capital by selling securities to investors over the Internet. Some argue that this novel type of financing, endorsed and perhaps spawned by the Jumpstart Our Business Startups (JOBS) Act, is contrary to investor interests because the benefits of the proposed regulation do not outweigh the costs. Others contend that ECF advances the interests of investors, and of retail investors especially, by increasing the number of investment opportunities available to them. Is it possible for a particular policy proposal to be simultaneously good and bad for investors?

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2. See, for e.g., Jeffrey MacIntosh, (untitled, unpublished draft on file with author). MacIntosh argues that the marginal costs of equity crowdfunding are outweighed by its marginal benefits.
This article examines these divergent viewpoints, and argues that ECF is not only an effective means for small and mid-size firms to raise capital, but also a viable avenue through which investors can access investment opportunities. Reviewing the advantages and disadvantages of crowdfunding, the article concludes that, on the whole, ECF is beneficial, not harmful, for investors. Within certain regulatory boundaries, ECF can be consistent with the objectives of securities regulation and should be permitted to proceed as a means by which issuers can raise capital.

Generally, “crowdfunding” or “rewards crowdfunding” is a means of selling any product or service over the Internet to a broad group of consumers. In an ECF transaction, an issuer makes a direct offer of securities to a large number of potential investors with the aim of raising a small amount from each one. The principles of crowdfunding are a contrast to traditional methods of raising capital, where issuers turn to small groups of investors to complete the offering. The conduit of information from issuer to investor is a website, rather than an underwriter or intermediary. The website houses information regarding the proposed project, the means by which investors can “buy in” or contribute to the project, and the issuer’s objectives.

The absence of an underwriter may appear to be a significant disadvantage for the investor, and the unsophisticated investor

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6. This return is usually a reward related to the proposed project. For instance, if the project is seeking to build a phone, the contributor might get a discounted or advanced copy of the phone in return for the donation.
especially. In any securities distribution, investors face costs from the acquisition, consolidation, evaluation and verification of the issuer’s information,\(^7\) which usually require the employment of skilled persons such as underwriters, accountants and lawyers. Investors also seek to ensure that the information is credible; they rely heavily on underwriters to absorb the verification costs inherent in the fact-finding mission. The underwriter, together with a prospectus, serves to reduce these costs for investors and to make the information gathered readily available to investors.

Even though investors have neither a prospectus nor an underwriter in an ECF transaction, ECFs can be advantageous for them, especially where the investment occurs via a portal registered with a securities regulator. In such cases, investors’ costs (including the potential for fraud) are lowered, thereby increasing the potential for an efficient ECF transaction. Furthermore, ECF transactions increase investment opportunities for investors; these opportunities are, generally speaking, benefits, though perhaps unquantifiable ones.

For issuers, the cost savings are obvious: the issuer can raise capital more quickly than under the traditional prospectus method because it does not need to compile a lengthy disclosure document. Furthermore, the absence of an underwriter means that there is no “spread” (i.e., the net profit between the proceeds of the issue and the amount the issuer receives) payable to the underwriter. The issuer “speaks to” investors directly by selling its securities over the Internet.

In further probing the pros and cons of ECFs, this article questions the meaning of “investor protection.” Does the term mean shielding investors from financing opportunities that may be fraudulent? Or is it purely the provision of disclosure, to ensure that investors have the ability to be well-informed prior to making investment decisions? Part 2 outlines the regulatory regime that governs ECF proposals. Part 3 then examines the advantages and disadvantages of ECFs, arguing that investors can benefit from ECFs. Part 4 examines policy options, and proposes an ECF exemption from the prospectus requirement. The addendum briefly addresses the Ontario Securities Commission’s recently proposed crowdfunding prospectus exemption.

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II. REGULATORY BACKGROUND

Historically, securities regulators have operated under the dual mandate of protecting investors and promoting market efficiency.\(^8\) In executing this mandate, they seek to: ensure that issuers make adequate disclosure so that investors can make informed decisions; oversee capital market stakeholders such as issuers, dealers and self-regulatory organizations; and, enforce regulations by investigating possible violations of the law, prosecuting those who violate the law and applying penalties in the case of breach.\(^9\)

In order to distribute securities, issuers are required to prepare a mandatory disclosure called a registration statement (in the United States) or a prospectus (in Canada). They must file the relevant document with the respective securities commission and obtain a receipt for it prior to issuing the securities.\(^10\) In fact, the issuer must prepare and clear both a preliminary and final version of the document, which must contain full, true and plain disclosure of all material facts.\(^11\) One of the most challenging aspects of the public offering process for the issuer is isolating an investor base and ensuring that investors purchase the securities being distributed. Issuers will usually retain an underwriter to assist with the marketing of the securities, as underwriters lend their reputational capital to the distribution and serve as a gatekeeper of information in the offering process.\(^12\)

The main problem with the public offering process is that it is expensive.\(^13\) Drafting and compiling the prospectus comprise part of the issuer's total cost, but underwriting commissions of up to 12%, as well as legal, accounting and listing fees, can push the cost of an Initial Public Offering (IPO) above $1 million.\(^14\) For smaller firms in particular, these expenses can be prohibitive. In light of these costs, securities regulation permits firms to issue securities without a prospectus, provided that the issuer (and/or investors

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\(^8\) Securities Act, R.S.O. 1990, c. S.5, s. 1.1 (osA).

\(^9\) Ibid. s. 2.1.

\(^10\) Ibid.

\(^11\) Ibid. s. 56(1); see 15 U.S.C. § 77g (2013) for the U.S. equivalent.

\(^12\) Gibson and Kraakman, supra, footnote 5.


who are purchasing its securities) meets conditions of pre-established exemptions from the prospectus requirement.\textsuperscript{15}

Exemptions are based on various rationales, one of which is the sophistication of the investor. The "accredited investor" exemption permits issuers to sell any amount or type of securities to individuals who, either alone or with their spouse, have financial assets exceeding $1 million or net assets exceeding $5 million. Issuers can also sell any amount or type of securities to those individuals who have a net income before taxes exceeding $200,000, or who have a net income before taxes exceeding $300,000 in combination with their spouse.\textsuperscript{16} Under the minimum amount exemption, to cite another example, investors must invest at least $150,000 in the issuer in exchange for the issuer's securities.\textsuperscript{17} These financial thresholds are proxies for investors' sophistication; the legislation assumes that these individuals do not require the protection (via information or statutory right of action for misrepresentation) that the prospectus provides.

A second type of exemption relates to those who have close relationships with the issuer, such as family members, friends and business associates.\textsuperscript{18} The idea is that these investors have close ties to the issuer and can glean more information, if they need to, by speaking or corresponding with the issuer's representatives, including directors, founders and promoters. A further assumption underlying this exemption, and perhaps not a legitimate one, is that individuals who are associated with the issuer would not commit fraud against close relations who decide to invest.

A third type of exemption allows private companies to distribute securities to a maximum of 50 persons.\textsuperscript{19} The rationale underlying this particular deviation from the prospectus requirement is that


\textsuperscript{16} Ontario Securities Commission, Considerations for New Capital Raising Prospectus Exemptions, OSC Staff Consultation Paper 45-710 (December 14, 2012), online: Ontario Securities Commission <http://www.osc.gov.on.ca/documents/en/Securities-Category4/sn_20121214_45-710_exempt-market-review.pdf>, at p. 7. The vast majority of Ontario exempt market trades occur under the accredited investor exemption. For instance, in 2011, over 50% of securities purchased, over 70% of distributions, and over 80% of funds raised in the exempt market in Ontario fell under this exemption (at p. 73).

\textsuperscript{17} Ontario Securities Commission, \textit{ibid.}; NI 45-106, \textit{supra}, footnote 15.

\textsuperscript{18} Ontario uses the "founder, control person and family" exemption, whereas other jurisdictions permit investments from "family, friends and business associates." \textit{Ibid.} at 2.5-2.7.

\textsuperscript{19} \textit{Ibid.}
small firms often require capital quickly and should be able to raise it from investors who have a close association with the firm, including directors, officers and employees. The ceiling on the number of investors is meant to prevent "backdoor underwriting," or the practice of effectively distributing securities to the public without a prospectus.

Current ECF reform proposals contemplate a distribution of securities over the Internet under an exemption, which means that no prospectus would accompany the distributed securities. A key question is: how to craft the exemption? One alternative would be to implement an exemption that permits ECF based on one of the rationales just discussed, by requiring that issuers ensure that the investor is sophisticated or that he or she has a close relationship with the issuer.20 Another alternative would be to create an ECF exemption but include an oversight mechanism, such as a portal, so that transactions are vetted and monitored by the regulator. Before considering these policy choices, it is necessary to examine arguments for and against ECF and, thereafter, to ask: is equity crowdfunding a good idea?

III. ANALYZING ECF

This section analyzes the advantages and disadvantages of ECF from the standpoint of the two main parties in a securities transaction — issuers and investors — and asserts that there are significant advantages for both parties. For issuers, the advantages relate primarily to transaction costs, while the advantages for investors rest in opportunities to participate in investments to which they would not otherwise have access.

Distributing securities pursuant to an exemption is an attractive alternative for issuers that wish to raise capital, because exemptions typically do not require the issuer to file any disclosure, which can be both cumbersome and expensive.21 Furthermore, issuers that distribute securities under an exemption rather than through a

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20. These rationales are in play by <AngelList.co> in collaboration with SecondMarket, for example, where accredited investors can crowdfund start-ups in exchange for equity.

21. It is true that the issuer may prepare some type of disclosure document, such as a term sheet, but this disclosure is not mandatory. Investors may demand some disclosure, even if it is less rigorous than it would be under a prospectus. The list of exemptions includes an offering memorandum exemption, under which the issuer provides prospective investors with a lengthy disclosure document containing some of the same information contained in a prospectus, as well as a statutory right of action for misrepresentation.
prospectus can tap capital markets more quickly as they do not need to obtain regulatory approval before proceeding with the distribution. An ECF exemption for issuers is attractive to issuers for these reasons.

ECFs can also be advantageous for investors. As ECFs occur over the Internet, the costs of acquiring information are lower because investors do not need to rely on underwriters for information; rather, they can access it easily online from their homes. In order to ensure that the information on the Internet is consistently credible, securities regulators could mandate that securities must be distributed through a registered portal, as discussed below. The portal would enable the regulator to undertake a vetting process to ensure, for example, that only solvent issuers are able to issue securities via the portal and that the portal is a member of the country’s dealer’s association.22 This stamp of approval provides information to investors — both sophisticated and unsophisticated — about the credibility of the issuer.

Further, ECF transactions can expand investor choice and “democratize” startup investing by allowing retail investors to participate in securities distributions to which they may not otherwise be privy. Andrew Schwartz argues that crowdfunding is beneficial because it extends the ability to invest in potentially high reward startups to everyone, not just to the wealthy and well-connected.23 While investing in startups is risky, some early investors can earn thousands of times their money by backing the right company.24 Crowdfunding is one potential means to this end as it can expose investors to a wider range of investment opportunities than would otherwise be available.

Some of these opportunities may relate to a community project or investment initiative that meets the investor’s social or moral objectives (e.g., environmental sustainability).25 For example, Thomas Martin discusses “social good projects,” such as initiatives to provide microloans to entrepreneurs in developing countries.26

22. This endorsement of portal based crowdfunding follows from the JOBS Act, which permits equity crowdfunding via a licensed intermediary (in the U.S. called a broker-dealer) or via a registered portal. See JOBS Act, supra, footnote 1, § 304 discussed below.


24. Ibid. at p. 1475.

Non-equity based crowdfunding has raised money for social causes. Indiegogo.com, one of the oldest crowdfunding platforms, specifically identifies “social good” projects, allowing site users easy access to a wide variety of social causes seeking donations. Such opportunities — indeed, moral considerations that coincide with one’s non-pecuniary preference and motivate one to invest — must also be balanced against the likelihood that a particular allowable venture is costly.

There are two major objections to ECF from an investor protection standpoint. The first is that ECF transactions can lead to fraud and abuse. Notably, however, the persistence of fraud in ECF has not been borne out by available evidence. Ethan Mollick has undertaken an empirical study of Kickstarter projects in the Design and Technology category. He examined 381 successful projects, and found that only 14/381 (0.37%) had stopped responding to funders “and could potentially have given up on delivering entirely.” According to a U.K. report, the established evidence shows that little fraud actually occurs with crowdfunded transactions. This is not to say that fraud in these transactions cannot or will not occur; it suggests only that the available data undermines the criticism that there are significant investor protection issues with these transactions because of the potential for fraud.

The potential for securities fraud in ECF cannot be assessed in a vacuum, but must be examined relative to the incidence of fraud in

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32. Ibid.
33. Kathryn Curtis, “UK Group Targets Crowdfunding Compliance” (March 27, 2013), online: Crowdex <http://crowdex.co/2013/03/27/uk-group-targets-crowdfunding-compliance/>. 
the exempt market generally, as well as in traditional IPOs. Currently, there is no rigorous data on the incidence of fraud in the Canadian exempt market, but studies suggest that fraud may be fairly common in the exempt market. In May, 2013, the Ontario Securities Commission (OSC) did a sweep of 45 exempt market dealers (EMDS), and found many cases of EMD non-compliance with OSC regulations. Eighteen percent of EMDS were found to have sold securities to non-accredited investors who did not fit into any other exemption that would allow them to purchase securities legally.

With regard to IPO data, Wang et al. studied over 3,000 IPOs from 1995 to 2005, and found that fraud occurred either before or shortly after the IPO in over 11% of the cases. The authors admit that they are estimating fraud, and studying a high fraud period, the results are surprising. Other researchers have found lower, but still significant levels of fraud. Bohn and Choi found that, between 1975 and 1985, 3.5% of all IPOs ended in security fraud lawsuits. It remains unclear whether ECF will decrease the rates of fraud inherent in securities issuances, or whether dealing over the Internet will increase fraud. Current levels of fraud in traditional IPOs, however, combined with Mollick’s findings of little fraud in crowdfunding generally, at least suggest that ECF transactions may not actually increase fraud.

A second objection to ECF is that investors are unable to understand what is in their best interests, and that they, therefore, require laws to ensure that they are protected. We should be


careful not to exaggerate the supposed incompetence of investors. Mollick examines both venture capitalism and crowdfunding and finds that, in aggregate, crowdfunding investors look at the same signals of quality and risk that venture capitalists do. He also finds that the crowdfunding process reduces some of the biases often associated with venture capitalism, including geographic proximity bias and gender bias towards the entrepreneurs.

Mollick’s study suggests that ECF investors have the ability to distinguish between successful and unsuccessful investment opportunities just as well as venture capitalists. But this conclusion surely does not pertain to the entire universe of investors, and the question arises, therefore, as to the proper role of the regulator in seeking to protect investors. Securities regulation is, and has historically been, concerned with the level of disclosure that should be provided to investors. Regulators rightly understand that they cannot be responsible for ensuring that investors read and understand an issuer’s disclosure. While “investor protection” could broadly mean ensuring that investors understand the products they purchase, such a regulatory obligation would be unwieldy, not to mention impractical.

In sum, for issuers, the key advantage of ECF relates to cost savings in not having to prepare and qualify a prospectus, as well as being able to access capital markets more quickly. Investors may benefit from having access to a range of investment opportunities that allow them to place their funds in companies whose activities coincide with their moral preferences. The lack of a prospectus may mean that they may have less information about the issuer and its securities. Thus, the two major objections to ECF — lack of information and the potential for investors to be defrauded — can be addressed in the design of an exemption, a topic to which we now turn.

IV. POLICY PRESCRIPTIONS

The gist of the previous sections is that ECF provides investors with numerous advantages but, at the same time, raises concerns


39. Ibid.

40. Ibid. at p. 25.

from an investor protection standpoint. This section probes the policy implications of this argument, contending that ECF should be permitted, but only within certain legally mandated parameters. We begin by examining the purposes of securities regulation and the role that regulators play in fulfilling these purposes.

As noted in Part II above, securities regulation seeks to achieve the twin goals of investor protection and market efficiency. The Securities Act (Ontario) explicitly states that, "The purposes of this Act are to provide protection to investors from unfair, improper or fraudulent practices; and to foster fair and efficient capital markets and confidence in capital markets." If one surveys the panoply of legislation that comprises the securities regulatory regime, it is clear that the preponderance of rules relate to disclosure and, in particular, what issuers must disclose as "reporting" or public issuers. Disclosure rules are based on equity and reasonableness, rather than efficiency. They seek to create a level playing field so that investors and insiders alike have access to the same information prior to making decisions about whether to purchase or sell securities.

How should regulators craft an ECF exemption, given their mandate? One option endorsed by both the JOBS Act and proposals outside of the United States is to limit the amount an individual can invest. The JOBS Act caps overall investment at $1 million in a 12-month period. By contrast, the OSC is considering imposing a limit of $2,500 per investment, together with a risk acknowledgement form to be signed by the investor. This conservative ceiling offsets risk involved in start-up investing. It also differs from other exemptions that impose a "floor" on the amount that an individual can invest. For example, the minimum amount exemption applies to investments of at least $150,000, providing the purchaser purchases as principal. No risk acknowledgement form is required in the minimum amount exemption.

42. osa, supra, footnote 8, s. 1.1.
43. Condon, supra, footnote 41.
44. See JOBS Act, supra, footnote 1, § 302(a)(6)(A).
45. Prospectus and Registration Exemptions, supra, footnote 15, § 2.10; Saskatchewan's Financial and Consumer Affairs Authority (FCAA) has proposed a new equity crowdfunding exemption, which would enable companies to make two offerings, of up to $150,000 each, per year. Investors would be limited to making $1,500 investments, and both the business and the investor would have to be based in Saskatchewan. James Langton "Saskatchewan Regulator Proposes Crowdfunding Exemption", Investment Executive, October 7, 2013, online: <http://www.investmentexecutive.com/-/saskatchewan-regulator-proposes-crowdfunding-exemption?redirect=%2Fnews%2Ffrom-the-regulators>. 
Caps on the amount an individual can invest are a good idea but they are insufficient to protect investors from fraud, as fraudsters may misrepresent the cap to potential investors. Further protections may be necessary, including requiring issuers to make certain disclosure. This disclosure would not be as comprehensive as that found in a prospectus, or even an offering memorandum, but would provide investors with basic information about the issuer and its financial condition. Along these lines, the OSC has proposed that investors should be permitted to invest more than $2,500 in a single investment under the exemption, or more than $10,000 in total during any calendar year.46

To ensure that frequent ECF investors best understand the transaction and their rights, ECF securities could be governed by a set of standard conditions. In theory, standard form contracts reduce transaction costs by delineating the terms that the contracting parties will ultimately have to agree to, without requiring a lengthy bargaining process between the parties.47 Such terms, based on repeated interactions in the past, usually embody those clauses that sophisticated market actors have agreed to. Standard form contracts also provide parties with a common understanding of definitions of vague terms.48 For example, one proposal is that one single class of shares be issued containing standard terms that deal with a possible IPO, firm liquidation, etc.49

But there are problems with standard form contracts, including the fact that they are often misunderstood or unread.50 They may not, therefore, serve to protect investors at all. A reform that is more likely to be effective is to require that ECF securities be sold only through an approved portal that is registered with the securities regulator. The portal should be independent and operate pursuant to a list of conditions or restrictions that has been established by the regulator. These conditions may require that purchasers respect the actual funding caps, that they only invest a

46. Ontario Securities Commission, supra, footnote 16.
47. Marcel Kahan and Michael Klausner, "Standardization and Innovation in Corporate Contracting (Or 'The Economics of Boilerplate')" (1997), 83 Va. L. Rev. 713.
48. Ibid.
maximum amount over a particular time period, and that they are provided with certain disclosure. Of course, registration would be granted only after the regulator has obtained background information about the issuer and its directors, officers, and any significant shareholders, which is itself a response to fraud concerns. The onus for compliance with conditions may rest on issuers selling shares through the portal, as well as those registered individuals who operate the portal itself. The portal may be required to follow up with the regulator reporting on its investment activities and the number of securities taken up, by whom, and under what conditions.

Portal usage is without question an area where the Internet provides a clear advantage over paper-based means traditionally used to distribute securities. Portals can include efficient regulatory oversight with additional investor assistance through effective web design. For instance, the portal could link to relevant media reports on the issuer, or show a list of high profile investors who have already invested in the project. To combat fraud, a reporting system could be built into the portal, allowing for easy reporting to the regulator. Additionally, the portal could combine ECF with another form of fundraising. An issuer could raise funds through equity crowdfunding for its initial startup or general operations from investors who are seeking long-term returns. Later, the issuer could turn to rewards-based funding for the production of a certain product by promising contributors first

52. The OSC has recently granted permission for the creation of a platform that will allow for crowdfunded equity and debt to be issued to accredited investors by companies with a social or environmental focus. The platform consists of a public portal, where general information about the issuers will be listed, and a private portal accessible only to verified accredited investors. Issuers who have accessed the private portal can receive financial information or management biographies. These investors then have to be granted access by the issuer to an additional “Deal Room” to receive the business plan, detailed financial statements and other documents. Additionally, the private portal will be supplemented with investor meetings and presentations in person. See In The Matter of The Securities Legislation of Ontario (The “Jurisdiction”) and In The Matter Of Mars Vx (The “Filer”) (June 17, 2013), D. Foubert, Ont. Securities Comm., online: Ontario Securities Commission, <http://www.osc.gov.on.ca/en/SecuritiesLaw_20130620_215_mars-vx.htm>.
53. See, generally, <www.indiegogo.com> for examples of crowdfunding projects that link to news articles.
access to the product. Combining both options into one portal would streamline the capital raising process. For example, investors might prefer the reward of a smartphone when investing in a consumer technology manufacturer, but prefer an equity stake if investing in a heavy equipment manufacturer.

A further refinement of the portal concept is to ensure an alignment of the portal with investors' interests. Instead of taking a commission of funds raised, portals could take a portion of the profit, thereby becoming investors in the issuers that they host.56 The portal succeeds insofar as the issuers it hosts succeed, giving it an incentive to host legitimate, non-fraudulent issuers. An online portal in the United Kingdom called “Seedrs” performs a due diligence review before accepting issuers and again before closing, with investors receiving their funds back if the review is unsuccessful. Further, Seedrs holds all shares as nominee trustee on behalf of investors, and manages all dividend payments and disclosure through its online portal. It also earns a portion of the proceeds and future dividends, but only if the transactions close.57 Seedrs’ approach is consistent, though not perfectly aligned, with investors’ interests; it charges issuers 7.5% of the money raised and investors 7.5% of profits.

As it is a website, the portal is not a traditional intermediary. It is the role of the regulator to ensure that these intermediaries are permitted to operate only if they abide by certain conditions and procedures, as is the case with individual dealers, called “registrants,” who are required to act fairly, honestly and in good faith with their clients.58 This type of rulemaking is not new to securities regulators; it is the investor protection function they have fulfilled for decades. It is the medium that is somewhat new, and as Agrawal et al. have explained:59

56. This suggestion is an antidote to one problem with ECF and funding portals as the U.K. experience suggests: the alignment of portal and issuer interests to the detriment of investors. Derrick Auch, Don Collie and Marek Lorenc, “Equity-Based Crowdfunding: Coming to a Province Near You?” (July 10, 2013), online: Davis LLP <http://www.davis.ca/en/publication/will-equity-based-crowdfunding-work-in-canada/>.

57. Ibid.

58. Conditions of Registration, O.S.C. Rule 31-505 (September 18, 2009), s. 2.1. Such registration would render the portal registration akin to the process that relates to self-regulatory organizations (SROs).

59. Rotman School of Management, “Spectacular Failures, New Opportunities to be Expected from Equity Crowdfunding” (July 15, 2013), online: Rotman School of Management <http://www.rotman.utoronto.ca/Connect/MediaCentre/NewsReleases/20130716.aspx> ; Lee, supra, footnote 49.
It feels like we are being far more protective of people making mistakes buying small amounts of equity through crowdfunding than we are of people making mistakes buying other goods and services on the internet that are sometimes fraudulent, of lower-quality, or overpriced.

These suggestions for reform — standard form contracts, exemptions and portal design — focus on ex ante measures that can be adopted in order to protect investors. Yet these measures will not prevent investors from losing the value of their investment if they lack legal remedies.60 Remedies are important, as is an active regulator that monitors the exempt market, including portals, for abuse, and bringing actions in the public interest where necessary. Providing private protections in share conditions, such as anti-dilution protections and pre-emptive rights, is also possible.61 These rights would presumably give rise to a private action for breach of contract ex post and may be in addition to regulatory action taken for the wrongdoing.

The JOBS Act ensures that companies issuing ECF securities can be held liable to investors for making material misstatements concerning securities they have issued, or for omitting to disclose material information regarding those securities. In these situations, individuals who have purchased the issuer’s shares can bring legal action to recover their net losses: either in the form of consideration paid for the securities, if the securities are still owned, or damages if the securities are no longer owned.62 Because exemptions typically do not carry a disclosure requirement, civil remedies on which investors can rely in case of misrepresentation do not currently exist in the securities regulation, save for the right to sue issuers, and their directors and underwriters, for misrepresentations contained in offering memoranda.63 But this remedy could serve as a statutory template for a remedy to address misrepresentations in ECF disclosure.

60. See John Wroldsen, “The Social Network and the Crowdfund Act” (2013), 15 Vand. J. Ent. & Tech. 583, at p. 583:
When successful start-up companies raise additional funds from professional venture capitalists, the value of ground-floor investments can be severely diluted . . . when crowdfunded companies are acquired in private transactions, crowdfunders are at risk of being left out.

61. Ibid.

62. See JOBS Act, supra, footnote 1, § 4A(c). If the securities are still owned, the person charged with determining the extent of damages must also take into account not only profits received from the shares, but also interest.

63. CSA, supra, footnote 8, s. 130.1 (1).
V. CONCLUSION

The term “investor protection” does not mean that regulators will remove all risk from an investment; rather, it involves the provision of protections, such as adequate disclosure and, in the case of ECFs, registered portals, so that investors can make informed decisions. An ECF exemption would be a middle ground between full-blown prospectus offerings on the one hand, and exemptions that require no disclosure and carry little regulatory oversight on the other. The potential for fraud warrants careful consideration in the crafting of the ECF exemption, but should not stand as the reason that investors are denied the investment opportunities otherwise available under ECF.

VI. ADDENDUM

After this article had been accepted for publication, the OSC released a proposed crowdfunding prospectus exemption. The proposed exemption in Part IV of this article is similar, though not identical, to the OSC proposal. Both proposals support the introduction of investment limits, portal registration, standardized disclosure and a contractual right of action in the event of a misrepresentation in disclosure documents. Unlike the recommendation in Part IV of this article, however, the OSC proposal contains a maximum offering amount of $1.5 million per issuer per year and other measures (including rights of withdrawal and resale restrictions). The author is, generally, in favour of these additional restrictions as means of ensuring that investors are protected in the course of making investments in the crowdfunding context.
