Grassroots Capitalism or: How I Learned to Stop Worrying About Financial Risk in the Exempt Market and Love Equity Crowdfunding

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GRASSROOTS CAPITALISM OR:
HOW I LEARNED TO STOP WORRYING ABOUT FINANCIAL RISK IN
THE EXEMPT MARKET AND LOVE EQUITY CROWDFUNDING

Marco Figliomeni*

ABSTRACT

Crowdfunding represents a successful grassroots response to the funding gap present in many independent creative projects. While it traditionally operates on the basis of donations and rewards, the Ontario Securities Commission (OSC) has proposed implementing equity crowdfunding, which would permit the online sale of corporate securities to retail investors. This paper posits that equity crowdfunding should be adopted in Ontario. The ensuing growth in capital markets will ultimately benefit the Canadian economy and, in particular, the entertainment sector.

The OSC’s proposed regulatory framework for a crowdfunding prospectus exemption is a step in the right direction. The streamlined process makes it easier and less expensive for early-stage businesses to raise much-needed capital. The Internet’s global reach serves to match entrepreneurs and prospective investors with unprecedented ease. These reduced barriers create opportunities to kick-start the economy. The anonymity and ubiquity of the Internet make it equally important to provide sufficient investor protection. The OSC’s proposal does this in a number of ways: initial and continuous disclosure, modest investment limits, risk acknowledgement, and regulatory oversight. However, the OSC should also consider implementing a statutory action for continuous disclosure misrepresentation.

The investment model of crowdfunding preserves the democratic spirit and accessibility that are essential to this funding mechanism. A case study demonstrates how this model may also benefit large capital-intensive projects in the entertainment industry.

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1. INTRODUCTION

“Imagination is a force that can manifest reality.” Those are the inspiring words of one of the most ambitious film directors of our time, James Cameron. Indeed, an artist’s imagination is the fuel that fires his expression, and in most cases, his livelihood. In a world where imagination is sometimes not enough, the phenomenon of crowdfunding steps up to nurture the fruits of one’s creative labour.

Crowdfunding allows a creator to fund a project by pooling individual contributions over the Internet. It represents a grassroots response to plug the funding gap facing many independent creative projects. While crowdfunding is primarily used on a donation or rewards basis, there is global momentum in crowdfunding through investment products. The challenge is that this new type of investment or equity crowdfunding does not currently fit into the regulatory framework for securities in Ontario. There is also the philosophical issue as to whether introducing a profit incentive taints the democratic essence of traditional crowdfunding.

Either way, the Ontario Securities Commission (OSC) has proposed a new prospectus exemption that would allow a corporation to sell securities through online crowdfunding platforms. This paper posits that equity crowdfunding should be adopted because the OSC’s proposed, albeit preliminary, regulatory framework appropriately balances the dual purposes of securities regulation in Ontario. Secondly, the ensuing growth in capital markets will ultimately benefit the Canadian economy and, in particular, the arts and entertainment sectors.

In arriving at these conclusions, this paper explores the concept of crowdfunding and the underlying motivations of its users. Equity crowdfunding is introduced, along with a look at the impact of a profit incentive in this context. I present a brief overview of securities regulation in Ontario before delving into the OSC’s proposed regulatory framework for equity crowdfunding. Then, I consider the following questions: does the OSC’s proposal satisfy the purposes of securities regulation to promote investor protection and foster fair and efficient capital markets? How does the proposed framework reconcile competing policy interests in increasing capital raising and minimizing financial risk? Finally, this paper looks at whether equity crowdfunding can be a viable financing tool for entrepreneurs in the arts and entertainment sectors.

2. A PRIMER ON CROWDFUNDING

2.1 What is it?

Most artists spend their entire lives perfecting their chosen craft. So much so that the business of actually financing and marketing their work is often handed off to industry experts. For better or worse, these external forces have the power to influence the final product in some way because they have a financial stake in its success. But what about the young and idealistic filmmaker who defines success as communicating something meaningful to the world through art, rather than in terms of box office receipts? Retention of creative control is important to achieving this end. Young filmmakers often find themselves out of financing options after having exhausted funds from
friends, family, and public and private investors. At this point, passion projects—for instance, a documentary on the plight of the leatherback sea turtle—may never see the light of day. If only there was a way for independent artists to rely on fans to fund their passion projects. By simplifying old-world communication and distribution network challenges, the Internet offers one solution to bridge the funding gap that kills many independent projects.

Crowdfunding is the pooling of individual contributions from the general public through the Internet to fund a particular initiative. This new tool democratizes the project finance process by turning power over to the crowd. It should be made clear that crowdfunding serves more than just filmmakers. While “films and performing arts” accounted for 11.9% of crowdfunding activity in 2012, “music and recording arts,” “general art” and “fashion” are all part of the creative categories of crowdfunding. Entrepreneurial ventures and social causes were the largest categories in 2012, representing almost half of all crowdfunding activity.

2.2 How does it work?

The defining feature of crowdfunding is how it allows an entrepreneur, the “creator,” to pitch his or her project to an unprecedented number of potential supporters in a short time frame for relatively little cost. Generally speaking, supporters donate money knowing that there is no guarantee the project will come to fruition. However, the level of certainty that accompanies crowdfunded projects may vary depending on whether a particular crowdfunding platform operates based on donations, lending, or investment.

Models

The donation model was the most widely used form of crowdfunding in 2012, representing 52% ($1.4 billion) of funds raised globally. Under this model, individual contributors have no expectation of profit. Most non-charitable campaigns offer rewards according to each backer’s level of contribution, but contributors do not gain any ownership rights in the project. For example, donations can yield branded merchandise, a final copy of the project, a meet and greet with the creative team, an executive producer credit, and everything in between. Creators choose the types and the number of rewards they will offer. Backers are motivated to help fund the project because of their affinity for its cause. They simply want something to exist in the world and are willing to pay to make it happen.

Under the lending model, a person who loans money to the creator expects repayment with interest. This can take the form of a traditional lending agreement, forgivable loan, or pre-sale arrangement. Lastly, the investment model, which this paper will cover

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2 Canada Media Fund, Facts & Stats: Crowdfunding by the Numbers in 2012 (31 May 2013), online: CMF Crowdfunding in Canada <http://crowdfunding.cmf-fmc.ca>.
4 Ibid.
in depth, can be in the form of equity or debt securities, a profit/revenue-sharing model, or an investment contract.\textsuperscript{5}

**Platforms, Funding Allocation, and Fees**

Crowdfunding platforms act as a facilitator and intermediary for creators and the crowd. This hands-off approach means that platforms usually do not guarantee completion of the project, nor do they investigate a creator’s ability to complete it beyond ensuring that the project complies with the platform’s guidelines.

Canada is home to a large network of crowdfunding sites. Kickstarter, Indiegogo, and RocketHub are the most popular sites for funding creative projects as they generate the highest level of traffic. Kickstarter, in particular, has become synonymous with crowdfunding. It has facilitated the raising of nearly $1 billion\textsuperscript{6} and accounts for over 80% of funding dollars in North America.\textsuperscript{7} Niche platforms exist as well. For instance, PledgeMusic and Halifax-based ioumusic cater specifically to musicians.

What happens if a project fails to meet its funding goal by the deadline date? The creator does not keep the funds in an “all-or-nothing” model. Kickstarter, for instance, does not execute pledges until the funding goal is reached.\textsuperscript{8} But with “keep-what-you-earn,” the creator keeps the funds regardless of whether the funding goal is reached or not. RocketHub, FundRazr and Indiegogo offer a “keep-what-you-earn” option. Indiegogo offers creators the option to refund pledges in exchange for a lower commission fee.\textsuperscript{9}

Crowdfunding platforms earn money by taking a commission off the top of all capital raised before advancing the balance to the creator. The larger, mainstream platforms charge a commission of 4–9% of funded dollars, while rates on the smaller, music-specific sites noted above range from 10–15%. Transaction fees of 3–5% for each contribution are charged in addition to the commission on funds raised.

**Mechanics of a Campaign\textsuperscript{10}**

Each crowdfunding platform has different rules, processes, and obligations for creators, backers, and the platform itself. Given that Kickstarter has emerged as the dominant platform for funding creative projects, the following discussion describes that site’s guidelines on how to set up a reward-based campaign.

The creator must have a clear and definable goal that results in a finite product, like a film, music album, or video game. The creator makes a webpage on the site that lists information explaining the project, the parties involved, and how funds are to be allocated. Posting a video pitch is also common. A reasonable funding goal is established and this goal must be reached within a certain period of time (usually 30 to 60 days) or the creator receives nothing. Creators have a vested interest in being as transparent as

\textsuperscript{5} Ibid.

\textsuperscript{6} Kickstarter, Kickstarter Stats, online: Kickstarter <http://www.kickstarter.com>.


\textsuperscript{8} Kickstarter, Kickstarter FAQ, online: Kickstarter <http://www.kickstarter.com> [Kickstarter FAQ].

\textsuperscript{9} Indiegogo, How Pricing Works on Indiegogo, online: Indiegogo <http://www.indiegogo.com>.

\textsuperscript{10} Kickstarter FAQ, supra note 8.
possible in an effort to earn the trust of potential backers. Furthermore, their reputation is on the line in a very public way. Therefore, it is crucial that creators fulfil their obligations once projects are funded. Ultimately, backers will only support projects they have faith in. Based on the creator’s history and the information he or she posts, the backer can assess the creator’s ability to execute the project successfully.

Reaching the funding goal does not dissolve a creator’s obligation to deliver the project as promised. Given the volatile nature of developing artistic projects, unexpected delays are not uncommon. In these instances, if the creator puts forth a good faith effort and communicates the project’s progress or lack thereof, backers tend to be more understanding and patient. If the creator cannot complete the project, he or she must find a resolution to satisfy the backer. This may include offering refunds or detailing how funds were allocated. The creator is obligated to fulfil all rewards or refund any backer whose reward cannot be fulfilled.

If a project surpasses its funding goal, the creator retains the surplus. Creators can use the additional funds to increase the scale of their project or improve the variety of rewards available to backers.

2.3 Why does it exist?

Crowdfunding platforms enable creators to reach an unprecedented number of supporters with considerable ease. As a result, creators are able to bridge their funding gap without sacrificing creative control over their work.

There are important secondary benefits vital to a project’s long-term viability. Firstly, successfully funding a project proves that the concept has an existing market. The number of backers can be used to estimate the size and enthusiasm of a potential target audience. Secondly, the funding campaign provides no-cost promotion and advertising for the final product. This can be more effective than other promotional campaigns because of the inherent trust relationship between backer and creator. In addition, offering pre-release access to content as a reward can double as reliable market testing. This leads to the third benefit: audience building. Crowdfunding provides the unique opportunity for creators to engage with fans on a whole new level. Being part of the development process can create an evangelizing effect on backers that grows a project’s audience. Lastly, the creator has a new channel for soliciting audience feedback through a comments feature.11

Those who doubt the staying power of crowdfunding should consider this: there are over 500 crowdfunding platforms around the world, dozens of which are available to Canadians.12 In 2012, these platforms raised more than $2.7 billion USD globally. In 2013, crowdfunding volume was estimated at $5.1 billion USD.13 The aggregate data is impressive, but who are the players driving these numbers? The following are a few success stories:

- The Pebble Smartwatch was the most successful Kickstarter campaign ever, exceeding its funding goal by 100 times to raise over $10 million.

11 CMF, Canadian Context, supra note 1 at 23.
12 CMF, Market Overview, supra note 3.
13 Ibid.
• Amanda Palmer spearheaded the most successful music-based Kickstarter campaign for her *Theatre is Evil* album by raising over $1 million.
• After raising over $50,000, the film *Inocente* became the first Internet-crowdfunded film to win an Academy Award.\(^\text{14}\)
• Protest the Hero, a progressive metal band from Whitby, ON, almost tripled their goal on Indiegogo by pulling in $341,146 to fund their fourth album.

What started out as a grassroots movement is now fundamentally altering the landscape of project finance throughout the world. Crowdfunding is accessible and democratic. Never before have creators been able to engage their supporters so intimately in the project development process. Never before has the crowd been given such an important role in influencing what items enter the market. Never before have creators had such a direct route to filling a budgetary gap. The end result is greater innovation and more content that the public wants.

3. EQUITY CROWDFUNDING

So far, this paper has provided an overview of donation-based crowdfunding. Even when a reward system is in place, this model does not trigger securities law because the exchange is one of money for goods. However, what if an entrepreneur is willing to offer securities in their corporation through a crowdfunding platform? Determining the rights of security holders in this scenario goes to the heart of corporate law. More importantly, such an offering raises certain securities law obligations, which will be discussed in Part 4, below.

3.1 Corporate Law and the Fundamental Rights of an Equity Shareholder

The primary purpose of early corporate law was to fund business ventures by pooling large amounts of capital from a large number of “passive” and unrelated investors. Although corporate law is much broader in scope and can become quite complex, this basic purpose remains the same. A corporation can be funded through a mix of debt and equity securities. Debt securities can be in the form of notes, bonds, or debentures. In exchange for a loan of money, the corporation is contractually obligated to repay the principal of the loan with interest. But being exclusively financed by debt can be an expensive proposition. Regular interest payments can put a strain on cash flows and make it very difficult for a corporation—especially a risky startup—to finance its operations.

Offering equity in the corporation through shares is a less expensive form of capital raising, but does require that the entrepreneur relinquish some control over corporate affairs. A shareholder does not have formal legal title over the corporation or its property, but equitable title to a certain bundle of rights. While there is no contractual

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\(^{14}\) Michael Geist, “Lights, Camera, Kickstarter: How Internet Crowdfunding Is Changing the Way Movies are Funded” (5 March 2013), online: Michael Geist <http://www.michaelgeist.ca>.
obligation to repay shareholders for their investment, statute and the corporation’s articles of incorporation will dictate shareholders’ legal rights. The most fundamental of these rights is that shareholder liability is limited to the value of one’s capital contribution. This principle is grounded on the corporation being a separate legal entity, independent from the persons who finance its existence.\footnote{Canada Business Corporations Act, RSC 1985, c C-44, s 15(1) [CBCA].}

To illustrate, consider a federally incorporated company under the \textit{Canada Business Corporations Act}. Where there is only one class of shares in a corporation, a shareholder will have the right to (i) vote at shareholder meetings, (ii) receive dividends declared by the corporation, and (iii) receive the corporation’s remaining property on dissolution.\footnote{Ibid, s 24(3).} But a corporation can have multiple classes of shares. While these three basic rights must be present in all classes, they need not be present in each class.\footnote{Ibid, s 24(4).} This means that a corporation is at liberty to structure the rights, including those of convertibility and redemption, of multiple share classes in an endless number of ways through the articles of incorporation and a shareholders’ agreement.\footnote{Ibid, s 24(4).}

\section*{3.2 A Change in Motivation and Expectations?}

Equity crowdfunding is somewhat of a misnomer because both debt and equity securities would be available to investors. In fact, it may be that entrepreneurs will offer mostly debt securities, profit sharing units, or restricted preferred shares. This is because newcomers to crowdfunding, especially in the world of arts and entertainment, may be particularly sensitive about ceding control over the affairs of their enterprise to common shareholders.

Ultimately, each enterprise will structure its distribution according to its unique capital raising needs, which may or may not include a significant share of equity. However, analyzing the impact of a profit incentive, while more salient in the equity context, may predict how individuals will engage with investment-based crowdfunding as an option. Presumably, the contributor will be at least partially motivated by an expectation of a financial return. Equity-security holders, particularly common shareholders, want to participate in the growth of the business. They will only invest in a project if they believe in the entrepreneurs guiding it and their ability to increase its value. Although a profit motive distinguishes equity from donation-based crowdfunding, the two models are not necessarily at odds with each other. The crowdfunding environment is intimate and interactive. It was born as a grassroots movement for people to fund local projects that they care about. Therefore, it is foreseeable that a decision to equity crowdfund a particular initiative is still rooted in an affinity for the cause—a desire to see a product or piece of work come into being.

This means that the investment model retains the fundamental purposes of crowdfunding. The investment model is democratic because it gives the crowd a say in which projects are worthy of funding. It is accessible because the Internet allows creators to easily connect with the fans and the strangers that will fund and ultimately use their products. One lingering question is whether equity crowdfunding will alter the funding
landscape so significantly that “on the fringe” donation-based campaigns are crowded out. This risk is addressed in Part 7.5, below.

3.3 Potential for Success

It is difficult to forecast equity crowdfunding’s impact on seed finance in Canada and North America until it is operational in these jurisdictions. However, its value is evident even at this early stage. Where it has been permitted the investment model has been the most successful crowdfunding model globally, with more than 80% of campaigns in which securities were offered raising over $25,000 USD each. By comparison, only one-third of campaigns using the rewards model raised more than $5,000.\(^1\) The investment model also has the greatest potential for growth, as total global funding was expected to increase 300% between 2011 and 2012, compared to a 50% increase for the rewards model over the same period.\(^2\)

4. SECURITIES REGULATION IN CANADA

Securities regulation in Canada is dealt with at the provincial level. This part provides a basic overview of securities regulation in Ontario, which is home to the country’s largest regulator, the Ontario Securities Commission (OSC).

Currently, equity crowdfunding does not fit into the regulatory framework in Ontario.\(^2\) Broadly speaking, issuers are not permitted to offer securities in a corporation without providing a prospectus. Soliciting investment over the Internet is not allowed either. But there are exempt categories whereby securities can be distributed without fulfilling the prospectus requirements. Provincial regulators, including the OSC, are proposing a new prospectus exemption that would allow a corporation to sell securities through crowdfunding platforms. This is seen as an opportunity to kick-start the economy by making it easier for small businesses and startups to raise capital. In fact, the Financial and Consumer Affairs Authority announced that equity crowdfunding is available in Saskatchewan as of December 2013.\(^2\)

This part covers the requirements for a prospectus and continuing disclosure. A discussion on the exempt market touches on the different exempt categories available, with a focus on the Offering Memorandum (OM) exemption.

4.1 Fundamental Concepts

Under section 1(1)(n) of Ontario’s Securities Act (OSA), a “security” includes any “investment contract.”\(^2\) Obtaining equity shares through crowdfunding qualifies as an “investment contract” because (i) it involves an investment of funds with a view to

\(^{1}\) CMF, Canadian Context, supra note 1 at 15.
\(^{2}\) Ibid at 15.
\(^{21}\) The OSC has proposed new rules for a crowdfunding prospectus exemption. See Part 5 below.
\(^{23}\) Securities Act, RSO 1990 c S5, s 1(1)(n) [OSA].
profit, (ii) it is subject to risk of the enterprise, (iii) there is a common enterprise, and (iv) it is the managerial efforts of the entrepreneurs, and not the investors, that affect the success or failure of the enterprise.\(^{24}\) Profit-sharing agreements,\(^{25}\) as well as bonds, debentures, notes, or other evidence of indebtedness,\(^{26}\) come under the definition of security. This brings equity crowdfunding under the ambit of securities regulation in Ontario.

A corporation distributing securities must prepare and distribute a prospectus, unless the distribution falls into one of the exempt categories. An entity that is engaged in the business of trading must register with the OSC as a broker, advisor, or dealer.\(^{27}\) “Trade” encompasses any act, advertisement, solicitation, conduct, or negotiation in furtherance of the sale of a security for valuable consideration.\(^{28}\) A crowdfunding platform is in the business of “trading” by showcasing investment opportunities to the online community. The trade of securities of an issuer that have not been previously issued is considered a “distribution.”\(^{29}\) Such a distribution triggers the prospectus requirement under section 53 of the O.S.A.

### 4.2 The Prospectus

A prospectus is a comprehensive disclosure document that sets out detailed information about the issuer, the securities being issued, and the risks associated with purchasing those securities.\(^{30}\) It is primarily used as an informational tool for investors when a company first issues its shares to the public (IPO).

The content of a prospectus varies between different types of issuers and securities. Generally, it includes the business plan of the issuer, audited financial statements, the underwriting agreement, and information on the company’s capital structure and management. Also included are a careful explanation of the use of the proceeds, the risks associated with the securities, and the rights, terms, and conditions of ownership.\(^{31}\) The overarching principle is that the prospectus must provide full, true and plain disclosure of all material facts relating to the securities and must comply with Ontario securities law.\(^{32}\)

Aside from crucial information disclosure, major benefits of the prospectus are the statutory rights and remedies available to investors in the event of misrepresentation. Section 130(1) of the O.S.A provides the shareholder a right of action for damages against the issuer, members of the board, the underwriter, and anyone who signed off on the prospectus.\(^{33}\)

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\(^{25}\) O.S.A., supra note 23, s 1(1)(i).

\(^{26}\) Ibid, s 1(1)(e).

\(^{27}\) Ibid, s 25(1).

\(^{28}\) Ibid, s 1(1)(e).

\(^{29}\) Ibid, s 1(1)(a).


\(^{31}\) General Prospectus Requirements and Related Amendments, OSC NI 41-101 (22 December 2006), Form 41-101F1, s 3.1(1).

\(^{32}\) O.S.A., supra note 23, s 56(1).

\(^{33}\) Ibid, s 130(1).
The process starts with retaining an underwriter and then developing and filing a preliminary prospectus. A waiting period allows for comments and revisions. A final prospectus with pricing and an audit report is filed within 90 days of receipt of the preliminary prospectus. The process ends with permitting distribution and imposing continuous disclosure requirements on the corporation as a reporting issuer.\textsuperscript{34}

### 4.3 Continuous Disclosure

After delivering a prospectus, a reporting issuer (typically a publicly traded company) will be required to provide two types of continuous disclosure: (i) periodic disclosure documents and (ii) timely reporting of material changes.

The periodic disclosure documents include audited interim and annual financial reports prepared in accordance with International Reporting Financial Standards (IRFS).\textsuperscript{35} Management’s discussion and analysis (MD&A) must also be attached.\textsuperscript{36} The MD&A contains management’s explanation of the company’s performance in a given year, its strategy going forward, and its performance projections. Any information deemed material by Part 1 of Form 51-102F1 must be disclosed. Information is material if its omission or misstatement would influence an investor’s decision to buy, sell, or hold securities in a company.\textsuperscript{37} Overall, the MD&A assists investors in understanding the financial statements and overall health of the company. The annual information form (AIF) is a detailed document similar to a prospectus that discloses material facts, including information on operations and the risks facing the business.\textsuperscript{38} Lastly, information circulars and proxy solicitation rules are disclosed.\textsuperscript{39}

The second type of continuous disclosure is the timely reporting of material changes. The OSA defines material change as “a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market value of any of the securities of the issuer” or the decision to implement such a change.\textsuperscript{40} Firstly, the information must be material. The “market impact test” implicit in the material change definition is to be applied in an objective and common sense manner without the benefit of hindsight.\textsuperscript{41} The change must also be capable of achievement. For example, in Re AiT a merger negotiation between AiT and 3M was not a material change because there was insufficient evidence for the board to conclude that that there was a sufficient commitment to proceed and a substantial likelihood that the transaction would be completed.\textsuperscript{42}

Secondly, the information must be a change, not a fact. According to Pezim, a material change only concerns internal matters that impact business operations. This is narrower than a material fact, which encompasses both internal and external changes.\textsuperscript{43}


\textsuperscript{35} \textit{Continuous Disclosure Obligations}, OSC NI 51-102 (31 October 2011), s 4(1).

\textsuperscript{36} \textit{Ibid}, s 5.1.

\textsuperscript{37} \textit{Ibid} at Form 51-102F1, Part 1(f).

\textsuperscript{38} \textit{Ibid} at Form 51-102F2, ss 5.1-5.2.

\textsuperscript{39} \textit{Ibid}, s 9.1.

\textsuperscript{40} OSA, supra note 23, ss 1(1)(a)-(ii).

\textsuperscript{41} Re YBM Magnex International Inc, 2003 LNONOSC 337, (2003) 26 OSCB 5285 [YBM Magnex].


\textsuperscript{43} Pezim v British Columbia (Superintendent of Brokers), [1994] 2 SCR 557, 114 DLR (4th) 385.
This relieves issuers from the obligation to continuously monitor global economic trends that may relate to the business.44

4.4 The Exempt Market

The prospectus process takes a significant amount of time, effort, and money. But an issuer can bypass this and still offer securities in what is known as the “exempt market.” The exempt market offers an alternative to “going public” and becoming a reporting issuer through a variety of different exemptions. Exemptions exist in situations where the investor is sophisticated or has a level of familiarity with the issuer, the security is inherently safe or issued pursuant to a regulated transaction, or where the capital raising target is for small and medium-sized enterprises (SMEs). The rationale underpinning the exempt market is that the relaxed level of information disclosure is proportionate to the nature of the risk in a particular exempt transaction.45 The sacrifice of circumventing the prospectus requirement is that the same rights and remedies may not be available. Perhaps the most important concern for investors in the exempt market is that securities are subject to resale restrictions. This can include not selling securities for a specified hold or seasoning period.46

Exempt categories are found in National Instrument 45-106. For instance, the private issuer exemption allows non-reporting issuers to distribute securities to no more than 50 closely related persons.47 In lieu of the family, friends, and business associates exemption, Ontario has the founder, control person, and family exemption.48 The accredited investor exemption allows the sale of securities without any disclosure about the issuer. Accredited investors include: business entities with net assets of at least $5 million, individuals whose financial assets exceed $1 million in realizable value or whose net assets exceed $5 million or whose net income exceeded $200,000 in the past two years. Financial institutions and pension funds are also included.49 The minimum investment size exemption permits any issuer to distribute securities to an individual that invests at least $150,000.50 The rationale behind the accredited investor and minimum amount exemptions is that the investor is sophisticated in that he or she has the resources to obtain expert financial advice and the ability to withstand financial loss.

Although the offering memoranda (OM) exemption is available in most provinces, it is not available in Ontario.51 The OM exemption is the closest relative to the OSC’s proposed crowdfunding exemption. This exemption allows an issuer to sell its securities to anyone provided that it does two things before the purchase. Firstly, the issuer must obtain a signed risk acknowledgment form in which the buyer acknowledges that he could lose his money in the risky investment. Secondly, the issuer must distribute an OM to the buyer.52 The OM must contain a certificate stating that it does not contain a misrepresentation (untrue statement of material fact or omission to state a material fact).

45 Condon, Anand & Sarra, supra note 34, ch 5 at 316-318.
46 OSA, supra note 23, ss 2.5(2), 2.6(3).
47 General Prospectus and Registration Exemptions, OSC NI 45-106 (18 September 2009), s 2.
48 Ibid, s 2.5.
49 Ibid, s 2.3.
50 Ibid, s 2.10.
51 Ibid, s 2.9.
52 Ibid.
Reporting issuers who have filed an annual information form (AIF) can rely on a short form document that incorporates its public disclosure record. A non-reporting issuer must use a long form OM. Under an OM exemption, a purchaser has a two-day “cooling-off” period whereby he can cancel the purchase.53

5. PROPOSED EQUITY CROWDFUNDING REGIME

The OSC Staff Consultation Paper 45-710 Considerations For New Capital Raising Prospectus Exemptions, released in December 2012, develops a framework for a proposed crowdfunding exemption. Although this proposal is a preliminary framework subject to change, this article analyzes the framework as it currently stands in order to assess its merits. After the consultation paper’s release, the OSC followed up by soliciting public consultation and initiating an investor roundtable discussion in June 2013. Saskatchewan was the first Canadian province to implement an equity crowdfunding exemption for unaccredited investors, although it is quite different from Ontario’s proposal.54 On March 20, 2014, the OSC unveiled its proposed rules for a crowdfunding prospectus exemption. The 90-day comment period ended on June 18, 2014, which may result in changes to the rules before they take effect.55

The crowdfunding exemption concept in Ontario is largely based on the one set out in the United States’ Jumpstart Our Business Startups (JOBS) Act. In the US, equity crowdfunding is only available to accredited investors. However, unaccredited investors will have access once the rules surrounding Title III of the JOBS Act are finalized.56 This part highlights the parameters in the American legislative context before delineating the proposed framework of the Canadian crowdfunding exemption.

5.1 The JOBS Act and Equity Crowdfunding in the United States

The JOBS Act creates a crowdfunding exemption from issuing a prospectus. Under the exemption, a company will be able to raise $1 million in a 12-month period through the sale of securities to the public. If an individual’s annual income or net worth is less than $100,000 USD, then in that year the individual cannot invest more than $2,000.

53 Ibid.
54 National Crowdfunding Association of Canada, “Saskatchewan Approves Equity Crowdfunding” (6 December 2013), online: NCFA <http://www.ncfacanada.org>. Saskatchewan’s regime is quite different from what is currently proposed in Ontario, as both the business and investor must be based in Saskatchewan. Given the smaller geographical scope, the business is limited to two six-month offerings of $150,000. See Financial and Consumer Affairs Authority, “Securities – FCAA Asks for Comments Regarding the Proposed Equity Crowdfunding Exemption”, online: FCAA <http://www.fcaa.gov.sk.ca>.
55 A cursory review of the rules reveals that they maintain the spirit and many of the details of the initial consultation paper, while delving into greater detail. It is worth noting that the crowdfunding exemption is available to both reporting and non-reporting issuers, the offering cannot remain open for more than 90 days, there are specific requirements before an offering can be completed, the investment limits remain the same, securities of a non-reporting issuer are subject to an indefinite hold period, and greater details on portal obligations are provided. See Introduction of Proposed Prospectus Exemptions and Proposed Reports of Exempt Distribution in Ontario, OSC Supplement to the OSC Bulletin, 37 OSCB (20 March 2014).
USD or 5% of annual income or net worth, whichever is greater.\footnote{Ontario Securities Commission, supra note 30 at 15.} If an individual’s annual income or net worth is at least $100,000, then his or her aggregate investment for the year cannot exceed 10% of annual income or net worth, up to a maximum of $100,000 USD.\footnote{Ibid.} The securities purchased are subject to certain resale restriction for one year.\footnote{Ibid.}

Securities must be offered through the crowdfunding platform, which is to be registered with the SEC as a broker or funding portal under the US Securities Exchange Act of 1934. The Act defines “funding portal” as an intermediary in transactions involving the sale or offer of securities.\footnote{Securities Exchange Act of 1934, 15 USC §78c(a)(80), Pub L 73-291, 48 Stat 881.} A crowdfunding portal will be required to disclose the risks of the investment, provide investors with appropriate educational material, and ensure that investors review the material and affirm the risk of loss. Portals are also obligated to reduce the risk of fraud through background checks on directors, officers, and significant shareholders.\footnote{Ontario Securities Commission, supra note 30 at 16.}

Finally, issuers have streamlined disclosure requirements. They must disclose the price of the securities, the intended use of the funds raised, the funding goal, and the deadline. A business plan and details of the company must also be provided. This includes the names of officers, directors, and significant shareholders in addition to a description of the ownership, capital structure, and financial condition of the company. Where the funding goal exceeds $500,000, audited financial statements are required.\footnote{Ibid.}

### 5.2 OSC Proposed Crowdfunding Exemption

The OSC proposal attempts to strike a balance between fostering efficient capital markets and protecting investors. Streamlined disclosure requirements make it easier and less expensive for startups and SMEs to raise capital. This also gives retail investors greater access to the exempt market. There are also several investor protections measures to curb undue risk of financial loss. The following provides an overview of the preliminary regulatory framework proposed by the OSC.

**Investor Protection**

Investment limits are designed to reduce an investor’s exposure to significant financial loss. Under the proposed exemption, a single investment cannot exceed $2,500 and total investment for one year cannot exceed $10,000.\footnote{Ibid at 29.} Disclosure at the time of distribution will include a streamlined information statement on the offering, the issuer, and the funding portal. Specifically, financing facts will disclose the price and type of security being offered, any resale restrictions, and the intended use of the proceeds.\footnote{Ibid at 51-52.} The same types of issuer facts required by the JOBS Act must also be disclosed in the Canadian context. For example, in both countries, the
disclosure of management-certified (as opposed to audited) financial statements for offerings under $500,000 is intended as a cost-saving measure for startups and SMEs.\textsuperscript{65} An investor will have a two-day right of withdrawal of their investment. In the event of a misrepresentation on the information statement, the investor will be entitled to the statutory rights and remedies reserved for OMs under section 130.1 of the \textit{OSA}.\textsuperscript{66}

After the initial distribution, an issuer is obligated to provide continuous disclosure to its security holders. This amounts to providing annual financial statements and maintaining books and records that are available for inspection by security holders and OSC staff.

Lastly, investors are required to sign a risk acknowledgment form. Here investors confirm that: they fall within the investment limits, they understand the illiquid nature of the securities and the risk of losing their entire investment, and they are willing to bear such loss.

\textbf{Issuer Limitations}

To qualify for the crowdfunding exemption, an issuer must be incorporated and have its head office in Canada. Distributing securities will trigger a requirement to file a report of exempt distribution. No more than $1.5 million can be raised in any 12-month period.\textsuperscript{67} The types of securities that can be offered are limited to common shares, non-convertible preferred shares, non-convertible debt securities, and securities convertible into common shares or non-convertible preferred shares. Although there is no restriction on the type of securities offered in the \textit{JOBS Act}, the OSC does not believe that offering complex products such as derivatives is necessary to facilitate capital raising for SMEs.\textsuperscript{68} Online advertising of investments will be limited only to social media that directs investors to the website of issuers or funding portals and the websites themselves.\textsuperscript{69}

\textbf{Funding Portal Requirements}

Distribution under the crowdfunding exemption must be made through a registered funding portal. The funding portal must register in a dealer or advisor category where trade is conducted regularly and for a business purpose.\textsuperscript{70} A crowdfunding platform that advertises securities over the Internet, matches investors with issuers, and receives a fee based on the amount of funds raised is in the business of trade\textsuperscript{71} and must register. The funding portal has the same type of disclosure and fraud reduction obligations as outlined in the \textit{JOBS Act}. The limits to a registered platform’s scope are also greatly influenced by the restrictions in the American context. A registered Canadian funding portal will not be permitted to offer investment advice, solicit the sale of securi-

\begin{itemize}
\item \textsuperscript{65} Ibid.
\item \textsuperscript{66} Ibid at 55.
\item \textsuperscript{67} Ibid at 29.
\item \textsuperscript{68} Ibid at 48.
\item \textsuperscript{69} Ibid at 52.
\item \textsuperscript{70} \textit{OSA}, supra note 23, s 25(1).
\item \textsuperscript{71} Ibid, s 1(1)(e).
\end{itemize}
ties displayed on its website, or offer commission to any employees for the sale of such securities.\textsuperscript{72}

\section*{6. DOES THE PROPOSED FRAMEWORK ACHIEVE THE GOALS OF SECURITIES REGULATION?}

The \textit{OSA} sets out the purposes of securities regulation in Ontario as: (i) protecting investors from unfair, improper, and fraudulent activities, and (ii) fostering fair and efficient capital markets and confidence in capital markets.\textsuperscript{73} The exempt market still serves these dual functions because streamlined disclosure is justified in the face of reduced risk in exempt transactions.

A crowdfunding exemption will grant retail investors access to the exempt market. However, a common concern among critics is that these investors are exposed to an unjustified amount of risk. The worry is that retail investors do not have the financial means or expertise akin to an accredited investor. Therefore, they may not fully understand the high-risk nature of investing in an early-stage startup. However, safeguards proposed by the OSC offer a sufficient level of investor protection from misleading information, risk of financial loss, and fraud. In particular, investment ceilings and risk acknowledgement limit the severity of any financial loss. Although resale restrictions may prevent investors from selling bad investments and cutting their losses, initial and continuous disclosure requirements offer a fair amount of transparency in assisting individuals with investment decisions. Furthermore, the statutory rights and remedies attached to such disclosure provide an added sense of security in the event of misrepresentation. Lastly, registration of issuers and platforms adds a level of legitimacy to the whole undertaking and engages the oversight and enforcement power of the OSC.

\subsection*{6.1 Investment Limits and Risk Acknowledgment}

Limits on individual and annual investment amounts directly combat the risk of insurmountable financial loss to retail investors. Furthermore, signing a risk acknowledgement form forces investors to confront the risk that they may lose their whole investment and helps them determine whether they are willing to bear such a loss.

\subsection*{6.2 Restrictions on the Rights of Shareholders}

Purchases of securities under a crowdfunding exemption will be subject to resale restrictions. While the discussion paper does not dictate how restrictive resale will be, it is typically quite difficult to resell exempt market securities. This poses a significant risk to investors, as they may not be able to cut their losses if the risky startup venture fails and the shares become worthless. There are two policy justifications for this restriction. Firstly, the OSC intends the crowdfunding exemption to facilitate capital raising, not the resale of securities. Secondly, a retail investor may not be well positioned to provide

\textsuperscript{72} Ontario Securities Commission, supra note 30 at 54.

\textsuperscript{73} \textit{OSA}, supra note 23, s 1.1.
sufficient disclosure for subsequent purchasers to make informed investment decisions.\textsuperscript{74}

\textbf{6.3 Initial Disclosure Requirements}

On balance, the initial disclosure requirements in the information statement are proportional to the amount of risk involved in a crowdfunded securities transaction. \textit{YBM Magnex} is notable for the proposition that too much disclosure can be counter-productive to investor protection.\textsuperscript{75} That is, investors bombarded with the excessive information of a prospectus may be less able to discern what is truly important in making their investment decision.\textsuperscript{76} Accordingly, the information statement offers streamlined disclosure in the fashion of an OM. The information statement will still include details on the security and use of proceeds, a business plan, management information and the business’ idiosyncratic risks. The OSC is mindful of reducing costs that could be prohibitive for startups and SMEs. As a result, only management-certified financial statements (which are not audited) are required for non-reporting issuers with an offering of less than $500,000. A prospectus-like requirement of audited financial statements in all cases makes little sense for a company with barely any assets or revenue.

On the other hand, the information statement will not have gone through the same degree of review as a prospectus. Perhaps the largest discrepancy is that the information statement does not explicitly require “full, true and plain disclosure of all material facts,” as is the case in a prospectus.\textsuperscript{77} A prospectus also requires its accuracy to be certified by the CEO, CFO, and two directors of the issuer. A “material fact” is a fact that would reasonably be expected to have a significant effect on the market price or value of the securities.\textsuperscript{78} In \textit{YBM Magnex}, for example, the issuer was sanctioned for failing to disclose the material fact that the company was under investigation for money laundering. The OSC proposal states: “management of the issuer should certify the disclosure.”\textsuperscript{79} This may not explicitly require disclosure of material facts, but it may create the level of accountability that justifies the streamlined nature of disclosure in the information statement.

\textbf{6.4 Continuous Disclosure Requirements}

The crowdfunding exemption requires a much lower level of continuous disclosure when compared to a reporting issuer (discussed in Part 4.3). This is appropriate given the purpose of the exemption and the nature of the transaction.

The main purpose of equity crowdfunding is to facilitate capital raising. Resale restrictions help achieve this end. Conversely, a higher level of continuous disclosure for reporting issuers is meant for the efficient functioning of the secondary market. Granted, such a high level of public and transparent disclosure is beneficial for investors. It

\textsuperscript{74} Ontario Securities Commission, \textit{supra} note 30 at 69.
\textsuperscript{75} \textit{YBM Magnex}, \textit{supra} note 41.
\textsuperscript{76} Ontario Securities Commission, \textit{supra} note 30 at 51.
\textsuperscript{77} \textit{OSA}, \textit{supra} note 23, s 56(1).
\textsuperscript{78} \textit{Ibid}, s 1.1
\textsuperscript{79} Ontario Securities Commission, \textit{supra} note 30 at 51.
creates a level of accountability for the company’s management. Also, investors are better able to monitor the corporation’s financial health and managerial competence, which is helpful in deciding whether to keep or sell their securities. But resale restrictions under the crowdfunding exemption prevent this possibility, leaving a very small or non-existent secondary market for these types of securities. Therefore, continuous disclosure on the same level as that for a reporting issuer is unnecessary for a crowdfunding exempt category.

The OSC proposes a similar type of ongoing disclosure that is required under corporate law: annual financial statements and the maintenance of books and records. Extensive continuous disclosure, similar to that of a reporting issuer, would be unique in the exempt market, and particularly impractical for corporations using the crowdfunding exemption. The crowdfunding exemption creates the potential for a multitude of unrelated shareholders, each of whom would be entitled to continuous disclosure. This creates a unique cost burden for startups and SMEs compared to other exempt categories, such as the private issuer or founder, control person, and family exemptions.

The low-risk nature of a crowdfunded investment lends itself to minimal continuous disclosure requirements. Although investment in early-stage startups can be considered risky, there are a number of investor protection mechanisms, not necessarily present in public markets, which reduce the potential for catastrophic financial loss. These include low investment limits, risk acknowledgment, and background checks on the issuer performed by the funding portal, among others. This minimal disclosure still offers investors with information to assess the health of their investment. Annual financial statements become more relevant for startups as time passes after the initial offering. Making books and records available ensures transparency. Not only can OSC staff inspect them, but shareholders can also learn if the issuer is actually using the funds for the purpose indicated on the information statement. Both of these requirements curb the prospect of fraud.

Lastly, one should not forget to take into account the very nature of crowdfunding itself. Even in the equity context, investors are concerned with an enterprise’s success because they have an affinity for its cause. The trust relationship is particularly important in supporting a crowdfunding campaign. Therefore, the market will arguably compel creators to adopt a policy of transparency in dealing with their shareholders, which might include regular disclosure of annual financial statements, books, and records or other measures.

6.5 Statutory Civil Liability for Misrepresentation

**Offering Memorandum vs. Prospectus**

Misrepresentation is defined in section 1(1) of the OSA as either an “untrue statement of material fact” or an “omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading.” 80 Under the crowdfunding exemption, misrepresentation on the information statement triggers the rights of action reserved for OMs under section 130.1. Purchasers of securities in other exempt categories do not have access to statutory rights of action for misrepresentation. Al-

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80 OSA, supra note 23, s 1(1).
though the OM does not offer the same breadth of investor protection as a prospectus under section 130, it is still sufficient for the purposes of a crowdfunded exemption.

Liability for misrepresentation in a prospectus and OM share many of the same features. Both documents grant the purchaser of a security the right to damages and rescission against an issuer without regard to whether the purchaser actually relied on the misrepresentation.\textsuperscript{81} Issuers are absolved of any liability if they can prove that the shareholder purchased the security with knowledge of the misrepresentation.\textsuperscript{82} The extent of damages is limited to the depreciation in the value of a security as a result of the misrepresentation (i.e. the difference between the price paid and the value of the security if no misrepresentation had been made).\textsuperscript{83} The recoverable amount cannot exceed the offer price of the security.\textsuperscript{84}

There may not be a large difference in the liability that stems from the type of information required in each document. A prospectus must contain “full, true and plain disclosure of all material facts relating to the securities.”\textsuperscript{85} Although the OSA does not directly require OMs to state all material facts, the OM must contain a certificate stating that it does not contain a misrepresentation (which includes the failure to state a material fact). If one interprets this as an indirect requirement to state material facts, then reporting issuers may not necessarily be exposed to greater liability arising from a prospectus than a corporation using the crowdfunding exemption (if the information statement has a similar OM certificate requirement).

Misrepresentation in a prospectus also grants the investor multiple avenues for recovery not available in an OM. The right of action extends beyond the issuer to a right against the board, any person who offered opinions, statements or reports and every person or company that signed the prospectus.\textsuperscript{86} As a result, there are also more defences available to these additional parties in the prospectus context. These parties can raise defences of due diligence,\textsuperscript{87} lack of knowledge or withdrawn consent to the prospectus filing,\textsuperscript{88} and reasonable reliance on an expert\textsuperscript{89} among others.

**Continuous Disclosure**

Part XXIII.1 of the OSA deals with civil liability for secondary market disclosure. The two main causes of action are for misrepresentation of continuous disclosure documents and failure to make timely disclosure. Broad continuous disclosure requirements potentially expose reporting issuers to significant liability for misrepresentation. Reliance is not required.\textsuperscript{90}

Shareholders in a crowdfunded corporation would not automatically have access to these statutory rights of action. Part XXIII.1 does not apply to the acquisition of securi-

\textsuperscript{81} Ibid, ss 130(1), 130.1(1).
\textsuperscript{82} Ibid, ss 130(2), 130.1(2).
\textsuperscript{83} Ibid, 130(7), 130.1(3).
\textsuperscript{84} Ibid, ss 130(9), 130.1(6).
\textsuperscript{85} Ibid, s 56(1).
\textsuperscript{86} Ibid, ss 130(1)(a)-(e).
\textsuperscript{87} Ibid, s 130(5).
\textsuperscript{88} Ibid, ss 130(3)(a)-(b).
\textsuperscript{89} Ibid, s 130(3)(c).
\textsuperscript{90} Ibid, s 138.3(1).
ties through the exempt market, unless prescribed by regulation. However, a plaintiff could still bring an action for misrepresentation of financial statements or books and records under the common law. Where a plaintiff buys securities on the basis of a fraudulent or innocent misrepresentation, he may seek damages, rescission, or enforcement of the purchase. The difficulty, particularly in the securities law environment, is the additional burden of proving reliance, causation, and damages.

It would be desirable to enact statutory routes of recovery for purchasers of crowd-funded securities that do not require reliance on the misrepresentation. The right to sue after having purchased securities is just as important to investors as their rights at the time of distribution. This would further insulate investors from the uncharted waters of crowd-funded transactions. It might also have the effect of deterring fraud and encouraging greater due diligence from issuers. How can this be achieved? Part XXIII.1 can be modified or additional rules can be implemented to make it applicable to the crowd-funding exemption. Ultimately, this would lead to a more credible equity crowdfunding environment.

6.6 Registration and Enforcement

The registration of funding portals further enhances the legitimacy of a crowd-funding exemption. It serves the dual purposes of securities regulation. Registration provides investors with some assurance that the portal is not being used to facilitate fraud, which in turn boosts their confidence in the capital markets.

Registration of funding portals and issuers under a crowdfunding exemption will bring these stakeholders under the watchful eye of the OSC. By authority of the OSA, the OSC has broad powers of investigation and examination. Such oversight and enforcement serves as a deterrent and protects investors from wrongdoing. A breach of securities laws can lead to different avenues of enforcement, the most severe of which is through criminal law sanctions. For example, an issuer who fraudulently raises funds through equity crowdfunding could face imprisonment for fraud. A second avenue provides for quasi-criminal offences. Under section 122(1)(b) of the OSA, misrepresentation of an information statement or continuous disclosure document can lead to fines and imprisonment. In fact, any contravention of Ontario securities law can lead to a fine of up to $5 million and imprisonment for up to five years.

The other major avenue of enforcement is the OSC’s statutory authority to issue orders in the public interest following a hearing. This does not necessarily require a breach of securities law. The OSC has broad discretion to determine which matters fall within the public interest. Typically, the conduct must clearly be abusive of shareholders in particular and of capital markets in general. Such abusive conduct in the equity crowdfunding context could bring an end to the benefit of the exemption. For instance,

91 Ibid, s 138.2(b).
94 OSA, supra note 23, ss 11,12.
95 Criminal Code, RSC 1985, c C-46, s 380(1).
96 OSA, supra note 23, s 122(1)(b).
97 Ibid, s 122(c).
98 Ibid, s 127.
the registration of a funding portal or issuer can be terminated or suspended and issuers can be prohibited from further trading of securities.\textsuperscript{100} More significantly, a crowdfunding exemption can be deemed not to apply to a person or company permanently.\textsuperscript{101} Individuals can be ordered to resign from their post as director or officer.\textsuperscript{102} If the abusive act is a breach of securities law, a party can face an administrative penalty of up to $1 million per breach and the disgorgement of any gains caused by the breach.\textsuperscript{103}

7. DO PUBLIC POLICY OBJECTIVES JUSTIFY ADOPTING EQUITY CROWDFUNDING?

Equity crowdfunding has the potential to alter the face of project finance, entrepreneurialism, and the economy in Canada. Proponents see equity crowdfunding as an opportunity to boost the economy by making capital markets more accessible to Canadians and small business. Critics argue that lax regulations will undercut investor protection and undermine the essence of crowdfunding. However, the dual purposes of securities regulation are not necessarily at odds. If the OSC can strike a balance in crafting more detailed rules for equity crowdfunding, Canada may be in a better position to retain talent, spark innovation, and compete globally.

7.1 More Capital Raising Opportunities

Equity crowdfunding is meant to create greater access to capital for startups and SMEs. This can be said to further the objective of fostering fair and efficient capital markets. However, an important lingering question is whether supply-side investors exist to meet the capital demands of small enterprises that might use equity crowdfunding. It is difficult to predict investor behaviour for an exempt category not yet in existence. However, solicitation over the Internet is a novel approach for the securities industry in Canada. Entrepreneurs can leverage the Internet’s reach to spread their message to an unprecedented number of Canadians without the prohibitive costs involved in more traditional methods. Non-institutional investors do exist. They represent the 27.4\% of individual Ontarians earning more than $50,000 annually.\textsuperscript{104} The question remains whether they will be compelled in large enough numbers to support an equity crowdfunding industry in Canada.

Chance Barnetti is the CEO of Crowdfunder, one of a few websites in the US that offers investment crowdfunding. He argues that a “top-down” approach to solving local funding gap problems is unsustainable and does not improve the local ecosystem.\textsuperscript{105} This includes injecting public funds into government-backed startup incubators. While Barnetti’s position is debatable, he appropriately characterizes investment crowdfunding

\textsuperscript{100} OSA, supra note 23, ss 127 (1)(1)-(2).
\textsuperscript{101} Ibid, s 127 (1)(3).
\textsuperscript{102} Ibid, ss 127 (1)(6)-(8).
\textsuperscript{103} Ibid, ss 127 (1)(9)-(10).
\textsuperscript{104} Ontario Securities Commission, supra note 30 at 74-75.
as the ideal “bottom-up” approach to further accelerate access to capital for entrepreneurs.

7.2 Sustainable Competition from Canada

Adopting equity crowdfunding will help Canada keep pace with the phenomenon’s global momentum. The equity model was predicted to grow 300% from 2011–2012, the most of any funding model.\textsuperscript{106} It already exists in the United Kingdom, Australia, Germany, France, and the Netherlands, and it is partially operational in the US.

If Canada does not adopt equity crowdfunding or stalls in doing so, it risks losing entrepreneurs, innovators, and content creators to the US. SMEs play a vital role in the Canadian economy. In 2005, they accounted for over 54% of Canada’s GDP\textsuperscript{107} and were responsible for 54% of job creation between 2001 and 2010.\textsuperscript{108} Moreover, Canada is a hotbed for startup companies. Three Canadian cities rank in the Top 20 for startup ecosystems in the world, with Toronto ranking 8th.\textsuperscript{109} Canadian entrepreneurs need the favourable infrastructure that equity crowdfunding creates if they are going to propel economic growth in this country.

7.3 Greater Access to the Exempt Market

A crowdfunding exemption will reduce the barriers to wider investment options for retail investors. These are not the sophisticated, high net-worth individuals who can take advantage of the accredited investor or minimum amount exemption. The modest investment limits in the proposal target middle-class investors who may not otherwise have access to the exempt market. These investors have a unique opportunity at financial empowerment. The market demands a certain level of transparency for equity crowdfunding campaigns. But it also calls for investors to be prudent in exercising independent due diligence. A younger and more tech-savvy demographic may be better equipped to exploit the availability of financial and business information online. A survey commissioned by BMO reveals that investors are conducting more independent research as up to 30% of Canadians seek financial advice from online news articles and social media.\textsuperscript{110} By engaging a different investor demographic and potentially increasing the pool of capital, equity crowdfunding has the potential to strengthen the Canadian economy.

\textsuperscript{106} CMF, \textit{Canadian Context, supra} note 1 at 15.
7.4 Risk of Financial Loss

The primary concern among critics is that the very existence of equity crowdfunding will unduly expose retail investors to financial risk. This view is based on two interrelated ideas. Firstly, a lax regulatory framework will lead to “impossible-to-police fraud-funding.” The ubiquity of the Internet may make it easier for fraudsters to cloak their scheming ways and appear legitimate to unsophisticated investors. This may be particularly difficult to detect when individuals only invest a few hundred dollars. According to David Marlett, founder of the US-based National Crowdfunding Association, “There’s always going to be fraud.” However, with a 2% fraud rate for existing models—which Marlett says is better than most credit card companies—crowdfunding fraud will not be as rampant as some fear. If anything, moderate regulation enhances investor protection. It pushes crowdfunding under the spotlight of the OSC, whose enforcement powers can deter wrongdoing. Also, portals play an important gatekeeper role in conducting background checks on potential issuers.

The second concern is that streamlined disclosure will leave “unsophisticated” retail investors exposed to great financial risk. The reality is that the OSC framework combines several investor protection measures to counteract this problem, including investment limits, statutory rights of action, and initial disclosure. When an investor signs a risk acknowledgment form, he confronts the amount of risk inherent in the business and the illiquid nature of the investment. Once a corporation satisfies such duties, the onus shifts to the investor to ensure he is comfortable and willing to buy securities via crowdfunding. In the end, securities regulators must not sacrifice the pursuit of fair and efficient capital markets, when the regulatory framework already provides investor protection proportional to the amount of risk under this exempt category.

7.5 Crowding Out Donation-Based Projects

Will the prospect of a financial return through equity crowdfunding effectively siphon capital from donation-based projects? Probably not to an alarming extent. The common thread in any crowdfunding model is that individuals contribute funds to a project because they care about its cause. Some people simply want a final copy of a film from a local director for $30. It would be a significant shift in character for an individual who has donated numerous times to various causes to suddenly abandon that practice for the almighty dollar.

The investment model is an option that simply appeals to a different segment of individuals possessing slightly different motivations. These retail investors may never have invested in the exempt market. Equity crowdfunding might help them achieve their financial goals at the same time that they contribute to causes they care about. The result is a growing pool of contributors using different crowdfunding models, not the fragmentation of current users. This means that “on the fringe” indie projects will con-

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continue to attract an audience on donation-based platforms, even as equity crowdfunding facilitates the creation of more capital-intensive projects.

8. IS EQUITY CROWDFUNDING A VIABLE OPTION FOR THE ARTS AND ENTERTAINMENT INDUSTRIES?

So far I have discussed how equity crowdfunding can be used as an alternative capital raising tool for startups and SMEs. The question is whether equity crowdfunding’s power can also be leveraged in the arts and entertainment industries. I suggest that it can.

On the one hand, Kickstarter and most other donation-based platforms are designed to showcase one-off projects with definite goals. This may be incompatible with equity crowdfunding’s goal of financing ongoing enterprises. If most other platforms share the views of Kickstarter CEO Perry Chen, then equity crowdfunding may not find room in the arts and entertainment community. Chen has no plans to implement equity crowdfunding because he believes the most disruptive aspect of Kickstarter is the removal of the investment component: “…the entertainment industry is built around its established stars…Kickstarter wants to serve everyone else.”

It is also important to consider whether equity crowdfunding is practical for entertainment entrepreneurs. It would likely increase transaction costs. It may be a burden to deal with a large number of small investors. Increased public disclosure of sensitive business information may undermine a company’s competitive edge. There is also greater exposure to liability through statutory civil rights of actions for investors. Moreover, regular oversight and potential enforcement by the OSC could be a dark cloud hanging over a corporation’s head.

On the other hand, equity crowdfunding could mean the difference between a project taking off or staying grounded. The film Age of Stupid is a shining example of how a creator can successfully execute an investment crowdfunding campaign. The documentary from Spanner Films raised $450,000 for production through a profit-sharing plan. Given the film’s socio-political commentary on climate change, director and producer Franny Armstrong considered it vital to retain 100% creative control when funding the film. Spanner Films devised a do-it-yourself crowdfunding scheme where individuals could buy a 0.05% share in the profits from the film for £5,000. The lending terms provided that the profit dividends would be paid annually for 10 years after film completion, but only if the film made a certain amount of profit. Technically, these were “limited recourse debentures” and not equity shares. So the campaign worked within the legal and regulatory environment in the UK, presumably under a prospectus exemption. Franny Armstrong spearheaded an incredibly transparent cam-

114 Ibid at 13.
115 Spanner Films, Crowd-Funding FAQ, online: Spanner Films <http://www.spannerfilms.net>.
117 Spanner Films, supra note 115.
campaign where contributors could fully understand their relationship and rights regarding the project.

*Age of Stupid* is also notable for demonstrating how a socially conscious crowd financed a film because it wanted to deliver an important message to the masses, while sharing in the profits of the project. In the film’s funding plan, the creators characterized the crowdfunding process as a way to “deliver alternative ideas to...millions of people...while side-step[ping] the corporate control of the media.” Speaking to the profit-sharing plan, one first-round investor said, “It’s hard to think of another social investment which would return as much bang for my bucks.”

Equity crowdfunding can be a workable financing tool for large capital-intensive projects, such as film and television production and distribution. It could also extend to other large-scale projects in music and recording arts, fashion, media, communications, or software and video game development. As already mentioned, the profit motive creates a competitive environment for creative projects, but the direct influence of the crowd ensures that only the projects people genuinely care about get produced. Although it may be too early to predict its long-term viability, equity crowdfunding offers a promising alternative to conventional capital raising methods and entertainment entrepreneurs would do well to give it a chance.

9. CONCLUSION

Crowdfunding has shaken up project finance by making the process more accessible and democratic. The power to decide which projects are funded is left in the hands of a faithful crowd. Individuals are compelled to financially support a project in large part because of their affinity with it. This is still the case in equity crowdfunding in spite of an additional expectation to profit. Such a successful alternative financing tool is worth preserving.

This paper posits that equity crowdfunding should be adopted in Ontario and regulated by the OSC. Securities law must reflect the pervasiveness of the Internet in the world of commerce. It is through this worldwide communication network that entrepreneurs can reach a mass of potential purchasers of their securities. The anonymity and ubiquity of the Internet makes it important to permit such transactions in a way that protects investors while fostering fair and efficient capital markets.

The OSC’s proposed regulatory framework for a crowdfunding prospectus exemption is a strong step in the right direction towards achieving these purposes in a balanced way. Streamlining the sale of securities makes it easier and less expensive for early-stage businesses to raise much-needed capital. This also makes it easier for retail investors to participate in the exempt market. Reducing the barriers to matching investors with issuers creates efficiency and fairness in capital markets.

Equity crowdfunding is open to investors without a sophisticated grasp of the securities industry. The high failure rate of early-stage businesses adds a significant layer of risk to the purchase of their securities. Taken together, this could leave investors exposed to considerable financial risk. However, the proposed crowdfunding exemption

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employs several measures to protect investors from unfair, improper, or fraudulent practices. Modest investment limits and a risk acknowledgment requirement significantly reduce the risk of sizable financial loss. Streamlining initial and continuing disclosure requirements provides individuals with the information they need to make prudent investment decisions and to ensure the business carries out operations as promised.

Some difficulty arises in an instance of misrepresentation. Since initial disclosure will not require the inclusion of all material facts, it may be difficult for an investor to pursue a statutory right of action. Although this is undesirable for investors, it is consistent with the OM exemption and a cost of streamlined disclosure. To add legitimacy to the framework, I propose that investors be granted a statutory route of action for continuous disclosure misrepresentation, which is currently not the case. Lastly, portal registration brings equity crowdfunding activity under the oversight of the OSC. Its strong enforcement powers can act as a deterrent against improper, unfair, or fraudulent conduct.

The arts and entertainment sectors have benefited greatly from donation-based crowdfunding services, such as those offered by Kickstarter, Indiegogo, and Rocket-Hub. Nevertheless, entrepreneurs in creative industries can benefit from equity crowdfunding as well. This is particularly true with respect to large capital-intensive projects in music and recording arts, film, fashion, media, communications, and software and video game development.

Before equity crowdfunding comes into effect, the OSC should craft more detailed rules. If it is implemented in a way that satisfies the purposes of securities regulation, equity crowdfunding has the potential to cultivate innovation, enrich creative industries, and propel Canada to great heights. The change that equity crowdfunding promises to bring may be frightening. However, no important endeavour requiring innovation has ever succeeded without accepting risks. Canadian securities regulators must embrace risk if they want to push the Canadian economy forward because, in the words of director James Cameron, “Failure is an option. But fear is not.”