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the new age of investing – equity crowdfunding

Natalia Vandervoort
Crawley MacKewn Brush LLP

the idea of equity crowdfunding

Crowdfunding as a method to gain access to funds is on the rise. It has been reported that $2.7 billion was raised through crowdfunding platforms in 2012 and there is a forecast of an 81% increase in global crowdfunding to $5.1 billion in 2013.[1] Crowdcube, an equity crowdfunding platform based in England, grew by 400% in 2013.[2] According to the National Crowdfunding Association of Canada, there are currently 67 crowdfunding portals in Canada, including 29 in Ontario, and this number continues to grow.[3]

Crowdfunding involves raising money online from the interested "crowd" by using an online intermediary platform.

It has generally been used to raise funds for artistic projects (e.g., film and music) based on a rewardsbased model. This involves the crowd donating to a particular project in exchange for some reward – for example, a copy of the book when it is published. It is also widely used to raise money for charitable causes by donation without reward. Equity crowdfunding pushes the envelope further by permitting the crowd to own a stake in the company. The company registers on an online funding portal, provides limited disclosure and announces its target offering. Any person interested in the issuance may invest up to a certain amount without meeting eligibility requirements.

Early-stage companies and particularly startup companies will likely be the primary users of equity crowdfunding platforms due to the constraints they face raising initial capital through traditional methods such as bank loans or venture capital firms. Fostering access to capital by early-stage companies is the motivation behind the recent interest of the Ontario Securities Commission (the "OSC") in developing a regulatory framework to create a new prospectus exemption for equity crowdfunding.[4] This new proposed exemption will permit the issuance of shares without a prospectus to unaccredited investors.

The OSC's concept idea is largely based on investor protection issues identified in the proposed regulatory framework under the

[1] http://news.cnet.com/8301-1023_3-57578565-93/crowdfunding-raises-$2.7-billion-worldwide-in-2012; http://research.crowdsourcing.org/2013cf-crowd funding-industry-report.
[2] http://www.telegraph.co.uk/technology/internet/10404683/Equity-based-crowdfunding-is-the-brand-new-firestarter.html.
[3] http://ncfacanada.org/canadian-crowdfunding-directory/.

[1] 4 OSC Exempt Market Review, OSC Notice 45-712: Progress Report on Review of Prospectus Exemptions to Facilitated Capital Raising (August 28, 2013); OSC Staff Consultation Paper 45-710: Considerations for New Capital Raising Prospectus Exemptions (December 14, 2012).

Jumpstart Our Business Startups Act (the "JOBS Act") that legalized equity crowdfunding in the United States and directed the Securities and Exchange Commission (the "SEC") to draft rules. In October 2013, the SEC released its proposed rules in a 585-page report, with 295 questions posed for public comment, which constitutes the most comprehensive regulatory framework on equity crowdfunding in the world.[5] The implementation of the SEC's proposed rules will likely have a strong influence on shaping the development of rules in Ontario and the speed with which they develop.

The real challenge in regulating equity crowdfunding is to develop rules that balance the need for investor protection with the need to make participation in the crowdfunding platform affordable for early-stage companies.

Lack of regulation over reporting obligations would expose investors to increased risk of fraud and sham investments. Over-regulation could cause equity crowdfunding to become cost-prohibitive to many early-stage companies. Proponents of equity crowdfunding argue that if Ontario (and Canada generally) does not adopt rules to foster access to capital by early-stage companies, such companies may be inclined to launch in foreign jurisdictions where equity crowdfunding is already active.[6]

Corporate executives and accounting professionals will play a significant role in preparing early-stage companies to enter the crowdfunding market and will be faced with new challenges and risks. Ontario companies may also acquire foreign subsidiaries that are already engaged in equity crowdfunding. An understanding of equity crowdfunding is key to ensuring that the acquiring company does not inherit unnecessary risk. An overview of the OSC's concept idea and the relevant issues it raises is provided next.

the investor at risk

The OSC proposes that regardless of the investor's income or net worth, any investor can invest a maximum of $2,500 in one issuer per year and not more than $10,000 per year in all issuers. The investor is provided with a two-business day "cooling-off" period to retract on the transaction. Conversely, the SEC considers the net worth and income of the investor and the investor has the option of cancelling its transaction 48 hours prior to the issuer's target deadline. If the SEC's proposed rule is adopted, it will create a level of uncertainty for the issuer as the number of investors may significantly decrease right before the target deadline.

The biggest concern is that legalizing equity crowdfunding would subject vulnerable and unsophisticated investors to fraud due to lack of comprehensive reporting obligations on the part of the issuer. In fact, the North American Securities Administrators Association lists crowdfunding scams as 2012's top threat to investors.[7] The OSC reports that the rate of fraud is about 2% in non-equity crowdfunding, without any regulation. North American securities regulators have also noted a "material increase" in the number of securities fraud cases mediated through the Internet.[8] However, to date, there has been no reported incident of fraud on an equity crowdfunding platform. This may largely be due to the stringent screening processes adopted by funding portals (discussed below) and the increased level of due diligence performed by accredited investors who may be investing large sums of money. In particular, it has been observed that investors who are investing small amounts may not have as much financial incentive as those investing larger amounts to perform their own due diligence.

Aside from fraud, there is a general risk inherent in investing in early-stage companies. According to a Statistics Canada 2012 report, more than

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[5] SEC Proposed Rules for Crowdfunding: http://www.sec.gov/rules/proposed/2013/33-9470.pdf

[6] http://business.financialpost.com/2012/10/22/equity-crowdfunding-source-of-innovation-capital-for-startups/

[7] http://www.inc.com/kathleen-kim/crowdfunding-scams-biggest-threat%20to-investors.html

[8] Jake van der Laan et al.,"Identifying Internet Mediated Securities Fraud: Trends and Technology," Webscience.org, 2 April 2010: http://journal.webscience.org/367/2/websci10_submission_71.pdf

30% of small and medium-sized businesses fail in their first two years.[9] On the non-equity crowdfunding front, the estimates in the technology and designer categories on Kickstarter suggest that more than 50% of the products are delivered late. A report from December 2012 stated that over 84% of Kickstarter's 50 top-funded projects missed their estimated delivery dates.[10]

The OSC has proposed that investors be required to sign a risk acknowledgment form agreeing to a potential risk that all of their investments may be lost and that they can bear the loss. For non-reporting issuers, investors will also be warned that their investments may prove to be largely illiquid and that they will not be able to resell the security in the secondary market.

the obstacles to the issuer

The Offering – the OSC proposes that the issuer must be domestic and that the maximum amount to be raised by the issuer in any 12-month period cannot exceed $1.5 million. The issuer can be both a reporting and non-reporting issuer. It is still uncertain how the issuing limits will be enforced as issuers may use multiple funding portals. The SEC's proposal suggests that the funding portal would rely on self-reporting by issuers.

The issuer will rely on advice from professionals on how much equity it should issue. Generally speaking, the larger the offering, the greater the responsibility the issuer will bear. Since there are imposed caps on individual investments, the issuer has the potential to experience an increase in the number of shareholders from zero to hundreds, if not thousands, in a very short period of time. The issuer must be prepared to take on the responsibility of providing each of the investors with the required disclosure, ongoing financial reporting and dealing with their various demands. The issuer must also be prepared for any consequences arising from share dilution.

Valuations of Shares – the OSC's concept idea and the proposed SEC rules do not prescribe a method for valuing the securities. Instead, the SEC directs issuers to describe the terms of the issued securities and the valuation method in their offering materials. The determination of share value for startup companies may present challenges and may impact the corresponding success of the offering and/or business.

Financial Disclosure – the OSC proposes that the issuer provide various financing, issuer and registrant facts prior to being able to issue shares to the public. Under its financial reporting obligations, the issuer would be required to provide management certified financial statements for one year at point of sale if the total distribution is under $500,000. If the total distribution is over $500,000 (or if the issuer is a reporting issuer), the issuer would be required to provide audited financial statements for one year at point of sale. The information statement that is part of the disclosure would fall under the definition of an offering memorandum under the Ontario *Securities Act*[11] and will be subject to the regulatory regime respecting misrepresentations under section 130.1 of the Act (i.e., making an untrue statement about a material fact).

For early-stage companies, especially startups, the financial disclosure requirements are problematic because financial statements may simply not be available or may be very limited. Management may be reluctant to certify financial statements without consulting an accountant first and auditors may be reluctant to audit limited financial statements. By agreeing to stamp a seal of approval on a startup's financial statements, management and auditors may also be increasing their exposure to liability.

The risk with the current financial disclosure requirements (similar ones are proposed by the SEC) is that the very segment of the issuer market that will benefit most from equity crowdfunding may not even be able to gain access by virtue of having no financial history or being unable to afford regulatory compliance. One of the questions posed by the SEC to the public is whether startups that have been operating for

[9] http://www.theglobeandmail.com/report-on-business/small-business/sb-money/business-funding/crowdfunding-20-will-turn-customers-into-shareholders/article14870380
[10] Ajay K. Agrawal, Christian Catalini, Avi Goldfarb, "Some Simple Economics of Crowdfunding" (June 2013) at 9.
[11] R.S.O. 1990, c. S.5 (the "Act").

less than 12 months should be exempt from a requirement to provide financial statements altogether.

Based on an investor survey conducted by the OSC, as part of its public consultation, it was found that about 75% of those interested in crowdfunding would prefer financial information from the issuer that has been verified by an independent source. As such, further relief from financial disclosure to low offering companies may not result in those issuers being successful on the platform.

The bottomline is that investors require a level of disclosure before making investments, regardless of how small the investments are.

Management and accounting professionals will be the gatekeepers to early-stage companies entering the equity crowdfunding market and will have to decide how to manage both the associated risk and the accounting methods and standards that should be adopted to achieve the desired result.

Ongoing Financial Reporting – subsequent to the offering, the issuer would be required to provide ongoing disclosure composed of annual financial statements. This additional requirement is a novel one in the exempt market. Additionally, the issuer would be required to maintain books and records to be available for inspection by the investor and the OSC Staff.

the online funding portal

The online funding portal will screen prospective issuers to join the crowdfunding portal and will likely charge a commission. It has been observed that the funding portals in operation typically charge a 4-5% fee for successful projects.[12] As such, since there is a potential for profit-making on the part of funding portals, it will be in their interest to uphold the reputation of the portal to entice issuers to join and to protect investors.

The OSC proposes that the funding portal conduct background checks on the issuers, its directors and key executives and take other reasonable measures to reduce the risk of fraud. To date, funding portals have adopted stringent screening mechanisms. It has been noted that funding portals generally have a rejection rate of between 80% to 98% of all issuer applications.[13] For example, the world's first online venture capital firm, Funders Club, accepts fewer than 5% of startups by implementing "extensive vetting and due diligence processes."[14] As a further example, Seedrs, an equity crowdfunding platform in the United Kingdom, holds all shares as nominee trustee for investors and manages all dividend payments and disclosure through the portal.

Under the SEC's proposed rules, the funding portal is not permitted to hold investor funds. Instead, investors would be directed to transmit the funds to a bank. The bank would agree to hold the funds for the benefit of the issuer and release those funds to the issuer when the offering target is met. The inability of the issuer to instantly obtain the funds further emphasizes the importance of setting an appropriate offering target.

Further, the OSC wants to require all funding portals to be registered as a broker/dealer with the OSC, but will be prepared to offer exemptions from certain requirements. By way of an example, in June 2013, the OSC granted an exemption from KYC and suitability requirements to Mars XV, an online funding portal. The purpose of Mars XV is to bring together accredited investors with social and/or environmental impact issuers. The agreement between the portal and the issuer requires each issuer to provide the investors with annual audited financial statements in accordance with the Canadian Institute of Chartered Accountants handbook, interim financial statements and updates on the business. The granting of this exemption has been applauded by some as a positive move towards equity crowdfunding. However, the stringent requirements under the broker/dealer registration may dissuade registration by prospective funding portals.

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[12] Supra note 10 at 15.

[13] http://opinion.financialpost.com/2013/08/29/let-the-crowd-raise-capital/

[14] https://fundersclub.com/

conclusion

Equity crowdfunding will present new challenges to financial governance. It will permit early-stage companies with a limited track record to issue shares to the larger investing public without providing extensive financial disclosure. From valuing shares, to complying with financial reporting obligations, to dealing with a sudden surge in the number of shareholders, early-stage companies and their advisors will have to tread carefully. While we wait for the next word from the OSC, the spotlight is now on the SEC for the implementation of its proposed crowdfunding rules.

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