August 4, 2021

We've Got New Harmonized Crowdfunding Rules. But How Will Industry Respond?

By: Dr. Ryan Clements

Legislation Commented On: National Instrument 45-110, *Start-Up Crowdfunding Registration and Prospectus Exemptions*

The Canadian Securities Administrators (CSA) recently published, in final form, a harmonized national framework for securities crowdfunding (National Instrument (NI) 45-110), which, subject to ministerial approval, will come into force on September 21, 2021. This is a positive development and shows that provincial securities regulators can work together to make Canadian capital markets more efficient without a national regulator.

It is uncertain, however, how industry will respond – and this is no fault of the regulator. The harmonized framework balances dual policy pillars of investor protection and fair and efficient capital markets, and this should be applauded. But crowdfunding isn't a panacea. It's a tool that may fill a small gap in the capital raising ecosystem for start-ups. One might be skeptical about the net impact it will ultimately have on capital formation in Canada, and there are several good reasons why firms and investors may want to avoid it altogether.

Crowdfunding generally refers to individuals or companies that raise small amounts of money from a large number of people. There are different "models" of crowdfunding including equity, where shares are issued by companies to investors; debt, where small-value creditors pool a loan; or donation or product pre-sale based – like the popular funding platforms *Kickstarter*, *GoFundMe*, and *Indiegogo*. To understand the crowdfunding harmonization framework, it's important to note two foundational principles in Canadian securities law.

First, securities are regulated provincially. To lower regulatory fragmentation, and streamline Canadian capital markets, the ten provinces and three territories organized the CSA as an umbrella organization to create unified national rules (which must be adopted in individual provinces and territories) and a "passport system" allowing market participants access to national markets through a single "principal" regulator. The CSA has developed many harmonized "National Instruments" including among others, rules for public and non-public companies raising capital, ongoing disclosure requirements for public companies, and registration rules for investment dealers, advisors and portfolio managers. The CSA has also created a "regulatory sandbox" that provides exemptive relief for fintech innovations.

The second fundamental principle is that we have a 'closed' system of distributing securities in Canada, where all forms of distribution to investors are regulated. To distribute securities to an investor, an 'issuer' must either 1) file a prospectus with the regulator (a comprehensive information disclosure document) as per s 110 of the Alberta *Securities Act*, RSA 2000, c S-4 (*ASA*) and comply with other rules for a public distribution; 2) qualify for an exemption from the prospectus rules (of which there are many, including National Instrument 45-106); or 3) obtain a discretionary exemption from the regulator (per s 144 of the *ASA* and analogous provincial statutory provisions). Only securities issued via a prospectus are freely tradeable on secondary markets (i.e., stock exchanges), and the issuer of these securities is a 'reporting issuer' subject to ongoing disclosure, corporate governance, and other rules.

Prospectus exemptions (commonly called 'private placements' or the 'private' or 'exempt' market) are provided for many policy reasons including the needs of start-ups, wealthy and sophisticated investors, pre-existing relationships with issuers, and the inherent safety of some securities (like government bonds). The new crowdfunding National Instrument (NI 45-110) provides certain Canadian-based issuers (including cooperative associations), under harmonized conditions, with a prospectus exemption to issue "eligible securities" to investors via an online crowdfunding portal (see Part 4, NI 45-110).

The CSA (and the provincial securities regulators) should be applauded for their efforts to harmonize the crowdfunding rules. The previous crowdfunding regime was highly fragmented, costly, and overly complex. Firms desiring to crowdfund a securities distribution across Canada faced a daunting task of navigating local rules in Ontario, British Columbia, Quebec, Alberta, Saskatchewan, Manitoba, New Brunswick, and Nova Scotia. This was supplemented by a Multi-Lateral Instrument (MI 45-108), not adopted by all provinces, which was both costly and unpopular. The Alberta Securities Commission (ASC) recently identified that MI 45-108, despite being enacted in 2016, has literally never been used once in Alberta.

The new rules reduce barriers to crowdfunding use and respond positively to numerous comments received on the proposed instrument. Among other measures, the CSA increased the total amount of capital that firms can raise over a 12 month period to $1.5 million (from $1 million in the original version of the instrument). It also increased the amount that non-accredited investors can invest to $10,000 (the original proposal was $5,000) if such eligible investor receives suitability advice from a registered investment dealer. Without suitability advice, the maximum limit for a non-accredited investor per distribution is $2,500. It also provides an exemption (see Part 2 of NI 45-110) for certain funding portals, under prescribed conditions, from the costly dealer registration requirement.

NI 45-110 also does not jeopardize investor protection given the investment limits, risk acknowledgment, contractual rights to withdraw, and the requirement of a prescribed "offering document" (like a prospectus, but much smaller) which provides plain language information about the offering and use of proceeds, the risks of the enterprise, the issuer's business, its directors, officers, founders, and control persons, and whether the offered securities are subject to rights and restrictions (such as contractual restrictions, voting trusts or pre-emptive rights). The issuer is also subject to liability if the document contains a misrepresentation (see Form 45-110F1). The CSA also published Staff Notice 45-329, providing guidance on what is required for issuers to satisfy the exemption, and guidance for funding portals. The new framework more closely aligns Canada with other international jurisdictions, including the US and the UK, which have seen success with crowdfunding.

Despite the positive steps by the CSA in establishing this harmonized framework, there are many reasons to be skeptical about how much impact this will have on the day-to-day financing activities of Canadian start-ups. Prior to 2021, provincial crowdfunding exemptions were rarely used. The ASC noted, in its July 2020 report on "The Alberta Capital Market," that 90 percent of the capital raised in the exempt market in 2019 in Alberta was through the accredited investor exemption, followed by the friends, family and business associates exemption, and then ASC Rule 72-501 (distribution to purchasers outside of Alberta).

Similarly, the Ontario Securities Commission reported an even higher institutional investor footprint with institutions accounting for nearly 96 percent of the prospectus exempt capital raises in 2019. While it's possible that the lack of crowdfunding use to date is due (in part) to the fragmented regulatory structure, there are also numerous reasons why both issuers and investors would want to avoid this exemption altogether. These reasons may better explain the lack of take-up of crowdfunding to date.

There is often a "democratizing" finance sentiment accompanying discussions around crowdfunding – that it evens the playing field and allows the average investor to participate alongside wealthy and institutional investors. Yet, it's not certain that crowdfunding increases access to high growth companies for average investors or remedies income and wealth inequality. In fact, the inverse might actually be true. Crowdfunding might (ironically) contribute to greater income and wealth inequality.

Duke Law Professor Elizabeth de Fontenay has argued in written testimony to Congress, that retail investors in exempt market securities are likely to earn "lower risk-adjusted returns" than if they invested in the public market. She notes in her testimony (and I agree), the "notion that retail investors are 'missing out' on the opportunity to invest in private securities is based on faith, rather than data," and she suggests investors would be better off (empirically) buying index funds. The phenomenal growth of passive investing (including in exchange traded funds) is driven by the fact that most investors are much better off, over the long run, by simply buying the entire market.

Also, consider the adage that 'good companies get funded.' By implication, a company that fails to attract institutional capital, or accredited investors, and seek outs small-dollar crowdfunding may be as Professor Erik Gerding has described, "the smallest issuers with the worst prospects." Venture Capital (VC) firms - institutional investors who specialize in investing in high-growth start-ups - anticipate a large proportion of failure in their portfolio companies. So, they aim for high risk, high payout scenarios with infrequent (but massive) home runs to compensate for the many companies who will go bust.

To experience similar risk-adjusted returns over time as a VC, a retail crowdfunding investor needs to play the long game - invest in a large number of crowdfunding issuers at large dollar amounts (while avoiding being diluted) and being willing to lose often in the process of landing a runaway success. Even if a crowdfunded issuer becomes a "unicorn," and manages to scale without tapping institutional capital, the small dollar exposure of the crowdfunding investor (given the investment limits in NI 45-110) precludes the massive payouts that higher stakes investments give to a VC.

Then there is the issue of liquidity (or the lack thereof). Securities distributed via a prospectus exemption (including crowdfunding) are not freely tradeable in secondary markets. They are subject to strict re-sale rules in National Instrument 45-102. A crowdfunded investor can get stuck in an indefinite waiting period, watching from the sidelines with very little ability to influence the actions of the company, liquidate their investment, or avoid dilution through contractual bargaining. They may also be subject to pre-existing contractual rights in shareholder agreements established prior to the crowdfunded offering itself. Liquidity is one reason why the *National Crowdfunding & Fintech Association* has repeatedly advocated that peer-to-peer or crowdfunded marketplace lending (which creates a security under Canadian jurisprudence) be regulated differently, since small dollar, short duration creditors have different risk and liquidity considerations than crowdfunded shareholders.

It isn't certain that private companies in Canada lack funding. In fact, given current declining trends in public markets, the opposite might be true. The Canadian public markets, where shares freely trade, and listed companies ('reporting issuers') must comply with significant continuous disclosure, corporate governance, and other ongoing regulatory requirements, have experienced significant contraction with fewer companies seeking out "initial public offerings" (IPOs) but rather choosing to remain private where they operate with much less transparency.

Instead of encouraging crowdfunding participation it may be a better idea, to revitalize the IPO market, and lower the regulatory burden of public companies. This would enhance investor liquidity, price discovery, improve firm-level outcomes, provide more investor protection and information transparency, and potentially decrease the odds of investing in a crowdfunded firm that has marginal growth prospects and has been passed over by numerous institutions. As U.S. scholars have argued, there may be a substitutional dynamic at work here, where growth in private capital markets may be coming at the "expense" of the public markets. To this end, the recently proposed "streamlined capital raising option" for issuers listed on a Canadian stock exchange is a great initiative.

From an issuer's perspective, if you're a high-growth company with scaling prospects (like a technology company) you may not want a small-dollar value investor as a shareholder at such an early stage. As argued by Professor de Fontenay, just because you may want to get in early on "the next Amazon", doesn't mean that the next Amazon wants (or needs) you! A crowdfunded investor offers very little to a high-growth issuer (other than a small amount of accessible capital spread across a large investor base). Institutional investors provide governance and operational expertise and help to open new opportunities and markets.

An entrepreneur who understands these dynamics will look first to accredited or institutional funding sources for seed and early series capital. Another issuer consideration is that not all money is "good money." As noted by U.S. law firm *Foley & Lardner LLP*, there is a potential in crowdfunding for negative social media sentiments (which can spread virally) by disgruntled small-value shareholders who provide little, if any, additional value to the ongoing enterprise and are now armed with a host of shareholder rights pursuant to corporate law (*Business Corporations Act*, RSA 2000, c B-9).

There may be a gap that crowdfunding fills, and scenarios where institutions and accredited investors pass on a huge opportunity that the 'wisdom of the crowd' otherwise scoops up. But I have my doubts. The more likely funding gap is for family-run enterprises, who aren't interested in scaling (or can't) and who have difficulty tapping private capital networks or attracting accredited or institutional investors. To this end, the recently proposed "small business financing initiative" by the ASC and the Financial and Consumer Affairs Authority of Saskatchewan fits an important gap for small and local businesses that operate outside of the typical VC portfolio and should be enacted. On the question of online crowdfunding, it's still uncertain how industry will ultimately react to these harmonized rules.

This post may be cited as: Ryan Clements, "We've Got New Harmonized Crowdfunding Rules. But How Will Industry Respond?" (August 4, 2021), online: ABlawg, http://ablawg.ca/wp-content/uploads/2021/08/Blog_RC_Harmonized_Crowdfunding_Rules.pdf

To subscribe to ABlawg by email or RSS feed, please go to http://ablawg.ca

Follow us on Twitter @ABlawg