

Business Law

October 2014

Crowdfunding – Corporate Finance Goes Viral

In response to the financial crisis of 2007-2008, governments on both sides of the border passed laws that made it harder for companies to raise money by selling its securities. For example, in Canada, the Canadian Securities Administrators (the “CSA”) enacted new regulations and passed amendments to existing regulations requiring enhanced disclosure for securitized products issued by public companies and narrowing the class of investors that could purchase securitized products on a private placement basis. In the United States, the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law on July 21, 2010 which provided for: (i) more fulsome disclosure for the securities-based swaps market, (ii) increased oversight and transparency with respect to hedge fund and private equity operations, and (iii) greater shareholder input on executive compensation issues. As a result of the implementation of these stricter rules, North American businesses found it increasingly difficult to raise equity capital and financial centres in North America, such as New York and Toronto, were increasingly worried about maintaining their competitiveness in the global financial marketplace.

To address these concerns, businesses and governmental regulators are currently looking to leverage a tool that was developed through the use of social media; this tool is crowdfunding.

What is Crowdfunding?

The term crowdfunding is defined as the practice of soliciting financial contributions from a large number of people especially from the online community. Although the term “crowdfunding” was first mentioned in a blog during 2006, the practice of raising funds in small increments from a large number of sources has been used for centuries. For example, in 1885, when the United States was unable to raise US \$250,000 to provide a plinth or base for the Statue of Liberty, *The New York World* launched a campaign to raise US \$100,000 towards the building of the base with a promise to publish the names of each person that made a contribution no matter how small. The outpouring of support and donations in response was astounding. Within five months, approximately US \$102,000 was raised from over 120,000 donors in total; over 80% of those donations were in amounts that were less than one dollar.

Through websites such as Kickstarter and IndieGoGo, millions have contributed money through the use of crowdfunding techniques. Crowdfunding has been used for philanthropic enterprises, artistic development projects, scientific research and other purposes. Some of the more successful crowdfunding campaigns include:

- Development of *Star Citizen*, an online space trading and combat video game developed by Cloud Imperium Games which claimed to have raised US \$40,000,000;
- Development of a “smart watch” by Pebble Technology Corp. which raised over US \$10.2 million from 68,928 contributors;
- An effort by alternative rocker Amanda Palmer to obtain funds needed to produce a new album and develop an art book which raised US \$1.2 million from 24,883 backers;
- Development of a feature film based on the TV series *Veronica Mars* which raised US \$5.7 million from 91,585 fans; and
- Revival of the long-running PBS show *Reading Rainbow*, which raised US \$6.5 million from 105,857 contributors (the number of contributors is a record for Kickstarter).

Currently, crowdfunding is estimated to raise approximately US \$1.5 billion each year. On average, US \$60,000 is raised each hour through crowdfunding and 442 separate crowdfunding campaigns are launched on a daily basis.

Efforts to Incorporate Crowdfunding Techniques in Equity Transactions

There is a natural fit between crowdfunding and financing corporate activities through the issuance of securities. Crowdfunding provides a cost effective way for businesses to solicit potential investors and it allows investors a way to diversify their risk by making purchases of shares in private companies that used to be available only to hedge funds, private equity concerns and other large or sophisticated investors. The problem is that selling securities through the use of crowdfunding currently violates the law in both Canada and the US unless the securities are registered under the laws of the relevant country, and the process to register securities is too costly and time-consuming for most of the start-up level companies that could best take advantage of the crowdfunding process. To address this prohibition and to help encourage capital formation for smaller businesses on both sides of the border, governmental entities are proposing rules that bring decades-old securities laws up to date to make them relevant to our socially connected world. You may find below a summary of the current legal initiatives taking place in the United States and in Canada regarding crowdfunding.

The United States: The Jumpstart Our Business Startups Act

The Jumpstart Our Business Startups Act (the “JOBS Act”) was signed into law by the President on April 5, 2012. It was intended to provide small businesses with easier and less expensive access to equity capital by: (i) increasing the number of shareholders a company may have before it is required to become a public company; (ii) relieving emerging growth companies (which the JOBS Act defines as companies with US \$1 billion or less in annual revenue) from certain regulatory and disclosure requirements when they go public (including without limitation the requirement to assess the effectiveness of a company’s internal controls); (iii) relaxing the prohibition on general solicitation and general advertising for securities offered to investors in certain private placement transactions; and (iv) allowing corporations to use crowdfunding techniques to

issue and sell up to US \$1,000,000 of securities during a 12-month period.

The provisions of the JOBS Act state that the aggregate amount that may be sold to any investor through the use of crowdfunding cannot exceed:

- The greater of US \$2,000 or 5% of the annual income or net worth for an investor if the annual income or net worth of such investor is less than US \$100,000;
- 10% of the annual income or net worth of such investor if the annual income or net worth of such investor is equal to or greater than US \$100,000; and
- US \$100,000 under any circumstances.

The JOBS Act requires that any securities offered via crowdfunding must be done through the use of either a broker or a funding portal that is registered with the US Securities and Exchange Commission (the “SEC”). In addition, the JOBS Act forbids the following issuers to use crowdfunding to raise capital: (A) companies that are not incorporated or formed under the laws of a US state or other jurisdiction, (B) mutual funds and other investment companies, and (C) publicly traded companies. Companies that wish to use crowdfunding to sell securities must file with the SEC and make available to the funding portal as well as to investors: (i) its name and the name of its officers, directors and significant shareholders, (ii) its business plan; (iii) the target offering amount and the deadline to reach this amount (as well as periodic updates in reaching the target); (iv) a description of the intended use of proceeds of the offering; (v) the price of the securities offered and a description of how they are being valued; (vi) the terms of the securities being offered and of each other class of security of the issuer; and (vii) the risks associated with purchasing and holding the securities being offered including those risks associated with additional issuances of shares as well as with related party transactions.

SEC Proposed Rules under the JOBS Act

On October 25, 2013, the SEC issued proposed rules pursuant to its authority under the JOBS Act. These rules build upon the provisions of the JOBS Act and add a few interpretive refinements to these provisions. Some of the

most important concepts introduced in these rules are as follows:

- The crowdfunding limit imposed in the JOBS Act (which state that an issuer may raise only \$1,000,000 every 12 months) may be added to other applicable limits in the private placement market; this means that an issuer that raises \$1,000,000 using crowdfunding, may continue to sell its securities in private placements with accredited investors pursuant to the provisions of Regulation D, in offshore transactions pursuant to the provisions of Regulation S or using other means permitted under US securities law.
- The information that issuers are required to file pursuant to the JOBS Act will be done on Form C, which is a new form developed by the SEC for this purpose.
- The requirement that an issuer's directors and officers disclose their relevant business experience over the past three years.
- The requirement that issuers disclose how any amounts raised in excess of the targeted offering amount would be allocated.
- The requirement that issuers allow an investor to cancel the relevant investment commitment 48 hours or more prior to the deadline stated in the issuer's offering materials.
- The requirement to disclose: (i) the amount of compensation paid to the broker or funding portal for conducting the offering, (ii) the issuer's number of employees at the time of offering, (iii) a description of the key terms of any indebtedness of the issuer, and (iv) disclosure of any securities offered by the issuer that were exempt from the registration requirement under US securities law.
- The requirement that the broker or funding portal that acts as intermediary for the issuer's securities conduct a background check on the issuer as well as its officers, directors or any person or entity that beneficially owns more than 20% of the issuer's securities.

- The requirement that the broker or funding portal provide new investors with educational materials in plain English that describe the crowdfunding process, the risks associated with investing in securities offered through the use of crowdfunding and the restrictions on the resale of securities purchased during the crowdfunding process.
- The requirement that the investor represents that he or she has reviewed the materials referenced in the prior bullet point and understands that he or she may lose all of his or her investment in securities offered.
- The requirement that the intermediary clearly disclose the manner in which the intermediary will be compensated to each new investor.
- The requirement that each intermediary maintain written anti-money laundering policies, procedures and internal controls.

The SEC stated that its rules are intended to align the central tenets of crowdfunding (the opportunity to invest in a company or business after exchanging information with other members of the crowd) with its prime directive to protect investors. The result was a set of rules that was not so burdensome so as to discourage participation in crowdfunding, but were not so permissive so as to undermine investor confidence in the crowdfunding process.

Proposed Multilateral Instrument 45-108 – Canada's Roadmap for those who Pursue Crowdfunding

In order to effectively respond to efforts by the US and by other countries to allow companies to raise capital through the employment of crowdfunding techniques, the CSA also issued a series of proposals designed to increase access to capital for entrepreneurs and small businesses. Included in these proposals was Proposed Multilateral Instrument 45-108 ("PMI 45-108") which provided rules allowing for the issuance of securities through crowdfunding. PMI 45-108 had two basic components: (i) the Crowdfunding Prospectus Exemption; and (ii) Crowdfunding Portal Requirements. These components are summarized below.

Crowdfunding Prospectus Exemption

The Crowdfunding Prospectus Exemption provides several tests that securities offerings must meet in order to realize the opportunities afforded by crowdfunding. These tests are:

- Issuer Qualification Criteria – securities issuers that wish to use crowdfunding must be incorporated under Canadian law, their headquarters must be located in Canada and a majority of its directors must be resident in Canada. Investment funds and private issuers of real-estate backed securities are not eligible to use crowdfunding; private corporations that do not have a written business plan are also ineligible.
- Available Types of Securities – businesses who issue and offer the following types of securities may take advantage of the practice of crowdfunding: (i) common shares, (ii) non-convertible preferred shares, (iii) securities which are convertible into (i) or (ii) above, (iv) debt securities, (v) limited partnership units, and (vi) flow-through shares.
- Offering Parameters – businesses are limited to raising CAD \$1.5 million over a 12 month period. In addition, each offering of securities cannot remain open for more than 90 days and the disclosure document associated with the offering must disclose the minimum offering size and, if applicable, the maximum offering size. No offering may be completed unless the minimum offering target stated in the disclosure document is reached and unless, as a result of the offering, the issuer has sufficient resources to achieve the objectives in the written business plan or, if applicable, to reach the next milestone in the business plan.
- Advertising Restrictions; Disclosure – an issuer must make its offering materials available on the funding portal's website and nowhere else; the issuer must deliver such offering materials to the appropriate provincial securities regulator at the same time they are posted on the portal's website. The only materials that may be posted on the portal's website are the offering document, any documents described in the offering document and any applicable term sheet. A company may direct potential investors to the offering materials on the portal's website either by hard copy or through the use of social media. In addition, the issuer must provide a concise disclosure document that includes basic information about the offering, the issuer and the portal including third party verification of cash on hand and audited financials if the issuer has raised more than CAD \$500,000 or spent more than CAD \$150,000 since its formation.
- Investor Protection Measures – an investor may not invest more than CAD \$2,500 in any single investment, nor may such investors invest more than CAD \$10,000 in crowdfunding related investments in any calendar year. In addition, investors cannot borrow money from, or have their financing facilitated by, any issuer, any funding portal or any director or officer of an issuer or funding portal. At the time of purchase of the securities, investors must sign a form acknowledging that such investor could lose some or all of the money invested and that the investor is aware of other risks relevant to the purchase of securities. As in the US, investors have the right to withdraw their investments up to 48 hours prior to deadline to withdraw that is provided in the applicable disclosure documents. However, investors are also entitled to rescission or damages if the issuer makes any material misrepresentation in any of the offering materials. The securities offered under the crowdfunding exemption are generally subject to a four month hold period if the issuer is a public company or an indefinite hold period if the issuer is not a public company.
- Ongoing Obligations of the Issuer – once the crowdfunding transaction is completed, a private issuer must provide on at least an annual basis to the applicable securities regulator: (i) financial statements, (ii) disclosure regarding how the proceeds from the crowdfunding offering have been used, and (iii) other material disclosure. In addition, a private issuer must keep books and records including offering documents and executed risk acknowledgement forms as well as records as to the number of securities issued and the names of all investors in such securities and the number and type of securities each such investor holds.

Once an issuer completes a crowdfunding transaction, it must file a report of exempt distribution with the applicable securities regulator within 10 days of the completion of such transaction.

Requirements for Funding Portals

Since the funding portal plays a critical role in connecting the issuer to potential investors, PMI 45-108 devotes a considerable amount of attention to setting standards applicable to these intermediaries. Some of the material provisions affecting funding portals are as follows:

- **Portal Obligations** – funding portals must meet the same standards which the CSA sets for exempt market dealers in the provisions of National Instrument 31-103 including maintaining a minimum amount of net capital and adhering to regulatory reporting, record-keeping and record-retention requirements. In addition, funding portals must conduct background checks on the issuers they support and on the officers, directors and other key people associated with either the issuer or the offering, and a funding portal must be prepared to deny access to any issuer if the portal has any reason to believe either the issuer or the proposed offering is fraudulent. Funding portals need to understand the general features of the securities that are offered and need to review the information presented on the portal to make sure that such information is proper and adequate to disclose to potential investors.
- **Activities of the Funding Portal** – a portal cannot make specific recommendations or provide specific advice about the securities offered through the portal, nor may it solicit purchases or sales of any such securities. A funding portal may not hold or maintain any funds or securities of the investors, nor may it invest in the securities of any issuer listed on the portal, or of any underwriter associated with any such securities offering. Such portals may not compensate employees or agents for soliciting the sale of any securities listed on their platform, nor may they facilitate the resale of any such security.

The provisions of PMI 45-108 subject issuers and portals to greater regulatory scrutiny compared to the equivalent

statutes and regulations in the US. This is consistent with the differences in philosophies between the CSA and the SEC. The SEC has always applied a “principles based approach” to the regulation of securities which allows the marketplace to set standards of conduct, while affording the SEC the option of asserting its authority in situations where there is a marketplace failure. The regulatory philosophy north of the border is more active in nature; it envisions the regulators setting the roadmap by which the marketplace will guide its actions.

Conclusion

For small businesses that are looking to crowdfunding as a possible vehicle to raise equity capital and for those entities looking to act as funding portals for securities offerings in the crowdfunding space, there is little that can be done right now. The proposed crowdfunding securities rules that have been promulgated on both sides of the border are still subject to possible amendment and revision as a result of the comments generated with respect to such proposed rules. Thus, the rules proposed by each country cannot serve as effective roadmaps for issuers or funding portals until they become final.

However, at some point they will become final and effective. When this happens, entrepreneurs and small businesses will be able to leverage the tools of social media to gain unprecedented access to equity capital quickly and efficiently, and internet and social media service providers may be able to facilitate such access in their roles as funding portals. However, even when the crowdfunding rules become final, businesses and funding portals on each side of the border should look to their home country when employing crowdfunding to offer securities. Both the US and Canada have created rules that favour their own businesses and intermediaries. Although it may be tempting for Canadian companies to access the considerable capital resources of the US, the JOBS Act and the related SEC rules place too great a burden to make entry into the US securities marketplace through the implementation of a crowdfunding campaign a viable option. In addition, the requirement that issuers wishing to take advantage of the Canadian crowdfunding exemption be incorporated in Canada and have their headquarters, as well as most of

One of the top Ontario Regional Law Firms as chosen by the readers of *Canadian Lawyer* magazine.

their directors, located in Canada, effectively closes out the Canadian crowdfunding market for US issuers. A similarly high barrier between the two countries limits the flexibility for funding portals; the qualification regulations for such entities in each country are too detailed and intricate to allow for true cross-border competition among funding portals. It appears that, in terms of corporate finance, the crowdfunding marketplace has not quite gone global.

Even if the promise of crowdfunding has not yet been fulfilled, the arc of the intersection between finance and social media is bending towards greater access to capital for small businesses throughout North America. Those entities that are thinking of issuing shares or acting as a facilitator for such issuers should monitor future developments in this area closely.

Bill Kitay is Senior Counsel of the Business Law Practice. Bill is called to the bar both in the U.S. (in New York, Connecticut and the District of Columbia) and in Ontario.



Pallett Valo LLP Business Law Practice

Structuring your business, and business proposals, for success requires the right partnerships and specialized expertise. At Pallett Valo, we represent both growth businesses and established enterprises in all sectors. Our specific legal knowledge and wide-ranging experience will empower your business decisions - enabling you to act with confidence and decisiveness to take advantage of all opportunities. We bring a rarely-found enthusiasm, creativity and cost-effectiveness to both your day-to-day legal requirements and more complex strategic legal needs.

Contact Members of our Business Law Practice

Murray Box mbox@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 240

Joe Conte jconte@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 217

Murray Gottheil gottheil@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 245

Andréa Brinston abrinston@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 219

Olivia Gismondi ogismondi@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 209

Bill Kitay bkitay@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 291

This article provides information of a general nature only and should not be relied upon as professional advice in any particular context. For more information about Business Law, contact a member of our **Business Law Practice** at **905.273.3300**.

If you would prefer to receive your bulletins by email, visit www.pallettvalo.com/signup or send an email to marketing@pallettvalo.com.