

Land of Confusion – Crowdfunding Regulations in Canada

On November 5, 2015 the regulatory authorities in Manitoba, Ontario, Québec, New Brunswick and Nova Scotia (the “Participating Jurisdictions”) published Multilateral Instrument 45-108 (“MI 45-108”) which addressed the raising of capital through the use of crowdfunding. MI 45-108 became effective on January 25, 2016. MI 45-108 is the attempt by the Participating Jurisdictions to keep up with a trend of liberalizing small business’ access to capital through crowdfunding, but it was not the only attempt made in Canada. On May 14, 2015, regulators in British Columbia, Saskatchewan, Manitoba, Québec, New Brunswick and Nova Scotia (the “MCSAN Jurisdictions”) promulgated Multilateral CSA Notice 45-316 (“MCSAN 45-316”).

These regulations, combined with other recent governmental actions, have amply demonstrated the haphazard approach to the governing of crowdfunding activities in Canada. For example, in Ontario only MI 45-108 will be in effect. In British Columbia and Saskatchewan, only MCSAN 45-316 will be in effect. Meanwhile, the regulators in Manitoba, Québec, New Brunswick and Nova Scotia will try to enforce both MI 45-108 and MCSAN 45-316. To further complicate matters, Alberta and Nunavut (the “Proposed Jurisdictions”) adopted a third regulatory regime, Proposed Multilateral Instrument 45-109 (“Proposed 45-109”), which was designed to “coordinate” with both MI 45-108 and MCSAN 45-316. Meanwhile, Prince Edward Island, Newfoundland and Labrador, the Northwest Territories and the Yukon Territory do not appear to have established any crowdfunding regulatory regime. *To view a graphic representation of the present complex state of regulatory affairs for crowdfunding across Canadian jurisdictions, please see Appendix “A”.*

This article will provide a concise background on crowdfunding mechanics and attempts by securities regulators to establish rules governing the use of crowdfunding to raise capital. Next, it will provide a brief description of MI 45-108, MCSAN 45-316 and Proposed 45-109 and highlight the most significant differences among these rules. The article will conclude by providing some general, practical advice to small and medium sized enterprises.

Since the mission of securities regulators is to protect the investors who reside in their respective jurisdictions, even the smallest startup that plans to seek investment capital in Canada needs to be aware of MI 45-108, MCSAN 45-316 and Proposed 45-109 because crowdfunding knows no borders and the crowd is everywhere.

What is Crowdfunding?

The term crowdfunding is the practice of soliciting financial contributions from a large number of people from the online community. In a crowdfunding transaction, an individual or a business (referred to as the project initiator) seeks capital by making a pitch for such funds from a community of individuals or businesses (referred to as the crowd). The crowd considers the pitch and decides whether to commit funds to the project. The organization that brings project initiators together with the crowd is known as a funding portal. Through the services provided by funding portals such as Kickstarter and IndieGoGo, millions have contributed money through crowdfunding. According to crowdsourcing.org, crowdfunding worldwide was estimated to have raised US \$34.4 billion in 2015. According to entrepreneur.com, on average US \$87,000 is raised each hour globally through crowdfunding, and almost 6,000 projects are actively competing for funds on Kickstarter at any one time.

Efforts to Incorporate Crowdfunding Techniques in Equity Transactions

There is a natural fit between crowdfunding and corporate finance. Crowdfunding provides a cost effective way for businesses to solicit potential investors and a way for investors to diversify their risk by allowing them to make investments that used to be available only to large or sophisticated investors. The problem was that until recently selling securities through crowdfunding was a violation of the law unless the securities were previously registered, and securities registration is a costly and time-consuming process. To address this problem and to help encourage capital formation for business startups, Canadian securities regulators worked to develop rules that would make decades-old

securities laws relevant to our socially connected world. However, the failure of the regulators to coordinate their activities has led to the jumble of regulations that Canadian businesses must currently face if they wish to leverage crowdfunding tools to raise capital.

Multilateral Instrument 45-108 – the Crowdfunding Roadmap in the Participating Jurisdictions

MI 45-108 has two basic components: (i) the Crowdfunding Prospectus Exemption; and (ii) the Funding Portal Requirements. These components are summarized below.

Crowdfunding Prospectus Exemption

The Crowdfunding Prospectus Exemption addresses both the distribution of the securities to the investors in a crowdfunding offering and the ongoing disclosure private issuers must provide regarding both the issuer and the securities issued.

Distribution Requirements

An issuer that wishes to take advantage of the crowdfunding exemption needs to comply with the following requirements:

- It may not raise more than \$1,500,000 during any 12-month period;
- It may not raise more than \$2,500 from any non-accredited investor, or more than \$25,000 from any accredited investor, in any single offering;
- It must provide each investor with an offering document (“Offering Document”) that contains, among other items, the aggregate minimum proceeds of the offering, and a certificate stating that there are no untrue material statements in the Offering Document;
- It may make additional materials (the “Additional Materials”) available to investors (such as a term sheet, a video or other materials summarizing the information in the Offering Document) if the Additional Materials are provided only on the funding portal;
- It must file a Report of Exempt Distribution on Form 45-106F1, together with the Offering Document and any additional materials within 10 days after closing of the applicable distribution; and
- It may not close any distribution unless it has: (i) raised the aggregate minimum proceeds described in the Offering Document, and (ii) received from each purchaser a risk acknowledgement form which confirms the purchaser’s understanding of the risks disclosed in the Offering Document.

In addition, in Ontario only, non-accredited investors may not invest more than \$10,000, and accredited investors may not invest more than \$50,000, in all securities offered under MI 45-108 during any calendar year. Ontario requires each purchaser to confirm compliance with these investment limit rules on Form 45-108F3.

Ongoing Disclosure Requirements

Private companies who issue securities in reliance on MI 45-108 must provide much of the same information on a continuous basis that publicly traded businesses disclose to its investors, including:

- A full set of financial statements within 120 days of its fiscal year, which must be accompanied by an auditor’s report if the company has raised more than \$750,000 in securities offerings since its founding; and
- A report on its use of the proceeds raised in the offering.

MI 45-108 also imposes requirements that issuers retain certain documents (such as the Offering Document and Additional Materials) for at least 8 years after closing.

Funding Portal Requirements

MI 45-108 believes that funding portals must ensure that investors are protected in the crowdfunding space. As a result, MI 45-108 places stringent, continuous scrutiny upon funding portals. The rules each funding portal must follow include:

- It must register as either an investment dealer, exempt market dealer or restricted dealer;
- It may promote or distribute the Offering Document and related materials on its online platform and not through any other means;
- Before allowing an issuer to promote an offering on its platform, the funding portal must:
 - o Enter into an agreement with the issuer that includes language stating that the funding portal must terminate any offering and report immediately to the securities regulators if it appears that the issuer is not conducting its business with integrity,
 - o Conduct background checks for each director, executive officer and promoter of the issuer, and
 - o Review the Offering Document and Additional Materials and require the issuer to revise any misleading information contained therein prior to posting on the platform;
- It must require potential investors to acknowledge that: (i) no securities regulator has reviewed or approved any information regarding the offering, and (ii) they may lose all or most of the money invested in the offered securities;
- It must file a report every six months describing each securities distribution conducted through it during the relevant period; and
- If it registers as a restricted dealer, it must ensure that its chief compliance officer and all other individuals who act on its behalf have and will maintain sufficient education, training and experience to effectively perform in their respective positions.

Multilateral CSA Notice 45-316 – An Alternate Canadian Crowdfunding Regime

MCSAN 45-316 provides a different approach to the regulation of crowdfunding compared to MI 45-108. Perhaps the most significant difference between MI 45-108 and MCSAN 45-316 is the duration of each regulation. Currently, there is no expiration date for MI 45-108. In contrast, MCSAN 45-316 is expected to expire during May 2020 unless it is renewed or amended.

As with MI 45-108, MCSAN 45-316 has provisions that govern both issuers and funding portals. A summary of some of the distinctive provisions of MI 45-108 are as follows:

MCSAN 45-316's Rules Affecting Issuers

- Publicly traded companies cannot qualify for the exemption afforded by MCSAN 45-316 (MI 45-108 has no similar restriction);
- The issuer's head office must be located in one of the MCSAN Jurisdictions (MI 45-108 has no similar restriction);
- An issuer may not raise more than \$250,000 in any one offering, and may not conduct more than two offerings in any calendar year;
- No investor may invest more than \$1,500 in any offering (this applies to accredited investors as well); and
- An issuer is not compelled to provide financial statements or other ongoing disclosure but must provide similar disclosure to what is required under MI 45-108.

MCSAN 45-316's Rules Affecting Funding Portals

- In contrast to MI 45-108, a funding portal does not need to register under the Canadian securities laws if it meets certain conditions, such as:
 - o It (and each of its principals) must provide information forms to each regulator in the MCSAN Jurisdictions at least 30 days prior to the first crowdfunding distribution,
 - o It does not provide advice to a prospective purchaser about any investment listed on its platform,
 - o It does not receive any remuneration from a purchaser of securities listed on its platform,
 - o It does not allow an investor to purchase securities listed on its platform until it receives written confirmation that such investor has read and understood the applicable offering disclosure and risk warnings, and
 - o It has not received notification from any regulator that any of the funding portal's principals demonstrate a lack of integrity, financial responsibility, relevant knowledge or expertise;
- Also in contrast to MI 45-108, MCSAN 45-316 does not require funding portals to conduct background checks on the issuer, or on the officers, directors and other key people associated with the issuer.

Proposed Multilateral Instrument 45-109 – Alberta and Nunavut Try Their Hand

Proposed 45-109 provides a prospectus distribution exemption for issuers but does not provide a registration exemption for funding portals. This regulation treats funding portals as dealers who need to register under the Canadian securities laws. In fact, since this regulation addresses the raising of capital by business startups through crowdfunding or through other means, one may argue that funding portals are not needed under Proposed 45-109. This is the primary distinction between Proposed 45-109 and its peers, MI 45-108 and MCSAN 45-316.

For an issuer to qualify for this exemption, it must have its head office in one of the Proposed Jurisdictions or in one of MCSAN Jurisdictions. As with MCSAN 45-316, publicly traded companies may not raise capital under Proposed 45-109.

Issuers who wish to offer securities under Proposed 45-109 must provide an offering document on Form 45-109F1 (the "Offering Form"). The information required on Offering Form is similar to what issuers provide under MCSAN 45-316 and MI 45-108 with the following significant differences:

- The Offering Form must include the type of securities offered and the rights, restrictions and conditions related to such securities (such as tag-along, drag-along or pre-emptive rights);
- The Offering Form must have a separate section listing the risk factors associated with the investment in order of importance (containing a description of each material risk and the factual basis for such risk); and
- The Offering Form must describe how the issuer expects to provide disclosure to investors in the future.

Issuers do not have to furnish a copy of their financial statements to investors, but any financial statements furnished must either be prepared in accordance with Canadian generally accepted accounting principles for public companies or Part II of the CPA Canada Handbook.

Proposed 45-109 differs from MI 45-108 and MCSAN 45-316 with respect to investment limits. An investor may not invest more than \$1,500 in a single offering made by an issuer that does not use a registered dealer, and may not invest more than \$3,000 in such issuer during any 12-month period. For issuers that use registered dealers, these numbers increase to \$5,000 in a single offering and up to \$10,000 during any 12-month period. The total limit that an issuer may raise under Proposed 45-109 is \$1,000,000; this lifetime cap distinguishes Proposed 45-109 from its peer regulations.

Proposed 45-109 requires the issuer to file a report of exempt distribution within 30 days after the closing of the offering. However, this report is to be provided on a different form (Form 45-109F3) than a similar report required by MI 45-108 (Form 45-106F1).

What is an Issuer or Funding Portal Supposed to Do?

The current crowdfunding legal landscape in Canada is bewildering. MI 45-108, MCSAN 45-316 and Proposed 45-109 create a patchwork quilt of not quite harmonious regulations. An issuer that wishes to make the right crowdfunding choice needs to have the clairvoyance to know how it will conduct its affairs during the offering and beyond. For example, an issuer that wishes to raise significant funds from affluent investors should consider relying upon MI 45-108 because it: (i) allows issuers to raise greater amounts from accredited investors and provides a higher total funding limit for each 12 month period than MCSAN 45-319, and (ii) does not subject issuers to a lifetime limit unlike Proposed 45-109. If an issuer does not wish to provide financial statements or other ongoing disclosure, it should consider either MCSAN 45-319 or Proposed 45-109. However, if the issuer's head office is located in Ontario, it may have no choice but to rely upon MI 45-108.

Funding portals also need to think carefully about their future when deciding which regulatory regime to follow. If a funding portal wants to avoid the expense of registration and of performing investigations, it should consider MCSAN 45-319, but it should recognize that it (i) is limiting its potential market by doing so, and (ii) may not be significantly lightening its regulatory burden by doing so. In contrast, Proposed 45-109 seems to be a nonstarter for funding portals since this regulation simply does not recognize them.

It is logical to think that crowdfunding regulations have not reached their final destination; MCSAN 45-319 admitted as much when it provided for a fixed termination date. One uniform set of rules is the logical outcome over the long term, because crowdfunding works best when it allows those who seek funding to reach a diverse and dispersed audience who can assess, analyze and invest in a proposed project. In a socially connected world, where distance and divisions melt in the marketplace of ideas, issuers should have other things to consider than how to navigate conflicting legal regimes.



Bill Kitay is a member of the Business Law Practice.

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Contact Members of our Business Law Practice:

Murray Box

mbox@pallettvalo.com • (905) 273.3022 ext. 240

Joe Conte

jconte@pallettvalo.com • (905) 273.3022 ext. 217

Murray Gottheil

gottheil@pallettvalo.com • (905) 273.3022 ext. 245

Annette Pereira

apereira@pallettvalo.com • (905) 273.3022 ext. 241

Maria Zawidzki

mzawidzki@pallettvalo.com • (905) 273.3022 ext. 224

Andréa Brinston

abrinston@pallettvalo.com (905) 273.3022 ext. 219

Olivia Gismondi

ogismondi@pallettvalo.com (905) 273.3022 ext. 209

Bill Kitay

bkitay@pallettvalo.com (905) 273.3022 ext. 291

David H. Shlagbaum

dshlagbaum@pallettvalo.com (905) 273.3022 ext. 264

PALLETT VALO LLP
Lawyers & Trade-Mark Agents

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77 City Centre Drive, West Tower, Suite 300, Mississauga, Ontario L5B 1M5 • 1.800.323.3781

Appendix “A”

