

CROWD-FUNDING OFFERS UNDER CANADIAN AND US SECURITIES REGULATION: WILL AN EXEMPTION WORK?

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The paper reviews securities regulatory requirements in Canada and the US that may be prohibitively costly for crowd-funding. The authors argue that a regulatory exemption for crowd-funding can, in theory, fit the basic cost-benefit concept behind other regulatory exemptions. Implementing the conceptual cost-benefit basis for crowd-funding exemption while addressing investor protection and administrative issues, however, poses numerous challenges involving trade-offs that are difficult to assess empirically. Restrictions intended to provide investor protection may render the exemption ineffective at addressing the start-up and small business fundraising objectives it is aimed at. At the same time a failure to provide adequate investor protection may have damaging repercussions for the crowd-funding exemption itself and perhaps for other investments.

Cet article passe en revue certaines exigences réglementaires en matière de valeurs mobilières, au Canada et aux États-Unis, qui pourraient s'avérer trop coûteuses aux fins du financement collectif. Les auteurs soutiennent qu'une exemption spécifique de la réglementation visant le financement collectif peut, théoriquement, correspondre au concept fondamental des coûts par rapport aux avantages que sous-tendent d'autres exemptions réglementaires. Cette mise en œuvre de la théorie des coûts par rapport aux avantages aux fins d'une exemption du financement collectif bien qu'elle assure la protection des investisseurs et règle les questions administratives, présente toutefois de nombreux défis entraînant des compromis difficiles à évaluer de façon empirique. Les restrictions ayant pour objet de protéger les investisseurs pourraient sonner le glas de l'efficacité de l'exemption par rapport aux objectifs mêmes de financement des entreprises en démarrage et des petites entreprises qu'elle vise. Parallèlement, le fait de ne pas offrir cette protection aux investisseurs pourrait avoir des conséquences préjudiciables sur l'exemption visant le financement collectif et peut-être également sur d'autres investissements.

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** JD 2015, University of Victoria. The authors wish to thank Dentons Canada LLP for providing research funding for this paper through the UVic First Year Fellowship in Business Law.

1. Introduction

In June of 2012 an Ontario man raised over \$700,000 in a four-day Internet campaign for a woman in New York who had been bullied by young boys on a school bus.¹ This sort of charity fundraising campaign has come to be known as “donation crowd-funding.”² Its popularity has grown and numerous Internet platforms have been created to facilitate it.³

If substantial amounts can be raised in a short time for charity from numerous small donations, it is not surprising that some entrepreneurs would be tempted to use a similar Internet campaign to raise funds by seeking small investments from many investors.⁴ Where this is done with a promise of return on investment it is referred to as “investment crowd-funding.”⁵ Securities laws would, however, require a prospectus unless it is an exempt transaction.⁶ Raising funds by way of broad appeals to the public is also normally done through persons licenced in accordance with securities laws.⁷

¹ The Ontario man was Max Sidorov. A spokeswoman for the fundraising site Indiegogo said more than 30,000 people from all over the world contributed, with donations coming in from at least 84 countries and all 50 states. See “Online fund for bullied elderly bus monitor raises \$700K”, *CBC News* (21 July 2012) online: CBC News <<http://www.cbc.ca/news/canada/toronto/story/2012/07/21/toronto-bullied-bus-monitor.html>>; “Toronto man raises funds for bullied elderly woman” *Herald News* (22 June 2012): <<http://thechronicleherald.ca/canada/109764-video-toronto-man-raises-funds-for-bullied-elderly-woman>>).

² For a summary of different types of crowd-funding see C Steven Bradford, “Crowdfunding and the Federal Securities Laws” (2012) *Colum Bus L Rev* 1 at 14-27, with donation crowd-funding discussed at 15-16.

³ See e.g. IndieGoGo.com; Kickstarter.co, RocketHub and ignitiondeck.com.

⁴ An interesting example of this occurred in Australia where crowd-funding was used to raise funds to make a Lego car powered by air. The Australian entrepreneur “wanted to show what is possible when you crowd-fund an idea and use young talented people.” He sent out a tweet that read, “Anyone interested in investing \$500 - 1,000 in a project which is awesome and a world first tweet me. Need about 20 participants.” See “Crowd-funded Lego car powered by air”, online: BBC Technology News 19 December 2013, <http://www.bbc.co.uk/news/technology-25446912>.

⁵ See Bradford, *supra* note 2 at 20-26, discussing both lending and equity crowd-funding. Crowd-funding has also been done as reward-based crowd-funding where the funder gets something in return for the investment, such as the product produced from the funds, or the opportunity to buy the product produced from the funds at a low price, instead of getting interest on investment or participation in the equity of the investment; see Bradford, *ibid* at 16-20.

⁶ See Part 2, below.

⁷ See Part 2, below.

Crowd-funding using the Internet is relatively new, but raising funds in small amounts from many persons, whether for charitable purposes or otherwise, by mail, telephone, newspaper, radio, television or some other means of broad-based communication has, of course, been done for a long time.⁸ Indeed, the idea of using the Internet to access potential investors has been around since the mid-1990s.⁹ Using the Internet for crowd-funding is likely to be more cost-effective than other means of broad-based communication, particularly where crowd-funding is being used by small businesses seeking to raise relatively small total amounts of investment funds.¹⁰

There has also long been a concern that the cost of complying with securities regulatory requirements can be prohibitively expensive for a small business.¹¹ This limits the financing alternatives for small businesses putting

⁸ For instance, the US *Securities Act of 1933*, 15 USC §77a(1), provided when it was enacted in 1933 that it is unlawful for any person “to make use of any means or instruments of transportation or *communication* in interstate commerce *or of the mails* to sell [a] security” unless a registration statement is in effect.

⁹ For Canada see e.g. Gavin Sinclair, “Internet Direct Public Offerings: New Opportunities for Small Business Capital Finance” (1999-2000) 27 Man LJ 297. For the US see e.g. Daniel M Weisenfeld, “IPOs on the Internet: The Need for the Next Step” (1999-2000) 22 Hastings Comm & Ent LJ 529 at 534-6; Bernard S Black, “Information Asymmetry, the Internet, and Securities Offerings” (1998) 2 J Small and Emerging Bus L 91; Holly Fontana, “Securities on the Internet: World Wide Opportunity or Web of Deceit” (1997-1998) 29 U Miami Inter-Am L Rev 297; Stephen Knute Gregg, “Regulation A Initial Public Offerings on the Internet: A New Opportunity for Small Business?” (1997) 1 J Small and Emerging Bus L 417; Robert K Bertram, “Advanced Technology Issues – The Internet, and State Securities Regulation – A Primer” (1996) 67(3) Pa Bar Assoc Q 133; and Michael D Stovsky, “The Dasnaq – Private Securities Offerings on the Internet” (1996) 68(1) Clev Bar J 46-49.

¹⁰ Some form of broad-based communication is likely to be required for crowd-funding since it involves seeking a large number of small investments. In many cases it is likely to result in investments by only a very small percentage of the persons who receive the communication so a broad-based form of communication will be needed to access a very large number of persons. Mail will involve significant postage costs, telephone campaigns will involve high labour costs in making the calls, and radio, newspaper and television time or space can also be expensive.

¹¹ In Canada see e.g. Jeffrey G MacIntosh, *Legal and Institutional Barriers to Financing Innovative Enterprise in Canada* (Government and Competitiveness School of Policy Studies, Queen’s University, Study 94-10, 1994); and the Ontario Securities Commission Task Force on Small Business Financing, *Final Report* (Toronto: Queen’s Printer for Ontario, 1996) (available in (1996) 19 OSCB 5757). For the US see e.g. Max Jarman, “Scarcity of Funding Blamed on Regulation, Consolidation” (16 February 1995) Arizona Bus Gazette 16; Allen N Berger and Gregory F Udell, “The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle” (1998) 22 J Banking & Finance 613; Stephen J Choi, “Gatekeepers and the

them potentially at a disadvantage to larger competitors.¹² Crowd-funding may be seen as one way of easing this burden for small businesses but, as noted above, securities regulation imposes constraints on crowd-funding.¹³ The *Crowdfund Act*, enacted in the US as part III of the *JOBS Act* in April of 2012,¹⁴ responds to these constraints by providing an exemption from federal securities law requirements for crowd-funding if certain conditions are met.¹⁵ In March of 2014 the Ontario Securities Commission (OSC) also responded to these constraints by proposing a crowd-funding exemption.¹⁶

This article argues that an exemption for crowd-funding fits the basic cost-benefit concept behind other securities regulatory exemptions. It reviews the regulatory requirements that, without an exemption, would impose what are likely, in most circumstances, to be prohibitive constraints on crowd-funding. The regulatory requirements highlight a number of issues that need to be addressed in creating a crowd-funding exemption that retains a degree of investor protection consistent with the current securities regulatory regime. In addressing these concerns securities administrators will need to be careful that the costs of qualifying for a crowd-funding exemption do not defeat the primary small business finance objective of a crowd-funding exemption.

Part 2 identifies securities regulatory requirements that would constrain

Internet: Rethinking the Regulation of Small Business Capital Formation” (1998) 2 J Small and Emerging Bus L 27. Evidence of the proportionately high cost of financing for smaller issuers in the US was provided in e.g. Susan M Phillips and J Richard Zecher, *The SEC and the Public Interest* (Cambridge: MIT Press, 1981) at 42-51. Earlier evidence was presented in George J Benston, “The Effectiveness and Effects of the SEC’s Accounting Disclosure Requirements,” in Henry G Manne, ed, *Economic Policy and the Regulation of Corporate Securities* (Washington: American Enterprise Institute for Public Policy, 1969), at 60-65.

¹² It has been argued that securities regulation may have allowed larger issuers to gain at the expense of smaller issuers since costs of disclosure for smaller issuers tend to be a larger percentage of the amount of funds raised than for larger issuers. See e.g. DJ Schulte, “The Debatable Case for Securities Disclosure Regulation” (1988) J Corp L 535 at 536; Nicholas Wolfson, “A Critique of the Securities and Exchange Commission” (1981) Emory LJ 119 at 149-56.

¹³ See e.g. Edan Burkett, “A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation” (2011) 13 Transactions: Tenn J Bus L 63 at 63; Bradford, *supra* note 2 at 5.

¹⁴ *Jumpstart Our Business Startups Act (JOBS Act)*, Pub L No 112-106, 126 Stat 306 (2012).

¹⁵ See the discussion in Part 5, below.

¹⁶ See “Introduction of Proposed Prospectus Exemptions and Proposed Reports of Exempt Distribution in Ontario” (2014) 37 OSCB (Supp 3) at 26-27 and D-1 to D-27.

crowd funding in in Canada and the United States. Part 3 discusses the cost-benefit basis for exemptions and makes a cost-benefit argument in favour of a crowd-finding exemption. Part 4 discusses several issues that would have to be addressed in designing a crowd-funding exemption. With this background in mind, Parts 5 and 6 examine the US federal *Crowdfund Act* and the proposal for a crowd-funding exemption in Canada. Part 7 provides several comments and Part 8 concludes that while there is a conceptual basis for a crowd-funding exemption consistent with existing exemptions, investor protection requirements likely to be imposed as conditions for relying on such an exemption will make it a largely ineffective means of promoting small business finance.

2. *Securities Law Constraints on Crowd-Funding*

A key objective of securities regulation is the protection of investors.¹⁷ One of the key methods of protecting investors is to disclose information to investors. Information about an investment is disclosed to investors before they invest followed by ongoing disclosure after they invest.¹⁸ Another key method of protecting investors is the registration of persons

¹⁷ The International Organization of Securities Commissions (IOSCO) lists three core objectives of securities regulation: (1) the protection of investors; (2) ensuring markets are fair, efficient and transparent; and (3) the reduction of systemic risk. See International Organization of Securities Commissions (IOSCO), *Objectives and Principles of Securities Regulation* May 2003 at 5-7, online: <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>>, accessed 25 June 2014 at para. 4.1. See also *Report of the Attorney General's Committee on Securities Legislation in Ontario* (Toronto: Queen's Printer, March 1965) at para 1.06.

¹⁸ This is discussed with respect to both Canada and the US in subparts A) and B) below.

¹⁹ An underwriter provides services in the distribution of securities. It assists an issuer of securities in finding buyers for the securities. It may do so by buying the securities from the issuer and selling them to investors or by acting as agent for the issuer entering into agreements with investors on behalf of the issuer or by otherwise participating in the distribution of securities to investors. An "underwriter" is defined in the Ontario *Securities Act*, RSO 1990, c S.5 (*OSA*), s 1(1) as "a person or company who, as principal, agrees to purchase securities with a view to distribution or who, as agent, offers for sale or sells securities in connection with a distribution and includes a person or company who has a direct or indirect participation in any such distribution ...". Similar definitions are provided in other provincial securities acts. See e.g. *Securities Act*, RSA 2000, c S-4 (*ASA*"), s 1(kkk); *Securities Act*, RSBC 1996, c 418 (*BCSA*), s 1(1); *The Securities Act*, CCSM 1988, c S50 (*MSA*), s 1(1); *Securities Act*, SNB 2004, c S-5.5 (*NBSA*), s 1(1); *Securities Act*, RSNL 1990, c S-13 (*NLSA*), s 2(1)(tt); *Securities Act*, SNWT 2008, c 10 (*NWTA*), s 1(1); *Securities Act*, RSNS 1989, c 418 (*NSSA*), s 2(1)(at); *Securities Act*, SNU 2008, c 12 (*NuSA*), s 1(1); *Securities Act*, RSPEI 1988, c S-31 (*PEISA*), s 1(iii); *The Securities Act*, SS 1988, c S-42.2 (*SSA*), s 2(1)(ww); *Securities Act*, RSY 2007, c 16 (*YSA*), s 1(1). The Quebec *Securities Act*, RSQ, c V-1.1 (*QSA*) does not

who provide securities industry services such as underwriters,¹⁹ securities dealers,²⁰ securities brokers,²¹ and investment advisors.²² This regulation of securities industry service providers is directed at assuring their proficiency, integrity and solvency²³ as well as assuring that trades are properly made and that agreed upon delivery of securities in exchange for agreed upon consideration will occur with virtual certainty.²⁴ The purpose of this Part is to briefly describe the Canadian provincial securities regulatory regime and the federal securities regulatory regime in the United States as it relates to these aspects of investor protection in relation to crowd-funding. The significant and potentially prohibitive cost of these requirements is noted as is the available, but arguably inadequate, exemptions from these requirements. The review of these securities regulatory constraints on crowd funding highlight not only the regulatory requirements from which an exemption needs to be provided to facilitate crowd funding, but also other issues that need to be addressed to maintain investor protection.

define the term “underwriter” but it defines a “dealer” in s 5 to include “a person engaging in or holding himself out as engaging in the business of ... (2) distributing a security for their own account or for another’s account.”

²⁰ A securities dealer is a person or securities firm that trades in securities on his, her, or its own behalf. A “dealer” is defined in the *OSA*, *ibid*, s 1(1) as “a person or company engaging in or holding himself, herself or itself out as engaging in the business of trading in securities as principal or agent.” Similar definitions are provided in other provincial securities acts. See *ASA*, s 1(m); *BCSA*, s 1(1); *NBSA*, s 1(1); *NLSA*, s 2(1)(i); *NWTSa*, s 1(1); *NuSA*, s 1(1); *NSSA*, s 2(1)(i); *PEISA*, s 1(f); *QSA*, s 5; *SSA*, s 2(1)(n); *YSA*, s 1(1), all *ibid*. In *MSA*, *ibid*, s 1(1) “dealer” is defined as “a person or company that is registered or required to be registered under this Act in one or more of the categories of dealer prescribed in the regulations.” National Instrument (NI) 31-101, “Registration Requirements, Exemptions and Ongoing Registrant Obligations,” para 7.1 identifies five categories of dealer.

²¹ A securities broker is a person who arranges transactions between a buyer and seller of securities. Securities acts in Canada do not separately define securities brokers but instead include the concept of securities brokerage within the term “dealer,” see legislation cited *supra* note 19.

²² An “adviser” is defined in the *OSA*, *ibid*, s 1(1) as “a person or company engaging in or holding himself, herself or itself out as engaging in the business of advising others as to the investing in or the buying or selling of securities.” Similar definitions are provided in other provincial securities acts; see *ASA*, s 1(a); *BCSA*, s 1(1); *MSA*, s 1(1); *NBSA*, s 1(1); *NLSA*, s 2(1)(a) and (a.1); *NWTSa*, s 1(1); *NSSA*, s 2(1)(a); *NuSA*, s 1(1); *PEISA*, s 1(a); *QSA*, s 5; *SSA*, s 2(1)(a.1); and *YSA*, s 1(1), all *ibid*.

²³ See Companion Policy 31-103 to National Instrument 31-103 of the Canadian Securities Administrators, “Registration Requirements, Exemptions and Ongoing Registrant Obligations” available on the BC Securities Commission website, online: https://www.bccsc.bc.ca/Securities_Law/Policies/Policy3/Group/?group=31%20103.

²⁴ See e.g. *Objectives and Principles of Securities Regulation*, *supra* note 17 at paras 4.2.3 and 12.2.

A) Canadian Provincial Securities Regulatory Constraints

1) The Prospectus Requirement

Securities market regulation in Canada is primarily provincial and the primary provincial legislation governing securities markets is provincial securities acts.²⁵ The discussion below focuses on the Ontario *Securities Act* (OSA). The footnotes provide references to roughly corresponding provisions in the securities legislation of other provinces.²⁶

Section 53(1) of the OSA²⁷ provides:

No person or company shall trade in a security on his, her or its own account or on behalf of any other person or company if the trade would be a distribution of the security, unless a preliminary prospectus and a prospectus have been filed and receipts have been issued for them by the Director.

The section requires a person or company to file a preliminary prospectus and a prospectus if the person or company (1) “trades;” (2) in a “security;” and (3) the trade would be a “distribution.” The terms “trade,” “security” and “distribution” are defined in the legislation. Other provincial securities acts have a similar provision with the same elements of “trade,” “security” and “distribution.”²⁸

²⁵ The provincial power to regulate securities markets has been upheld under the provincial power to enact legislation dealing “property and civil rights in the province” under s 92(13) of the *Constitution Act, 1982* enacted as Schedule B to the *Canada Act 1982*, (UK) 1982, c 11. See the discussion of the provincial property and civil rights power in Peter W Hogg, *Constitutional Law of Canada*, 5th ed Supplemented (Toronto: Carswell, 2007) loose-leaf, ch 21. While federal securities regulation may be possible under various heads of federal power, in *Reference re Securities Act (Canada)*, 2011 SCC 66, [2011] 3 SCR 837, the Supreme Court of Canada held that a particular proposed piece of comprehensive federal securities legislation would not be valid under the federal trade and commerce power in s 91(2) of the *Constitution Act, 1982*.

²⁶ Cites to the legislation of the various jurisdictions and abbreviations for the legislation are provided *supra* note 19.

²⁷ RSO 1990, c S.5.

²⁸ *ASA*, s 110; *BCSA*, s 61 (as amended SBC 1999, c 20, s 15); *MSA*, s 37 (as amended SM 2007, c 12, s 3(f)) (referring to a “primary distribution to the public”); *NBSA*, s 71; *NLSA*, s 54 (as amended SNL 2004, c 37, s 44(1)); *NWTSa*, s 94; *NSSA*, s 58 (as amended SNS 1990, c 15, s 80 and SNS 2006, c 46, s 23); *NuSA*, s 94; *PEISA*, s 94; *QSA*, s 11; *SSA*, s 58; and *YSA*, s 94; all cited *supra* note 19.

a) When does the Prospectus Requirement Apply?

The word “security” is defined in section 1(1) to include common types of securities such as shares and debentures.²⁹ Many persons seeking investment funds have attempted to avoid the prospectus requirement by raising funds in some other way that does not involve the sale of shares or debentures.³⁰ The definition of “security,” however, includes an “investment contract.”³¹ “Investment contract” is not defined in the legislation, but it has been defined judicially as:³²

²⁹ See the definition of “security” in *ASA*, s 1(ggg)(v); *BCSA*, s 1(1) (d); *MSA*, s 1(1) (e); *NBSA*, s 1(1) (e); *NLSA*, s 2(1)(qq)(v); *NWTSa*, s 1(1) (a), (d); *NSSA*, s 2(1)(aq)(v); *NuSA*, s 1(1) (a), (d); *PEISA*, s 1(bbb)(i), (iv); *QSA*, s 1(1); *SSA*, s 2(1)(ss)(v); *YSA*, s 1(1) (a), (d); all *ibid*.

³⁰ Thomas Lee Hazen has captured this with the following statement based on court decisions in the United States:

What do the following have in common: scotch whisky, self-improvement courses, cosmetics, earthworms, beavers, muskrats, rabbits, chinchillas, animal breeding programs, cattle embryos, fishing boats, vacuum cleaners, cemetery lots, coin operated telephones, master recording contracts, pooled litigation funds, and fruit trees? The answer is that they have all been held to be securities within the meaning of federal or state securities statutes.

See Thomas Lee Hazen, *Treatise on the Law of Securities Regulation*, 6th ed (St Paul, Minn: Thomson Reuters, 2009) vol 1 at 84-6 [Hazen, *Treatise*]. *Ontario (Securities Commission) v Brigadoon Scotch Distributors (Canada) Ltd* (1970), 3 OR 714 (HCJ) is a Canadian case that involved receipts for kegs of scotch whisky that were found to be a “security.” Percentage interests in prospecting or drilling rights were also found to be “securities” in *R v Dalley*, [1957] OWN 123 (CA).

³¹ *OSA*, s 1(1) “security” (n). See also *ASA*, s 1(ggg)(xiv); *BCSA*, s 1(1) “security” (l); *MSA*, s 1(1) “security” (m); *NBSA*, s 1(1) “security” (n); *NLSA*, s 2(1)(qq)(xiv); *NWTSa*, s 1(1) “security” (k); *NSSA*, s 2(1)(aq)(xiv); *NuSA*, s 1(1) “security” (k); *PEISA*, s 1(bbb)(xi); *QSA*, s 1(7); *SSA*, s 2(1)(ss)(xiv); *YSA*, s 1(1) “security” (k); all cited *supra* note 19.

³² This test is known as the Howey-Forman test based on the US case of *SEC v Howey*, 328 U.S. 293 (USSC, 1945) [Howey] as modified by *United Housing Foundation Inc v Forman*, 421 US 837 (1975) [Forman] and by *SEC v Glen T Turner Enterprises Inc*, 474 F 2d 476 (USSC, 1973) [Glen Turner Enterprises]. This test was adopted by the Supreme Court of Canada in *Pacific Coast Coin Exchange of Canada v Ontario (Securities Commission)*, [1978] 2 SCR 112 at 126-29 [Pacific Coast Coin Exchange]. In *Pacific Coast Coin Exchange* at 131, the Court also adopted the test from *State of Hawaii v Hawaii Market Center, Inc*, 485 P 2d 105 (US Hawaii, 1971) (the “Hawaii test” or “risk capital test”). The Hawaii test requires that: (1) the offeree furnish initial value; (2) a portion of the initial value is subjected to risks of the enterprise; (3) the furnishing of initial value is induced by promises or representations leading to a reasonable expectation or understanding that a benefit above initial value will accrue; and (4) the offeree does not have the right to exercise practical and actual control over the managerial decisions of the enterprise.

- (1) a transaction or scheme whereby a person invests;³³
- (ii) in a common enterprise;³⁴ and
- (iii) the person is led to expect profit or gain³⁵ that comes from the undeniably significant efforts³⁶ of a promoter or third party.

If a person or company asks other persons to provide funds not as a gift but with the expectation of getting back the funds plus something more it is likely to be considered an “investment contract” and therefore a “security.”

³³ See e.g. Dictionary.com which defines “invest” as meaning “to put (money) to use, by purchase or expenditure, in something offering potential profitable returns, as interest, income, or appreciation in value.” *The Oxford Paperback English Dictionary*, 4th ed (Oxford: Oxford University Press, 1994) says that “invest,” as a verb, means to “use (money) to buy stocks, shares, or property in order to earn interest or bring profit for the buyer.” The ninth definition of “invest” given in *The Oxford English Dictionary*, 2d ed (Oxford: Oxford University Press, 1989) is “to employ (money) in the purchase of anything from which interest or profit is expected; now, esp. in the purchase of property, stocks, shares, etc., in order to hold these for the sake of interest, dividends, or profits accruing from them.” *Black’s Law Dictionary*, 9th ed (St Paul, Minn: West Group, 2009) says that “invest,” as a verb, means “to apply (money) for profit” or “to make an outlay of money for profit.” The key feature in each of these definitions for the purpose of the Howey-Forman test is that there is an expected return in some form over and above the amount of money or property put in.

³⁴ Courts in the US have come to different views on whether the common enterprise element needs to involve “horizontal commonality” (i.e. common among the investors) or can be satisfied with just “vertical commonality” (i.e. common between an investor and the promoter). See the discussion in Hazen, *Treatise*, *supra* note 30, vol. 1 at 97-101; and Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation*, 4th ed (New York: Aspen Law and Business, 2001) at 220-23. The majority decision in *Pacific Coast Coin Exchange*, *supra* note 32 at 131 said:

In my view, the test of common enterprise is met in the case at bar. I accept respondent’s submission that such an enterprise exists when it is undertaken for the benefit of the supplier of capital (the investor) and those who solicit (the promoter). In this relationship, the investor’s role is limited to the advancement of money, the managerial control over the success of the enterprise being that of the promoter; therein lies the community. In other words, the “commonality” necessary for an investment contract is that between the investor and the promoter. There is no need for the enterprise to be common to the investors between themselves.

³⁵ The *Forman* case, *supra* note 32, held that the reference to “profit” in the *Howey* case, *supra* note 32, included a gain in the form of an appreciation in value of the investment.

³⁶ The third part of the test set out in the *Howey* case, *ibid*, said “that the person is led to expect profits *solely* from the efforts of a promoter or third party” [emphasis added]. This was modified in the *Glen Turner Enterprises* case, *supra* note 32, replacing the word “solely” with the words “undeniably significant.” This modification was approved by the Supreme Court of Canada in *Pacific Coast Coin Exchange*, *supra* note 32 at 129.

The word “trade” is also defined and, in particular, it includes “(a) any sale or disposition of a security for valuable consideration ...”³⁷ The “security” will consist of the rights the investor has, such as voting rights or a right to dividends or interest payments. The rights are being provided to the investor in return for the payment by the investor (the “consideration”) so the fund-raising transaction is likely to involve a “trade.” After listing a few other situations that involve a trade, the definition adds that a “trade” includes “(e) any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of the foregoing.”³⁸ Consequently, an Internet request for funds could be a trade in a security even if no sales of the securities are ever made.

The word “distribution” is defined to include “a trade in securities of an issuer that have not been previously issued.”³⁹ As noted above, a “security” will consist of rights given to an investor, such as a right to receive a return on investment, and a security will be “issued” when those rights are conferred upon an investor for the first time. The “issuer” is the person who grants such rights.⁴⁰ The initial conferring of one or more such rights to the investor in exchange for money, or other property, provided

³⁷ This is so “whether the terms of payment be on margin, instalment or otherwise,” see *OSA*, s 1(1) “trade” (a), *supra* note 19. See also *ASA*, s 1(jjj)(i); *BCSA*, s 1(1) “trade” (a); *MSA*, s 1(1) “trade” (a); *NBSA*, s 1(1) “trade” (a); *NLSA*, s 2(1)(ss)(i); *NWTSa*, s 1(1) “trade” (a); *NSSA*, s 2(1)(as)(i); *NuSA*, s 1(1) “trade” (a); *PEISA*, s 1(hhh)(i); *SSA*, s 2(1)(vv)(i); *YSA*, s 1(1) “trade” (a); all cited *supra* note 19. The *QSA*, *supra* note 19, does not define the term “trade” but would apply in a similar way given the use of the word “distribution” in the prospectus requirement in s 11 and the definition of “distribution” in s 5 to include “(1) the endeavour to obtain, or the obtaining, by an issuer, of subscribers or acquirers of his securities; (2) the endeavour to obtain, or the obtaining, by a firm underwriter, of purchasers for securities he has underwritten.”

³⁸ See *OSA*, s 1(1) “trade” (e), *supra* note 19. See also *ASA*, s 1(jjj)(vi); *BCSA*, s 1(1) “trade” (f); *MSA*, s 1(1) “trade” (d); *NBSA*, s 1(1) “trade” (h); *NLSA*, s 2(1)(ss)(v); *NWTSa*, s 1(1) “trade” (f); *NSSA*, s 2(1)(as)(v); *NuSA*, s 1(1) “trade” (f); *PEISA*, s 1(hhh)(vi); *SSA*, s 2(1)(vv)(v); *YSA*, s 1(1) “trade” (f); all cited *supra* note 19. For the *QSA*, see *supra* note 37.

³⁹ See *OSA*, *ibid*, s 1(1) “distribution” (a). See also *ASA*, s 1(p)(i); *BCSA*, s 1(1) “distribution” (a); *MSA*, s 1(1) (“primary distribution to the public”); *NBSA*, s 1(1) “distribution” (a); *NLSA*, s 2(1)(l)(i); *NWTSa*, s 1(1) “distribution” (a); *NSSA*, s 2(1)(l)(i); *NuSA*, s 1(1) “distribution” (a); *PEISA*, s 1(k)(i); *SSA*, s 2(1)(r)(i); *YSA*, s 1(1) “distribution” (a); all *ibid*. For the *QSA*, see *supra* note 37.

⁴⁰ “Issuer” is defined in s 1(1) of the *OSA*, *ibid*, as “a person or company who has outstanding, issues or proposes to issue, a security.” There are similar provisions in other provincial securities acts. See e.g. *ASA*, s 1(cc); *BCSA*, s 1(1); *MSA*, s 1(1); *NBSA*, s 1(1); *NLSA*, s 2(1)(t); *NWTSa*, s 1(1); *NSSA*, s 2(1)(s); *NuSA*, s 1(1); *PEISA*, s 1(dd); *QSA*, s 5; *SSA*, s 2(1)(x); *YSA*, s 1(1); all *ibid*. The definitions of “issue” from the *Oxford English Dictionary*, 2d ed (Oxford: Oxford University Press, 1989) vol VIII that are likely to be relevant are “8a. That which proceeds from any source; the outcome or product of any

by the investor will therefore involve “a trade in securities of an issuer that have not been previously issued” and will therefore be a distribution.

A person seeking investment funds through crowd-funding will, therefore, have to file a preliminary prospectus and prospectus and obtain receipts for them before the funds can be raised since such a campaign would satisfy all the elements of section 53(1) of the Ontario *Securities Act* and corresponding provisions in other provincial securities acts.⁴¹ The process involves filing a preliminary prospectus that is in the required form and complies with the requirements of the regulations passed pursuant to the *Securities Act*.⁴² The Securities Commission will issue a receipt for the preliminary prospectus if it is in compliance with the form and the regulations. After issuing the receipt for the preliminary prospectus the Commission will examine the preliminary prospectus more closely to identify possible disclosure gaps. When this examination of the preliminary prospectus is complete the Commission will notify the issuer of any concerns it has with disclosure. Once these concerns are addressed to the satisfaction of the Commission the prospectus, in its final form (often referred to as the “final prospectus”), can be filed. A receipt for the final prospectus will normally be issued within a couple of days of the filing of the final prospectus. The raising of the investment funds (or “sales of” or “trades in” securities) can only begin, according to section 53(1), when a receipt for the prospectus (that is, the final prospectus) has been issued.⁴³

b) Prospectus Contents

The prospectus must provide disclosure concerning several specified matters such as the number and types of securities offered, the method of distributing the securities, the expected proceeds of the issue and what they will be used for, the rights associated with the securities offered, a description of the business and its development over the previous three years, the names and occupations of directors⁴⁴ and officers, ownership by

practice or condition” and “15a. The action of sending or giving out officially or publicly; an emission of ... bonds, shares, ..., etc.”

⁴¹ See *supra* notes 27 and 28.

⁴² See NI 41-101 (“General Prospectus Requirements”) and Form 41-101F1 (“Information Required in a Prospectus”).

⁴³ The prospectus clearance process is described in David Johnston and Kathleen Doyle Rockwell, *Canadian Securities Regulation*, 4th ed (Toronto: LexisNexis Canada, 2006) at 156-59; see also Mark R Gillen, *Securities Regulation in Canada*, 3d ed (Toronto: Carswell, 2007) at 136-45.

⁴⁴ *OSA*, *supra* note 19, s 1(1) defines “director” to include “an individual performing a similar function or occupying a similar position for any person.” See also *ASA*, s 1(o); *BCSA*, s 1(1); *MSA*, s 1(1); *NBSA*, s 1(1); *NLSA*, s 2(1)(k); *NWTSa*, s 1(1);

directors and officers of securities of the issuer, and factors that make the purchase of the securities a risk or speculation. In addition to the listed specific matters the prospectus must include “full, true and plain disclosure of all material facts.”⁴⁵

c) Prospectus Liability and Cost

A failure to provide the prospectus or to provide the required disclosure in a prospectus, including all the disclosure required to provide “full, true and plain disclosure of all material facts,” is subject to penal, administrative and civil sanctions. The penal sanction includes a fine and, for individuals, can include imprisonment.⁴⁶ It can apply not just to the issuer but to directors or officers who authorize, permit or acquiesce in the failure to provide required disclosure.⁴⁷ The securities commission has authority to make a wide range of orders “if in its opinion it is in the public interest” to do so.⁴⁸ These include an order to cease trading in securities⁴⁹ or to pay an administrative penalty of up to \$1 million.⁵⁰

NSSA, s 2(1)(k); *NuSA*, s 1(1); *PEISA*, s 1(j); *QSA*, s 5; *SSA*, s 2(1)(q); *YSA*, s 1(1); all cited *supra* note 19.

⁴⁵ *OSA*, *ibid*, s 56. See also *ASA*, s 113; *BCSA*, s 63; *MSA*, s 41; *NBSA*, s 74; *NLSA*, s 57; *NWTSa*, s 99; *NSSA*, s 61; *NuSA*, s 99; *PEISA*, s 99; *SSA*, s 61; *YSA*, s 99; all *ibid*. See also item 29 in Form 41-101F1. A “material fact” is defined in *OSA*, *ibid*, s 1(1) as “a fact that would reasonably be expected to have a significant effect on the market price or value of the securities.” See also *ASA*, s 1(gg); *BCSA*, s 1(1); *NBSA*, s 1(1); *NLSA*, s 2(1)(x); *NWTSa*, s 1(1); *NSSA*, s 2(1)(w); *NuSA*, s 1(1); *PEISA*, s 1(gg); *QSA*, s 5; *SSA*, s 2(1)(z); *YSA*, s 1(1) “material fact;” all *ibid*.

⁴⁶ *OSA*, *ibid*, s 122(1)(c). The penalty is a fine of up to \$5 million or to imprisonment for a term of up to five years. Other provinces and territories have similar penalties although the maximum fine and term of imprisonment varies from jurisdiction to jurisdiction. See *ASA*, s 194(1); *BCSA*, s 155(1) and (2); *MSA*, s 136(1); *NBSA*, s 179(2); *NLSA*, s 122(1); *NWTSa*, s 164; *NSSA*, s 129(1); *NuSA*, s 164; *PEISA*, s 164(1); *QSA*, ss 195(3), 204.1, and 208.2; *SSA*, s 131(2); *YSA*, s 164; all *ibid*.

⁴⁷ *OSA*, *ibid*, s 122(3). See also *ASA*, s 194(3); *BCSA*, s 155(4); *MSA*, s 136(3); *NLSA*, s 122(4); *NSSA*, s 129(3); *NWTSa*, s 164(2); *NuSA*, s 164(2); *PEISA*, s 164(2); *QSA*, s 205; *SSA*, s 131(3); *YSA*, s 164((2); all *ibid*.

⁴⁸ *OSA*, *ibid*, s 127. See also *ASA*, s 198; *BCSA*, s 161; *MSA*, ss 148, 148.2 and 148.3; *NBSA*, s 184; *NLSA*, s 127; *NWTSa*, s 60; *NSSA*, s 134; *NuSA*, s 60; *PEISA*, s 60; *SSA*, s 134(1); *YSA*, s 60; all *ibid*. Corresponding powers can be found in *QSA*, *ibid*, s 262.1, 264, and 265.

⁴⁹ *OSA*, *ibid*, s 127(1) 2. See also *ASA*, s 198(a) and (b); *BCSA*, s 161(1)(b); *MSA*, s 148; *NBSA*, s 184(1)(c); *NLSA*, s 127; *NWTSa*, s 60(1)(c); *NSSA*, s 134(1)(b); *NuSA*, s 60(1)(c); *PEISA*, s 59; *QSA*, s 265; *SSA*, s 134(1)(b) and (d); *YSA*, s 60(1)(c); all *ibid*.

⁵⁰ *OSA*, *ibid*, s 127(1) 9. See also *ASA*, s 199; *BCSA*, s 162; *MSA*, s 148.1; *NBSA*, s 186 (\$750,000); *NLSA*, s 127.1; *NWTSa*, s 60(1)(m); *NSSA*, s 135; *NuSA*, s 60(1)(m); *PEISA*, s 60(m); *QSA*, s 273.1 (up to \$2 million); *SSA*, s 135.1; *YSA*, s 60(1)(m); all *ibid*.

There are civil sanctions that allow persons who have invested to sue for rescission or damages. An investor can sue for rescission where there has been a failure to file a prospectus with the securities regulator or to deliver a copy of the prospectus to the investor.⁵¹ An investor can also sue for rescission or damages where there is a misrepresentation in a prospectus.⁵² A remedy of rescission or damages is available against the issuer of the securities or the underwriter.⁵³ A remedy of damages is available against the directors⁵⁴ and certain officers⁵⁵ of the issuer as well as against experts, such as accountants, whose opinion or report is provided in the prospectus.⁵⁶

Directors and officers will not be liable for a misrepresentation in a prospectus if they can show they have conducted a reasonable investigation to provide reasonable grounds for a belief that the prospectus did not contain a misrepresentation.⁵⁷ Accountants who provide an opinion

⁵¹ In Ontario it has been held that the sale of securities made without filing a prospectus as required is void (or voidable) entitling the investor to rescission; see e.g. *Jones v FH Deacon Hodgson Inc* (1986), 31 DLR (4th) 455 (Ont HC). A court in BC reached a different conclusion in *Ames v Investo-Plan Ltd*, [1973] 5 WWR 451; 35 DLR (3d) 613 (BCCA), reversing [1972] 3 WWR 443, 25 DLR (3d) 581 (BCSC).

⁵² *OSA*, *supra* note 19, s 130. See also *ASA*, s 203; *BCSA*, s 131; *MSA*, s 141; *NBSA*, s 149; *NLSA*, s 130; *NWTSa*, s 111; *NSSA*, s 137; *NuSA*, s 111; *PEISA*, s 111; *QSA*, ss 217, 218, and 219; *SSA*, s 137; *YSA*, s 111; all cited *supra* note 19.

⁵³ *OSA*, *ibid*, s 130(1). See also *ASA*, s 203(1), (2); *BCSA*, s 131(1), (3); *NBSA*, s 149(1), (2); *MSA*, s 141(1), (2); *NLSA*, s 130(1); *NWTSa*, s 111(1), (2); *NSSA*, s 137(1); *NuSA*, s 111(1), (2); *PEISA*, s 111(1); *QSA*, ss 217 and 218; *SSA*, s 137(2); *YSA*, s 111(1), (2); all *ibid*.

⁵⁴ *OSA*, *ibid*, s 130(1)(c). See also *ASA*, s 203(1)(c); *BCSA*, s 131(1)(b)(iii); *MSA*, s 141(1)(c); *NBSA*, s 149(1)(c); *NLSA*, s 130(1)(c); *NWTSa*, s 111(1)(c); *NSSA*, s 137(1)(c); *NuSA*, s 111(1)(c); *PEISA*, s 111(1)(c); *QSA*, s 218; *SSA*, s 137(1)(c); *YSA*, s 111(1)(c); all *ibid*.

⁵⁵ Under *OSA*, *ibid*, s 130(1)(e) persons liable for damages under the statutory civil liability provision include “every person ... who signed the prospectus or the amendment to the prospectus.” See also *ASA*, s 203(1)(e); *BCSA*, s 131(1)(b)(v); *MSA*, s 141(1)(e); *NBSA*, s 149(1)(e); *NLSA*, s 130(1)(e); *NWTSa*, s 111(1)(e); *NSSA*, s 137(1)(e); *NuSA*, s 111(1)(e); *PEISA*, s 111(1)(e); *QSA*, s 218; *SSA*, s 137(1)(e); *YSA*, s 111(1)(e); all *ibid*. A certificate to be provided by the issuer of the securities in the prospectus must be signed by the chief executive officer, the chief financial officer (or their equivalent where the issuer does not have persons so named) and each promoter of the issuer; see NI 41-101, Part 5.

⁵⁶ *OSA*, *ibid*, s 130(1)(d). See also *ASA*, s 203(1)(d); *BCSA*, s 131(1)(iv); *MSA*, s 141(1)(d); *NBSA*, s 149(1)(d); *NLSA*, s 130(1)(d); *NWTSa*, s 111(1)(d); *NSSA*, s 137(1)(d); *NuSA*, s 111(1)(d); *PEISA*, s 111(1)(d); *QSA*, s 218; *SSA*, s 137(1)(d); *YSA*, s 111(1)(d); all *ibid*.

⁵⁷ *OSA*, *ibid*, s 130(5). See also *ASA*, s 203(7); *BCSA*, s 131(7); *MSA*, s 141(7); *NBSA*, s 149(6); *NLSA*, s 130(5); *NWTSa*, s 111(7); *NSSA*, s 137(5); *NuSA*, s 111(7);

on financial statements that must be included in the prospectus have a similar defence.⁵⁸ This “due diligence” defence can be prepared in advance of the filing of the preliminary prospectus by conducting a reasonable investigation. The preparation of the preliminary prospectus together with due diligence work can be costly. The prospectus also requires audited financial statements.⁵⁹ This will require engaging auditors long before the offering of securities and audits can be quite costly.

d) Merit Discretion

As noted above, no person or company can distribute a security unless a receipt has been given for a prospectus.⁶⁰ A receipt for a prospectus can be refused if it does not comply in a substantial respect with the requirements of the applicable securities act or regulations, contains a statement, promise, estimate or forward-looking information that is misleading, false or deceptive, or contains a misrepresentation.⁶¹ A receipt for a prospectus can also be refused where it appears that it is in the public interest to do so.⁶² While securities administrators do not, in exercising this discretion, review the merits of a particular investment in the sense of assessing whether the investment is a good investment or a safe investment, they are given specific discretion to refuse a receipt for a prospectus where, for instance: ⁶³

PEISA, s 111(5)(c); *QSA*, s 220(1); *SSA*, s 137(6); *YSA*, s 111(7); all *ibid*. The same defence is available for other experts with respect to any part of the prospectus purporting to be made on the person’s own authority as an expert, or to be a copy of, or an extract from, the person’s own report, opinion or statement as an expert.

⁵⁸ *OSA*, *ibid*, s 130(4). See also *ASA*, s 203(6); *BCSA*, s 131(6); *MSA*, s 141(c); *NBSA*, s 149(5); *NLSA*, s 130(4); *NWTSa*, s 111(6); *NSSA*, s 137(4); *NuSA*, s 111(6); *PEISA*, s 111(6); *QSA*, s 220(1); *SSA*, s 137(5); *YSA*, s 111(6); all *ibid*.

⁵⁹ Form 41-101F1, Item 32.2.

⁶⁰ See *supra* notes 27 and 28 and the accompanying text.

⁶¹ *OSA*, *supra* note 19, s 61(2)(a). See also *ASA*, s 120(2)(a); *MSA*, s 61(2)(a); *NBSA*, s 75(2)(a); *NLSA*, s 62(2)(a); *NWTSa*, s 100(2)(a); *NSSA*, s 66(2)(a); *NuSA*, s 100(2)(a); *PEISA*, s 100(2)(a); *QSA*, s 15(1); *SSA*, s 70(2)(a); *YSA*, s 100(2)(a); all cited *supra* note 19. See also *BC Securities Rules*, BC Reg 194/97, s 120(2)(a).

⁶² *OSA*, *ibid*, s 61(1). See also *ASA*, s 120(1); *BCSA*, s 65(2); *MSA*, s 37(1.2); *NBSA*, s 75(2); *NLSA*, s 62(1)(a); *NWTSa*, s 100(1); *NSSA*, s 66(1); *NuSA*, s 100(1); *PEISA*, s 100(1); *QSA*, s 15 (does not refer to a public interest discretion but is an overall similar provision); *SSA*, s 70(1); *YSA*, s 100(1); all *ibid*.

⁶³ *OSA*, *ibid*, s 61(2). See also *ASA*, s 120(2); *BC Securities Rules*, BC Reg 194/97, s 120(2); *MSA*, s 61(2); *NBSA*, s 75(2)(a); *NLSA*, s 62(2); *NWTSa*, s 100(2); *NSSA*, s 66(2); *NuSA*, s 100(2); *PEISA*, s 100(2); *QSA*, s 15; *SSA*, s 70(2); *YSA*, s 100(2); all *ibid*.

- (1) there is a concern that an unconscionable consideration has been, or will be, paid for services, promotional purposes or the acquisition of property;
- (2) the business of the issuer cannot reasonably be expected to be conducted with integrity and in the best interests of the security holders because of the past conduct of the issuer, or any of its officers, directors, promoters or control persons;
- (3) the issuer cannot reasonably be expected to be financially responsible in the conduct of its business because of the financial condition of the issuer, or any of its officers, directors, promoters or control persons; or
- (4) the aggregate of the proceeds from the sale of the securities under the prospectus together with the other resources of the issuer is insufficient to accomplish the purpose of the issue.

This “public interest” discretion to refuse a receipt for a prospectus is sometimes referred to as “merit discretion.”

Care will need to be taken to avoid such grounds for a refusal of a receipt. There will, however, remain some risk, and it may be a somewhat higher risk for smaller issuers particularly in the start-up phase, that a receipt for a prospectus may be refused even after the costs of preparing and filing it have been incurred.

If an exemption is provided from the prospectus requirement, the refusal of a receipt for a prospectus will no longer be a basis on which securities administrators can prohibit a distribution of securities. In providing an exemption for crowd-funding one may, therefore, want to consider some way of addressing concerns of the sort identified as public interest or merit discretion grounds for the refusal to issue a receipt for a prospectus.

2) *The Continuous Disclosure Requirement*

Once a person or company distributes securities under a prospectus the person or company becomes a “reporting issuer” under the *Securities Act*.⁶⁴ A reporting issuer must also provide ongoing, or “continuous,”

⁶⁴ “Reporting issuer” is defined in s 1(1) of the *OSA*, *ibid*, to mean, among other things, “an issuer ... (b) that has filed a prospectus and for which the Director has issued a receipt...” The term “reporting issuer” is also used in other provincial securities acts. See e.g. *ASA*, s 1(ccc); *BCSA*, s 1(1); *MSA*, s 1(1); *NBSA*, s 1(1); *NLSA*, s 2(1)(oo);

disclosure in the form of audited annual financial statements, unaudited quarterly financial statements, an annual information form, annual and interim management discussion and analysis, proxy circulars, insider trading reports and timely disclosure (in the form of material change reports).⁶⁵ These reporting requirements continue for as long as the person or company remains a reporting issuer.⁶⁶ Consequently, in addition to the cost of preparing the prospectus and the cost of the underwriter, there will be the annual cost of complying with these continuous disclosure requirements. Misrepresentations in continuous disclosure documents can also lead to common law or statutory civil liability.⁶⁷

3) *Exemptions from the Prospectus Requirement*

Securities regulation does provide exemptions from the prospectus requirement. The primary underlying basis for these exemptions is arguably an intuitive sense that the cost of compliance would outweigh the benefits a prospectus would provide.⁶⁸ If securities can be distributed under an exemption, and consequently not through a prospectus offering, the cost of a prospectus and continuous disclosure requirements that would apply once a prospectus offering is made can be avoided.

While some of the available capital-raising exemptions can be helpful to a small or start-up business they are not likely to be helpful to a small or start-up business seeking funds through crowd-funding.⁶⁹ Initial capital-

NWTSa, s 1(1) “reporting issuer” (b); *NSSA*, s 2(1)(ao); *NuSA*, s 1(1) “reporting issuer” (b); *PEISA*, s 1(zz); *QSA*, ss 5 and 68; *SSA*, s 2(1)(qq); *YSA*, s 1(1) “reporting issuer” (b); all *ibid*.

⁶⁵ These continuous disclosure obligations are now set out in NI 51-102 “Continuous Disclosure Obligations”, online: <http://www.osc.gov.on.ca/en/SecuritiesLaw_51-102.htm>.

⁶⁶ Each of the various continuous disclosure obligations set out in NI 51-102 apply to a “reporting issuer” and continue to apply as long as the issuer continues to be a “reporting issuer.”

⁶⁷ For statutory civil liability provisions for fraud or misrepresentation in continuous disclosure, see *OSA*, *supra* note 19, ss 138.1 to 138.14. See also *ASA*, ss 211.01 to 211.095; *BCSA*, ss 140.1 to 140.94; *MSA*, ss 174 to 197; *NBSA*, s 161.1 to 161.9; *NLSA*, ss 138.1 to 138.4; *NWTSa*, ss 122-135; *NSSA*, ss 146A to 146N; *NuSA*, ss 122-135; *PEISA*, ss 122 to 135; *QSA*, ss 225.2 to 225.33; *SSA*, ss 136.01 to 136.7; *YSA*, ss 122-135; all cited *supra* note 19. For a discussion of common law liability for frauds or negligent misrepresentation see e.g. Philip H Osborne, *The Law of Torts*, 4th ed (Toronto: Irwin Law, 2011) at 176-87 and 315-18; Allen M Linden and Bruce Feldthusen, *Canadian Tort Law*, 9th ed (Toronto: LexisNexis Canada, 2011) at 450-75.

⁶⁸ See e.g. Johnston and Rockwell, *supra* note 43 at 227-29; and Gillen, *supra* note 43 at 250-62.

⁶⁹ Many of the capital-raising exemptions are not likely to be helpful to a start-up business. For instance, the rights offering exemption in NI 45-106, para 2.1 would

raising prospectus exemptions that are most likely to be available for a small business seeking business start-up funds in Ontario are the private issuer exemption⁷⁰ and the minimum amount investment exemption. In other provinces, a small business seeking business start-up funds might also rely on an offering memorandum exemption.⁷¹ For reasons noted below, however, these exemptions provide limited sources of funds for small businesses and are not really suitable for crowd-funding.

a) Private Issuer Exemption

To rely on the private issuer exemption the issuer must be a “private issuer.”⁷² The definition of “private issuer” requires that the issuer is neither a reporting issuer nor an investment fund. It also requires that the securities of the private issuer (other than non-convertible debt securities) be subject to restrictions on transfer, be owned by not more than 50 persons (other than employees or former employees), and be owned only by persons falling in a list of described persons.⁷³

The list of described persons includes, for example, a director, officer, employee, founder or control person of the issuer; a director, officer or employee of an affiliate of the issuer; a close relative of a director, executive

normally be relied on by an issuer that has previously issued securities under a prospectus. Selling securities to an affiliated entity is not likely to be a means for a small or start-up business to raise funds for its business purposes so the exemption in NI 45-106, para 2.8 is not likely to be useful. While the accredited investor exemption in NI 45-106, para 2.3 might be used to seek funds from wealthy investors, other “accredited investors” (defined in NI 45-106, para 1.1) such as governments, banks, credit unions, insurance companies, trust companies, or pension funds will be reluctant to invest in small businesses the securities of which are not publicly traded since it will be difficult to dispose of such securities when needed. Other exemptions relate to specific transactions such as business combinations or reorganizations, redemptions of securities, or take-over bids that would not normally be relied on to raise funds for business purposes. Other exemptions are provided for investment funds or for transactions with employees, officers, directors and consultants.

⁷⁰ The exemptions are set out in NI 45-106 “Prospectus and Registration Exemptions”, online: <http://www.osc.gov.on.ca/documents/en/Securities-Category4/rule_20120413_45-106_unofficial-consolidated.pdf>. The private issuer exemption from the prospectus requirement is in para 2.4 of that NI.

⁷¹ See NI 45-106, para 2.9. The requirements for the offering memorandum exemption vary depending on the particular provincial or territorial jurisdiction. See the discussion in Part 2 A) 3) c) below. Ontario has proposed the introduction of a similar exemption; see *Introduction of Proposed Prospectus Exemptions and Proposed Reports of Exempt Distribution in Ontario* (2014), 37 OSCB (Supp-3), March 20, 2014, part 5 and Appendix A.

⁷² The private issuer exemption is set out in NI 45-106, s 2.4.

⁷³ See NI 45-106, s 2.4(1).

officer, founder or control person of the issuer or of the spouse of such a person; or a close personal friend or close business associate of a director, executive officer, founder or control person of the issuer.⁷⁴ There will be a limited number of these persons and a limit on the funds these persons are either able, or willing, to invest. It will be difficult for many small businesses to obtain sufficient start-up funds from these persons.

The list of described persons also includes an “accredited investor” and while the list of persons defined to be “accredited investors” is long,⁷⁵ the only persons on the list that are likely candidates for a small business seeking business start-up funds are wealthy individuals or private investment funds.⁷⁶ While there may be many such persons, identifying them,⁷⁷ documenting that they meet specified levels of wealth,⁷⁸ and convincing them to invest can be time-consuming and costly.

⁷⁴ NI 45-106, s 2.4(2)(a) to (f).

⁷⁵ NI 45-106, s 1.1.

⁷⁶ “Accredited investor” is defined in NI 45-106, s 1.1 to include institutional investors such as federal, provincial and municipal governments, banks, insurance companies, pension funds, and investment funds. These persons are likely to be reluctant to invest in a small start-up business under the private issuer exemption since the private issuer’s securities cannot be publicly traded making it difficult for these investors to sell the securities in the context of portfolio management decisions. These institutional investors are generally subject to fiduciary duties requiring prudence in investment and while investment prudence is now measured in terms of portfolio and not individual investments, potential liability concerns may, nonetheless, continue to make such institutional investors reluctant to invest in start-up enterprises.

⁷⁷ It should be noted that while NI 45-106, s 2.4(3) says that “no commission or finder’s fee may be paid to any director, officer, founder or control person of an issuer in connection with a [private issuer exemption],” this restriction does not apply to a distribution to an accredited investor.

⁷⁸ Specified levels of wealth are set out in NI 45-106, s 1.1(j), (k), (l), (m) and (n). An individual meets the wealth test if the individual, either alone or with a spouse, has cash or owns securities, contracts of insurance, or deposits having an aggregate realizable value that, before taxes but net of any related liabilities, exceeds \$1,000,000; see NI 45-106, s 1.1(j). An individual also meets the wealth test if the individual has net income before taxes of over \$200,000 in each of the two most recent calendar years or if the individual’s net income before taxes combined with that of a spouse exceeded \$300,000 in each of the two most recent calendar years and, in either case, the individual reasonably expects to exceed that net income level in the current calendar year; see NI 45-106, s 1.1(k). An individual also meets the required level of wealth if, either alone or together with a spouse, has net assets of at least \$5,000,000; see NI 45-106, s 1.1(l). The specified level of wealth also includes a person other than an individual or investment fund that has net assets of at least \$5,000,000; see NI 45-106, s 1.1(m). It also includes an investment fund that has distributed its securities only to persons who are accredited investors or who invested a minimum of \$150,000 – that is, a private investment fund; see NI 45-106, s 1.1(n).

The list goes on to include any person “that is not the public.”⁷⁹ While this arguably expands the list in a very broad way, the jurisprudence on the meaning of “the public” leaves a significant degree of uncertainty that a prudent person would be reluctant to rely on.⁸⁰

While start-up funds for some small businesses can be raised through the private issuer exemption, the 50-person limit on the private issuer exemption does not fit with the concept of crowd-funding that involves raising small amounts from a large number of investors that, in most cases, is likely to involve far more than just 50 persons in addition to employees or former employees. Other exemptions will have to be considered for a small business start-up that can’t obtain sufficient funds under the private issuer exemption.

⁷⁹ NI 45-106, s 2.4(2)(l).

⁸⁰ In the US case of *SEC v Ralston Purina Co*, 346 US 119 (1953) [*Ralston Purina*] it was said that whether an offer was being made “to the public” was a question of whether the persons offered the security needed to know the kind of information a prospectus would provide. The test from *Ralston Purina* has been referred to as the “need to know” test. In the Alberta case of *R v Piepgrass* (1959), 29 WWR 218, 23 DLR (2d) 220 (Alta CA), it was said that the persons sold to “were not in any sense friends or associates of the accused, or persons having common bonds of interest or association.” This test has been referred to as the “common bonds” test. In *Re Bilinski*, 2002 CarswellBC 3849 (BCSecCom), the BC Securities Commission considered the meaning of “the public” in the context of a private issuer exemption. It referred at para 437 to both the “need to know” test and the “common bonds” test. It said “the ‘need to know’ test is met when persons have access to the kind of information that would normally be disclosed in an offering document or when persons have a certain amount of sophistication about making investment decisions enabling them to fend for themselves.” It also said at para 440, “the ‘common bonds’ test focuses on the relationship between the seller of the securities and the persons to whom the securities are being offered. Frequently the ‘common bonds’ test is met when the person: 1. has known the officer or director for a number of years, 2. through personal knowledge and friendship, is in a position to assess the capabilities and the trustworthiness of the officer or director, and 3. is likely to receive the same moral commitment from the officer or director as would a family member of the officer or director.” See also e.g. *R v McKillop* (1972), 1 OR 164 (Prov Ct); *Chan v. Moorehead*, 2002 CarswellBC 450 (Prov Ct). In terms of the number of persons to whom an offer is made the *Ralston Purina* case noted at 125 that an offering to the “public” did not mean the offering had to be made to the whole world, but could be an offering to many persons or only a few persons. In the English case of *Nash v Lynde*, [1929] AC 158 at 169, the House of Lords said that perhaps even one person could be the public. On the uncertainty of the meaning of “primary distribution to the public,” see the discussion in the *Report to the Committee of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements*, February, 1970, ch III at 37-39 (with the report recommending getting rid of the expression “primary distribution to the public” in the existing version of the *OSA*, RSO 1970, c 426, s 35).

b) Minimum Amount Investment Exemption

The minimum amount investment exemption allows the sale of securities to persons who purchase at least \$150,000 worth of the securities.⁸¹ So-called “angel investors” could fit under this exemption⁸² and can be a helpful source of funds for small and start-up businesses but these persons tend to conduct very thorough examinations of businesses before they invest and there are high rejection rates.⁸³ Consequently, while this exemption is quite useful for small businesses, significant difficulties for small business finance remain. Crowd-funding would, in spite of the minimum amount exemption, still have a useful role to play in facilitating small business finance, particularly for start-up businesses, by seeking investments from persons who would be unable or unwilling to invest amounts of \$150,000 or more. Crowd-funding may, indeed, involve seeking many quite small investments, perhaps in the order of as little as \$10 for some investors.

c) Offering Memorandum Exemption

There is an offering memorandum exemption in all Canadian jurisdictions other than Ontario. There are two models for the offering memorandum exemption. One applies in BC, New Brunswick, Nova Scotia, and Newfoundland and Labrador⁸⁴ and the other applies in Alberta, Manitoba, Northwest Territories, Nunavut, Prince Edward Island, Quebec, Saskatchewan and the Yukon Territories.⁸⁵ The OSC has proposed

⁸¹ NI 45-106, s 2.10 (where cash is paid for the securities). NI 45-106, s 2.12 provides a similar exemption where assets, other than cash, of a minimum \$150,000 value are given in exchange for the securities. The assets exemption can be useful for small and start-up businesses, but it is not likely to be useful for crowd-funding or other broad distributions of securities seeking small amounts of investment from numerous investors.

⁸² Sales to these investors may also meet other exemptions. A 1993 study found that about 62% of investments by angel investors were less than \$100,000. See A Riding *et al*, *Informal Investors in Canada: The Identification of Salient Characteristics* (report submitted to the Department of Industry, Science and Technology Canada and the Ministry of Economic Development and Trade of the Province of Ontario, May 1993), cited in MacIntosh, *supra* note 11 at 21-22.

⁸³ See MacIntosh, *ibid*, noting a finding of Riding *et al*, *ibid*, showing a rejection rate of 97% with 72 % of all projects being rejected before investors even met with the entrepreneur, an additional 16% being rejected after meeting with the entrepreneur, a further 6% being rejected in the investor's due diligence stage, and then 3% being rejected in the process of negotiations to strike a deal.

⁸⁴ NI 45-106, s 2.9(1).

⁸⁵ NI 45-106, s 2.9(2). The form for the risk acknowledge is Form 45-106F4.

adopting an offering memorandum exemption that would track the Alberta model.⁸⁶

In the BC model the purchaser of the security must purchase as principal and the issuer must deliver an offering memorandum to the purchaser and obtain a signed risk acknowledgement from the purchaser.⁸⁷ The same requirements apply in the Alberta model except that in addition the purchaser must either be an “eligible investor” or acquire not more than \$10,000 worth of the securities.⁸⁸ An “eligible investor” is essentially a person who meets a specified test of wealth or has obtained advice regarding the suitability of the investment from a registered investment dealer authorized to give advice with respect to the type of security being distributed.⁸⁹

The offering memorandum must be in a required form that sets out a wide range of matters that must be disclosed that correspond, in many respects, to the disclosure that is required in a prospectus.⁹⁰ As with purchasers of securities under a prospectus, the purchasers of securities pursuant to the offering memorandum exemption have a two-day withdrawal right and a right of action for a misrepresentation in the offering memorandum.⁹¹

One important benefit of the offering memorandum exemption is that it does not need to be vetted by the securities commission. This reduces the delay that the securities commission vetting process entails. While both models of the offering memorandum exemption would allow for small investment amounts from a large number of investors⁹² and the offering

⁸⁶ See “Introduction of Proposed Prospectus Exemptions and Proposed Reports of Exempt Distribution in Ontario” (20 March 2014), (2014 37 OSCB Supp 3).

⁸⁷ NI 45-106, s 2.9(1). The form for the risk acknowledge is Form 45-106F4.

⁸⁸ *Ibid*, s 2.9(2).

⁸⁹ *Ibid*, s 1.1 “eligible investor” and “eligibility advisor.” In Saskatchewan and Manitoba the advisor can also be a lawyer or accountant who does not have a professional, business or personal relationship with the issuer or any of its directors, executive officers, founders or control persons and has not been retained personally or otherwise as an employee, executive officer, director, associate or partner of a person that has acted for or been retained by the issuer or any of its directors, executive officers, founders or control persons within the previous 12 months; see NI 45-106, s 1.1 “eligibility advisor.”

⁹⁰ Form 45-106F2.

⁹¹ If these rights are not provided with respect to offering memorandums pursuant to securities legislation in the jurisdiction then they must be provided as a contractual right in the offering memorandum; see NI 45-106, s 2.9(6) and (7).

⁹² The exemption does not set out a minimum investment amount and it does not restrict the number of persons who can purchase securities under the exemption.

memorandum could be delivered electronically,⁹³ it still involves a potentially significant cost of complying with the offering memorandum disclosure requirements including the due diligence work to reduce the risk of potential liability for misrepresentations in the offering memorandum.

d) Summary

Consequently, while there are exemptions that can be relied on by small and start-up businesses to raise investment funds, they are arguably not particularly amenable to an Internet investment crowd-funding campaign. The exemptions are also somewhat limited and persons or companies carrying on a small business may find the constraints on raising investment funds put them at a significant disadvantage to larger businesses.

4) Resale Restrictions

The investor protection intended to be provided by securities regulation would be undermined if securities could be sold to a person under an exemption and that person was then able to resell the securities shortly thereafter, perhaps on the same day, to investors of the types securities regulation was intended to protect. Consequently, resale restrictions typically apply to exemptions to prevent the person who acquires securities pursuant to an exemption from reselling the securities to persons that need investor protection.⁹⁴

Resale restrictions apply to the private issuer, minimum amount and offering memorandum exemptions discussed in Part 2 A)3) above.⁹⁵ A person who purchases securities pursuant to one of these exemptions can only sell the securities pursuant to an exemption unless certain conditions are met.⁹⁶ For a small business this usually means selling pursuant to one of the exemptions discussed above unless the issuer of the securities has gone public by filing and obtaining a receipt for a prospectus.⁹⁷

⁹³ The circumstances in which electronic delivery of documents can be made are set out in National Policy 11-201, online: <http://www.osc.gov.on.ca/en/SecuritiesLaw_11-201.htm>.

⁹⁴ For a discussion of resale restrictions and the reasons for them see Johnston and Rockwell, *supra* note 43 at 222-26; Gillen, *supra* note 43 at 242-50.

⁹⁵ NI 45-102, ss 2.3, 2.5 and Appendix D apply to the offering memorandum and minimum amount exemptions. NI 45-102, ss 2.4, 2.6 and Appendix E apply to the private issuer exemption.

⁹⁶ Conditions for the private issuer exemption are set out in NI 45-102, s 2.6 and conditions for the minimum amount and offering memorandum exemptions are set out in NI 45-102, s 2.5.

⁹⁷ The first condition in NI 45-102, ss 2.5(2) and 2.6(3) is that “the issuer is and has been a reporting issuer in a jurisdiction of Canada for the four months immediately

The resale restriction makes securities acquired pursuant to one of these exemptions much less liquid (that is, less readily sold) than securities that are publicly traded. Investors generally prefer to have liquidity (that is, the ability to sell the securities and use the proceeds for personal consumption or make what they believe to be a better investment). Investors are likely to want some compensation for a lack of liquidity. Where there are two identical businesses with the same risk profile and one has publicly traded securities while the other does not, the one that does not have publicly traded securities is likely to have to offer a higher rate of return than the one with publicly traded securities. This would make the costs higher for the business without publicly traded securities since it has a higher cost of finance (that is, the return on investment it must provide to attract investment).⁹⁸

5) Registration Requirements and the Need for an Underwriter

Section 25(1) of the *OSA* provides that:

Unless a person or company is exempt under Ontario securities law from the requirement to comply with this subsection, the person or company shall not engage in or hold himself, herself or itself out as engaging in the business of trading in securities unless the person or company,

(a) is registered in accordance with Ontario securities law as a dealer; or

(b) is a representative registered in accordance with Ontario securities law as a dealing representative of a registered dealer and is acting on behalf of the registered dealer.

There are corresponding provisions in other provincial securities acts.⁹⁹ A “dealer” is defined in section 1(1) of the Act as “a person or company engaging in or holding himself, herself or itself out as engaging in the business of trading in securities as principal or agent.”¹⁰⁰

If the dealer registration requirements apply it would be difficult for most, if not all, persons or companies carrying on small businesses to meet them. Registration requirements include, among other things, education

preceding the trade.” To become a reporting issuer the issuer will have to file and obtain a receipt for a prospectus. On the meaning of “reporting issuer” see *supra* note 64.

⁹⁸ See e.g. the discussion in Zvi Bodie *et al.*, *Investments*, 7th Canadian ed (Toronto: McGraw-Hill Ryerson, 2011) at 229-30 and 767.

⁹⁹ See e.g. *ASA*, s 75(1); *BCSA*, s 34; *MSA*, s 6; *NBSA*, s 45; *NLSA*, s 26(1); *NWTSA*, s 86; *NSSA*, s 31(1); *NuSA*, s 86; *PEISA*, s 86; *QSA*, s 148; *SSA*, s 27(2); *YSA*, s 86; all cited *supra* note 19.

¹⁰⁰ For other provincial securities acts see *supra* note 20.

and experience requirements,¹⁰¹ capital requirements,¹⁰² insurance requirements,¹⁰³ financial reporting requirements,¹⁰⁴ conflict of interest restrictions,¹⁰⁵ client disclosure and reporting obligations,¹⁰⁶ and investment allocation requirements.¹⁰⁷

The section 25(1) registration requirement does not apply unless the person or company involved in the raising of funds for the business is “engage[d] in or is holding himself, herself or itself out as *engaging in the business of trading in securities*.” If the section 25(1) registration requirement applies, registration can be avoided if the person or company qualifies for an exemption from the registration requirement.

a) Engaging in the Business of Trading in Securities

A person seeking investment funds in an Internet campaign – “crowd-funding” – would, as discussed in subpart A) 1) above, be engaging in the trading of securities. The question then would be whether the person is “engaged in the *business of trading in securities*.” Since one would want to be fairly confident that the registration requirement in section 25(1) of the *OSA* does not apply, one needs to have a good sense of when one will be considered “engaged in the business of trading in securities.” In Companion Policy 31-103CP “Registration Requirements and Exemptions,” the Canadian Securities Administrators (CSA) have set out factors they consider relevant to determining whether an individual or firm is engaged in the business of trading securities. The factors are whether an individual or firm is:

- (i) engaging in activities similar to a registrant;
- (ii) intermediating trades or acting as a market maker;
- (iii) directly or indirectly carrying on the activity with repetition, regularity or continuity;
- (iv) being, or expecting to be, remunerated or compensated; or

¹⁰¹ See Part III of NI 31-103 “Registration Requirements, Exemptions and Ongoing Registrant Obligations”, online: <http://www.osc.gov.on.ca/documents/en/Securities-Category3/ni_20130715_31-103_unofficial-consolidated.pdf>.

¹⁰² *Ibid* at para 12.1.

¹⁰³ *Ibid* at para 12.3.

¹⁰⁴ *Ibid* at paras 12.10, 12.11 and 12.12.

¹⁰⁵ *Ibid* at para 13.4.

¹⁰⁶ *Ibid* at paras 14.2 to 14.4, and 14.12, and 14.14.

¹⁰⁷ *Ibid* at para 14.10.

(v) directly or indirectly soliciting securities transactions.¹⁰⁸

The Companion Policy goes on to provide that a securities issuer (an entity that issues or trades in its own securities) “with an active non-securities business” does not have to register as a dealer if it:

- i) does not hold itself out as being in the business of trading in securities;
- (ii) trades in securities infrequently;
- (iii) is not, or does not expect to be, compensated for trading in securities;
- (iv) does not act as an intermediary; and
- (v) does not produce, or intend to produce, a profit from trading in securities.¹⁰⁹

One may, therefore, be able to raise funds without having to comply with the registration requirement for a one time, or at least infrequent, distribution of securities if there will be no remuneration or compensation of anyone for the sales of the securities, no one connected to the issuance of the securities holds themselves out as being in the business of trading in securities and, while profits might be made from carrying on the business for which the funds are being raised, sale of the securities does not itself produce a profit. The remaining factor of intermediation might, however, be a bit more of a problem. If there are persons involved in the sales of the securities other than the issuer itself, those persons might be considered intermediaries for the issuer. If, for instance, the business is carried on through a corporation (a separate legal entity) sales of the securities will have to be entered into on its behalf by one or more individuals and they might, therefore, be considered to be acting as an intermediary for the corporation.¹¹⁰ Some comfort may be drawn from the statement in Companion Policy 31-103 that the Canadian Securities Administrators “do not automatically assume that any one of these factors on its own will

¹⁰⁸ See Companion Policy 31-103 “Registration Requirements and Exemptions” at para 1.3, online: <http://www.osc.gov.on.ca/documents/en/Securities-Category3/ni_20130715_31-103_unofficial-consolidated.pdf>.

¹⁰⁹ *Ibid.*

¹¹⁰ The same might apply to a partnership where one partner acts as agent for the other partners or if the partners engage a person, as agent, to enter into sales of securities on behalf of the partners.

determine whether an individual or firm is in the business of trading ... in securities.”¹¹¹

b) Exemption from the Registration Requirement

There is an exemption from the registration requirement in section 25(1) where a trade is done through a registered dealer.¹¹² The registered dealer could simply act as agent in conducting the trades or could buy the securities from the person or company seeking the investment funds and then resell the securities to investors. Either way the dealer would be acting as an “underwriter” since an “underwriter” is defined in section 1(1) of the *OSA* as:

a person or company who, as principal, agrees to purchase securities with a view to distribution or who, as agent, offers for sale or sells securities in connection with a distribution and includes a person or company who has a direct or indirect participation in any such distribution ...¹¹³

Section 25(2) requires that a person or company is not to act in such a way unless registered as a dealer authorized to act as an underwriter.¹¹⁴

While engaging an underwriter can avoid the registration requirement it may not be a realistic option for persons or companies seeking funds for small businesses. Underwriting firms do not take on every request they receive to underwrite an offering of securities.¹¹⁵ They are selective and only underwrite an offering where there is potential for the offering to succeed since the underwriter will only profit if the securities are sold. The underwriter may also have to be careful not to underwrite poor quality investments since investors may come to associate that underwriter with poor quality investments. Underwriters tend to examine the business very carefully before agreeing to underwrite securities offered in connection

¹¹¹ See para 1.3 of Companion Policy 31-103.

¹¹² See NI 31-103 “Registration Requirements, Exemptions and Ongoing Registrant Obligations” at para 8.5.

¹¹³ For corresponding provisions in other provincial securities acts see *supra* note 19.

¹¹⁴ For corresponding provisions in other provincial securities acts see *ASA*, s 75(1) together with s 1(m) which defines “dealer” to include “acting as an underwriter;” *BSCA*, s 34(d); *MSA*, s 6(d); *NBSA*, s 45; *NLSA*, s 26(1) together with s 1(1)(i.1) which defines “dealing in securities” to include “acting as an underwriter;” *NWTSa*, s 86(2); *NSSA*, s 31; *NuSA*, s 86(2); *PEISA*, s 86(2); *QSA*, s 148 and the definition of “dealer” in s 5; *SSA*, s 27(2); *YSA*, s 86(2); all cited *supra* note 19.

¹¹⁵ See Frederick D Lipman, *The Complete Going Public Handbook: Everything You Need to Know to Turn a Private Enterprise into a Publicly Traded Company* (Roseville, California: Prima Venture, 2000) at 44-45.

with it.¹¹⁶ They will ask questions and will want to see a very carefully worked out business plan. Preparation for an offering of securities will therefore start long before the preparation of a preliminary prospectus. This will involve costs. The underwriter will also charge a fee for doing the underwriting. These fees can be quite significant and tend to be higher as a percentage of funds raised for small issues of securities.¹¹⁷

c) Summary and Comment on the Crowd Funding Context

If the registration requirement applies to a proposed fund-raising scheme it will have to be conducted through a registered person or company. While an issuer of securities could seek registration, the registration requirements are likely to make this impractical. Registration can be avoided if the fundraising is conducted through a person or company registered and authorized to act as an underwriter. There are good reasons for engaging an underwriter. The issuer's business is not likely to involve expertise in the marketing of securities but that is the expertise of an underwriter. An underwriter can also provide a degree of certainty that the required funds will be raised. It can, however, be difficult for a small or start-up issuer to convince an underwriter to underwrite a distribution of securities. Even if the small or start-up business can engage an underwriter, the cost may be prohibitive. If engaging an underwriter is to be avoided, one will have to be careful about the way the fundraising campaign is conducted to avoid triggering the registration requirement.

In the crowding funding context one might want use a crowd-funding Internet platform. By acting as an intermediary in the sales of the issuer's securities, the Internet platform provider is likely to be found to be engaging in the business of trading in securities and would therefore need to be registered. If there is no exemption modifying the registration requirements, the Internet platform provider would have to meet the many requirements usually imposed on registered dealers in securities.

B) United States Federal Securities Regulatory Constraints

The application of US federal securities law to crowd-finding maps on fairly closely to the application of Canadian provincial securities laws discussed above. In the United States, however, Congress has recently

¹¹⁶ *Ibid.*

¹¹⁷ See e.g. MacIntosh, *supra* note 11, at 50-51. See also *Considering an IPO?: The Costs of Going and Being Public may Surprise You* (September 2012 – A publication from PwC's Deals practice) at 7, online: http://www.pwc.com/en_us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf).

enacted the *Jumpstart Our Business Startups Act*,¹¹⁸ generally referred to as the *JOBS Act*, in response to the impediments securities laws cause for small business finance. The *JOBS Act* amends federal securities laws in a number of ways to reduce impediments to small business finance, including an exemption for crowd-funding in the *Crowdfund Act* set out in Title III of the *JOBS Act*. The application US federal securities laws to crowd-funding in the absence of an exemption is briefly noted here¹¹⁹ as background to a discussion in Part 3 below of a basis for an exemption and a description in Part 4 below of the crowd-funding exemption in the US *Crowdfund Act*.

1) *The Disclosure Requirement on the Distribution of Securities*

a) *When it Applies*

The application of US federal securities law to investment crowd-funding, subject to the *Crowdfund Act* discussed below, maps on quite closely to the Canadian securities regulatory requirements discussed above. Section 5(a) of the US federal *Securities Act of 1933* provides that:

Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise...

The registration statement is a disclosure document that must be filed with the US Securities and Exchange Commission (SEC). It has two main parts. The first part of the registration statement contains information required to be included in a prospectus that must be delivered to investors.¹²⁰ The

¹¹⁸ *JOBS Act*, *supra* note 14.

¹¹⁹ The application of US Federal securities laws to crowd-funding has been discussed in several law journal articles in the US. See e.g. Bradford, *supra* note 2 at 29-48; Thomas Lee Hazen, “Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption must be Conditioned on Meaningful Disclosure” (2012) 90 NCL Rev 1735 at 1739-50 [Hazen, “Crowdfunding or Fraudfunding?”].

¹²⁰ The statutory provision for the content of the registration statement is the *Securities Act of 1933*, § 7 (15 USC § 77g). The statutory provisions for the content of the prospectus are § 10 (15 USC § 77j) and Schedule A (15 USC § 77aa). Regulations governing the content of disclosure are Regulation S-K (17 CFR § 229) generally, Regulation S-B (17 CFR § 244) for small issuers and Regulation S-X (17 CFR § 210) for disclosures relating to accounting matters. The relevant form for a first-time issuer or for issuers with only a limited number of equity investors is Form S-1. For a discussion of

second part of the registration statement contains additional information not set out in the prospectus but that is available for public inspection in the files of the SEC.¹²¹ Consequently, as with securities regulation in Canada, a disclosure document must be prepared and filed before one can “sell” a “security.”

The word “security” is defined in section 2(a)(1) of the US federal *Securities Act of 1933*. Very similar definitions are found in Canadian provincial and territorial securities acts.¹²² Indeed, the similarity of the definition was one of the reasons given by the Supreme Court of Canada in *Pacific Coast Coin Exchange* for adopting US jurisprudence on the meaning of that term in Canadian securities acts.¹²³ The definition in the US federal *Securities Act of 1933* also refers to an “investment contract” and, as noted above, the main test applied in Canada as to the meaning of an “investment contract” is the Howey-Forman test developed in U.S. jurisprudence.¹²⁴ Therefore, for the reasons discussed above in part 2 A) concerning Canadian securities law, if a person or company asks other persons to provide funds not as a gift but with the expectation of getting back the funds plus something more it is likely to be considered an “investment contract” and therefore a “security.” Section 5(a)(1) of the US federal *Securities Act of 1933* noted above would therefore prohibit the sale of that security unless “a registration statement is in effect as to [that] security.”

While the particulars of the process for a registration statement to become effective under the US federal *Securities Act of 1933* are different from those under Canadian provincial securities acts, the process is similar in many respects.¹²⁵ A registration statement must be prepared and filed. No offers to sell or buy securities can be made prior to the filing of a

the contents of the registration statement and prospectus see generally Loss and Seligman, *supra* note 34 at 138-81; Hazen, *Treatise*, *supra* note 30, vol 1 at 312-34.

¹²¹ See Hazen, *Treatise*, *supra* note 30, vol 1 at 316.

¹²² See the statutory references for the definitions of “security” in Canadian securities legislation cited in notes 29 and 31. The definition of “security” that reflected the definition in the US *Securities Act of 1933* appears to have been first adopted in Ontario in *The Securities Act*, SO 1947, c 98, s 1(q).

¹²³ *Supra* note 24 at 126.

¹²⁴ For a discussion of the meaning of “security” in US federal securities laws see Loss and Seligman, *supra* note 34 at 201-77 generally, and with respect to the “investment contract” element of the definition at 216-33. See also Hazen, *Treatise*, *supra* note 30, vol 1 at 82-182 generally and with respect to the “investment contract” element of the definition at 90-111.

¹²⁵ For a discussion of the process see e.g. Hazen, *ibid* at 211-91; Loss and Seligman, *ibid* at 88-138.

registration statement.¹²⁶ The registration statement will become effective twenty days after it is filed, or at an earlier date as the SEC may determine,¹²⁷ unless the SEC issues an order refusing to permit the registration statement to become effective¹²⁸ or a stop order.¹²⁹ The registration statement will often become effective at an earlier date if the SEC makes an acceleration order allowing the registration statement to become effective before the expiry of the twenty-day period.¹³⁰ The period between the filing of the registration statement and its effective date is referred to as the “waiting period.”¹³¹ Subject to certain restrictions one can solicit interest in the securities during this period. If the registration statement appears to the SEC to be incomplete or inaccurate in any material respect, the SEC may issue an order prior to the effective date refusing to permit the registration statement from becoming effective.¹³² The SEC may also issue a stop order suspending the effectiveness of the registration at any time if the registration statement includes any untrue statement of a material fact or omits to state a material fact required to be stated or necessary to make the statements in the registration statement not misleading.¹³³

While the SEC can refuse to permit the registration statement from becoming effective or issue a stop order suspending the registration statement, the practice of the SEC has, for many years, been to issue a “letter of comment” or “deficiency letter” advising of changes it would like to see in the registration statement.¹³⁴ The issuer of the securities normally responds to this letter to avoid the use of a stop order by the SEC.¹³⁵ If an amendment to the registration statement is required the effective period begins to run anew.¹³⁶ A 1996 report found an average delay between filing and effectiveness for a small business initial public offering to be 104 days.¹³⁷

¹²⁶ Section 5(c) (15 USC §77e(c)).

¹²⁷ Section 8(a) (15 USC §77h(a)). The effective period begins to run anew each time an amendment to the registration statement is filed.

¹²⁸ Section 8(b) (15 USC §77h(b)).

¹²⁹ Section 8(d) (15 USC §77h(d)).

¹³⁰ Section 8(a) (15 USC §77h(a)).

¹³¹ See Hazen, *Treatise*, *supra* note 30, vol 1 at 213-14 and 258-77; Loss and Seligman, *supra* note 34 at 98-106.

¹³² Section 8(b) (15 USC §77h(b)).

¹³³ Section 8(d) (15 USC §77h(d)).

¹³⁴ See e.g. Hazen, *Treatise*, *supra* note 30, vol 1 at 361-65; Loss and Seligman, *supra* note 34 at 117-24.

¹³⁵ See Hazen, *ibid* at 363-64.

¹³⁶ Section 8(a) (15 USC §77h(a)).

¹³⁷ See Bradford, *supra* note 2 at 43, citing SEC, *Report of the Advisory Committee on the Capital Formation and Regulatory Processes*, [1996-1997 Transfer

The process is therefore quite similar to the process in Canada. An initial disclosure document is filed. In Canada this is a preliminary prospectus and under the US federal *Securities Act of 1933* it is a registration statement (usually referred to as the “draft registration statement”). The regulator (usually one or more securities commissions in Canada and the SEC in the US) reviews the initial disclosure document and comments on concerns or deficiencies it has with the disclosure.¹³⁸ When the concerns or deficiencies have been addressed to the satisfaction of the regulator sales of the securities can begin. This is done in Canada by the filing of a final prospectus for which the regulator provides a receipt and in the US by the SEC allowing the registration statement to become effective.

b) Disclosure Contents

The registration statement disclosure requirements for small business issuers under the US federal *Securities Act of 1933* are set out in Form SB-1, Form SB-2 and Regulation SB.¹³⁹ While the contents of disclosure are somewhat less detailed than the full Form S-1, they are, nonetheless, quite detailed and include a description of the business; a description of the securities; the plan of operation; the intended use of the proceeds of the offering; audited annual financial statements; information on directors, executive officers, promoters and control persons; executive compensation; ownership of securities by directors and executive officers and owners of more than five percent of any class of the small business issuer’s voting securities; the plan for the distribution of the securities; and risk factors.¹⁴⁰ The cost of compliance with these disclosure requirements can be quite significant.¹⁴¹

Binder] Fed Sec L Rep (CCH) at para 85,834 tbl 2 (July 24, 1996), online: <<https://www.sec.gov/news/studies/capform.htm>>.

¹³⁸ For the US see the discussion in Hazen, *Treatise*, *supra* note 30, vol 1 at 263-64.

¹³⁹ Section 7 of the *Securities Act of 1933* (15 USC §77g) provides that the registration statement contain the information specified in Schedule A to the Act and gives the Securities Exchange Commission (SEC) the authority to add or subtract from the specified information in Schedule A. See the discussion in Loss and Seligman, *supra* note 34 at 138-39. Rule 405 permits a “small business issuer” to provide disclosure pursuant to Regulation SB (17 CFR §228) and Form SB-1 to register up to \$10 million of securities to be sold for cash. “Small business issuer” is defined in Rule 405 as an issuer that has, together with all of its subsidiaries, revenues of less than \$25 million and does not have a “public float” of \$25 million or more of outstanding voting and non-voting common equity securities. Form SB-2 may also be used and it provides for integration of registration statement disclosure and continuous disclosure using Forms 10-KSB and 10QSB.

¹⁴⁰ See Regulation S-B.

¹⁴¹ It has been estimated in a report in year 2000 that the average cost for a \$25 million underwritten public offering is \$2.3 million although much of that was underwriting commissions or discounts. The costs included \$9,914 for SEC registration

c) *Liability for Non-compliance and Misrepresentation*

As in Canada there are penal, administrative and civil sanctions for non-compliance with the disclosure requirement on a distribution of securities.¹⁴² There are also common law and statutory civil remedies for a misrepresentation in a registration statement.¹⁴³ Section 11 of the US federal *Securities Act of 1933* is very similar to the Canadian statutory civil liability provisions for misrepresentations in a prospectus.¹⁴⁴ It is therefore important to prepare the draft registration statement and prospectus carefully not only to minimize delays in the review process but to avoid a claim for damages based on a misrepresentation in the registration statement.

d) *Merit Discretion*

State securities acts in the US typically allow for merit discretion by allowing a state securities administrator to issue a stop order denying, suspending or revoking the effectiveness of a registration statement if the administrator finds it in the public interest to do so.¹⁴⁵ Such an order may

fees, \$160,000 for accounting fees and expenses, \$200,000 for legal fees and expenses, and \$100,000 for printing fees and expenses. See the US Government Accountability Office, *Small Business: Efforts to Facilitate Equity Capital Formation* 23 (29 September 2000, GAO/GGD-00-190). Another estimate put the cost of legal, accounting, filing and other fees for a public offering at between \$300,000 to \$500,000; see William K Sjoström, Jr, "Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?" (2001) 53 Fla L Rev 529 at 575-76. See also *Considering an IPO?: The Costs of Going and Being Public may Surprise You* (September 2012 – A publication from PwC's Deals practice) at 5-10, online: <http://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf>; Lipman, *supra* note 115 at 7.

¹⁴² See the *Securities Act of 1933*, s 24 (15 USC §77x) (re criminal penalties); s 20 (15 USC §77t) (re injunctions); and s 11 (15 USC §77k) and s 12 (15 USC § 77l) (re civil remedies). See the discussion of the various remedies under the *Securities Act of 1933* in Hazen, *Treatise*, *supra* note 30, vol 1 at 367-489.

¹⁴³ See Loss and Seligman, *supra* note 34 at 1105-11 and 1117-61.

¹⁴⁴ These both appear to have their origins in the *Directors' Liability Act, 1890*, 53 & 54 Vict, c 64. Ontario enacted a similar statute the following year (the *Directors Liability Act, 1891*, SO 1891, c 34). The provision that later appeared in the Ontario *The Securities Act*, SO 1947, c 98, s 73 was likely modelled on s 11 of the US *Securities Act of 1933*.

¹⁴⁵ See the 2002 *Uniform Securities Act*, s 306. See also s 306 of the 1956 *Uniform Securities Act*. The 1956 *Uniform Securities Act* had been adopted in 37 states prior to revisions in 2002. As of June 15, 2012 twenty states continued to have the 1956 *Uniform Securities Act* while seventeen states had adopted the 2002 *Uniform Securities Act*. See *US Survey: State Adoption of Uniform Securities Act as of June 15, 2012*, online: <<http://www.nafa.com/wp/wp-content/uploads/2012/07/20120920-NAFA-Uniform-Security-Act>

be made where, for instance, the issuer's enterprise or method of business includes or would include activities that are unlawful where performed; the offering will work or tend to work a fraud upon purchasers; the offering has been or would be made with unreasonable amounts of underwriter and seller discounts, commissions, or other compensation, or promoters' profits; or the offering is being made on terms that are unfair, unjust, or inequitable.¹⁴⁶

2) *The Continuous Disclosure Requirement*

The *Securities and Exchange Act of 1934*¹⁴⁷ imposes continuous disclosure requirements in certain circumstances.¹⁴⁸ The circumstance under which these requirements are most likely to apply for a small business or start-up business is that the issuer has filed a registration statement pursuant to the *Securities Act of 1933* and has three hundred or more shareholders.¹⁴⁹ Since investment crowd-funding seeks to obtain small investments from a large number of persons, it is likely, in many, if not most, cases, to involve investments from more than 300 investors. The disclosure requirement includes the filing of Form 10-K, Form 10-Q, and Form 8-K. Form 10-K includes financial disclosure, management discussion and analysis and

-Adoption_At-A-Glance.pdf>. For an example of the legislation of one of the states adopting the 2002 *Uniform Securities Act* see for the state of Michigan the *Uniform Securities Act* (2002), Act 551 of 2008. Several sections of the 2002 *Uniform Securities Act*, including s 306, are virtually identical to the 1956 *Uniform Securities Act*. For a discussion of the 2002 *Uniform Securities Act* see e.g. Joel Seligman, "The New Uniform Securities Act" (2003) 81 Wash ULQ 242. It is noteworthy that s 102(28)(E) of the 2002 *Uniform Securities Act* defines "security" to include an "investment contract" on terms based on *Howey*, *supra* note 32 and *Glen Turner Enterprises Inc.*, *supra* note 32.

¹⁴⁶ 1956 *Uniform Securities Act*, as revised in 2002, ss 306(4) and 306(7). See also the original 1956 *Uniform Securities Act*, s 306(D), (E), and (F).

¹⁴⁷ June 6, 1934, c 404, title I, 48 Stat 881; 15 USCA §78.

¹⁴⁸ One such circumstance is where an issuer of securities has securities listed on a national securities exchange since s. 12(a) makes it "unlawful for any member, broker or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange..." Another such circumstance is where an issuer has total assets of over \$10 million and a class of a non-exempt equity security held by either 2,000 persons or 500 persons who are not accredited investors (section 12(g)(1)). The reports include an annual report (Form 10-K), a quarterly report (Form 10-Q), and a current report in Form 8K when events specified in Form 8K occur (see s 13 of the *Securities and Exchange Act of 1934*, Rule 13a, and Forms 10K 10Q and 8K). In addition an information statement must be provided; see s 14 of the *Securities and Exchange Act of 1934* and Rule 14c.

¹⁴⁹ Section 15(d) of the *Securities and Exchange Act of 1934* provides that the disclosure obligations apply to all persons who have issued securities pursuant to a registration statement filed under the *Securities Act of 1933* (except where the issuer has less than 300 security holders).

detailed disclosure of executive compensation. Form 10-Q also includes quarterly financial disclosure and management discussion and analysis. Form 8-K is to be filed within specified periods of time after the occurrence of specific events. While there is no general timely disclosure requirement, there is a jurisprudential “disclosure or abstain” rule under which insider trading is prohibited unless the material information has been publicly disclosed.¹⁵⁰

There are penal, administrative and civil liability sanctions for failures to comply with registration or reporting requirements under the *Securities and Exchange Act of 1934*.¹⁵¹ There is also express statutory civil liability under section 18 of that Act¹⁵² and implied statutory civil liability under Rule 10b-5 passed pursuant to section 10(b) of the Act.¹⁵³

As in Canada, if a small or start-up business raises funds in compliance with the registration statement disclosure obligation, it will also likely have to comply with the continuous disclosure obligations. This would make the cost of compliance much more onerous than just the cost of filing a registration statement on the distribution of securities.¹⁵⁴

3) *Exemptions from the Disclosure Requirement on Distribution*

a) *Not a “Public Offering”*

Section 4(a)(2) of the *Securities Act of 1933* provides that the prohibition of a sale of securities without a registration statement under section 5 does not apply to “transactions by an issuer not involving any public offering”. While this might appear to provide a useful exemption for sales of securities by small issuers, it has the disadvantage that it depends on the meaning of “public offering.” That expression, as noted in the discussion of it in the Canadian context in part 2 A) 3) a) above,¹⁵⁵ has been given an arguably broad and uncertain meaning. More precise exemptions are

¹⁵⁰ See e.g. Loss and Seligman, *supra* note 34 at 474-75; and Hazen, *Treatise*, *supra* note 30, vol 4 at 353.

¹⁵¹ Section 32 (15 USC §78ff) for penalties; s 21 (15 USC §78u), s 21A (15 USC §78u-1), s 21B (15 USC §78u-2) and s 21C (15 USC §78u-3) for investigations; orders such as mandamus, injunctions or compliance; civil penalties; and cease and desist orders.

¹⁵² 15 USC §78r. See the discussion of this provision in Hazen, *Treatise*, *supra* note 30, vol 4 at 410-16.

¹⁵³ 17 CFR §240.10b-5. See the discussion of Rule 10b-5 in Loss and Seligman, *supra* note 34 at 1199-1226; and Hazen, *Treatise*, *ibid*, vol 4 at 416-57.

¹⁵⁴ See also *Considering an IPO*, *supra* note 141 at 13-9; Lipman, *supra* note 115 at 7.

¹⁵⁵ *Supra* note 80.

needed to give greater comfort for the issuer that an issue not complying with section 5 is permitted.

b) Regulation D

More precise exemptions from the requirement to file a registration statement have been provided in Regulation D (Rules 500 to 508).¹⁵⁶ Some of these are suitable for small businesses. Rule 504, for instance, allows the sale of up to \$1 million worth of securities in any twelve-month period.¹⁵⁷ Such sales may, however, be subject to state securities regulation requirements for either registration statements or specified disclosure requirements.¹⁵⁸ The Regulation D Rule 504 exemption is also subject to a prohibition of general solicitation under Rule 502.¹⁵⁹

Rule 505 allows for the sale of up to \$5 million worth of securities in any twelve-month period but limits sales to non-accredited investors to thirty-five persons.¹⁶⁰ The prohibition of general solicitation in Rule 502 also applies to the Rule 505 exemption.¹⁶¹

Rule 506 allows for the sale of an unlimited amount of securities to accredited investors and to up to thirty-five non-accredited investors.¹⁶² Under Rule 506, however, each of the thirty-five non-accredited investors must be a person who the issuer reasonably believes immediately prior to

¹⁵⁶ Section 3(b) of the *Securities Act of 1933* (15 USC §77c(b)) gives the SEC the power to enact regulations exempting sales of securities in aggregate amount of up to \$5 million from the registration requirement in s 5.

¹⁵⁷ Rule 504(b)(2) sets out the \$1 million limit for any twelve-month period.

¹⁵⁸ Regulation D, Rule 500(b) says that, “nothing in Regulation D obviates the need to comply with any applicable state law relating to the offer and sale of securities.”

¹⁵⁹ Rule 504(b)(1) says that the exemption in Rule 504 is subject to the terms and conditions of Rule 502(a), (c) and (d). Rule 502(c) provides that “except as provided in Rule 504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising ...” The exception in Rule 504(b)(1) involves offers of securities made “exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions.”

¹⁶⁰ Rule 505(b)(ii). The calculation of the thirty-five person number is provided for in Rule 501(e). It excludes accredited investors. It also excludes any relative, spouse or relative of the spouse of a purchaser who has the same principal address as the purchaser.

¹⁶¹ Rule 505(b)(1) says that to qualify for the exemption offers and sales must satisfy the terms and conditions of Rule 502.

¹⁶² Rule 506(b)(1)(i) sets out the limitation on the number of non-accredited purchasers. See Rule 501(e) for the calculation of the number of purchasers that excludes, among others, accredited investors.

making the sale has enough knowledge and experience in financial and business matters to enable that person to properly evaluate the merits and risks of the investment.¹⁶³ The Rule 506 exemption is also subject to the Rule 502 prohibition of general solicitation.¹⁶⁴

Crowd-funding involves a general solicitation over the Internet. Since the exemptions in Rules 504, 505 and 506 of Regulation D are subject to the prohibition of general solicitation in Rule 502 they are, therefore, not suitable for crowd-funding.

c) Regulation A

Regulation A (Rules 251 to 263) provides another small business exemption. One advantage of the Regulation A exemption is that it is not subject to the Regulation D, Rule 502, prohibition of general solicitation. It allows for sales of up to \$5 million worth of securities in any twelve-month period, but requires specified disclosure in an offering circular in lieu of a registration statement.¹⁶⁵ It also allows for a general solicitation of expressions of interest in the securities although subject to specified

¹⁶³ Rule 506(b)(2)(ii) says that, “each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.”

¹⁶⁴ Rule 506(1) says that to qualify for the exemption offers and sales must satisfy all the terms and conditions of Rule 502.

¹⁶⁵ See Rule 251 to Rule 255. See also the discussion of Regulation A in Hazen, *Treatise*, *supra* note 30, vol 1 at 509-20. Rule 251(b) sets out the \$5 million limit and Rule 251(d)(1)(i) says that no offer of securities can be made unless a Form 1-A offering statement has been filed with the SEC and Rule 251(2)(i)(A) says that no sales of securities can be made until the Form 1-A offering statement has been qualified. Rule 251(1)(iii) says that after the Form 1-A offering statement has been qualified other written offers may be made but only if accompanied with or preceded by a Final Offering Circular. Form 1-A requires, among other things, a description of the business of the issuer in accordance with a list of items marked 3(a) through 3(k), the intended use of proceeds of the issue, a description of the capitalization of the issuer, a description of the securities offered, the plan of distribution, information on the directors, officers and key personnel of the issuer, a five-year history of any dividends or distributions on the issuer's shares, the holdings of principal shareholders (holding 10% or more), the remuneration of officers, directors and key personnel for the last fiscal year, financial statements and management discussion and analysis of the financial statements. Since there is no registration statement the statutory civil liability for a misrepresentation in a registration statement under s 11 of the *Securities Act of 1933* does not apply. Statutory civil liability can, however, still arise under s 12(a)(2) of the Act (15 USC §77l(2)(a)) and under Rule 10b-5 passed pursuant to s 10(b) of the *Securities Exchange Act of 1934*.

conditions.¹⁶⁶ While the disclosure costs should be significantly less than the cost of a registration statement, they can still be a substantial deterrent to crowd-funding.¹⁶⁷

4) *Resales*

If a person who purchased a security pursuant to an exemption later intended to sell the security there would be a potential violation of section 5 of the *Securities Act of 1933*.¹⁶⁸ The purchaser, therefore, cannot sell unless a registration statement has been filed with respect to the security or the particular transaction in which the purchaser sells the security is an exempt transaction. Section 4(a)(1) provides that section 5 does not apply to “any transactions by any person other than an issuer, underwriter, or dealer.” The purchaser could be considered an “underwriter” as that term is defined in section 2(a)(11) which defines “underwriter” to mean “any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.” There is uncertainty as to whether a person “has purchased from an issuer with a view to ...” but if the person has held the securities for long enough to make a credible assertion that the securities were not acquired with a view to distribution, the resale should be exempt under section 4(a)(1).¹⁶⁹ Some certainty is provided for in Rule 144 that allows sales of securities acquired under an exemption by persons other than the issuer or its affiliates after a two-year holding period and allows sales after shorter holding periods if certain conditions are met (such as a one-year holding period if the issuer was not subject to the continuous disclosure requirements under the *Securities Exchange Act of 1934* at the time the securities were issued but has since filed all reports required under section 13 or section 15(d) of that Act).¹⁷⁰ Raising funds

¹⁶⁶ Rule 254(a) allows an issuer to “publish or deliver to prospective purchasers a written document or make scripted radio or television broadcasts to determine whether there is any interest in a contemplated securities offering.” Rule 254(b) requires the written document or the script of any broadcast to be submitted to the SEC.

¹⁶⁷ Bradford, *supra* note 2 at 48; and Ross S Weinstein, “Crowdfunding in the U.S. and Abroad: What to Expect When You’re Expecting” (2013) 46 Cornell Int’l LJ 427 at 433.

¹⁶⁸ There is a potential violation of s 5 since s 5 provides that it is unlawful for any person, directly or indirectly, to sell a security unless a registration statement is in effect for that security.

¹⁶⁹ See the discussion in Loss and Seligman, *supra* note 34 at 378-87.

¹⁷⁰ If the issuer was not subject to the reporting requirements under the *Securities Exchange Act of 1934* at the time the purchaser acquired the securities, the purchaser must have held the securities for a period of one year after the purchase of the securities

through an exemption can, therefore, impose significant constraints on the resale of securities acquired under the exemption.

Rule 502 of Regulation D imposes a specific restriction on the resale of securities sold under a Regulation D exemption.¹⁷¹ The securities acquired under a Regulation D exemption “cannot be resold without registration under the Act [the *Securities Act of 1933*] or an exemption therefrom.”¹⁷² Where securities are sold by small issuers pursuant to the Regulation A exemption discussed above, the resale of those securities are not subject to a resale restriction.¹⁷³

5) Registration Requirements and the Need for an Underwriter

Section 15(a)(1) of the *Securities Exchange Act of 1934* requires the registration of brokers and dealers. “Broker” is defined in section 3(a)(4) to mean “any person engaged in the business of effecting transactions in securities for the account of others.” “Dealer” is defined in section 3(a)(5) to mean “any person engaged in the business of buying and selling securities ... for such person’s own account ...” Both definitions refer to

and the issuer must have filed all reports required under s. 13 or 15(d) of the *Securities Exchange Act of 1934*. See Rule 144(b)(1)(i), (c)(1) and (d).

¹⁷¹ Rule 502(d) provides that, “except as provided in Rule 504(b)(1), securities acquired in a transaction under Regulation D shall have the status of securities acquired in a transaction under s. 4(2) of the Act and cannot be resold without registration under the Act or an exemption therefrom.” The issuer is required to take reasonable care to assure the purchasers are not underwriters. That requirement can be met by (i) reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons, (ii) providing written disclosure that the securities have not been registered under the *Securities Act of 1933* and can’t be resold unless they are registered under the Act or unless an exemption from registration is available, and (iii) putting a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Act and setting out or referring to the restrictions on transferability and sale of the securities. The exception in Rule 504(b)(1) involves offers of securities made “exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions.”

¹⁷² *Ibid.*

¹⁷³ Regulation A provides an exemption from s 5 of the *Securities Act of 1933* pursuant to s 3(b), so there would be no need to rely on the exemption in s 4(a)(1) and the question under that provision of whether the seller is an “underwriter.” Under Regulation A there would be a filed offering statement providing disclosure that subsequent purchasers could examine.

“engaged in the business of” and this involves a degree of regularity in trading in securities not just a few isolated transactions.¹⁷⁴

An Internet portal for crowd-funding would, therefore, likely be considered to be a broker, particularly if it provided its services for more than one crowd-funding issue or solicited or advertised that it provides a portal for “effecting transactions in securities.” An issuer might be able to raise funds through a single crowd-fund offering without being considered a dealer, but if it did several offerings over a period of time, perhaps connected with subsequent repurchases of securities, it might also be considered to be “engaged in the business of buying and selling securities” for its own account.¹⁷⁵

3. *Basis for a Crowd-funding Exemption*

As discussed in Part 2 above, while investment crowd-funding might be an effective means of financing a small business, particularly a start-up business, it is constrained by securities regulatory requirements and heretofore available exemptions from those requirements are not particularly amenable to investment crowd-funding. A more specific exemption is needed to facilitate investment crowd-funding. The concept of investment crowd-funding arguably fits the cost-benefit basis that underlies existing exemptions from securities regulatory disclosure requirements.

A) The Cost-Benefit Basis of Existing Exemptions

A cost-benefit argument can be made for exemptions from the prospectus requirement. Sales to institutional investors are, for instance, exempt from the prospectus requirement.¹⁷⁶ Various institutional investors are included as “accredited investors” in NI 45-106 that sets out exemptions from the prospectus requirement.¹⁷⁷ These include, for example, banks, insurance companies, pension funds and national, provincial and municipal governments.¹⁷⁸ These institutions tend to buy securities in large volumes and, in doing so, are likely to engage persons having expertise in investments. Given this expertise institutional investors are likely to know

¹⁷⁴ See the discussion in Loss and Seligman, *supra* note 34 at 756-57; Hazen, *Treatise*, *supra* note 30, vol 5 at 213-15. See also David A Lipton, “A Primer on Broker-Dealer Registration” (1987) 36 Cath U L Rev 899 at 910-12.

¹⁷⁵ On the meaning of “engaged in the business of buying and selling securities” see Hazen, *Treatise*, *supra* note 30, vol 5 at 215.

¹⁷⁶ NI 45-106, s 2.3.

¹⁷⁷ *Ibid*, s 1.1 “accredited investor.”

¹⁷⁸ *Ibid*, s 1.1 “accredited investor” (a), (f), (g), (i), and s 1.1 “Canadian financial institution.”

what information they need to gather, where to get it and how to assess it. Given the large volumes they buy they would normally be in a position to demand that the issuer provide the information they want and to demand protections they deem appropriate, such as payment priority, collateral, voting rights, or a dividend preference. In short, the assumption, arguably reasonable, is that these institutional investors can protect themselves and do not need a prospectus provided under securities regulation to protect them. The significant cost of a prospectus is therefore not justified in terms of any benefit the institutional investors might receive.

Another example of the cost-benefit basis of an existing exemption is the distribution of securities to directors or officers.¹⁷⁹ While these persons do not necessarily have the kind of investment expertise institutional investors have, they should have a significant degree of knowledge about the issuer of the securities. Indeed, if a prospectus were prepared, they would be, or at least should be, directly involved in the preparation of the prospectus. It seems likely that in most cases there would be little benefit from requiring these persons to prepare a prospectus for themselves as buyers of the securities when the prospectus would consist, for the most part, if not entirely, of information they already have access to.¹⁸⁰ The cost of having them prepare the prospectus would, therefore, likely exceed any benefit that might be derived from doing so.

Two more exemption examples are useful in relation to an argument for a crowd-funding exemption. One is the exemption for the wealthy investors included in the list of “accredited investors” in NI 45-106.¹⁸¹ The wealthy investor aspect was discussed in the context of the private issuer exemption above. This exemption is particularly relevant to an argument in favour of a crowd-funding exemption. A sale can be made to persons meeting prescribed measures of wealth. The cost-benefit trade-off is not as sharp as it seems to be in the exemptions described in the previous two paragraphs. It may, however, be based, in part, on the assumption that persons who have that level of wealth are likely to have engaged some

¹⁷⁹ Exemptions for distributions of securities to these persons are provided for in, for example, NI45-106, s 2.4 (the “private issuer” exemption); and s 2.5 (family, friends and business associates).

¹⁸⁰ In very simple terms, it seems odd that one would, in the name of investor protection, ask persons, such as directors and officers of a particular issuer who would have to be involved in the preparation of a prospectus, to prepare a prospectus and then deliver it to themselves before they acquire the securities of that issuer. It seems that the only justification for this would be that making them actually prepare a prospectus would force them to gather information they should consider before investing their own money in the business.

¹⁸¹ Exemptions applicable to wealthy investors are provided in NI 45-106, s 2.3 (“accredited investor” exemption); and s 2.4 (“private issuer” exemption).

financial planning expertise that would hopefully impress upon them the old adage that is not a good idea to have too many eggs in one basket. Exemptions for sales to these persons do not, however, require that they have obtained financial advice. Another argument in favour of the wealthy investor exemption is, presumably, that these persons can afford to suffer a loss.

The offering memorandum exemption¹⁸² also has features that might be part of a basis for a crowd-finding exemption. It provides an exemption from the prospectus requirement but provides substitute disclosure in the form of an offering memorandum that is not vetted by securities administrators. It requires that the investor sign a risk acknowledgement in which, among other things, the investor acknowledges that “this is a risky investment and ... I could lose all the money I invest.” It also requires an acknowledgement that “no securities regulatory authority or regulator has evaluated or endorsed the merits of these securities or the disclosure in the offering memorandum” and “I will not be able to sell these securities except in very limited circumstances. I may never be able to sell these securities.” The Alberta model of the exemption requires that if the investor is not an “eligible investor,” the acquisition cost to the investor must not be more than \$10,000. Where the investor is not an “eligible investor” the \$10,000 investment limit makes the benefit lost by granting an exemption small relative to the cost of providing a prospectus.

B) Crowd-funding Exemption Cost-benefit

A cost-benefit justified exemption for crowd-funding might be based on features of the wealthy (“accredited”) investor exemption and the offering memorandum exemption. One could limit the loss to investors by limiting the amount any given investor could invest as has been done in the Alberta model of the offering memorandum exemption where the acquisition cost is limited to \$10,000 if the investor is not an “eligible investor.” This would limit the benefit the prospectus requirement might have provided were it not for an exemption. The cost of the prospectus requirement would therefore likely be more than any benefit from the prospectus requirement. One might borrow the concept from the wealthy investor exemption and adjust the limit on the amount an investor could invest by the wealth of the investor. Investors that have assets or annual income above specified amounts might be permitted to invest more in a particular investment but still have a relatively small amount of their wealth at risk in any one investment.

¹⁸² NI 45-106, s 2.9. See the discussion, *supra*, Part 2 A) 3) c).

If there were a very large number of investors the total amount of investment, and therefore the total potential loss, could be quite high. The cost of providing a prospectus might then be justified if it could reduce the risk of that high loss. This high potential loss could be limited by limiting the total amount that could be raised by an issuer in reliance on a crowd-funding exemption.

4. Issues Raised for a Crowd-funding Exemption

The securities regulatory requirements discussed in Part 2 above highlight a number of the many issues that need to be addressed in the context of a crowd-funding exemption, particularly if the exemption is to fit in the current securities regulatory scheme. This Part briefly discusses some of these issues.

A) Fraud

Investment crowd-funding is, as suggested in the introduction, not a new thing. It involves seeking funds from many investors and this has been done in England since at least the late seventeenth century.¹⁸³ Blue-sky laws have been said to have been a response to fraud involving broad distributions of securities.¹⁸⁴ The US *Securities Act of 1933* has also been said to have been enacted to address fraud in the “use of any means or instruments of transportation or communication in interstate commerce or of the mails” to sell securities.¹⁸⁵ The legislation was intended, in part, to

¹⁸³ In England corporate forms of organization had developed to the point of seeking capital from a large number of investors by at least as early as the late seventeenth century. See Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690-1860* (Cambridge: Cambridge University Press, 1998) at 14 where the author notes:

Two institutional developments in late seventeenth-century England – the beginning of the permanent national debt and the rapid spread of the corporate form of enterprise – caused the volume of English securities transactions to become large enough to give rise to an organized securities market... By 1720, the year of the South Sea Bubble, the market and its participants were established London institutions.

Banner goes on to note at 24 that, “by the end of 1695, at least 150 corporations had their shares publicly traded, and trading had centralized in a group of London coffee houses lining ‘Exchange Alley.’”

¹⁸⁴ Assertions that blue-sky laws originating with the Kansas statute of 1911 (Act of March 10, 1911, c 133, 1911 Kan Sess Laws 210) responded to fraud are noted in Jonathan R Macey and Geoffrey P Miller, “Origin of the Blue Sky Laws” (1991) 70 Tex L Rev 347 at 348, n 7, although Macey and Miller present a different account emphasizing the political influence of local state banks, businesses and farmers against out of state interests raising capital in the state.

¹⁸⁵ The quoted words are from s 5 of that Act.

address concerns about securities market fraud in the distribution of securities.¹⁸⁶ What is different about investment crowd-funding now is that it can be done through the Internet instead of through mail, phone, newspaper or other non-Internet means of communication. If investment crowd-funding were allowed to proceed in an unregulated way, it might be said to be effectively a return to the pre-securities regulation days.¹⁸⁷ A concern for opening the door to securities fraud by allowing investment crowd-funding suggests that any exemption for crowd-funding must be constrained in a way that provides some control against securities fraud. It would, however, have to do so in a way that does not make the crowd-funding exemption so costly that it becomes useless, particularly to the start-up and small business enterprises it is intended to benefit.

B) Misrepresentation

Fraud is usually understood to involve a deliberate act. Persons promoting a business venture *may*, however, have very optimistic views of the potential for the business's success and that may cause them to have an honest focus on positive information and an honest lack of awareness of negative information.¹⁸⁸ Anxious to raise funds they may be inclined to present a more favourable picture of the business than a more neutral observer might.¹⁸⁹ Securities regulation not only requires full, true and plain disclosure of all material facts, but it gives teeth to that requirement by backing it up with penal, administrative and civil sanctions for non-compliance.¹⁹⁰ It is therefore intended to give promoters a greater incentive than they might otherwise have to investigate the truth of the information provided in the mandated disclosure.

¹⁸⁶ On fraud being a concern that the *Securities Act of 1933* responded to see Joel Seligman, "The Historical Need for a Mandatory Corporate Disclosure System" (1983) 9 J Corp L 1 at 18-33.

¹⁸⁷ A concern for opening the door to fraud has been expressed in the context of investment crowd-funding. See e.g. warnings from the North American Securities Administrators Association, "NASAA Warns of Potential Dangers of Crowdfunding Investment Opportunities", May 5, 2012, online: <<http://www.nasaa.org/12835/nasaa-warns-of-potential-dangers-of-crowdfunding-investment-opportunities/>>; "Laws Provide Con Artists with Personal Economic Growth Plan", August 21, 2012, online: <<http://www.nasaa.org/14679/laws-provide-con-artists-with-personal-economic-growth-plan/>>. See also Hazen, "Crowdfunding or Fraudfunding?" *supra* note 119 at 1763-68.

¹⁸⁸ This is, admittedly, a speculative observation not based empirical evidence.

¹⁸⁹ This too is a speculative observation.

¹⁹⁰ See the discussion *supra* Parts 2 A) 1) and 2 B) 1). Louis Brandeis suggested in 1914 that fraud could be discouraged through disclosure saying "sunlight is said to be the best of disinfectants; electric light the most efficient policeman;" see Louis D Brandeis, *Other People's Money* (New York: Frederick A. Stokes, 1914) at 92.

C) Disclosure on Distribution

To address concerns about fraud or misrepresentation one might consider alternatives, such as those used in the offering memorandum exemption, that avoid the cost and delay of the prospectus requirement while still providing a degree of investor protection. Like the offering memorandum exemption, one might consider some substitute form of disclosure that would be less costly and less dilatory than prospectus level disclosure.

D) Continuous Disclosure

As noted in Part 2, once an issuer distributes securities under a prospectus the issuer must then comply with the continuous disclosure requirements. If a crowd-funding exemption from the prospectus requirement was provided but with a degree of investor protection provided through some substitute form of disclosure, one should consider whether there should be a form of follow-up disclosure that would give investors some relatively low-cost way of monitoring their investments.

E) Liability for Misrepresentations in Alternative Disclosure

As noted in Part 2, there is statutory civil liability for a misrepresentation in a prospectus in Canada or in a registration statement or prospectus in the US. If an exemption is granted from the prospectus requirement in Canada, or from the registration statement in the United States, there would be no prospectus or registration statement to which the respective statutory civil liability provisions would apply. If there is to be an alternative form of disclosure then one should consider whether there should be statutory civil liability for a misrepresentation in that alternative form of disclosure.

If there were no alternative statutory civil liability it would leave just the common law contractual remedies of rescission of contract for innocent misrepresentation, damages for breach of contractual warranty, or damages based on common law tort actions for deceit or negligent misrepresentation. Rescission of contract or damages for breach of contractual warranty would not be of much assistance where the issuer has become insolvent. The tort actions both require proof of reliance which can limit the effectiveness of a class action law suit that would likely be necessary in the crowd-funding context since the small investment by each investor would make bringing an action alone prohibitively costly.

F) Cooling-off Period

Another issue to consider is whether investors investing pursuant to a crowd-funding exemption should be entitled to a two-day cooling off period as investors would be in a non-exempt securities offering. If it makes sense to give investors in non-exempt offerings a two-day cooling off period, it also makes sense in the context of a crowd-funding exemption particularly if an alternate form of disclosure is to be provided. The cooling-off period gives investors time to consider the point of sale disclosure provided.

G) Resale Restriction

Another question to be addressed is whether securities acquired under a crowd-funding exemption should be subject to a restriction on resale. If there were no resale restriction one or more persons in a group of initial purchasers of the securities might resell the securities to persons who do not have the benefit of the investor protection conditions of the exemption.¹⁹¹ Perhaps a purchaser under the exemption could be allowed to resell to other investors subject to providing similar protection through Internet access to disclosure documents, together with evidence of meeting other requirements for the crowd-funding exemption.

H) Failure to Raise Required Funds

Securities regulatory merit review, as noted in Part 2 above, gives securities regulators discretion to prohibit a distribution of securities if the amount of funds raised together with the resources of the issuer are insufficient to accomplish the purpose of the issue. One basis for the exercise of this discretion in Canada is that the funds will be insufficient to carry out the issuer's proposed business. One might ask what would happen if the funds raised from the crowd-funding offering were not sufficient to carry out the issuer's proposed business. Should the funds be held in trust until a sufficient amount has been raised? What steps need to be taken (such as record-keeping) to assure that funds can be returned to investors if insufficient funds are raised?

¹⁹¹ In the crowd-funding exemptions discussed below investor protection is provided, in part, through limits on the amount individual investors can invest. Without a resale restriction investors who purchase under the exemption might resell to others who acquire the securities in amounts beyond the individual investment limits of the exemption thereby undermining the cost-benefit concept behind it.

I) Risk Acknowledgement and Investment Advice

Start-up and small business enterprises can be quite risky.¹⁹² Investors sought in a broad Internet crowd-funding campaign may not be particularly sophisticated and might not realize the risks associated with investments in start-up and small business enterprises. One might consider a way of informing them of the risk and having them acknowledge that they are aware of the risk, including the risk that they could lose everything invested in the particular issuer. Another approach might be to require that investors get investment advice from a registered investment adviser who can advise the investor as to whether the particular investment is appropriate for that investor, although that might be quite expensive relative to the small amounts individual investors would invest through crowd-funding.

J) Need for an Intermediary

Distributions of securities under a prospectus offering usually involve an underwriter.¹⁹³ One of the services an underwriter provides is the marketing of the securities. Part of the purpose of most investment crowd-funding offerings, particularly for small business or start-up business offerings, would be to avoid the cost of engaging an underwriter to market the offering. A reduction of small business finance costs through a crowd-finding exemption might be defeated if the issuer had to engage an underwriter. One therefore might want to permit crowd-finding without an underwriter.

Even if there is no underwriter marketing a crowd-funding securities offering, an intermediary may still perform useful functions. An intermediary might, for instance:

- (1) help ensure that the sales of the securities are properly executed with funds being collected from investors who commit to

¹⁹² Only 50% of new businesses in the US survive past the first five years. See Robert Langley, "Why small businesses fail: sba", online: <<http://usgovinfo.about.com/od/smallbusiness/a/whybusfail.htm>>. The number is similar for Canada with a survival rate in the first five years of 51%. See Start Up Canada, *Statistics on Small Business in Canada*, online: <http://www.startupcan.ca/wp-content/uploads/2012/01/Statistics-on-Small-Business-in-Canada_StartupCanada.pdf>.

¹⁹³ A distribution of securities under a prospectus can, and sometimes is, made to exempt purchasers without the involvement of an underwriter. Although the purchasers are "exempt purchasers" because they fall under an exemption from the prospectus requirement, a prospectus may nonetheless be produced with the issuer becoming a reporting issuer so that the exempt purchasers can resell the securities without being subject to a resale restriction.

purchasing the securities and with evidence of ownership of the securities being delivered to the investors;

- (2) be responsible for delivery of disclosure documents to be provided on the sale of securities if some form of disclosure is to be provided in connection with the distribution of securities in a crowd-funding exemption;
- (3) receive and hold funds invested in trust until the amount of funds required to carry out the issuer's business under the offering are collected;
- (4) be responsible for keeping track of the names of and contact information for investors in the event funds are to be returned to them if the funds collected are insufficient for the purpose of the offering and perhaps also for the purpose of facilitating delivery of follow up disclosure, payment of interest or dividends, or delivery of documents in connection with the exercise of voting rights on the securities.

As noted in the introduction, a number of Internet platforms have been developed to assist in crowd-funding for charitable donations. These sorts of platforms could provide similar services in the context of investment crowd-funding.

An issuer of securities might choose to carry out each of the functions an intermediary might provide or perhaps engage any number of other persons to perform these functions on its behalf. Should these functions, however, be performed by an intermediary registered under securities legislation? The advantage of having a registered intermediary perform these sorts of functions is that the registration system can provide greater assurance that these functions will not only be performed but will be performed properly by persons having the proper knowledge and experience to do so. The registration requirement could back up the performance of these functions with penal, administrative and civil sanctions for non-performance or negligent performance. The registrant could be required to maintain a minimum capital to meet unfulfilled obligations relating to non-performance or negligent performance of registrant functions and a contingency fund could be set up to cover losses incurred as a result of a non-performance or negligent performance of these functions in the event the registrant is insolvent.

K) Cost of Exemption Compliance

Exemptions from the prospectus requirement are provided where certain specified conditions are met. To rely on an exemption and thereby avoid potential penal, administrative and civil sanctions for non-compliance with the prospectus requirement, the issuer must take steps to satisfy itself, presumably with a reasonable degree of certainty, that the exemption conditions are met. The issuer will incur costs in taking steps to satisfy itself that the conditions are met. If the point of the exemption is to relieve the issuer of the costs of the prospectus requirement where those costs are greater than the benefits of the prospectus requirement, it would not make sense for the costs of exemption compliance to be as high, or higher, than the costs of complying with the prospectus requirement. One therefore has to be careful in setting out the conditions for the exemption, including alternate means of investor protection such as an alternative form of disclosure or measurement of wealth, that one does not render the exemption useless. This can be a tricky exercise if the costs of prospectus compliance relative to exemption compliance are not easily measured and different persons are likely to reasonably disagree on whether the proper balance has been struck.

L) Corporate Law Shareholder Communication Requirements

If the issuer is an incorporated entity there will be provisions in the statute under which it was incorporated that it will have to comply with.¹⁹⁴ If shares are issued in a crowd-funding offer, the corporate issuer will have to notify shareholders of upcoming annual and special shareholder meetings,¹⁹⁵ distributions of dividends and possible distributions of capital if the corporation is dissolved. Consequently there needs to be some system for communicating with shareholders. This is typically done by issuing

¹⁹⁴ Some provisions in corporate statutes are “enabling” provisions in the sense that they permit the corporation to have a particular provision in its corporate constitution. The pre-emptive right in s 28 of the *Canada Business Corporations Act*, RSC 1985, c C-44 (*CBCA*) is arguably of this sort. Some provisions in corporate statutes are “default” provisions in the sense that what the statute says applies unless the corporate constitution provides otherwise. Section 121 of the *CBCA* is of this default sort saying that directors can appoint officers but this is “subject to the articles, the by-laws or any unanimous shareholder agreement.” Some provisions are, however, “mandatory” in the sense that they cannot be overridden by the corporate constitution. The *CBCA* has provisions of this mandatory sort such as class voting rights (s 176), the appraisal remedy (s 190), and the oppression remedy (s 241).

¹⁹⁵ See e.g. *CBCA*, *ibid*, s 135 concerning notice of shareholder meetings. Notice of a shareholder meeting may also be necessary even for shares that do not carry general voting rights since Canadian corporate statutes give voting rights to otherwise non-voting shares in certain situations; see e.g. *CBCA* ss 176, 184, 188(4), 189(6), (7), and 211(3).

shares in registered form¹⁹⁶ and maintaining a shareholder register.¹⁹⁷ Maintaining a shareholder register, or having it maintained on the corporation's behalf, can be costly where there are a significant number of shareholders. Since the idea behind investment crowd-funding is usually to attract funds in small amounts from a very large number of investors, it may turn out that the per-shareholder cost of shareholder records and communications is high relative to the average shareholder investment.

M) Corporate Governance

A longstanding issue in corporate governance is what has been described as the "separation of ownership and control."¹⁹⁸ The problem is that with many persons holding relatively small interests in a business, as investment crowd-funding would normally be expected to produce, each investor has little incentive to monitor the persons who are managing the business day-to-day. In addition to having little incentive to monitor managers, investors may be inclined to rely on other investors to monitor managers so they can share in the benefits of monitoring while allowing those other investors to bear the monitoring costs. Who then checks to see that the managers are using investor funds for the intended purposes? Who checks to see that the managers are otherwise acting in the interests of investors and not their own interests? Who checks to see that managers are devoting the attention to the business they should? These are problems in the context of virtually all businesses with investments from other than a sole proprietor, but the problem is likely to be exacerbated where there are a large number of investors who have made relatively small investments as is likely to be the case for a business that has raised funds through investment crowd-funding.

¹⁹⁶ *CBCA, ibid*, s 48(4) says that a security is in registered form if it specifies a person entitled to the security or to the rights it evidences and its transfer is capable of being recorded in a securities register or it bears a statement that it is in registered form. *CBCA, ibid*, s 49(1) says that every security holder is entitled at their option to a security certificate that complies with the Act, and s 49(7) says that each share certificate shall state on its face, among other things, the name of the person to whom it was issued.

¹⁹⁷ See e.g. *CBCA, ibid*, s 50 which requires that the corporation maintain a securities register in which it records the securities issued by it in registered form showing the names and latest known address of each person who is or has been a security holder, the number of securities held by each security holder and the date and particulars of the issue and transfer of each security.

¹⁹⁸ Recognition of this concern is usually attributed to Adolf A Berle and Gardiner C Means, *The Modern Corporation and Private Property* (New York: The MacMillan Company, 1933) in which ch VI discusses "The Divergence of Interest between Ownership and Control."

N) Disgruntled Investor Lawsuits

Given the high rate of failure of start-ups and small businesses there will be a significant number of ventures that fail and others that give little or no return on investment. Individual investors may not be inclined to sue on their own since amounts invested will be relatively small making the risk and cost of unsuccessful litigation too high relative to potential awards. Some disgruntled investors may, however, pursue, or be encouraged to pursue, a class action law suit. The risk and cost of such law suits for the issuer and its promoters would be another cost that should be weighed not just by issuers and promoters, but in addressing the question of whether the costs of a crowd-funding exemption would outweigh the benefits. The cost of law suits for a start-up or small business that has relied on a crowd-funding exemption may be proportionately higher and this is a cost that should, perhaps, be considered in assessing the cost-benefit of a crowd-funding exemption.

O) Failures, Frauds, and Reputational Effects on Venture Capital Formation

Another concern is the reputational effect crowd-funding failures might have. If a crowd-funding exemption did, in fact, lead to a higher risk of fraud and exposed a greater number of investors to start-up and small business failures, it might have a reputational effect on start-up and small business finance more generally. If the reputational effect was not confined to investment crowd-funding but affected other means of start-up and small business finance, the crowd-funding exemption might have the perverse effect of making start-up and small business finance more difficult instead of easier.

P) Other Issues

The issues noted above are just a few of the many issues that might need to be considered in creating a crowd-funding exemption intended to facilitate start-up and small business finance while protecting investors in a manner that fits existing securities laws. A great many other specific issues have been raised in the SEC's proposed crowd-funding rules¹⁹⁹ and in the OSC's request for comments on its crowd-funding exemption proposal.²⁰⁰ With the issues noted in A to O above in mind, Parts 5 and 6

¹⁹⁹ SEC, *Proposed Rules on Crowdfunding*, 17 CFR Parts 200, 227, 232, 240 and 249 [Release Nos. 33-9470; 34-70741; File No S7-09-13] (23 October 2013).

²⁰⁰ See OSC Staff Consultation Paper 45-710. Crowd-funding is discussed in part 2.2 E at 14-17 and part 5.2 at 26-31; and *Introduction of Proposed Prospectus Exemptions*

describe the provisions of the US *Crowdfund Act* and the investment crowd-funding exemptions that have been proposed in Canada.

5. The US Federal Crowdfund Act

The SEC has authority to exempt crowd-funding from the registration statement disclosure requirement under the Securities Act of 1933²⁰¹ and to exempt crowd-funding websites from registration under the Securities and Exchange Act of 1934 as brokers or investment advisors.²⁰² A number of proposals for a crowd-funding exemption were made to the SEC and there was Congressional pressure on the SEC to consider a crowd-funding exemption.²⁰³ In November of 2011, however, Congress passed a bill providing for a crowd-funding exemption.²⁰⁴ A Senate bill providing for such a crowd-funding exemption was introduced in November of 2011 followed by the introduction of another Senate bill containing a crowd-funding exemption in December of 2011.²⁰⁵ The discussion of these bills ultimately culminated in the inclusion of a crowd-funding exemption in the *JOBS Act* enacted on April 5, 2012.²⁰⁶

and Proposed Reports of Exempt Distribution in Ontario (2014), 37 OSCB (Issue 12, Supp-3) [OSC Proposals] at 15-21 and D-1 to D-22.

²⁰¹ Section 3(b) of the *Securities Act of 1933* (15 USC §77c(b)) authorizes the SEC to exempt offerings of less than \$5 million where “enforcement ... with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering.” Section 28 of that Act also authorizes the SEC to exempt “any person, security, or transaction, or any class or classes of persons, securities, or transactions” from any provision of the Act or rules passed pursuant to the Act. See the discussion in Bradford, *supra* note 2 at 87-88.

²⁰² Section 36(a) of the *Securities and Exchange Act of 1934* (15 USC §78mm(a)) authorizes the SEC to “conditionally or unconditionally exempt any person, security, or transactions” from any provisions of the Act if it finds it “is necessary or appropriate in the public interest, and ... consistent with the protection of investors.” See the discussion in Bradford, *ibid* at 88.

²⁰³ See the discussion of proposals made to the SEC in Bradford, *ibid* at 81-86.

²⁰⁴ *Ibid* at 88-91.

²⁰⁵ *Ibid* at 91-98.

²⁰⁶ The Act was to come into force when the SEC had passed rules for the implementation of the Act. Section 302(c) of the *JOBS Act*, *supra* note 14, gave the SEC a period of 270 days after the enactment of the *Crowdfund Act* to issue rules for the protection of investors to carry out the crowd-funding exemption provided for in ss 4(6) and 4A added to the *Securities Act of 1933* by the *Crowdfund Act*. At the date of the writing of this article the rules had yet to be promulgated and the *Crowdfund Act* had yet to come into force.

The *Crowdfund Act* is in Title III of the *JOBS Act*.²⁰⁷ As noted above, the *JOBS Act* modifies US federal securities laws to facilitate small business finance. For instance, Title I of the *JOBS Act* reduces financial and executive compensation disclosure obligations for a company that has less than \$1 billion in annual gross revenues during its most recently completed fiscal year (referred to in the *JOBS Act* as an “emerging growth company”).²⁰⁸ Title II of the *JOBS Act* requires the SEC to set out rules facilitating communications with potential accredited investors.²⁰⁹ Title IV requires the SEC to create a class of exempt securities up to \$50 million worth of which can be sold in any 12-month period with the distribution to investors of an offering statement containing such disclosure as the SEC prescribes, together with annual audited financial statements and such other continuous disclosure as the SEC prescribes.²¹⁰ The focus in this paper is on the *Crowdfund Act* in Title III of the *JOBS Act*.

The *Crowdfund Act* amends section 4 of the *Securities Act of 1933* that provides a series of exemptions from the requirements of section 5.²¹¹ In particular, the *Crowdfund Act* adds section 4(a)(6) to the *Securities Act of 1933* providing a new exemption subject to specified conditions.²¹² The specified conditions:

- (1) restrict the amount that can be raised under the exemption in any 12-month period;
- (2) restrict the total amount that can be raised under the exemption from individual investors in any 12-month period;
- (3) substitute modified disclosure requirements for the normal registration statement and prospectus disclosure;
- (4) provide a modified liability for misrepresentations in the disclosure used when offering the securities;

²⁰⁷ Title III of the *JOBS Act*, *ibid*, bears the heading “CROWDFUNDING” but s 301 of the *JOBS Act* says that title III of the *JOBS Act* may be cited as the “*Crowdfund Act*.” Section 301 says the Act in Title III may also be cited as the “*Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012*.”

²⁰⁸ See the *JOBS Act*, *ibid*, s 102 amending s 14A(e) of the *Securities Exchange Act of 1934*.

²⁰⁹ *JOBS Act*, *ibid*, s 201.

²¹⁰ *Ibid*, s 401.

²¹¹ *Ibid*, s 302.

²¹² *Ibid*, s 302(a).

- (5) require the distribution to be done through a registered broker or “registered funding portal”; and
- (6) provide for reduced continuous disclosure requirements.

A) Maximum Amount Raised in any 12-month Period

Section 302 of the *Crowdfund Act* adds section 4(a)(6)(A) to the *Securities Act of 1933*. It allows an issuer to raise up to \$1 million in any 12-month period.

B) Restrictions on Amount Individual Investors can Invest

Section 302 of the *Crowdfund Act* also adds section 4(a)(6)(B) to the *Securities Act of 1933* that limits the amount individual investors can invest in any given issuer in a 12-month period in reliance on the crowd-funding exemption. If the investor has either annual income or net worth of less than \$100,000, the total amount an investor can invest in a 12-month period under the crowd-funding exemption is limited to a maximum of \$2,000 or 5 per cent of the investor’s annual income or net worth. If the investor’s annual income or net worth is \$100,000 or more, the amount that investor can invest in a 12-month period under the crowd-funding exemption is 10 per cent of the investor’s annual income or net worth to a maximum of \$100,000.

C) Disclosure on Distribution and Avoidance of the “Waiting Period”

The exemption exempts the person seeking investment funds from the requirement to file a registration statement under section 5 of the *Securities Act of 1933*. The effect of this is that the person does not have to provide the extensive disclosure required in a registration statement and does not have to go through the process by which the SEC reviews the registration statement. The delay created by the “waiting period” between the date a draft registration statement is filed and the date it becomes effective is thereby avoided.

The exemption, however, only applies if the person seeking the funds files with the SEC and provides investors with an alternative form of disclosure specified pursuant to section 4A(b) of the *Securities Act of 1933* that has been added by the *Crowdfund Act*. The required disclosure includes:

- (1) the name, legal status, address and website address of the issuer;

- (2) the names of the directors and officers and of each person who holds more than 20 percent of the shares of the issuer;
- (3) a description of the business of the issuer and the anticipated business plan of the issuer;
- (4) a description of the financial condition of the issuer;
- (5) the stated purpose and intended use of the proceeds of the offering;
- (6) the amount to be raised by the offering and the deadline for reaching that amount;
- (7) the price or method for determining the price of the securities; and
- (8) a description of the ownership and capital structure of the issuer.

The SEC is also given the power to prescribe other information to be disclosed “for the protection of investors and the public interest.”

A registration statement would require audited financial statements and, as noted above, audits can be expensive. The *Crowdfund Act* modifies this. It requires, as noted in item (4) of the list above, “a description of the financial condition of the issuer” and sets out three different levels of verification of the financial information provided. If the amount to be raised is \$100,000 or less, the issuer must provide the income tax returns filed by the issuer for the most recently completed year (if any), and financial statements for the issuer that must be certified by the principal executive officer of the issuer to be true and complete in all material respects. If more than \$100,000 but less than \$500,000 is being raised, the issuer must provide financial statements “reviewed by a public accountant who is independent of the issuer.” If more than \$500,000 is being raised, the issuer must provide audited financial statements.

D) Statutory Civil Liability

As noted in Part 2 B) 1) c) above, statutory civil liability for misrepresentations in a registration statement is provided for in section 11 of the *Securities Act of 1933*. That section refers to liability for misrepresentations in a “registration statement.” Since the *Crowdfund Act* provides an exemption from the registration statement requirement in section 5 of the *Securities Act of 1933*, no registration statement will be filed when the exemption is relied upon and therefore section 11 will not

apply. The *Crowdfund Act* addresses this by setting out a separate statutory civil liability regime for the disclosure required where the exemption is relied on. Section 302(b) of the *Crowdfund Act* adds section 4A(c) to the *Securities Act of 1933* giving a person who purchases securities offered under the exemption a statutory right of action for rescission or damages against the issuer, and any director, principal executive officer, principal financial officer, principal accounting officer of the issuer or selling security holder who makes an untrue statement of a material fact or fails to state a material fact required to be stated or necessary in order to make statements not misleading in the circumstances under which they were made. The section provides two defences. One is that the purchaser knew the statement was untrue or that there was an omission. The other is that the defendant proves that he did not know, and in the exercise of reasonable care could not have known of the untruth of the statement or that there was an omission.

E) Distribution through Registered Broker or “Registered Funding Portal”

Section 4(a)(6)(C) of the *Securities Act of 1933*, added by section 302(a) of the *Crowdfund Act*, requires an issuer relying on the crowd-funding exemption to use a broker or “funding portal” registered under section 4A(a) of the *Securities Act of 1933*. Section 4A(a), added by section 302(b) of the *Crowdfund Act*, requires a person acting as an intermediary in a transaction involving the offer or sale of securities under the crowd-funding exemption to register with the SEC as either a broker or a “funding portal.”

The “funding portal” concept is a new addition to the registration requirement. As noted above, a funding portal would likely have been considered a “broker” as that term is defined in the *Securities Exchange Act of 1934*. It would therefore likely have had to be registered as a broker and would have been subject to the full panoply of regulation relating to brokers. Making a funding portal a separate category of registrant allows the regulatory requirements for funding portals to be different from those for brokers and therefore can be better suited to the specific service of providing a portal for crowd-funding.

Section 304(b) of the *Crowdfund Act* adds the definition “funding portal” to the *Securities Exchange Act of 1934*.²¹³ It is defined to mean

²¹³ This added definition appears as s 3(a)(80) of the *Securities Exchange Act of 1934*. Curiously s 101(b) of the *JOBS Act* also designated s 3(a)(80) of the *Securities Exchange Act of 1934* as the spot for the added definition of “emerging growth company.”

“any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to section 4(6) of the Securities Act of 1933.” The definition restricts the activities of a “funding portal” to crowd-funding since section 4(6) of the *Securities Act of 1933* is the crowd-funding exemption. A person may also be registered under the added section 4A as a “broker” for the purpose of acting as an intermediary in a crowd-funding offer so the definition of “funding portal” goes on to distinguish a “funding portal” from a “broker.” The definition of “funding portal” therefore provides that a “funding portal” must not (1) offer investment advice or recommendations; (2) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; (3) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; or (4) hold, manage, possess, or otherwise handle investor funds or securities.

The *Crowdfund Act* imposes a number of obligations on persons acting as intermediaries in a crowd-fund offering making, in effect, these registered intermediaries the gatekeepers for investor protection. The intermediary must:

- (1) provide such disclosures, including disclosures related to risks and other investor education materials, as the SEC determines by rule;
- (2) ensure each investor:
 - (a) reviews investor-education material;
 - (b) positively affirms he or she understands the risk of losing the entire investment and that he or she could bear such a loss; and
 - (d) answers questions showing an understanding of the level of risk associated with small or start-up businesses, and of the risk associated with the difficulty of selling the securities;
- (3) take measures to reduce the risk of fraud including obtaining a background and securities enforcement regulatory history check on each officer, director and person holding more than 20 per cent of the outstanding equity of the issuer;
- (4) file with the SEC and make available to potential investors the information the issuer is required to provide in connection with the crowd-funding exemption;

- (5) ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount and allowing investors to cancel their commitments to invest in the manner the SEC determines by rule;
- (6) make efforts to ensure that no investor investment exceeds the investment limits for the crowd-funding exemption;
- (7) take steps to protect the privacy of information obtained from investors;
- (8) not compensate promoters or finders for providing it with personal identifying information of any potential investor; and
- (9) prohibit its directors, officers or partners from having any financial interest in an issuer using its services.

F) Continuous Disclosure

There will be continuous disclosure obligations associated with a crowd-funding exemption. The *Crowdfund Act* adds section 4(6)(b)(4) to the *Securities Exchange Act of 1933* which provides that an issuer relying on the crowd-funding exemption must file with the SEC and provide to its investors annual reports of its results of operations and financial statements as the SEC may, by rule, determine.

G) Resale Restriction

As noted in Part 4 G) above, the investor protection intended to be provided by securities regulation would be undermined if securities could be sold to a person under an exemption and that person was then able to resell the securities shortly thereafter (perhaps on the same day) to the kinds of investors securities regulation was intended to protect. Consequently, resale restrictions typically apply to exemptions to prevent the person who acquires securities pursuant to an exemption from reselling the securities to persons that need investor protection.²¹⁴ The *Crowdfund Act*, therefore, sets out restrictions on resales. It adds section 4A(e) to the *Securities Act of 1933* which provides that securities issued pursuant to the crowd-funding exemption cannot be transferred by the purchaser for one year from the date of purchase except to the issuer of the securities, an accredited investor, pursuant to an offering under a registration statement, or to a member of the family of the purchaser in connection with the death

²¹⁴ For the US see *supra* Part 2 B) 4).

or divorce of the purchaser.²¹⁵ The SEC is also given the authority to set out other restrictions on re-sales.

H) Application of State Law

State securities laws also require registration of broker-dealers and of securities offerings.²¹⁶ Registering securities offerings in every state can delay and increase the cost of offerings.²¹⁷ While a small business raising funds by means other than crowd-funding might restrict the offering to a particular state (usually one in which the business is being carried on or where its head office is located), crowd-funding, by its nature, is likely to involve investors from many states. If securities offered under a crowd-funding exemption had to be registered in every state where offers were made it would likely defeat the purpose of the crowd-funding exemption. The *JOBS Act*, therefore, amends section 18 of the *Securities Act of 1933* to exempt securities offered under the crowd-funding exemption from the requirement to register the securities under state securities laws.²¹⁸ It also restricts states from charging fees with respect to securities sold under the crowd-funding exemption except for the state where the principal place of business of the issuer is located.²¹⁹ The *JOBS Act* also exempts funding portals from state registration with respect to its business as a funding portal.²²⁰

State securities regulatory authorities have played an active role in securities enforcement²²¹ and there was concern that the federal SEC would not have the resources to monitor the many relatively small securities offerings that might be made under the crowd-funding exemption.²²² Consequently the *JOBS Act* provides that the exemption from state regulation “relate[s] solely to State registration, documentation, and offering requirements ... and shall have no impact or limitation on other State authority to take enforcement action with regard to an issuer,

²¹⁵ The SEC is given the authority to establish other circumstances similar to death or divorce in which a transfer to a member of the family of the purchaser can be made; see s 4A(e)(D).

²¹⁶ See the discussion in Michael W Shumate, “Crowdfunding and State Level Securities Fraud Enforcement Under the JOBS Act” (2013) *Denv UL Rev* 109.

²¹⁷ *Ibid* at 109.

²¹⁸ *JOBS Act*, *supra* note 14, s 305(a).

²¹⁹ *Ibid*, s. 305(c).

²²⁰ *Ibid*, s 305(d).

²²¹ Shumate, *supra* note 215 at 111.

²²² *Ibid* at 114, referring to comments in a letter from Jack E Herstein, President of the North American Securities Administrators Association saying the SEC lacked “the resources and time to effectively police these small-scale offerings.”

funding portal, or any other person or entity using the [crowd-funding] exemption from registration.”²²³

6. *A Crowd-funding Exemption in Canada*

On December 5, 2013 the Financial and Consumer Affairs Authority of Saskatchewan issued a crowd-funding exemption order effective December 6, 2013.²²⁴ On March 20, 2014 the BC Securities Commission issued a request for comments on a proposed crowd-funding exemption modelled on the Saskatchewan exemption, referring to it as a “start-up crowdfunding exemption.”²²⁵

Also on March 20, 2014, the OSC, armed with comments on a consultation paper it issued in December of 2012,²²⁶ and after further consideration, published and requested comments on proposals for new prospectus exemptions including a crowd-funding proposal (referred to as the “Integrated Crowdfunding Exemption”).²²⁷ The Integrated Crowdfunding Exemption proposal indicated that in developing the proposal the OSC had worked closely with the Autorité des marchés financiers in Quebec, the Manitoba Securities Commission, the New Brunswick Financial and Consumer Services Commission, the Saskatchewan Financial and Consumer Affairs Authority and the Nova Scotia Securities Commission.²²⁸ Unlike the US, where a crowd-funding exemption was provided for in legislative form for reasons discussed earlier, such an exemption in Canada, as in the case of Saskatchewan, would be provided for through the exercise of securities administrator rule-making powers and would likely take the form of a multilateral or national instrument.

The start-up crowd-funding exemption and the Integrated Crowdfunding Exemption can arguably co-exist. The start-up crowd-funding exemption, while not specifically limited to “start-up” businesses,

²²³ *JOBS Act*, *supra* note 14, s 305(b).

²²⁴ Financial and Consumer Affairs Authority of Saskatchewan General Order 45-925.

²²⁵ British Columbia Securities Commission, “Notice and Request for Comment on Start-Up Crowdfunding,” BC Notice 2014/03. The reference to the Saskatchewan exemption as the “start-up crowdfunding exemption” is at 1 of the notice.

²²⁶ See OSC Staff Consultation Paper 45-710 entitled “Considerations for New Capital Raising Prospectus Exemptions” which included an “exploration of crowdfunding” and a “crowdfunding concept” that encompassed “many of the investor protection elements of the crowdfunding exemption in the JOBS Act.” Crowd-funding is discussed in part 2.2 E at 14-17 and part 5.2 at 26-31 of the consultation paper.

²²⁷ OSC Proposals, *supra* note 200.

²²⁸ *Ibid*, Part 5 D at 15-16.

is likely to be more suited to a start-up situation since it has a low limit on the amount of funds that can be raised (\$150,000), an individual investment limit of \$1,500 and can only be used by non-reporting issuers (that is, issuers that have not issued securities in a prospectus offering). It also has fewer conditions and, therefore, arguably less investor protection. The Integrated Crowdfunding Exemption would be open to both reporting issuers and non-reporting issuers and would allow offerings of up to \$1.5 million with individual investments of up to \$2,500, but would be subject to more conditions directed primarily at providing investor protection. More detail on each of these exemptions is provided below.

A) The Start-up Crowd-funding Exemption

The Saskatchewan exemption order in December of 2013 allows non-reporting issuers to raise up to \$150,000 twice per year offering securities other than derivative securities to investors who can invest no more than \$1,500 in any given offering under the exemption. The offering must be done through a “portal.” The offering period can be no longer than six months. The issuer must file a form ten business days prior to the sale of the securities²²⁹ and must use an offering document that indicates:²³⁰

- (1) the issuer’s form of organization;
- (2) where the constating document of the organization can be viewed;
- (3) what business the issuer does;
- (4) how funds were previously raised and what they were used for;
- (5) information on the management team’s business experience;
- (6) whether the issuer has financial statements if so where they can be viewed;

²²⁹ Form GO45-925F1, online: <<http://www.fcaa.gov.sk.ca/adx/asp/adxGetMedia.aspx?DocID=6238,246,243,1,Documents&MediaID=3a50f513-53ef-4ef6-976b-32e26e42b21f&Filename=Issuer+Information+Form.pdf>> that asks for six pieces of information: (1) the issuer’s name and address; (2) the name of the issuer’s contact person; (3) the full names of each promoter, director, officer and control person of the issuer; (4) the name of the portal the issuer will use; (5) the date the issuer will begin raising money; and (6) whether the issuer has made an offering under the crowd-funding exemption before.

²³⁰ Form GO45-925F3, online: <<http://www.fcaa.gov.sk.ca/adx/asp/adxGetMedia.aspx?DocID=6238,246,243,1,Documents&MediaID=3bc43e46-b9b8-4a4b-babb-6d6039084e2b&Filename=Offering+Document.pdf>>.

- (7) what the current financial condition of the issuer is;
- (8) the minimum amount the issuer intends to raise and by what date;
- (9) what the funds raised will be used for, including what will be done with amounts raised in excess of the minimum amount;
- (10) the type of security being offered, the rights attached to that security and the offering price;
- (11) how reporting on the business will be done; and
- (12) risks associated with the investment.

The offering document goes on to ask the investor to “please consult with a professional adviser to go over your legal rights in detail” and then notes certain legal rights under the Saskatchewan *Securities Act*. The securities acquired under the exemption cannot be resold unless the issuer has become a reporting issuer and has been a reporting issuer for a period of four months.²³¹

The portal through which a crowd-funding offering must be done does not need to be registered.²³² The portal can charge the issuer a fee but cannot charge a fee from investors. It must make the offering document of the issuer available to investors electronically on-line along with “Important Risk Warnings.” The Important Risk Warnings require the investor to acknowledge certain things including that “I understand that I might not make any money from this investment, I could lose my entire investment, and I will find it very difficult to sell this investment.”²³³ The

²³¹ Financial and Consumer Affairs Authority of Saskatchewan General Order 45-925, *supra* note 224 at para 18 (referring to NI 45-102 applied as if the securities were acquired under section 2.5 of NI 45-106).

²³² *Ibid*, where it is “further ordered” that the registration requirement does not apply to the portal if it files certain information, is not related to the issuer of the securities, is located in Canada, provides no advice and meets certain other specified conditions.

²³³ See *ibid* at Appendix A. The investor is also required to acknowledge that “I have read and understood the Offering Document. This investment opportunity has not been ‘approved’ in any way by the Financial and Consumer Affairs Authority of Saskatchewan, or by anyone else. I understand that I have not received any advice about this investment from this website or the Government of Saskatchewan. If I want guidance, I know that I need to seek professional investment advice. I understand that I do not have as many legal rights when purchasing this investment as I would when investing through a ‘prospectus offering.’ If I want to know more, I know that I need to seek professional legal advice. I currently reside in Saskatchewan.”

portal must not allow an investment until the investor confirms online that he or she has read and understood the offering document and the Important Risk Warnings.²³⁴ The portal must not release funds to the issuer until the minimum amount to close the offering has been reached and ensures the funds are held in trust for investors in an account located in Canada.²³⁵

The March 20, 2014 request for comments by the BC Securities Commission outlined an exemption similar to the one in the Saskatchewan exemption order allowing a non-reporting issuer to raise up to \$150,000 twice per year through an on-line funding portal using a streamlined offering document with no investor investing more than \$1,500. The portal would not need to be registered but would have to comply with conditions similar to those outlined above for the Saskatchewan exemption.

B) The Integrated Crowdfunding Exemption

The Integrated Crowdfunding Exemption proposed by the OSC in conjunction with other securities regulators in Canada²³⁶ has two main components that are similar to the U.S. *Crowdfund Act*: (1) the “Crowdfunding Prospectus Exemption;” and (2) “a set of Crowdfunding Portal Requirements.”²³⁷ The basic elements of the crowd-funding exemption and crowd-funding portal requirements are set out in tabular form on pages 16 to 19 of the OSC Proposals. Further details are provided in Annex D-1 together with specific requests for comments.

1) Crowd-funding Exemption

a) Crowd-funding Exemption Limit and Individual Investor Investment Limits

The crowd-funding exemption would allow an issuer to raise up to \$1.5 million in a 12-month period. An individual investor could not invest more than \$2,500 in a single investment under the exemption and could not invest more than \$10,000 under the crowd-funding exemption in a calendar year.

²³⁴ See item 6 of what is “further ordered” under Financial and Consumer Affairs Authority of Saskatchewan General Order 45-925, *supra* note 224.

²³⁵ *Ibid.*

²³⁶ See *supra* notes 227 and 228 and the accompanying text.

²³⁷ The OSC Proposals, *supra* note 225, Part 5 D, pp. 15.

b) Portal Requirement

The issuer would have to use a “portal” and would have to make the offering materials available on the portal’s website. The issuer could not post the offering materials on any other website but investors could be directed to the portal’s website by paper notice or through social media. Portals, issuers and their directors and officers would be prohibited from lending money to, or arranging financing for, potential investors. Requirements for crowd-funding portals are discussed in subpart 2 below.

c) Issuers that can Rely on the Crowd-funding Exemption

The crowd-funding exemption is intended to support start-up businesses and small to medium-size enterprises²³⁸ in Canada not elsewhere.²³⁹ Use of the crowd-funding exemption is, therefore, restricted to issuers incorporated or organized in Canada, that have their head office in Canada and for which the majority of the directors are resident in Canada. This restriction on where the issuer is organized, has its head office and where the majority of its directors are resident will also presumably facilitate enforcement.

The proposed crowd-funding exemption is intended not only to facilitate start-up business but also to provide a means for established small and medium-size businesses to access additional funds.²⁴⁰ It would, therefore, be available to both reporting issuers and non-reporting issuers. It

²³⁸ The OSC Proposals, *supra* note 200, refer to the widely-use term “SME” that stands for “small to medium-size enterprises.” This paper has referred to small and start-up businesses.

²³⁹ The comment in the table in Annex D-1 under “Issuer Qualifications” at D-5 says that “one of the key objectives of our crowdfunding initiative is to facilitate capital raising for Canadian issuers and we think these restrictions are consistent with that objective.” It is also suggested in the comments that requiring incorporation or organization in Canada may reduce risks to investors. The comment also notes that having a majority of resident Canadian directors may reduce risk to investors.

²⁴⁰ This is indicated in the OSC Proposals, *supra* note 200 at 13 and in the comments in the table Annex D-1 under “Issuer Qualifications” at D-3.

would not be available to investment funds,²⁴¹ real estate issuers that are not reporting issuers,²⁴² or to issuers that do not have a written business plan.²⁴³

d) Restrictions on Types of Securities Offered

There are a number of restrictions on the exemption presumably intended to provide a degree of investor protection. The exemption is available only for distributions by an issuer of securities of its own issue and the types of securities that would be offered would be limited to common shares, non-convertible preference shares, securities convertible into common shares or non-convertible preference shares, non-convertible debt securities linked to a fixed or floating interest rate, units of a limited partnership, or flow-through shares under the *Income Tax Act*. This limits the exemption to more widely-used securities the general terms of which investors might reasonably be expected to be more familiar with. It therefore prevents the exemption from being used to offer more complex securities that might not be easily understood by the type of investors that would be the likely target of crowd-funding. One might have approached this problem by attempting to define categories of excluded securities but this could be prone to abuse since issuers might be very creative in coming up with securities that are quite complex but outside the category of excluded securities.

²⁴¹ The comment in Annex D-1 of the OSC Proposals, *ibid* at D-4 indicates that this restriction was thought to be consistent with “the overall goal of our crowd-funding initiative which is to facilitate capital raising for start-ups and SMEs.” Presumably the idea is to facilitate the raising of funds that will be invested in productive activities rather than in a portfolio of investments.

²⁴² According to the table in Annex D-1 under “Issuer Qualifications” at D-4 of the OSC Proposals, *ibid*, these would include real estate investment trusts (REITs), mortgage investment entities, and issuers that primarily invest in, or develop, real estate, or derive their revenues primarily from investments in real estate. The comment in the table says, “our objective is to facilitate capital raising by start-ups and SMEs.” As with investment funds, presumably the idea is to facilitate the raising of funds that will be invested in productive activities rather than investment funds such as REITs or mortgage investments providing primarily rental income. The National Crowdfunding Association opposes this restriction in comments submitted June 18, 2014, online: <http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/com_20140618_45-106_asanoc.pdf> in response to the OSC Proposals, *ibid*.

²⁴³ That would mean that one preparatory step issuers relying on the exemption would have to take is the preparation of a written business plan. That, however, is probably a prudent step for issuer promoters and managers whether they intend to raise funds from the public or not. It also means, as suggested in Annex D-1 of the OSC Proposals, *ibid*, that so-called “blind pools” (that would invest in some unspecified business or would merge with or acquire an unspecified business) would not be able to use the crowd-finding exemption.

e) Disclosure Requirements on Distribution

Disclosure must be provided in the form of a streamlined disclosure document that includes basic information about the offering, the issuer and the portal. It would include information as to the amount of the issuer's cash with third party confirmation that that amount is held in a bank account or trust. If the issuer has incurred expenditures then annual financial statements must be provided. The annual financial statements need to be audited if the issuer has raised more than \$500,000 through prospectus exemptions and has expended more than \$150,000. Investors must have a statutory right of action for a misrepresentation in any materials provided to investors or, if there is no statutory right of action, an equivalent contractual right of action must be provided.

f) Offering Period Limitation, Withdrawal Right, Risk Acknowledgement and Sufficiency of Funds Raised

The offering could only remain open for a maximum period of 90 days. There would be a right of withdrawal on notice to the issuer at least 48 hours prior to the disclosed offering deadline. Investors would have to sign a risk acknowledgement form in which the investor would have to acknowledge that the investor falls within the investment limits, that the investor could lose all of the money invested, and that the investor understands the other specified risks set out in the acknowledgement form. The offering could not be completed unless the minimum offering is fully subscribed and, at the time of completion of the offering, the issuer has sufficient financial resources to achieve the next milestone in its written business plan or, if there are no such milestones, to carry out the activities set out in its business plan.

g) Continuous Disclosure Requirements

There would be requirements for ongoing (or continuous) disclosure. Reporting issuers using the crowd-funding exemption would be subject to the regular securities law disclosure requirements for reporting issuers. A non-reporting issuer relying on the crowd-funding exemption would have to disclose how the proceeds of the crowd-funding offering have been expended. It would have to provide annual disclosure in the form of annual financial statements that would have to be audited if the issuer has raised more than \$500,000 through prospectus exemptions and has expended more than \$150,000. Instead of the regular securities law requirements for quarterly disclosures and timely disclosure, a non-reporting issuer that has distributed securities in reliance on the crowd-funding exemption would have to disclose certain specified events. A non-reporting issuer would

have to maintain books and records containing the offering materials, completed risk acknowledgement forms, the ongoing disclosure documents referred to above, the number of securities issued under the crowd-funding exemption and the issue prices and dates. It would also have to maintain a record of the names of all the security holders and the number and type of securities held by each security holder.

h) Resale Restrictions

There would be restrictions on the resale of securities acquired under the crowd-funding exemption. If the issuer was a reporting issuer the securities would be subject to a four-month hold period unless other conditions were met. If the issuer was not a reporting issuer the resale of the securities would be subject to an indefinite hold period and could only be resold under another prospectus exemption or under a prospectus.

2) Crowd-funding Portal Requirements

Crowd-funding portals would have to be registered as restricted dealers and would not be permitted to register in any other dealer or advisor category. Registration would require having a specified minimum capital and the acquisition of insurance. There would be reporting, record-keeping and record retention requirements. As in the US *Crowdfund Act*, the portals would have a gatekeeper function. This would include:

- (1) conducting background checks on issuers, directors, officers, promoters and control persons;
- (2) understanding the general structure, features and risks of securities being offered;
- (3) reviewing the information presented by the issuer on the portal's website to confirm it adequately sets out the general features and structure of the security, issuer-specific risks, parties involved, any identified conflicts of interest, and the intended use of funds;
- (4) denying access to an issuer if the portal has reason to believe that the issuer or its offering is fraudulent; and
- (5) provide investor education materials in plain language and obtain from investors a signed risk acknowledgement.

Portals would be prohibited from engaging in the following specified activities:

- (1) providing specific recommendations or advice to investors about securities being offered on their platform;
- (2) soliciting purchases or sales of securities offered on their platform other than through posting an offering on the platform;
- (3) compensating employees or agents for soliciting the sale of securities on their platform;
- (4) holding or handling investor funds or securities;
- (5) investing in any issuer or underwriting the securities of any issuer other than receiving fees in the form of securities that do not exceed a 10 per cent ownership interest in the issuer;
- (6) endorsing or commenting on the merits or expected returns of an investment; or
- (7) facilitating secondary trading in any securities issued under the exemption.

7. Comments on the Proposed Crowd-funding Exemptions

This Part provides some comments on the US federal crowd-funding exemption proposal and the Canadian crowd-funding exemption proposals. A great many comments have been made on a wide range of issues in response to securities administrator requests for comments.²⁴⁴ The comments range from arguments to reduce or remove many of the constraints on the proposed crowd-funding exemption to those that oppose the concept entirely.²⁴⁵ Some comments accept a crowd-funding exemption either in principal or as politically inevitable and focus on ways to strengthen investor protection.²⁴⁶ Canvassing the range of comments

²⁴⁴ Comments in response to securities administrator requests for comments can be found on the SEC website and the websites of Canadian securities administrators.

²⁴⁵ See e.g. the comments of The National Crowdfunding Association, June 18, 2014, online: <http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/com_20140618_45-106_asanoc.pdf>, submitted in response to the OSC Proposals, *supra* note 200.

²⁴⁶ Among the comments submitted in response to the OSC Proposals, *ibid*, see e.g. the comments of the Investment Advisory Panel, June 18, 2014, online: <http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/com_20140618_45-106_craddockc.pdf>; comments from the Canadian Foundation for Advancement of Investor Rights (FAIR), June 18, 2014, online: <http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/com_20140618_45-106_grossn.pdf>; and comments from the Small Investor Protection Association, April 4, 2014, online: <<http://www.osc>

made would require a treatise-length discussion. This part, therefore, simply provides a few of the authors' thoughts on some of the many issues raised some of which reflect comments of others made in response to securities administrator requests for comments.

A) Fraudulent Schemes and their Effects

Whether the investor protection provided in the US *Crowdfund Act* or the Canadian proposals will ultimately be effective remains to be seen. The proposals do, however, attempt to provide a degree of investor protection primarily through the use of funding portals as gatekeepers for crowd-fund offerings. It seems inevitable that in spite of the investor protection safeguards built into a crowd-funding exemption, some fraudulent schemes will slip through and questions will be raised about the adequacy of investor protection in the context of reliance on the crowd-funding exemption. Fraudulent schemes can, of course, occur not just with start-up and small businesses but large businesses as well. They can also occur with the full panoply of corporate and securities law protections for investors. The question is the extent to which a crowd-funding exemption will exacerbate the risk of fraud and what the effect of fraud will be on investment.

1) Bogus Business Schemes

One form of fraud would be bogus business schemes advanced by promoters intending to line their own pockets. Perhaps funding portals will have some ability to identify these. They may also have an incentive to avoid them if there is a significant risk of becoming associated with bad investments and if that results in a consequent reluctance of investors to invest in offerings facilitated by them.

2) Diversion of Profits

Another more subtle type of fraud would involve legitimate successful business schemes in which successful promoters deploy techniques to divert profits to themselves at the expense of the crowd of persons investing in a crowd-fund offering. These techniques can be difficult to detect. When they are detected investors may be able to pursue legal remedies but these can be costly to pursue and have uncertain outcomes dependant on being able to provide sufficient evidence to establish the claims. Pursuit of any legal remedies will likely have to be by way of class action since the potential cost of pursuing legal remedies will likely be far

http://www.gov.on.ca/documents/en/Securities-Category4-Comments/com_20140404_45-106_buells-kivenkok.pdf>.

beyond the potential benefit for any given investor in a crowd of investors who have made relatively small investments. Some, perhaps many, diversions of profits will go undetected. Where detected remedies may not be pursued or, if pursued, may not lead to a remedy. Investors may, therefore, find their investments to be worth nothing or considerably less than they would have expected given the success of the business.

Perhaps a potential reputational effect of diversion of profit frauds will cause funding portals to be vigilant about the kinds of protections investors should have against potential profit diversions and will shun issuers that do not provide them. One might hope, instead, that the crowd would monitor diversions of profits, but monitoring depends on the disclosure of sufficient information to allow detection and the crowd-funding exemption is, in part, designed to reduce disclosure to control offering costs. Further, detection, as noted above, is only the first step – one also has to pursue a remedy. Perhaps the remedy would simply be that investors in the crowd would no longer invest in further securities offerings by the issuer. That may work but only as long as the promoters anticipate seeking more funds from investors.

If one was hesitant to rely on such a funding portal reputational effect to provide protection against diversions of profit or on monitoring and enforcement by the crowd, one might want to consider requiring that issuers provide certain minimum rights on securities offered. In setting out such minimum rights one should bear in mind that promoters might not use a corporation incorporated under a statute that carries such minority shareholder protections as supermajority voting for fundamental changes, class voting rights, statutory derivative actions, an appraisal remedy, or an oppression remedy. The promoters might, indeed, use some other form of organization such as partnership or trust where these sorts of corporate remedies could be avoided.

3) Effect on Investment

The concern for fraud under a crowd-funding exemption raises a number of difficult to assess empirical questions. Will fraud be more prevalent in crowd-funded offerings? If they are, will investors shy away from investment crowd-fund offerings leaving investment crowd-funding as just a passing fad? If crowd-fund frauds do affect investment decisions, will the effect be confined to crowd-fund investments or will it have a broader effect on investments? For instance, if investors are not be able to distinguish crowd-fund fraud risk from fraud risk in certain other investments, investment in those other investments may also be affected. One might attempt to address these empirical questions by experimenting

with a crowd-funding exemption, but once such an exemption is in place it may prove politically difficult to remove even if it subsequently appears to impose costs that outweigh its benefits.

B) Effect of Start-up and Small Business Failures

Even without frauds, it will also be interesting to see whether reliance on the exemption will be affected by the high rate of start-up and small business failures. Will investors truly appreciate the risks involved at the outset or, on becoming aware of the risks after a series of failed investments, shy away from crowd-funding thereby discouraging start-ups and small businesses from making crowd-fund offerings? Similarly, will investors truly appreciate the difficulties involved in selling the securities given the resale restriction? If they come to better appreciate the liquidity problem after having invested under the exemption, will they then shy away from such investments?

C) Will Cost of Compliance Deter Use of the Exemption?

Time will also tell whether the exemption will be much used from the outset. Use of the exemption may be deterred by the cost of providing the alternative point of sale disclosure followed by the required continuous disclosure and the potentially significant fees to a funding portal to cover the cost of the funding portal's various services and obligations under the exemption. These costs may be worthwhile for established small to medium-sized enterprises, but, in spite of the somewhat reduced disclosure obligations for small offerings, might not be worthwhile for start-ups. The US *Crowdfund Act* does not seem sufficiently attentive to the start-up situation where the potential costs may be too high to make reliance on the exemption worthwhile. The Canadian proposals, if adopted together as complimentary, seem to better address this question with the Saskatchewan start-up crowdfunding exemption being arguably more suitable for a start-up.

D) Investment Limits

Conceptually the income and wealth limits in the US *Crowdfund Act* make sense, since an investor's ability to bear a loss would presumably depend on their annual income or wealth. The difficulty is that for many investors their income and wealth may not be easily or reliably determined. It will also not be easy for funding portals to verify these amounts unless the numbers are verified by independent assessors. Disclosure of such information to funding portals also raises investor confidentiality

concerns.²⁴⁷ The cost of obtaining accurate, reliable measures of income and wealth might severely constrain the usefulness of a crowd-funding exemption.

There is also the question of how non-compliance with investment limits is to be sanctioned. If the investor is to blame, a sanction in the form of a fine or imprisonment seems counterproductive. Perhaps an injunction against further crowd-fund investing by the investor could be considered, but how would that be monitored and enforced? Would breach of an injunction order be dealt with by fine or imprisonment with the admonition to the investor that it is for his own good? If the funding portal is to blame one would need to be mindful of the effect a sanction would have on the funding portal and the implications that might have for other crowd-fund investors.

The Canadian crowd-funding exemption proposals avoid the income and wealth assessment concerns by not requiring such assessments. They rely instead on simply limiting the amount of individual crowd-fund investments and the total amount of annual crowd-fund investing. While this avoids potential problems with the measurement of income or wealth and reduces concerns over investor confidentiality, it sacrifices, to some extent, part of the conceptual basis for the exemption in terms of measuring the investor's ability to bear a loss.

Having no wealth test and just a total investment cap may, however, allow an investor to invest a significant portion of his or her annual income or wealth where the investor has little wealth or annual income. The \$2,500 limit with a \$10,000 cap for a year would encourage investors to hold a portfolio of investments (a minimum of four investments per year if the investor invested the entire cap amount in each year). The investor might, unfortunately, end up with a portfolio of risky investments in start-up or small businesses leading to an overall quite risky portfolio.²⁴⁸ An investor could make four investments of \$2,500 in just four such offerings in a given year exhausting the individual's available liquid investment funds perhaps making it difficult for the investor to pay debts as they come due if the crowd-funding portfolio performs poorly. One can imagine more costly scenarios where an investor, foolishly perhaps, invests at the \$10,000 limit several years in a row. That may result in a large number of

²⁴⁷ Confidentiality concerns are noted in the OSC Proposals, *supra* note 200, Appendix D at D-15.

²⁴⁸ On this point, see the comments of Ajay Agrawal, Christian Catalini, Avi Goldfarb, and Max Koven, June 12, 2014, at 1-2, online: <http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/com_20140612_45-106_agrawal-catalini-goldfarb-koven.pdf>, submitted in response to the OSC Proposals, *ibid*.

investments reducing the risk that they all fail, but the portfolio would remain a very risky one exposing a potential quite significant amount of the investor's wealth to a fairly high degree of risk.

The start-up crowdfunding exemption reduces the amount risked in any individual investment to \$1,500 but it has no limit on the number of such investments one can make. An investor might, therefore, have a portfolio of investments that is heavily weighted towards investments in crowd-funded offerings. If the exemption ends up being primarily used for start-ups, as apparently intended, the portfolio will be a particularly risky one given that roughly 50 per cent of start-up businesses do not survive beyond their first five years.

Perhaps investor protection cannot, or even should not, extend to discouraging the investor from taking such high risks. Investor protection might, however, be extended to protecting investors against losing all or a substantial part of their savings. This approach to investor protection is arguably present in exemptions, such as proposed crowd-funding exemptions, that seem to be based, in part, on whether the investor can bear the loss the investment might entail. It may also be the politically relevant approach to investor protection, especially when one contemplates the potential political implications of a significant number of retirees losing a substantial part of their life savings in failed investment schemes. One might, therefore, want to consider means to control against investors acquiring an ill-advised overall risky portfolio of investments. Perhaps, for instance, a registered advisor could certify that an investment is a reasonable addition to a particular investor's overall portfolio in light of the investor's other investments and overall investment needs. Perhaps a more modest approach would be to at least require a registered advisor to certify that he or she was consulted by the particular investor about the investor's overall investment plan.

Annual investment caps will likely be hard to enforce. If the investor invests through different funding portals, it will be difficult for any given funding portal to verify the investor's self-certification of compliance with the limit. What does one do in terms of sanctioning the violation if a violation of the cap limit is detected but could not reasonably have been detected by the funding portal at the time of a particular investor's investment? Perhaps a central database could be maintained that allowed a funding portal, with proper investor identification information, to check whether an investor has reached the investment limit.²⁴⁹ The availability of such a central database might make funding portal responsibility for

²⁴⁹ A centralized database was suggested in comments made to the Ontario Securities Commission; see e.g. para 1.5. of the comment from the Canadian Foundation

verifying investment limits easier thereby providing stronger grounds for sanctioning funding portals where annual caps on investment by individual investors are violated.

E) Resale Restrictions

Enforcement of resale restrictions may prove to be a challenging enforcement problem. Crowd-funding under the exemption could produce a large number of investors investing small amounts which may then lead to many sales of small amounts by investors in violation of the resale restriction. Such sales may be expensive to monitor and difficult to detect. If an investor sells his securities in violation of the resale restriction, it may seem overly harsh to impose a substantial fine (let alone imprisonment), especially if the investor is of modest wealth and has invested a relatively small amount. An injunction against crowd-funding investments seems a plausible sanction but sanctioning non-compliance with the injunction may raise concerns similar to those with respect to a fine. Whether a fine or some other sanction is imposed, notoriety of the sanction might discourage others from violating the resale restriction but might also deter investments under the crowd-funding exemption if the sanction reinforces in investors' minds the lack of liquidity of such investments (although perhaps reinforcing that fact would be a good thing).

One might consider giving the purchaser a statutory action thereby providing a private means of enforcement. That might address the difficulty of monitoring the potentially large number of small dollar value resales replacing public monitoring with private monitoring by purchasers. Given, however, what is likely, in the crowd-funding context, to be a relatively small dollar amount at stake, purchasers would probably not pursue a remedy in any case. Then there would be the question of the appropriate remedy. Giving the purchaser a right to rescission might allow the purchaser to speculate at the expense of seller by seeking rescission if the investment does badly, but retaining the investment if it does well. A remedy of damages might be provided, but what would be the appropriate measure of damages. If the damages were measured by the loss to the purchaser due to a decline in the value of the investment, it would give the purchaser the benefit of the upside gain with protection against downside loss again allowing the purchaser to speculate at the expense of the seller by pursuing damages only where the investment did badly. Perhaps rescission or damages for losses due to a decline in value of the investment is an appropriate remedy since it leaves the loss with the seller which is where it would have been if the seller had retained the investment in

for Advancement of Investor Rights, online: <http://www.osc.gov.on.ca/documents/en/Securities-Category4-Comments/com_20140618_45-106_grossn.pdf>.

compliance with the resale restriction. Rescission might be preferred to damages since measuring a decline in value of an investment that is not publicly traded is likely to be very difficult and therefore expensive.

Regardless of whether one chooses to give the purchaser a statutory right of action, one should consider addressing the common law consequences of a failure to comply with the regulatory resale restriction. While a contravention of a resale restriction would be subject to a penal or administrative sanction under securities legislation, the resale restriction provisions do not indicate the effect a contravention has on the contract of sale. Does contravention of a resale restriction have no effect on the validity of the contract or does it make the contract either void or voidable?²⁵⁰ Courts have taken a flexible approach to this question assessing whether the particular statutory provision or regulation offended was, or was not, intended to have the effect of making the contract void or voidable.²⁵⁰ Greater certainty might, therefore, be provided by having the resale restriction address the effect of its contravention on the contract of sale.

8. Conclusion

A crowd-funding exemption can be justified on a cost-benefit basis in a way that is consistent with existing exemptions such as the wealthy investor exemption or the offering memorandum exemption. Implementing the conceptual basis for a crowd-funding exemption, however, raises numerous challenging issues that involve difficult trade-offs. The trade-offs raise many difficult to assess empirical questions. Restrictions intended to provide investor protection may render the exemption ineffective at addressing the start-up and small business fund-raising concerns it is aimed at. At the same time a failure to provide sufficient investor protection may have damaging repercussions for the crowd-funding exemption itself and perhaps also for other investments.

The crowd-funding exemptions proposed in the US and Canada arguably follow concepts that form the basis of existing exemptions and attempt to address many of the issues raised in the context of providing a crowd-funding exemption. The conditions imposed on the proposed crowd-funding exemptions in Canada and the US, apparently in an attempt to address these issues and retain a degree of investor protection, may have made the cost of complying with the exemption high enough that many of the start-up and smaller businesses it is presumably primarily directed at may find it not worthwhile. Consequently, while a crowd-funding

²⁵⁰ See e.g. Stephen M Waddams, *The Law of Contracts*, 6th ed (Toronto: Canada Law Book, 2010) at 410, 419-28; John D McCamus, *The Law of Contracts*, 2d ed (Toronto: Irwin Law, 2012) at 453-55, 486-509.

exemption is conceptually consistent with existing exemptions, the necessary investor-protection conditions on it are likely to make it largely ineffective in facilitating small business finance.