

November 6, 2013

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RE: Saskatchewan Equity Crowdfunding Exemption

FAIR Canada is pleased to offer comments on the Saskatchewan Financial and Consumer Affairs Authority's ("FCAA") General Order 45-925 Saskatchewan Equity Crowdfunding Exemption (the "**Consultation Document**") published on October 7, 2013.

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

FAIR Canada Executive Summary

1. FAIR Canada Does Not Support Current Equity Crowdfunding Initiatives

- 1.1. Existing equity crowdfunding proposals result in too large a degree of informational asymmetry and too great a risk of fraud and potential for investor harm. These proposals will not result in efficient markets nor will they have the desired economic benefits that proponents argue equity crowdfunding will achieve. FAIR Canada urges governments and securities regulators to determine other ways to help small and medium size enterprises raise capital which are not detrimental to investor protection.
- 1.2. FAIR Canada does not believe that securities regulators have the ability to afford equity crowdfunding investors adequate protections. Equity crowdfunding is a significant departure from modern securities regulation, and is premised upon unsophisticated consumers investing in high-risk, illiquid, opaque securities. We outline several specific problems with the proposal outlined in the FCAA's Consultation Document in the sections below. Please refer to our comment letter to the Ontario Securities Commission for further, more principled, comments and recommendations relating to equity crowdfunding.¹

¹ FAIR Canada comment letter, "RE: OSC Exempt Market Review: OSC Staff Consultation Paper 45-710 Considerations for New Capital Raising Prospectus Exemptions" (March 8, 2013), online:

- 1.3. FAIR Canada notes that the lack of data regarding the exempt market prevents key information from forming part of the policy-making process. We caution against expanding the exempt market in the absence of necessary empirical information. In our view, it would be prudent for the FCAA to conduct and publically disseminate research regarding the exempt market, and to conduct a fulsome public consultation on the results prior to introducing an exemption that is a drastic departure from the current regulatory structure.
- 1.4. We note that on October 24, 2013 the U.S. SEC issued proposed crowdfunding rules in a consultation document that posed 295 questions for comment. Clearly the SEC is grappling with the investor protection issues posed by equity crowdfunding, and we encourage Canadian regulators, including the FCAA, to thoroughly consider the implications on investors and market confidence before introducing any exemptions.
- 1.5. It is not clear that the capital raised through equity crowdfunding will have the positive economic effects that its proponents laud, and we caution that we foresee that crowdfunding will likely cause significant detrimental effects on market integrity, which would lead to greater difficulties and more costly capital for issuers going forward.
- 1.6. The North American Securities Administrators Association (“**NASAA**”), which represents U.S. state and Canadian provincial securities regulators, listed crowdfunding and internet offers as the top new investor threat in its 2012 Enforcement Report.² The Report states:

The 2012 JOBS Act makes significant changes to the methods start-up businesses and entrepreneurs may employ to bring their ventures to the investing market, and investors must be wary of the attendant risks....Even when the relaxed rules and registration exemptions are effective, they will not make investments in small businesses less risky – just more prevalent. And the JOBS Act provisions do not eliminate fraud, an unfortunate common feature of Internet securities activity.
- 1.7. Thomas Lee Hazen at the University of North Carolina has examined the JOBS Act legislation and has commented on who it would attract: “...the solicitation of small investors is likely to attract more unsophisticated investors who are in need of the investor protection provisions generally found in the securities laws. It also is likely to attract investors with limited funds who cannot tolerate high investment risk, even for small amounts of money.”³
- 1.8. There are no provisions in the concept proposal that incentivize SMEs to use any capital that may be raised to expand their business or create jobs in Saskatchewan or Canada. An address in Saskatchewan does not mean that the funds raised will contribute to Saskatchewan’s economy. The lowering of investor protections with the resultant likely

<http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-submission-re-CP-45-710-Prospectus-Exemptions.pdf>.

² North American Securities Administrators Association, “NASAA Enforcement Report” (October 2012), online: <http://www.nasaa.org/wp-content/uploads/2012/10/2012-Enforcement-Report-on-2011-Data.pdf>.

³ Thomas Lee Hazen, “Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must be Conditioned On Meaningful Disclosure”, at page 1766, online: <http://ssrn.com/abstract=1954040>.

increase in fraud has the real possibility of hurting legitimate businesses by increasing the cost of capital while making it easy for fraudsters and scammers to make off with investors' funds. While FAIR Canada opposes any proposals to introduce equity crowdfunding exemptions in Canadian jurisdictions absent clear evidence that the benefits outweigh the costs, we comment below on specific elements of the FCAA's proposed exemption.

2. Portals Must be Registered

- 2.1. FAIR Canada is strongly unsupportive of the FCAA's proposal to allow unregulated portals to facilitate equity crowdfunding trades and payments. Registration and regulation of crowdfunding portals is essential to investor protection. Portals must be registered with the FCAA for there to be adequate oversight and compliance, and to ensure that small and medium size enterprises use a legitimate intermediary. We believe that permitting equity crowdfunding transactions through unregulated portals would be a complete abandonment of the FCAA's consumer protection mission, and will cause irreparable damage to investor and issuer confidence in Saskatchewan's financial markets.
- 2.2. A recent NASAA survey of U.S. state securities regulator members (the "**2013 NASAA Enforcement Report**") noted that the majority of investment fraud cases reported by state securities regulators featured unregistered individuals selling unregistered securities.⁴ Although detailed statistics regarding the number of reported fraud cases in Canada are not made publically available, we suspect that a similar correlation between unregistered individuals selling unregistered securities and fraud exists in Canada.
- 2.3. Further, the 2013 NASAA Enforcement Report stated: "Unregistered securities sold by unlicensed individuals continue to attract the most attention from state regulators. These fraudulent offerings are increasingly being marketed through the Internet."⁵ The earlier 2012 NASAA Enforcement Report notes that many U.S. states and Canadian provinces have seen an increase in active investigations and recent enforcement actions related to internet activity.⁶ U.S. state securities regulators' comments regarding "the increased presence of questionable securities offerings made available via the Internet"⁷ and the persistence of affinity fraud is difficult to reconcile with claims about the "wisdom of the crowd" and claims that the internet provides opportunity for better due diligence and more information. While technology has advanced, it has also created a wider net for potential fraud victims and affords considerable anonymity to fraudsters.
- 2.4. The 2013 NASAA Enforcement Report notes that even regulated portals open issuers up to potential fraud.

⁴ NASAA Enforcement Section, "NASAA Enforcement Report: 2013 Report on 2012 Data" (October 2013), online: <<http://www.nasaa.org/wp-content/uploads/2013/10/2013-Enforcement-Report-on-2012-data.pdf>> at page 7.

⁵ *Ibid.* at page 8.

⁶ NASAA Enforcement Section, "NASAA Enforcement Report" (October 2012), online:

<<http://www.nasaa.org/wp-content/uploads/2012/10/2012-Enforcement-Report-on-2011-Data.pdf>>

⁷ *Supra* note 4 at page 8.

Use of crowdfunding portals, while subject to some regulation, also opens the door to scams. Startup businesses, especially small local businesses, should be very careful to verify the legitimacy of a portal before engaging their services. Investors are not alone in their potential to be scammed. Using a fraudulent portal means both the business and the investor stand to lose.⁸

FAIR Canada questions how investors and small businesses are expected to assess the legitimacy of portals absent regulation by the FCAA.

- 2.5. The registration of crowdfunding portals is essential to transparency and security. This is the model that has been proposed by the SEC, the Australian Government's Corporations and Markets Advisory Committee⁹ and the Ontario Securities Commission. Given that equity crowdfunding targets unsophisticated investors, a portal must provide essential services that would provide a minimum level of investor protection, and securities regulators must oversee this function. Regulation and oversight is critical to the proper function of equity crowdfunding portals.

3. Specific Portal Recommendations

- 3.1. Further, FAIR Canada has additional recommendations to ensure that portals provide some basic investor protections to unsophisticated investors:
 - 3.1.1. The funding portal should be required to supervise and certify offerings, with recourse against the funding portal for fraud and misrepresentation. Investors should have a statutory right to sue for misrepresentation against the issuer and the portal. Such a right should include the right to commence a class action to seek recovery due to misrepresentation or fraud against the issuer, its principals and the portal.
 - 3.1.2. The issuer, its directors and officers should have to disclose whether they have been the subject of any regulatory or criminal proceeding (not limited to securities matters), as a first step to reduce the risk of fraud.¹⁰
 - 3.1.3. The portal should be required to perform certain due diligence about the issuer and on the disclosure contained in the information statement, and should certify the information being provided to investors.
 - 3.1.4. The funding portal should be required to help issuers prevent mistakes and errors as to disclosure and to guide issuers as to what is appropriate and necessary to disclose to potential investors.

⁸ *Ibid.* at page 11.

⁹ Australian Government's Corporations and Market Advisory Committee, *Crowd Sourced Equity Funding Discussion Paper*, September 2013 at page 39.

¹⁰ Background checks are a vital first step given that media reports suggest that individuals who have been banned from the securities industry are involved with crowdfunding portals. See David Baines, "Crowd-funding: Mad money finds a new outlet", *Vancouver Sun* October 17, 2012.

- 3.1.5. Funding portals should be expected to attempt to actively prevent fraud from taking place including through the conducting of background checks and to be vigilant for the potential dilution or shareholder oppression.
- 3.1.6. The funding portal should be required to carry fidelity insurance to provide coverage from fraud or dishonest acts of its employees and professional liability insurance to cover errors and omissions in respect of its obligations.
- 3.1.7. The funding portal should be required to review the promotional and marketing material of the issuer that is on the portal's website and the funding portal should be included in the statutory liability regime for such statements.
- 3.1.8. The funding portal should be required to notify the crowd about any claims that have occurred as a result of fraud or other wrongdoing. They should have to post notifications about recent (suspected) frauds and track rates of return.

4. Investment Limits and Offering Size Limits

- 4.1. FAIR Canada does not believe that investment limits are adequate measures to reduce the risk of abuse and fraud. Firstly, such limits will be difficult if not impossible to police and, to FAIR Canada's knowledge, no method of enforcing any limits have been put forward by Canadian regulators. Secondly, "...fraud in small packages can be just as effective and damaging to the victims, many of whom may be least able to bear the risk of even a small investment in a speculative business."¹¹ Thirdly, limiting offerings to small amounts per investor will not deter scammers from taking advantage of investors via crowdfunding, particularly since fraudsters will have no reason to comply with the \$150,000 offering size limit.
- 4.2. Further, FAIR Canada is of the view that limiting only the amount a person may invest in a given offering is wholly inadequate. We recommend that the FCAA also cap the total amount a Saskatchewan resident is permitted to invest in equity crowdfunding investments, based upon their annual income or net worth. While this is not sufficient to reduce the risk of abuse and fraud, if adhered to, it will limit the potential losses of a given investor.
- 4.3. An offering size limit will not be observed by fraudsters, so it will only limit losses on legitimate, but highly risky, ventures, assuming such limits are adequately enforced.
- 4.4. We note that it is crucial that regulators enforce investment limits in order for them to limit investor losses. Unenforced investment limits will detract from market confidence and will expose investors to greater risk. It is essential that regulators devise an effective system to limit the amount that investors can lose by ensuring that the intermediaries

¹¹ Thomas Lee Hazen, "Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must be Conditioned On Meaningful Disclosure", at page 1766, available online: <<http://ssrn.com/abstract=1954040>>.

(portal or otherwise) verify the income and the compliance with aggregate investment limits.

- 4.5. Although investors have a right to sue for a misrepresentation, the practical benefit of this is questionable given the small investment amounts and the cost of litigation. Given that in many cases, the crowdfunding efforts will be modest and there will be modest potential damages, the economics of bringing such a claim and the adequacy of the economic incentives available to plaintiff law firms to bring suits will limit the ability to obtain a remedy.¹²

5. Risk Acknowledgement

- 5.1. FAIR Canada is of the opinion that the Important Risk Warnings provided in Schedule A of the Consultation Document will be of little to no assistance to investors. The proposed language appears to be directed more at absolving regulators and portals of responsibility than true, plain-language warnings and information for investors.
- 5.2. For example, the risk warnings do not include any reference to or explanation of the risks associated with investments in SMEs. The language refers to the investment as an “opportunity”, which has positive connotations. The language does not attest to the fact that the investor has not received advice, but rather that an investor ‘understands’ that they have not received advice, which is confusing.
- 5.3. Further, attesting to an understanding of legal rights and “prospectus offering” suggests that the investor would have a basic understanding of the difference between the rights attached to a prospectus-qualified investment as compared with an exempt offering. We highly doubt that any unsophisticated investor would understand the difference in legal rights without further information.
- 5.4. FAIR Canada recommends that the risk acknowledgement to be signed by the investor be preceded by an interactive knowledge quiz which informs investors of the high risk of failure of start-ups and SMEs in Canada, the average returns that SMEs provide, the possibility that the investment is not accurately priced, the investment is illiquid, and that their investment may be lost due to fraud, with very limited available remedies.

6. Poor Compliance with Current Exemptions

- 6.1. Saskatchewan’s Financial Services Commission Securities Division’s (now the FCAA) Staff Notice 45-704 noted that during its detailed review of non-qualifying issuers’ OMs, “[s]taff identified **material disclosure deficiencies in all of the OMs reviewed**. In general, the

¹² *Ibid.* at page 1759.

OMs were poorly prepared and did not provide the disclosure required.¹³ [emphasis added]

- 6.2. It also found considerable non-compliance with financial statement requirements, including non-provision of financial statements in the OM.¹⁴ Furthermore, the review identified significant investor rights issues in its notice.
- 6.3. FAIR Canada believes that the equity crowdfunding exemption proposed by the FCAA will similarly suffer from serious compliance deficiencies; this non-compliance with regulation which offers limited protections will negatively impact investors and market confidence.

7. Risks to Consumers and Market Integrity

- 7.1. FAIR Canada believes that the existing crowdfunding concept results in too large a degree of informational asymmetry and too great a risk of fraud and potential for investor harm and, therefore, will not result in efficient markets nor the desired benefits that its proponents would argue it will achieve. FAIR Canada agrees with the following assessment:

Crowdfunding of equity capital for start-ups is one of a handful of jewels in the crown of the JOBS Act....But the crowdfunding jewel is fool's gold ...As a savvy tech entrepreneur told me the other day, "I love crowdfunding: it is cheap money for me. I know it is not good for the investors". That is the problem: **crowdfunding will at best be good only for the entrepreneurs and middlemen, paid for by unwitting consumers who simply cannot know enough about the highly risky ventures or the highly complex venture investing process to make informed investment decisions.**¹⁵

- 7.2. The Canadian Securities Administrators' ("CSA") 2012 CSA Investor Index found that "...2-in-5 Canadians failed the general investment knowledge test included in the survey, answering fewer than four of the seven questions correctly."¹⁶ We note that Saskatchewan's equity crowdfunding proposal is "...intended to encourage young investors and entrepreneurs"¹⁷. According to the 2012 CSA Investor Index, "...the majority (56%) of younger Canadians (18-34 years) fall into the low knowledge category"¹⁸, meaning that 56% of younger Canadians answered 0-3 of the seven survey questions correctly.

¹³ Saskatchewan Financial Services Commission Securities Division Staff Notice 45-704 Review of Offering Memorandums under NI 45-106 *Prospectus and Registration Exemptions* (last amended March 7, 2011) at page 2.

¹⁴ *Ibid.* at page 5.

¹⁵ Daniel Isenberg, "The Road to Crowdfunding Hell" (April 23, 2012), online: <http://blogs.hbr.org/cs/2012/04/the_road_to_crowdfunding_hell.html>.

¹⁶ Innovative Research Group, "2012 CSA Investor Index" (October 16, 2012), online: <http://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL_EN.pdf> at page 38.

¹⁷ Dave Wild, Chair of the Saskatchewan Financial and Consumer Affairs Authority, quoted in 'Proposal to allow equity crowdfunding', The Star Phoenix (October 8, 2013), online: <<http://www.thestarphoenix.com/business/Proposal+allow+equity+crowdfunding/9009555/story.html>>.

¹⁸ *Supra* note 16 at page 38.

- 7.3. The 2012 CSA Investor Index also found that 58% of Canadians do not understand the fundamental principle of risk-reward tradeoff and found that only 12% of Canadians have realistic expectations of market returns. Only 9% of low knowledge investors were found to have realistic market expectations.
- 7.4. A recent Exempt Market Study on Crowdfunding prepared for the OSC demonstrates that people interested in equity crowdfunding do not understand how risky it is.¹⁹ Only 52% deemed equity crowdfunding to be high risk while 43% thought it was medium risk.²⁰ Even more disturbing, 12% of the respondents who identified themselves as “low-risk” were strongly interested in equity crowdfunding.²¹
- 7.5. The Exempt Market Study on Crowdfunding noted that “[w]hile it is clear that investing via crowdfunding is more likely as risk tolerance increases, we are concerned with the high proportion of low risk people who might potentially invest via crowdfunding. In our view, the survey made the risks quite visible and explicit leaving us to wonder how they concluded that crowdfunding was appropriate for them.”²²
- 7.6. While proponents suggest that the crowd will be able to detect fraud and weed out the bad actors, existing research suggests that many retail investors are not able to adequately detect fraud and instead, become victims of fraud at an alarming rate. The CSA’s November 2011 through February 2012 BlueHedge Investments public education initiative demonstrated that “investors remain vulnerable to online investment fraud. Internet ads and unsolicited emails posted during the online campaign enticed many visitors to a phoney scam website set up by the regulators.”²³
- 7.7. FAIR Canada questions the purported “wisdom of the crowd”, as do others. As stated by Daniel Isenberg:

I did my Ph.D. degree in social psychology studying the behaviour of groups, and group irrationality is well-documented – crowds are “wise” only in a very limited set of circumstances. As often as not, crowds bring us tulip crazes, subprime meltdowns, the Kitty Genovese ...scandal, Salem witch trials and other tragedies. Crowdfunding advocates claim that social media will self-correct the madness of crowds, but this seems to me highly suspect.²⁴

¹⁹ Edwin L. Weinstein, “Exempt Market Survey on Crowdfunding” (May 28, 2013), online: <http://www.osc.gov.on.ca/documents/en/Securities-Category4/sn_20130828_45-712_progress-report-b-investor-survey-report.pdf>.

²⁰ *Ibid.* at page 27.

²¹ *Ibid.* at page 19.

²² *Ibid.* at page 34.

²³ Canadian Securities Administrators, “Online Fraud Awareness Campaign Confirms Investors’ Vulnerability” (March 6, 2013), online: <<http://www.spsc.gov.sk.ca/Default.aspx?DN=4dbd3b54-b532-4a90-9658-a8c97bc03b80>>.

²⁴ *Supra* note 15.

8. Other Issuer Disclosure

- 8.1. FAIR Canada suggests that the issuer should have to state the intended use of the funds, and have continuous disclosure obligations that go beyond than simply filing annual financial statements. Material changes and material developments (including actual use of the funds in a manner different than that disclosed in the offering document) should trigger disclosure to shareholders.
- 8.2. The principals of the issuer should have to disclose if they have any investment in the entity so that prospective investors can determine if they have any “skin in the game”. They should also have to disclose if they sell their shares or otherwise redeem their investment in the entity.

9. Investor Protections

- 9.1. Investors should be given anti-dilution protection, tag-along rights and pre-emptive rights. However, the ability of retail investors to understand and rationally employ these rights in order to protect themselves is highly questionable. Isenberg addresses this point directly when he states: “Many of the key concepts – such as implied valuation, liquidation preferences, minority protections, information rights, tagalong provisions, first refusal rights, anti-liquidation, reverse vesting, to name just a few- take years to grasp, let alone learn how to use.”²⁵ If the FCAA proceeds with crowdfunding, provisions should be in place to protect investors from having their rights and the value of their investments diluted by future capital raising initiatives.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca) or Lindsay Speed at 416-214-3442 (lindsay.speed@faircanada.ca).

Sincerely,



Canadian Foundation for Advancement of Investor Rights

²⁵ *Supra* note 15.