Crowdfunding on rise, along with fraud worries

By DONALEE MOULTON

With equity crowdfunding poised to become legal in Canada amid double-digit growth in the online money-raising field, concerns are building about its potential for fraud.

"Because it's unregulated, crowdfunding is ripe for fraudulent activities," said Jeff Musson of the National Crowdfunding Association of Canada.

The youthfulness of crowdfunding, and the fact that at least one form — equity crowdfunding — is unavailable to many, including in Canada, may account in part for its lack of appeal to fraudsters to date. It certainly hasn't lacked appeal for investors — according to Massolution, a crowdfunding research and implementation firm based in Los Angeles, worldwide crowdfunding in 2012 increased 81 per cent to $2.7 billion U.S., from more than one million campaigns.

Crowdfunding comes in two primary forms. Donation-and-reward crowdfunding, which is used to raise money to produce a record or expand a local restaurant, for example, offers contributors a small reward for their money, or simply the satisfaction that comes with helping a good cause or a company in their community. Equity crowdfunding, on the other hand, offers what all companies offer investors: shares or a return on their investment.

Most securities commissions, including Ontario and Nova Scotia, are working on exemptions that would allow the distribution of securities via crowdfunding.

"For a company to use a crowdfunding platform to sell securities in Canada, it would have to operate under the same rules as conventional businesses," said Mark Dickey, spokesperson for the Alberta Securities Commission in Calgary. "This means that the companies and investors involved must meet the existing rules and regulations set down in securities law. The only unique aspect is that investors and companies work online and not face to face."

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> *Neil Gross, FAIR Canada*

Regulation is intended to reduce the risk for equity crowdfunding, but the Canadian Foundation for Advancement of Investor Rights (FAIR) believes any stamp of approval from regulators will send a mixed message to potential investors and open the door to fraud.

"Until recently, a fairly consistent message was being sent to Canadian consumers: the Internet is not a safe place for finding enterprises to invest in because it's easy to scam people online. But if regulators decide to permit equity crowdfunding, that message will become less coherent. Consumers then will be told, in effect, that some investments available through the Internet are OK," said FAIR Canada executive director Neil Gross.

"Criminals will take advantage of this confusion. It will make it easier for them to defraud consumers because most people won't be able to tell the difference between a real start-up company and a fake one."

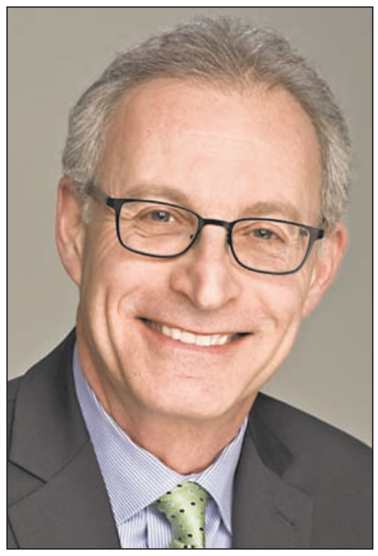
In addition to fraud, crowdfunding investors are susceptible on two other fronts.

"Crowdfunding is vulnerable from the standpoint that you don't know with any degree of certainty how successful these businesses will be. There is often no track record," said Musson.

The same could be said of the investors themselves. Crowdfunding has grown because many people have given a little bit of money. But when equity opportunities become available, a whole new cadre of investors will step forward, many of whom have never invested before.

"Susceptibility to fraud is increased based on the inherent risk of greater access to unsophisticated investors," said David Malamed, a partner in Grant Thornton's forensic and dispute resolution group in Toronto.

The U.S. has moved toward regulation more quickly than Canada, where securities commissions



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have looked south to see what the United States would first do. In 2012, the *JOBS Act* was signed into law, giving a green light to crowdfunding. The U.S. Securities and Exchange Commission put forward draft rules for comment last year, and many companies have responded by calling for an even more relaxed regime than that proposed by the SEC.

FAIR, on the other hand, wants tougher rules than those put forward in draft proposals from securities commissions in Canada.

"Frankly we don't think equity crowdfunding can be made safe. If (it) does go ahead, though, the

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potential harm can be limited somewhat by keeping the investment limits low and ensuring that investors adhere to those limits, though it's hard to imagine a practical mechanism to enforce that," said Gross.

His organization would like to see investors limited to putting $500 per year into any one company, to a maximum of $5,000 a year for all crowdfunded investments. At least seven securities commissions in Canada are proposing to cap individual investments at $2,500 in a single project, to a maximum of $10,000 a year.

"We do not see a need for the limits to be as high as the ones currently being contemplated," said Gross, noting that crowdfunding platform Kickstarter has generated tens of millions of dollars with an average donation of roughly $75.

Under the current process, safeguards do exist. Companies looking to raise money through crowdfunding must promote their project on a crowdfunding site such as Kickstarter or Indiegogo, for example. Such sites are unlikely to promote a questionable enterprise, said Andrew Dix, the Cleveland-based CEO and co-founder of Crowdfund Insider.

"Most of the portals are doing their own due diligence. They are so young and so inexperienced. They don't want to step on a landmine and blow up their business."

Crowdfunding platforms also promote communication — a fraud repellent.

"The portals have created an environment where entrepreneur and investor are engaged. There is a direct form of communication. Your offering can be challenged."

Accountants can help clients by learning as much about crowdfunding as possible and assisting potential investors to take precautions.

"To reduce the risk of crowdfunding campaigns turning into 'scampaigns,' investors need to find reputable crowdfunding companies, perform due diligence on both the investment opportunity and the crowdfunding platform and consider limiting their exposure," said Malamed, a chartered professional accountant.

Musson believes the process of investing and the online environment will also help transform unsophisticated investors into informed ones. It is not the same as a Bernie Madoff approaching someone with a fraudulent prospectus and charming smile — crowdfunding investors are likely to be comfortable browsing to find out more about their potential, he said.

"Investors learn a lot by doing this. It educates you. It increases the chances you'll make an educated investment."