



Canadian Foundation *for*  
Advancement of Investor Rights

June 18, 2014

British Columbia Securities Commission  
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**RE: BC Notice 2014/03 – Notice and Request for Comment on Start-Up Crowdfunding**

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FAIR Canada is pleased to offer comments on BC Notice 2014/03 Notice and Request for Comment on Start-Up Crowdfunding (the “**Notice**”).

Crowdfunding is a term that describes raising small amounts of money from many people, usually over the internet.<sup>1</sup> There are numerous models of crowdfunding, including the donation model, the reward model, the pre-purchase model, the peer-to-peer lending model, and the securities-based model. Our comments in this letter focus on the securities-based model, as this is the crowdfunding model that will generally involve a distribution of securities.

FAIR Canada is a national, charitable 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](http://www.faircanada.ca) for more information.

**1. Executive Summary**

- 1.1. FAIR Canada does not support the introduction of a Crowdfunding Exemption in any Canadian jurisdiction. We strongly oppose the proposed Start-Up Exemption, in BC and elsewhere in Canada.**
- 1.2. We believe both models are flawed and present significant potential for serious investor harm.

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<sup>1</sup> BC Notice 2014/03.

- 1.3. We believe that the Crowdfunding Exemption presents serious risks to investors as outlined below. The Start-Up Exemption is even worse – permitting unregistered portals to operate in Canada with no aggregate investment limit for individuals is simply unacceptable.
- 1.4. In FAIR Canada’s view, finite regulatory resources should be used to focus on initiatives that provide for strong investor protection as these would support true capital formation and fair and efficient markets. Meaningful investor protection initiatives, such as the implementation of a best interest standard and a ban on conflicted sales commissions, are essential protections that are missing from the current regulatory framework for both private and public equity investments.
- 1.5. FAIR Canada is surprised at how quickly the crowdfunding initiative has moved from the idea stage to proposed regulations. Despite a lack of evidence, Canada securities regulators have seen fit to steam forward with unproven rules that are widely acknowledged to cause investor losses. We are concerned that in their haste, securities regulators may have failed to consider how this grand experiment will reflect on the policymaking process a few years down the road.
- 1.6. We have difficulty understanding why the thorough, methodical, research-based approach that has been applied in important investor-protection matters has been cast aside with respect to crowdfunding and other exempt market initiatives. Regulatory capacity for swift action should be deployed in response to investor protection concerns.
- 1.7. Given the experimental nature of equity crowdfunding regulation, if Canadian securities regulators proceed with the introduction of a crowdfunding exemption, we strongly urge that a sunset clause of two years be included.
- 1.8. We have found some of the comments, rationales, or explanations for certain provisions to be unclear or lacking. The consultation period has not allowed adequate time for a thorough discussion (including in-depth roundtables) to discuss the implications of specific provisions being proposed.
- 1.9. FAIR Canada is concerned that Canadian securities regulators (and securities regulators around the world) will be unable to regulate crowdfunding. The internet does not abide by jurisdictional borders. The introduction of a crowdfunding exemption will send a message to Canadian investors that investing online in an unknown start-up company is a legitimate investment opportunity.
- 1.10. It is widely accepted that many (possibly most) investors will lose money by investing in crowdfunding. It is unclear whether the purported benefits of crowdfunding will outweigh the costs. The economic benefits of crowdfunding are unproven.
- 1.11. As a result, FAIR Canada believes that it is incumbent upon securities regulators who are intent on implementing such an exemption to do so in a way that affords the highest level

of investor protection possible. This is the best chance of serving the interests of both investors and issuers.

- 1.12. FAIR Canada is concerned that investment limits will be of limited effect in reducing the risk of abuse and fraud. We also believe that for legitimate offerings, investment limits are necessary to reduce losses.
- 1.13. The underlying premise of crowdfunding is that SMEs can meet their capital-raising needs by sourcing a small amount of money from a large number of people. We have recommended that other Canadian jurisdictions decrease the individual investor crowdfunding limits to \$500 or less per investment and \$5,000 in total under the crowdfunding exemption. The current proposed amounts are not small amounts for most retail investors. We recommend that BC cap the total amount an investor is permitted to invest in Start-Up Exemption investments at a total of \$2,000 per calendar year and limit investments to \$250 per offering.
- 1.14. FAIR Canada is concerned that adequate mechanisms have not been set out that will ensure adherence to the investor investment limits or the offering limit. FAIR Canada recommends the use of a centralized database to verify aggregate investment amounts rather than reliance upon self-certification.
- 1.15. FAIR Canada notes that, while suitability is a low threshold (we believe a best interest duty is necessary), investors could benefit from some form of advice with respect to crowdfunding offers. This could provide more protection than arbitrary investment limits as proposed, by ensuring that any crowdfunding investments do not make up a disproportionate amount of an investor's portfolio. We recommend that regulators examine whether a suitability element should be added to the exemption in the interests of investor protection and in light of research support which shows demand for it.
- 1.16. In light of academic research, FAIR Canada calls into question the "wisdom of the crowd", and suggests that crowdfunding investors may often fail to properly evaluate a crowdfunding offering, be subject to herding influences, and make 'impulse-purchase'-like decisions.
- 1.17. FAIR Canada is concerned that many investors will not understand the liquidity constraints of crowdfunding investments and will be 'squeezed out' of any profits in the rare event that they manage to invest in a successful equity crowdfunding offering. We recommend that basic mandatory protections for crowdfunding investors be required, including tag-along and pre-emptive rights.
- 1.18. It is essential that the advertising and marketing be limited to a registered portal so that regulators have some ability to provide oversight and monitoring of the advertising through the portal. While we anticipate there may be significant compliance concerns relating to advertising and soliciting, we view this to be an essential investor protection element of the crowdfunding proposal. FAIR Canada is concerned about the implications

of advertising and general solicitation provisions provided by other jurisdictions and we have made specific recommendations to address these provisions in our comments to those securities regulators. FAIR Canada recommends that BC limit advertising and solicitation in respect of any crowdfunding prospectus exemptions (Start-Up or otherwise).

- 1.19. FAIR Canada has asked various regulators for their research in respect of risk acknowledgement forms and understands that, despite their widespread use, regulators have not conducted research on investor use, investor understanding, utility or design of risk warning documents. We recommend that regulators test the risk acknowledgement form with investors prior to implementing any crowdfunding exemptions to ensure that it serves the purpose for which it was intended.
- 1.20. Additionally, we recommend that all portals should have minimum requirements to provide risk warnings to investors prior to the point of sale. We also recommend that portals be required to provide an interactive basic knowledge test that investors must pass in order to be permitted to view offerings. Regulators should mandate a minimum level of knowledge and understanding that investors must demonstrate prior to being permitted to view offerings.
- 1.21. It is vitally important that an issuer may not (directly or indirectly) pay a commission, finder's fee, referral fee or similar payment to any person in connection with an offering under the exemption, other than to a portal. We recommend that the BCSC include such a restriction in any crowdfunding exemption it may introduce.
- 1.22. FAIR Canada recommends that concurrent capital raising under other exemptions should be prohibited during a crowdfunding distribution period. We further recommend a cooling-off period between offerings made to different prospectus exemptions.
- 1.23. FAIR Canada recommends that the right of action for misrepresentation be available against issuers, management, directors and portals. We also recommend that the crowdfunding offering document incorporate by reference other marketing material and continuous disclosure (for reporting issuers). We also recommend that the limitation period be two years from the date on which the claim became discoverable.
- 1.24. FAIR Canada also suggests that issuers be required to track employment levels and innovation developments of issuers who use the crowdfunding exemption and report these to securities regulators.
- 1.25. FAIR Canada believes that self-regulatory organization ("**SRO**") membership should be required for crowdfunding portals.
- 1.26. FAIR Canada supports requirements proposed in other jurisdictions for crowdfunding portals to complete due diligence. It is essential that portals be required to conduct

background checks on issuers and their directors, executive officers, control persons and promoters. It is also essential that due diligence be conducted on the issuer's business.

- 1.27. FAIR Canada recommends that funding portals have obligations with respect to investor complaints, including participation in the Ombudsman for Banking Services and Investments. Portals should be required to have a formalized process for receiving complaints and tracking them.
- 1.28. FAIR Canada suggests that funding portals have an obligation to report potential fraud to police and securities regulatory authorities and notify investors on their portals as appropriate.
- 1.29. Additionally, we recommend that portals be required to be transparent about capital raised, success rates, instances of fraud, etc. We are concerned that the rare successful businesses will garner a considerable amount of attention and believe that complete information regarding failure rates and the amount of investor losses must also be reported to the relevant regulators and made publicly available.

## GENERAL COMMENTS

### 2. **FAIR Canada Opposes Crowdfunding and the Start-up Exemption**

*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.***<sup>2</sup>

- 2.1. **FAIR Canada does not support the introduction of a Crowdfunding Exemption. We strongly oppose the proposed Start-Up Exemption.** We refer you to our submission to the Autorité des marchés financiers, the Financial and Consumer Affairs Authority of Saskatchewan, the Financial and Consumer Services Commission of New Brunswick, the Manitoba Securities Commission and the Nova Scotia Securities Commission dated June 18, 2014.
- 2.2. We believe both models are flawed and present significant potential for serious investor harm. The expected return of a crowdfunding investment is extremely low due to the many barriers small investors face: high business risk; low survival rate of SMEs/new

<sup>2</sup> Daniel Isenberg, "The Road to Crowdfunding Hell" (April 23, 2012), available online: <[http://blogs.hbr.org/cs/2012/04/the\\_road\\_to\\_crowdfunding\\_hell.html](http://blogs.hbr.org/cs/2012/04/the_road_to_crowdfunding_hell.html) > [emphasis added].

firms; absence of professional support often provided to new entrants by venture capitalists; incompetent management; bad ideas; poor valuation; bad luck; lack of exits; potential dilution; and outright fraud and misappropriation. It is an understatement to say that the deck is stacked against crowdfunding investors.

- 2.3. **The start-up exemption is even worse – permitting unregistered portals to operate in Canada is simply unacceptable.** All the problems inherent in the crowdfunding exemption exist in the proposed start-up exemption, but the lack of registration for portals would make it that much more harmful to investors. Unregulated portals would impede effective regulatory oversight over portals. Issuers would not be subject to ongoing disclosure, which severely limits the information that will be received by investors and reduces the accountability of issuers. Further, the lack of a limit on the total amount an investor is permitted to invest in a calendar year exposes investors to potentially unlimited risk.
- 2.4. In FAIR Canada's view, finite regulatory resources should be used to focus on initiatives that provide for strong investor protection as these are the initiatives that support true capital formation and fair and efficient markets. FAIR Canada made submissions to this effect to the Autorité des marchés financiers and the Ontario Securities Commission in March 2013.
- 2.5. Such initiatives would also foster investor confidence in those markets. Meaningful investor protection initiatives, such as the implementation of a best interest standard and a ban on conflicted sales commissions would provide for stronger investor protection. These are essential protections that are missing from the current regulatory framework for both private and public equity investments. These protections would confer real benefits to investors and the Canadian economy by providing optimal outcomes (through the receipt of unconflicted advice in investors' best interests) at a lower cost to investors.
- 2.6. FAIR Canada is surprised at how quickly the crowdfunding initiative has moved from the idea stage to proposed regulations. Despite a lack of evidence, Canada's securities regulators have seen fit to steam forward with unproven rules that are widely acknowledged to cause investor losses. We are concerned that in their haste, securities regulators may have failed to consider how this grand experiment will reflect on the policymaking process a few years down the road.
- 2.7. We have difficulty understanding why the thorough, methodical, research-based approach that has been applied in important investor-protection matters has been cast aside with respect to crowdfunding and other exempt market initiatives. The need to foster capital raising for fledgling businesses is no more urgent or important than the need to protect investors. If anything, regulatory capacity for swift action should be deployed in response to investor protection concerns. FAIR Canada recommends that Canadian securities regulators apply a consistent approach to policy-making.

- 2.8. Given the experimental nature of equity crowdfunding regulation, if Canadian securities regulators proceed with the introduction of a crowdfunding exemption, **we strongly urge that a sunset clause of two years be included.** This would ensure that the appropriateness of and experience with the crowdfunding exemption is reconsidered once some insight has been gained into its operation and effect.

### 3. The Internet

Governments of the Industrial World, you weary giants of flesh and steel, I come from Cyberspace, the new home of Mind.... You have no sovereignty where we gather.

...You have no moral right to rule us nor do you possess any methods of enforcement we have true reason to fear.

... Cyberspace does not lie within your borders. Do not think that you can build it, as though it were a public construction project. You cannot. It is an act of nature and it grows itself through our collective actions.<sup>3</sup>

- 3.1. The results of the CSA's BlueHedge Investments campaign demonstrated Canadians' vulnerability to online investment fraud. Bill Rice, Chair of the CSA, was quoted as saying "Our recent campaign showed us that people are willing to click on online ads and open emails touting investment opportunities from unknown sources... Potential investors need to be more wary when dealing with investment opportunities they see advertised online."<sup>4</sup>
- 3.2. FAIR Canada is concerned that Canadian securities regulators (and securities regulators around the world) will be unable to regulate crowdfunding. What ability do the regulators have to prevent unregistered portals from also offering (or purportedly offering) investments to Canadians?
- 3.3. Will Canadian regulators know who is behind the operation of unregulated portals or other issuers who offer securities on the internet offside the rules? What jurisdiction (if any) do Canadian regulators have over websites hosted in other countries? How speedily can they be shut down? Are Canadian police forces equipped to assist? In the event securities regulators are unable to prevent online offerings from issuers who do not meet the qualification criteria, what are their options for enforcement action? The practical implications make success in these cases highly unlikely. How will regulators prevent these offerings from being sold to Canadians? Do securities regulators have sufficient enforcement power to deter non-compliance?

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<sup>3</sup> John Perry Barlow, "A Cyberspace Independence Declaration" (February 9, 1996), available online: <[https://w2.eff.org/Censorship/Internet\\_censorship\\_bills/barlow\\_0296.declaration](https://w2.eff.org/Censorship/Internet_censorship_bills/barlow_0296.declaration)>.

<sup>4</sup> Financial and Consumer Affairs Authority, Press Release: Online Fraud Awareness Campaign Confirms Investors' Vulnerability (March 6, 2012), available online: <<http://www.sfsc.gov.sk.ca/Default.aspx?DN=4dbd3b54-b532-4a90-9658-a8c97bc03b80>>.



- 3.4. The internet does not abide by jurisdictional borders. Equity crowdfunding offerings will not be limited to the rules prescribed in the Notice. While we expect that public education is a planned element of this initiative, FAIR Canada is aware that investor education takes considerable time and presents challenges, and we do not believe that investor education will be able to address these real and pressing concerns.
- 3.5. FAIR Canada believes, therefore, that it is extremely naïve to think that the proposed crowdfunding rules will have any real effect at all. In fact, the only thing they are likely to accomplish is a watering down of the critical message that the internet is not a safe place for investors.
- 3.6. The introduction of a crowdfunding exemption will send a message to Canadian investors that investing online in an unknown start-up company is a legitimate investment opportunity. Given the limited effect of noble investor education efforts to date, we seriously question whether securities regulators will be able to convey to ordinary investors the delineation between regulated crowdfunding offerings (for example, through compliant portals) and non-compliant offerings. Canadians are generally uninformed about securities regulation (many do not know of their provincial or territorial securities regulator and the majority do not check registration<sup>5</sup>). We have no reason to believe that the situation will be any different with respect to the Proposed Exemptions and this will lead to susceptibility to fraudulent offerings.
- 3.7. Permitting capital-raising by SMEs on the internet will increase the pool of unsuspecting investors vulnerable to frauds. The North American Securities Administrators Association (“NASAA”) listed crowdfunding as its top new threat to investors in 2012.<sup>6</sup> The following year, crowdfunding was listed as one of NASAA’s new top threats to small business and increased actions or enforcement efforts relating to crowdfunding were noted.<sup>7</sup>

#### **4. Economic Benefits Uncertain**

- 4.1. Crowdfunding is hailed as a tool to boost the economy and create jobs, by providing financing to small- and medium-sized entities<sup>8</sup> which then will create jobs and spur innovation.

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<sup>5</sup> The CSA’s 2012 Investor Index found that 39% of Canadians know that there is a provincial or territorial government agency responsible for regulating financial investments in their province or territory. It also found that 60% of people with a financial advisor had never done any form of background check on their advisor.

<sup>6</sup> North American Securities Administrators Association, “NASAA Enforcement Report” (October 2012), available online: <<http://www.nasaa.org/wp-content/uploads/2012/10/2012-Enforcement-Report-on-2011-Data.pdf>>.

<sup>7</sup> North American Securities Administrators Association, “NASAA Enforcement Report 2013 Report on 2012 Data” (October 2013), available online: <<http://www.nasaa.org/wp-content/uploads/2013/10/2013-Enforcement-Report-on-2012-data.pdf>>.

<sup>8</sup> An SME is a business establishment with 1 to 499 paid employees, more specifically: a small business has 1 to 99 paid employees and a medium-sized business has 100 to 499 paid employees. See <<http://www.ic.gc.ca/eic/site/061.nsf/eng/02834.html>>.



- 4.2. Failure rates of SMEs are high. Recent Canadian data shows that while approximately 70% of SMEs survive for two years<sup>9,10</sup>, only about 50% of small businesses (fewer than 250 employees) survive for five years.<sup>11</sup> Other research has found that the average (mean) survival time for new firms (not necessarily SMEs) is six years, while the median survival time is three years.<sup>12</sup> We expect businesses that use equity crowdfunding (rather than bank loans or self-funding) could have even lower odds of success due to moral hazard and other factors. Odds of survival, let alone profit, are against SMEs. We recognize that owners and principals of start-ups and SMEs take considerable risk in trying to create successful businesses. However, we are concerned that small investors who invest in crowdfunded offerings will be exposed to extreme risk without having the same access to information and decision-making power.
- 4.3. It is widely accepted that many (possibly most) investors will lose money by investing in crowdfunding. It is unclear whether the purported benefits of crowdfunding will outweigh the costs. A preliminary academic exploration of the underlying economics of crowdfunding notes that:
- Despite the best efforts of policy makers and platform designers, there will surely be spectacular failures. Funders will lose significant sums, not only to fraud, but also to incompetent managers, bad ideas, and bad luck... The growing pains experienced by the equity-based crowdfunding industry will be even more dramatic and severe than in the non-equity setting. Throughout the mayhem, policy makers will be faced with the question of whether, in the long term, the benefit from the private gains from trade (cash for equity) as well as from the social gains due to spillovers and other externalities will outweigh these significant costs.<sup>13</sup>
- 4.4. **The economic benefits of crowdfunding are unproven.** As stated by a Deutsche Bank report, "...it remains to be seen whether crowdfunding will achieve a scale that results in positive macro-economic spillover effects, such as a rising number of company start-ups and an attendant increase in positive employment effects."<sup>14</sup>
- 4.5. The introduction of equity crowdfunding is very much an experiment, one with uncertain outcomes and real, clear risks. **As a result FAIR Canada believes that it is incumbent upon securities regulators who are intent on implementing such an exemption to do so in a**

<sup>9</sup> Industry Canada, "Key Small Business Statistics – August 2013" (Date modified: 2013-09-13), available online: <<http://www.ic.gc.ca/eic/site/061.nsf/eng/02808.html>>. See also Business Development Bank of Canada, "SMEs at a Glance" (August 2011), available online: <<http://www.bdc.ca/EN/Documents/other/SMEsAtAGlance-Summer%202011.pdf>>.

<sup>10</sup> Industry Canada, "Archived - Key Small Business Statistics – July 2012" (Date modified: 2013-09-20), available online: <<http://www.ic.gc.ca/eic/site/061.nsf/eng/02717.html>>.

<sup>11</sup> *Ibid.*

<sup>12</sup> Statistics Canada, "Failure Rates for New Canadian Firms: New Perspectives on Entry and Exit" (2000), available online: <<http://publications.gc.ca/Collection/Statcan/61-526-XIE/61-526-XIE1999001.pdf>>.

<sup>13</sup> Ajay Agrawal, Christian Catalini, Avi Goldfarb, "Some Simple Economics of Crowdfunding" (June 1, 2013) at pages 37-38.

<sup>14</sup> Thomas F. Dapp and Christoph Laskawi, "Crowdfunding - Does crowd euphoria impair risk consciousness?" (May 23, 2014), at page 13.

way that affords the highest level of investor protection possible. This is the best chance of serving the interests of both investors and issuers, by attempting to foster a sufficient level of confidence in investors to encourage them to continue to supply capital to SMEs. If inadequate protections are implemented, retail investors will be harmed and eventually SMEs will be forced to find other willing providers of capital.

## 5. Can Crowdfunding Investors Afford to Lose Their Investment?

- 5.1. FAIR Canada is concerned that investment limits will have little effect in reducing 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 the limits has yet 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."<sup>15</sup> 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 offering size limits proposed.
- 5.2. We believe that for legitimate offerings, investment limits are necessary to reduce potential investor losses. As stated above, we strongly oppose the proposed Start-Up Exemption. If BC introduces such an exemption, we recommend that the **individual investor limits be decreased to \$250 or less per offering and \$2,000 in total under this exemption per calendar year**. Investments under the Start-Up Exemption should be lower than the crowdfunding exemption. There is no reason to believe limits of this size will be ineffective in meeting the goal of raising capital for SMEs; but such limits may be the best available means of mitigating the risk of harm that crowdfunding poses if regulators insist on going ahead with proposed exemptions.
- 5.3. According to a National Crowdfunding Association of Canada ("NCFA") survey of representatives of start-ups and/or SMEs, 85% of respondents agreed or strongly agreed that the statement "Investors can lose all their money" accurately states an investor risk inherent in crowdfunding.<sup>16</sup> FAIR Canada questions where retail investors will draw funds from in order to invest in equity crowdfunding. We do not believe that equity crowdfunding is intended to attract funding that would otherwise have been invested as retirement or other long-term savings. However, it is unclear whether investors' funds will be redirected from other discretionary spending or will come from funds that could otherwise have been directed to less-risky retirement savings or paying down debt.

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<sup>15</sup> Thomas Lee Hazen, "Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must be Conditioned On Meaningful Disclosure" (May 20, 2012), at page 1766, available online: <<http://ssrn.com/abstract=1954040>>.

<sup>16</sup> National Crowdfunding Association of Canada, "National Crowdfunding Survey Data Results – Summary of raw results" (April 24, 2013), available online: <<http://ncfacanada.org/national-crowdfunding-survey-data-results-summary-of-raw-results/>>.

- 5.4. 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."<sup>17</sup>
- 5.5. We are concerned that, currently, many retail investors do not understand the risks associated with crowdfunding. The OSC's Exempt Market Study on Crowdfunding found 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."<sup>18</sup> We question whether investor education efforts (on portals or elsewhere) could effectively address this concern. We are not optimistic that they can or will.
- 5.6. 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.<sup>19</sup>
- 5.7. The proposed crowdfunding investment limits per investor are \$1,500 per offering with no cap. These are too high for many of the investors targeted by crowdfunding. Given that there are numerous other prospectus exemptions available to wealthy investors<sup>20</sup>, we believe that serious consideration should be given to lowering these limits.
- 5.8. We note that in 2012, "...the median contribution [to registered retirement savings plans] was \$2,930..."<sup>21</sup> The average contribution was approximately \$6,000.<sup>22</sup> The average net contribution per tax free savings account was \$2,741 in 2011.
- 5.9. Research commissioned by the Ontario Securities Commission found that Canadians' median savings and investments (including RRSPs but excluding home) are about

<sup>17</sup> *Supra* note 15 at page 1766.

<sup>18</sup> The Brondesbury Group, "Exempt Market Study on Crowdfunding" (May 28, 2013) at page 34.

<sup>19</sup> Innovative Research Group, "2012 CSA Investor Index" (October 16, 2012), available online: <[https://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL\\_EN.pdf](https://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL_EN.pdf)>.

<sup>20</sup> We also note that FAIR Canada opposes certain prospectus exemptions that rely on wealth as a proxy for sophistication. We refer readers to other submissions we have made in response to other exempt market consultations, most recently the accredited investor exemption. See <http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-comments-re-Proposed-Amendments-to-AI-MA-Exemptions.pdf>.

<sup>21</sup> Statistics Canada, "Registered retirement savings plan contributions, 2012" (Date modified: 2014-03-25), available online: <<http://www.statcan.gc.ca/daily-quotidien/140325/dq140325b-eng.htm>>.

<sup>22</sup> Statistics Canada, "Table 1 – Registered retirement savings plan contributors – Canada, provinces and territories" (Date modified: 2014-03-25), available online: <<http://www.statcan.gc.ca/daily-quotidien/140325/t140325b001-eng.htm>>.

\$45,000.<sup>23</sup> Almost 6 out of 10 respondents were found to have less than \$50,000 in savings and investments.<sup>24</sup>

- 5.10. In addition to relatively low savings rates, “[o]ne-quarter of family units had lines of credit in 2012... The median line of credit debt was \$15,000 in 2012.”<sup>25</sup> Further, “[a]bout 40% of Canadian family units carried an outstanding balance on their credit cards in 2012... The median amount was \$3,000 in 2012...”<sup>26</sup>
- 5.11. While the proposed investor limits are intended to limit the amount individuals could lose, we question whether most Canadians can, in fact, afford to lose this much.
- 5.12. Given that the underlying premise of crowdfunding is that SMEs can meet their capital-raising needs by sourcing a small amount of money from a large number of people, FAIR Canada suggests that the proposed limits be lowered. If crowdfunding works as intended, and the good ideas are in fact identified by the crowd, we expect that the good ideas would draw an adequate number of investors to meet their capital-raising goals using small investment limits. In addition, lower limits per investment could discourage concentration in one SME and may result in some diversification of crowdfunding investments by purchasing offerings from more SMEs. While crowdfunding is very risky, less concentration could have benefits for both investors and SMEs.
- 5.13. The experience of Kickstarter shows that large fundraising goals can be met through small donations from a large number of funders.<sup>27</sup> The goal of the Participating Jurisdictions in proposing crowdfunding rules is to provide capital to SMEs. Investors will lose their money in many (perhaps most) cases. The Kickstarter experience suggests that fundraising goals can be met through crowd contributions in amounts only a fraction of the investment limits being proposed, without exposing individual Canadian investors to losses they cannot afford.

## **6. Enforcement of Investment Limits**

- 6.1. FAIR Canada is concerned that adequate mechanisms have not been set out that will ensure adherence to the investor investment limits or the offering limit. The current proposal does not provide any measures to verify compliance with the limits. Investment limits are the main protection – and perhaps the only potentially effective protection – afforded to investors by this exemption (i.e. limiting their losses). Therefore it is essential that regulators find a way to ensure that issuers, portals and investors adhere to the limits imposed.

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<sup>23</sup> *Supra* note 18 at page 9.

<sup>24</sup> *Ibid.*

<sup>25</sup> Statistics Canada, “Survey of Financial Security, 2012” (Date modified: 2014-02-25), available online: <<http://www.statcan.gc.ca/daily-quotidien/140225/dq140225b-eng.htm>>.

<sup>26</sup> *Ibid.*

<sup>27</sup> As of June 13, 2014 about 1,300 successful Kickstarter projects had each raised between \$100,000 and \$1 million, with an average pledge of \$73.60.

- 6.2. FAIR Canada recommends the use of a centralized database to verify aggregate investment amounts.

## 7. Advice and Suitability

- 7.1. FAIR Canada notes that, while suitability is a low threshold (we believe a best interest duty is necessary), investors could benefit from some form of advice with respect to crowdfunding offers. This could provide more protection than the arbitrary investment limits proposed (or added protection if lower investment limits are adopted), by reducing the chance that crowdfunding investments will make up a disproportionate amount of an investor's portfolio.
- 7.2. A survey by the NCFA found that SMEs supported the imposition of a suitability requirement for portals (62% agreed or strongly agreed), but this was noted by the NCFA in its summary of the raw results to be "...a surprising statistic and not feasible for many portal business models"<sup>28</sup>. FAIR Canada questions why this would be said to be infeasible, as 75% of survey respondents identified as either a planned portal or service provider.
- 7.3. Research conducted by the Brondesbury Group for the OSC also suggested that advice through a financial advisor was one of five strong influences on willingness to invest in crowdfunding.<sup>29</sup>
- 7.4. **We recommend that regulators examine whether a suitability element should be added to the exemption in the interests of investor protection and in light of research that supports demand for it.**

## 8. Investment Evaluation

- 8.1. Evaluating the value of a crowdfunding distribution by an SME, particularly a start-up, is notoriously difficult.

For an interested investor it is a huge challenge to gain a proper assessment of the business model including all of its opportunities and risks. After all, given the only short existence of a start-up as a company there is only a small amount of valuation-relevant data available. However, for an investment decision it is precisely the communicated valuation that plays a key role as an indicator of the start-up's prospective returns and risk profile.<sup>30</sup>

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<sup>28</sup> *Supra* note 16.

<sup>29</sup> *Supra* note 18 at page 3.

<sup>30</sup> *Supra* note 14 at page 8.

According to the NCFA's survey of representatives of start-ups and/or SMEs, 80% of respondents agreed or strongly agreed that "Limited disclosure at the time of purchase and on an ongoing basis" was an investor risk inherent in crowdfunding.<sup>31</sup>

8.2. Evaluation is even more difficult for unsophisticated retail investors who are inexperienced at performing such evaluation and are at a large information disadvantage relative to issuers. While there are significant risks inherent in investing in start-up companies, "...information asymmetry (i.e., creators have more information about risks than funders) may significantly increase the cost of these risks to investors."<sup>32</sup>

8.3. Technological advances have enabled quick investment decisions. According to a report by Deutsche Bank,

a current funding record in which EUR 250,000 was raised in only 7 hours and 18 minutes shows that investment decisions in crowdfunding are taken in an extremely short space of time. In fact, the first EUR 50,000 was collected in only 38 minutes. This raises the question of the extent to which it is at all possible to perform an appropriate valuation and calculate all the related opportunities and risks in this short timespan. Funding issues are usually fraught with complexity, risks and uncertainty. It is no doubt possible to estimate and calculate risks with a certain degree of probability following due diligence. By contrast, the black swans will remain unpredictable.<sup>33</sup>

We do not believe that retail investors have the capacity to complete adequate due diligence prior to investing.

8.4. The "Pebble" watch, which is one of (pre-purchase model) crowdfunding's great success stories, met its goal of raising \$100,000 in two hours. It is unclear whether investors will be able to make an informed investment decision in the short amount of time often observed in crowdfunding campaigns. We question whether this would result in rational investment decision-making or something more along the lines of an 'impulse' purchase.

8.5. Further, it has been observed that "[f]unders and creators are initially overoptimistic about outcomes"<sup>34</sup>. Canada's own Wealthy Barber, David Chilton, tweeted to this effect on Twitter recently, saying: "Just looked at 6 start-ups' 1st-year projections and assumed 5-yr growth rates. If they hit their numbers, collectively they'll own Canada."<sup>35</sup>

8.6. We are not convinced that investors will make informed decisions in respect of crowdfunding. The history of securities regulation is replete with examples of speculative

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<sup>31</sup> *Supra* note 16.

<sup>32</sup> *Supra* note 13.

<sup>33</sup> *Supra* note 14 at page 11.

<sup>34</sup> *Supra* note 13.

<sup>35</sup> Chilton, David (@wealthy\_barber). "Just looked at 6 start-ups' 1st-year projections and assumed 5-yr growth rates. If they hit their numbers, collectively they'll own Canada." May 21, 2014. Tweet.

market bubbles and subsequent crashes, illustrative of herding behaviour. Although there are examples of the crowd monitoring and successfully identifying fraud,

...in the context of funding, the crowd is subject to herding behavior. Much of the existing research on crowdfunding has emphasized that funders rely heavily on accumulated capital as a signal of quality... Thus, the sequential nature of investment has the potential of triggering an information cascade. This path dependence suggests that funding success will only reflect underlying project quality if early funders do a careful job screening projects.<sup>36</sup>

- 8.7. 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.<sup>37</sup>

- 8.8. While proponents of crowdfunding tout the “wisdom of the crowd”, **the wisdom of the crowd remains questionable.**

## 9. **Lack of Exits and Minority Rights**

- 9.1. According to the NCFA’s survey of representatives of start-ups and/or SMEs, 85% of respondents agreed or strongly agreed that “May not be able to resell or redeem their investment” is an investor risk inherent in crowdfunding.<sup>38</sup>
- 9.2. FAIR Canada is concerned that many investors will not understand the liquidity constraints of crowdfunding investments.
- 9.3. We do not believe that efforts to educate retail investors about minority investor rights (or lack thereof) would be successful, including an explanation of the risks associated with being a minority security holder in the offering document. Disclosure of what rights investors have (or do not have) is far inferior to requiring the provision of basic protections. At a minimum, we believe that the dilution statement must include a warning about potential dilution by existing securities issued by the issuer.

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<sup>36</sup> *Supra* note 13.

<sup>37</sup> *Supra* note 2.

<sup>38</sup> *Supra* note 16.



## 10. Fraud

- 10.1. According to the World Bank, "...as the [crowdfunding] market expands, there will inevitably be attempts to circumvent regulations and defraud investors."<sup>39</sup>
- 10.2. The CSA's brochure on avoiding fraud and scams notes that "[y]ou don't have to be wealthy to be scammed. One-third of fraud victims are scammed for less than \$1,000. Another 28% are taken for between \$1,000 and \$5,000."<sup>40</sup>
- 10.3. Anticipating an increase in online fraud stemming in part from passage of the JOBS Act, NASAA created a task force on Internet fraud investigations shortly after the enactment of the JOBS Act to monitor crowdfunding and other Internet offerings. The group is currently coordinating multi-jurisdictional efforts to scan various online offering platforms for fraud, and, where authorized, will coordinate investigations into online or crowdfunded capital formation fraud.<sup>41</sup>
- 10.4. In late 2012, NASAA noted a significant increase in internet domain names with "crowdfunding" in the name. A press release stated that "[m]any of these sites appear to have been formed by large credible organizations while others appear to be created by individuals that may be operating out of their basements... The pure volume suggests that the wave is about to overtake the dam." It also warned that "[i]nvestors soon can be expected to be inundated with crowdfunding pitches, legitimate or otherwise..."<sup>42</sup>
- 10.5. Crowdfunding provides opportunities for fraud. According to economic research,

[i]nexperienced and overly optimistic investors may not only channel capital towards bad projects but also subject themselves to outright fraud. It is relatively easy to use false information to craft fraudulent pages that look like authentic fundraising campaigns. While platforms try to filter out such cases of manipulation, crowdfunding may become an appealing target for professional criminals. Furthermore, because investments are small, the risk is exacerbated by weak individual-level incentives to perform due diligence. To the extent that the cost of performing due diligence is high and the individual benefit low, the crowdfunding community may systematically underinvest in due diligence; instead, funders may free-ride on the investment decisions of others, which is feasible to do since funding information is public and funders usually cannot be excluded. Moreover, relative to platforms such as eBay and Airbnb, where sellers have an

<sup>39</sup> The World Bank, "Crowdfunding's Potential for the Developing World" (2013), at page 10.

<sup>40</sup> Canadian Securities Administrators, "Protecting your money: Avoiding frauds and scams" (undated), available online: <[http://www.securities-administrators.ca/uploadedFiles/General/pdfs/Protect\\_your\\_money\\_EWeb\\_2012.pdf](http://www.securities-administrators.ca/uploadedFiles/General/pdfs/Protect_your_money_EWeb_2012.pdf)> at page 2.

<sup>45</sup> North American Securities Administrators Association, Press release: "NASAA Sees Sharp Spike in Crowdfunding Presence on the Internet" (December 5, 2012), available online: <<http://www.nasaa.org/18951/nasaa-sees-sharp-spike-in-crowdfunding-presence-on-the-internet/>>.

<sup>42</sup> North American Securities Administrators Association, Press release: "NASAA Sees Sharp Spike in Crowdfunding Presence on the Internet" (December 5, 2012), available online: <<http://www.nasaa.org/18951/nasaa-sees-sharp-spike-in-crowdfunding-presence-on-the-internet/>>.

incentive to build a reputation to signal against fraud, the lack of repeated interaction over a short period of time increases the potential for fraud.<sup>43</sup>

## 11. Start-Up Exemption Unacceptable

- 11.1. FAIR Canada believes that the proposed start-up exemption suffers from the same issues and concerns we note in our submission to the CSA with respect to crowdfunding, but with the additional serious deficiencies of a lack of portal registration, unlimited aggregate investment limits, and limited disclosures to investors.
- 11.2. As noted above, we question how broadly securities regulators will be able to disseminate the message to use registered portals and whether investors will understand and follow this advice and be able to distinguish between legitimate registered portals and fraudulent ones. Permitting the use of unregistered portals exacerbates this problem.

## 12. Portal Registration

- 12.1. As provided in the CSA's Notice,

[a] key investor protection element of the new crowdfunding exemption is the requirement for registration of the portal. Registration is necessary to address, among other things, potential integrity, proficiency and solvency concerns that may apply to funding portals and the persons operating them, as well as potential concerns relating to conflicts of interest and self-dealing. The registration requirement is also intended to serve as a safeguard against funding portals being used to facilitate fraudulent offerings of securities through the internet.<sup>44</sup>

- 12.2. Registration and regulation of crowdfunding portals is essential to investor protection. Portals must be registered with the relevant securities regulator for there to be adequate oversight and compliance, and to ensure that SMEs use a legitimate intermediary. We believe that permitting equity crowdfunding transactions through unregulated portals would be a complete abandonment of Canadian securities regulators' investor protection missions, and will cause irreparable damage to investor and issuer confidence in Canada's financial markets.
- 12.3. **FAIR Canada cannot support a prospectus exemption that allows unregulated portals to sell investments to retail investors.** Not only does this present serious potential harm to investors, it also undermines any efforts aimed at informing investors of the need to deal with registrants, including a registered funding portal.

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<sup>43</sup> *Supra* note 13 at pages 19-20.

<sup>44</sup> Key Provisions of the Proposed Crowdfunding Portal Requirements at page D-30.

### 13. Non-registrants and Fraud

13.1. 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.<sup>45</sup> 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.

13.2. 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.”<sup>46</sup> 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.<sup>47</sup> U.S. state securities regulators’ comments regarding “the increased presence of questionable securities offerings made available via the Internet”<sup>48</sup> 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.

13.3. The 2013 NASAA Enforcement Report notes that even regulated portals open issuers up to potential fraud.

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.<sup>49</sup>

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

13.4. 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 Committee<sup>50</sup> 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

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<sup>45</sup> *Supra* note 7 at page 7.

<sup>46</sup> *Ibid.*

<sup>47</sup> *Supra* note 6.

<sup>48</sup> *Supra* note 7 at page 8.

<sup>49</sup> *Ibid.* at page 11.

<sup>50</sup> Australian Government’s Corporations and Market Advisory Committee, “Crowd Sourced Equity Funding Discussion Paper” (September 2013), at page 39.

regulators must oversee this function. Regulation and oversight is critical to any hope of proper function for equity crowdfunding portals.

#### **14. Start-up Exemption Investment Limits and Offering Size Limits**

- 14.1. Further, FAIR Canada is of the view that limiting only the amount a person may invest in a given offering is wholly inadequate. The proposed start-up exemption would permit investors to invest up to \$1,500 per offering but does not limit the aggregate amount they can invest under this exemption. **As noted above in section 5.2 we recommend that BC cap the total amount an investor is permitted to invest in Start-Up Exemption investments at a total of \$2,000 per calendar year and limit investments to \$250 per offering.** 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.
- 14.2. We note again that 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.

#### **15. Risk Acknowledgement Form**

- 15.1. FAIR Canada is of the opinion that the risk warnings required at page 6 of the Notice will be of little to no assistance to investors. The proposed requirement appears to be directed more at absolving regulators and portals of responsibility than true, plain-language warnings and information for investors.
- 15.2. 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. Specific information must be provided.
- 15.3. FAIR Canada recommends that, if BC proceeds with a start-up exemption, the offering document be required to disclose information relating to the success and failure rates of SMEs and specific information relating to the absence of legal rights in the offering document.
- 15.4. Regulators should test any risk acknowledgement form prior to introducing any exemptions to ensure that it meets the need(s) it is intended to address and does not result in any unintended negative effects.

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 Neil Gross at 416-214-3408 ([neil.gross@faircanada.ca](mailto:neil.gross@faircanada.ca)) or Lindsay Speed at 416-214-3442 ([lindsay.speed@faircanada.ca](mailto:lindsay.speed@faircanada.ca)).

Sincerely,

A handwritten signature in blue ink, appearing to read "M. Oves", is positioned below the word "Sincerely,".

Canadian Foundation for Advancement of Investor Rights