



Canadian Foundation *for*
Advancement of Investor Rights

June 18, 2014

Autorité des marchés financiers
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Nova Scotia Securities Commission

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RE: Draft Regulation 45-108 respecting Crowdfunding

FAIR Canada is pleased to offer comments on Multilateral CSA Notice of Publication and Request for Comment on Draft Regulation 45-108 respecting Crowdfunding (the “**Notice**”) dated March 20, 2014.

Crowdfunding is a method of funding a project or venture through small amounts of money raised from a potentially large number of people over the internet via an internet portal acting as intermediary.¹ 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 for more information.

1. Executive Summary

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

¹ Policy Statement to Regulation 45-108 Respecting Crowdfunding. Available online at: <http://www.lautorite.qc.ca/files//pdf/reglementation/valeurs-mobilieres/45-108/2014-03-20/2014mars20-45-108-ig-cons-en.pdf>.

- 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. 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.
- 1.5. 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.
- 1.6. 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.
- 1.7. 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.
- 1.8. 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 recommend that the Participating Jurisdictions decrease the individual investor limits to \$500 or less per offering and \$5,000 in total under the crowdfunding exemption. The current proposed limits are not small amounts for most retail investors.
- 1.9. 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.
- 1.10. 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 which demonstrates demand for it.
- 1.11. 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.
- 1.12. 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 happen to invest in a successful equity crowdfunding offering. We recommend that the

Participating Jurisdictions prescribe basic mandatory protections for crowdfunding investors, including tag-along and pre-emptive rights.

- 1.13. It is essential that the advertising and marketing be limited to the 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 proposed advertising and general solicitation provisions and we make specific recommendations to address these provisions.
- 1.14. 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 the proposed crowdfunding exemption to ensure that it serves the purpose for which it was intended.
- 1.15. Additionally, we recommend that all portals 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 tutorial that investors must complete in order to view offerings.
- 1.16. FAIR Canada agrees that 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.
- 1.17. 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 through different prospectus exemptions.
- 1.18. FAIR Canada is concerned that some of the language proposed for the crowdfunding offering document is unclear or may be misleading. We make specific recommendations below in section 16.
- 1.19. 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.
- 1.20. FAIR Canada also suggests that issuers be required to track employment levels and innovation developments of issuers who use the crowdfunding exemption and report them to securities regulators.
- 1.21. FAIR Canada fully supports the restriction that a registered funding portal will not be permitted to obtain dual registration in another registration category.
- 1.22. FAIR Canada opposes the proposed rule that would allow the portal to accept securities from SMEs and start-ups as payment (even if this payment was limited to 10%). This inevitably gives rise to

conflicts of interest and, given the important obligations imposed on portals, we do not believe regulators should condone such conflicts.

- 1.23. FAIR Canada believes that self-regulatory organization (“SRO”) membership should be required for crowdfunding portals.
- 1.24. FAIR Canada supports the proposed requirements 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.
- 1.25. 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.
- 1.26. 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.
- 1.27. 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 disproportionate amount of public 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.
- 1.28. 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.
- 1.29. 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.
- 1.30. FAIR Canada notes that crowdfunding has moved abruptly from an idea to concrete rules. 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.
- 1.31. 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. If regulatory capacity for swift action exists, it ought to be deployed to address investor-protection concerns rather than capital-raising desires.

1.32. 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.

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) or Lindsay Speed at 416-214-3442 (lindsay.speed@faircanada.ca).

Sincerely,



Canadian Foundation for Advancement of Investor Rights