



Equity Crowdfunding

A model for financing start-ups & small businesses

Crowdfunding, the practice of funding a project or venture by raising small amounts of money from a large number of people, has expanded over the past few years as a potential new funding source for start-ups and small businesses. In light of the recent legislative changes related to equity crowdfunding in both the United States (US) and Canada, this report will discuss major types of crowdfunding and their growth before focusing on equity crowdfunding as a method of financing for small businesses and start-ups. It will cover the current global market and both countries' new legislation, as well the specific challenges and benefits of equity crowdfunding. Lastly, the report will also touch on what the new trends in crowdfunding could mean for impact investing with a spotlight on the millennial generation's investing patterns.

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Introduction

Crowdfunding emerged simultaneously in a number of developed economies (Australia, United Kingdom (UK), Netherlands, and the US), and took root immediately after the global financial crisis when traditional financing methods had seemingly dried up.¹ Arts and entertainment ventures were the initial focus of early platforms, such as ArtistShare, as they tend to face fewer regulatory boundaries. There are four main types of crowdfunding: product- or reward-based, donation-based, debt-based, and equity-based. After the financial crisis, debt and equity crowdfunding expanded rapidly.

Market Overview

The Global Crowdfunding Market

Massolution, a research and advisory firm specializing in the crowdsourcing and crowdfunding industries, released a report entitled: “Massolution Crowdfunding Industry 2015 Report” (Massolution Report), to highlight the current state of the market, based on 1,250 active crowdfunding platforms worldwide. These platforms raised \$16.2 billion USD in 2014, almost triple the \$1 billion in 2013 (a 167% growth rate)

¹ Bruton, G., Khavul, S., Siegel, D., Wright, M. (2014). “New Financial Alternatives in Seeding Entrepreneurship: Microfinance, Crowdfunding, and Peer- to-Peer Innovations.” Entrepreneurship Theory and Practice. Retrieved from: <http://onlinelibrary.wiley.com/doi/10.1111/etap.12143/epdf>

² Hobey, E. (2015) “Massolution Post Research Findings” <http://www.crowdfundinsider.com/2015/03/65302-massolution-posts-research-findings-crowdfunding-market->

and were estimated to raise \$34 billion in 2015.² The World Bank estimated that crowdfunding would reach a total market size of \$90 billion by 2020; however, if the current growth rates continued to hold, it could reach \$90 billion earlier.³ North America is the largest market for crowdfunding, totalling \$9.46 billion in 2014, followed by Asia at \$3.4 billion; Europe trails behind, in third place, at \$3.26 billion. It is important to note, however, that these numbers reflect the whole crowdfunding industry in each area. Figure 1, below, illustrates the growth rates of crowdfunding in each region.

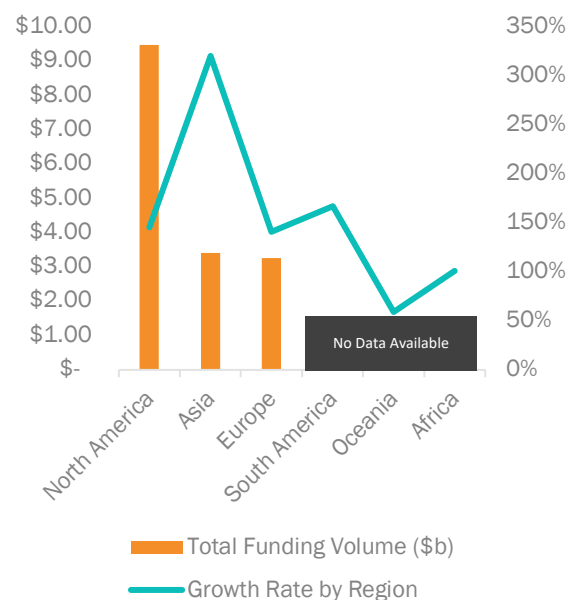


FIGURE 1. CROWDFUNDING AMOUNTS & GROWTH RATES, BY CONTINENT (2013 - 2014).⁴

³ Barnett, C. (2015) “Trends Show Crowdfunding to Surpass VC in 2016” <https://www.crowdfunder.com/blog/trends-show-crowdfunding-to-surpass-vc-in-2016/>

⁴ Graph created in Excel. Data: <http://www.marketwired.com/press-release/crowdfunding->

Within the crowdfunding industry, lending-based or debt-based crowdfunding is the most popular mode— raising \$11.08 billion in 2014. Royalty-based and hybrid-based crowdfunding have less volume but are growing the fastest. Equity-based and debt-based crowdfunding models are slowly gaining traction amongst other models. Figure 2 and 3, below, illustrate the models by current funding volume and growth rates.



FIGURE 2. TOTAL FUNDING VOLUME BY EQUITY CROWDFUNDING MODEL (2015).⁵

<http://www.marketwired.com/press-release/crowdfunding-market-grows-167-2014-crowdfunding-platforms-raise-162-billion-finds-research-2005299.htm>

⁵ Graph created in Excel. Data: <http://www.marketwired.com/press-release/crowdfunding-market-grows-167-2014-crowdfunding-platforms-raise-162-billion-finds-research-2005299.htm>

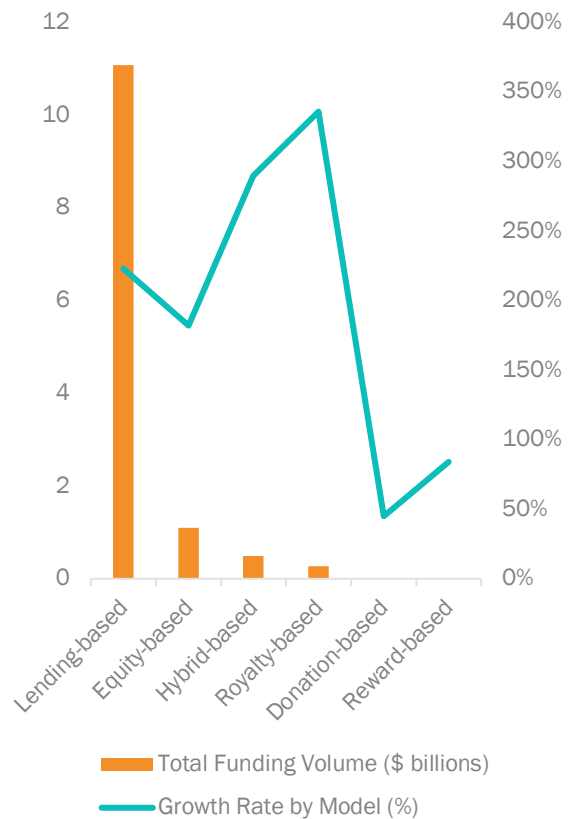


FIGURE 3. CROWDFUNDING AMOUNTS AND GROWTH RATES, BY EQUITY CROWDFUNDING MODEL (2013-2014)⁶

When crowdfunding is broken down by the category of investment the ‘Business & Entrepreneurship’ category tops both the funding volume and funding growth rate in both 2013 and 2014, followed by the ‘Social Causes’ category. Massolution’s data is detailed below.

⁶ Graph created in Excel. Data: <http://www.marketwired.com/press-release/crowdfunding-market-grows-167-2014-crowdfunding-platforms-raise-162-billion-finds-research-2005299.htm>

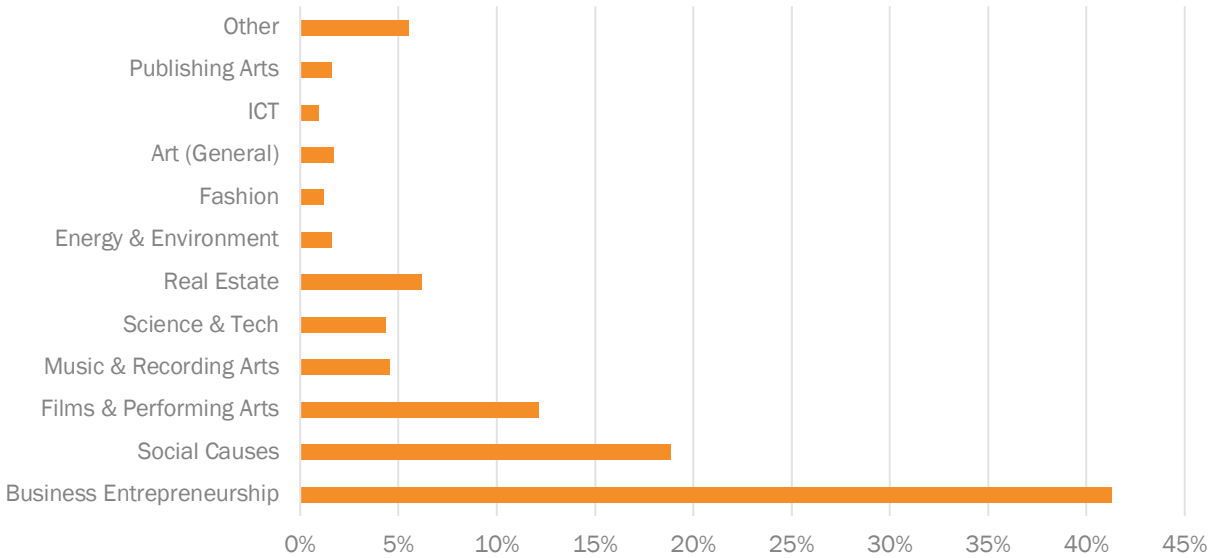


FIGURE 4. CROWDFUNDING, BY SECTOR/ CATEGORY (2014).⁷

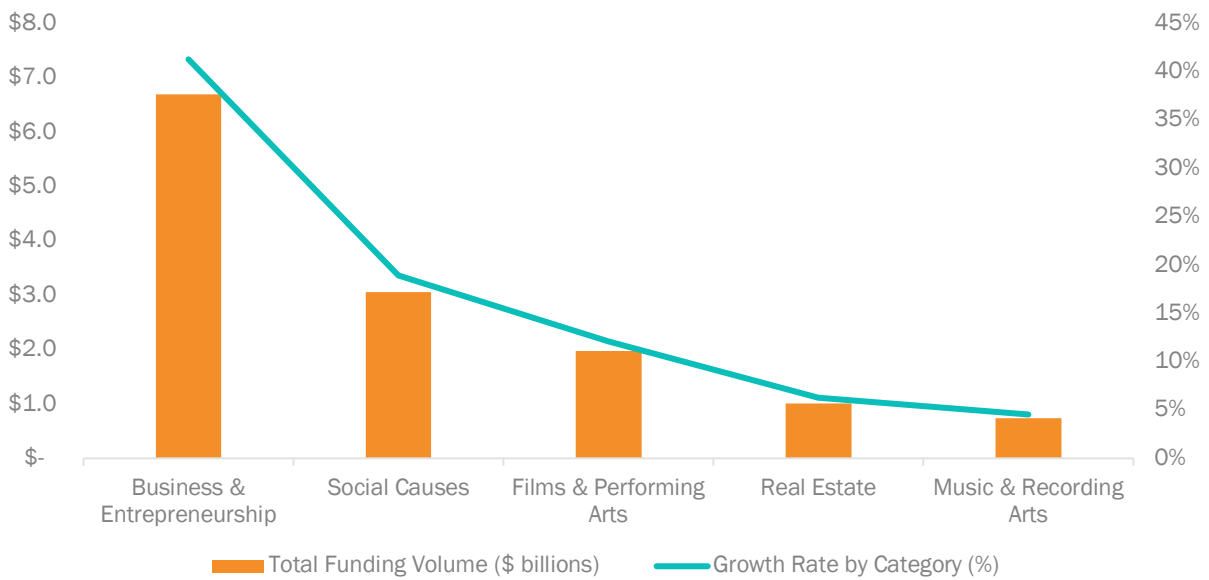


FIGURE 5. CROWDFUNDING AMOUNTS AND GROWTH RATES, BY SECTOR/ CATEGORY (2013-2014).^{8,9}

⁷ Figure 4 shows that Business & Entrepreneurship-related crowdfunding projects are the most popular, followed by social causes.

⁸ Figure 5 confirms that business & entrepreneurship projects are the most popular types of crowdfunded initiatives, as well as the fastest growing category.

⁹ Graph created in Excel. Data: <http://www.marketwired.com/press-release/crowdfunding-market-grows-167-2014-crowdfunding-platforms-raise-162-billion-finds-research-2005299.htm>

Categories of Crowdfunding

Rewards Crowdfunding

Rewards-based crowdfunding is the most popular type in terms of number of campaigns¹⁰, popularized by sites like Indiegogo and Kickstarter (2008 and 2009, respectively). It offers individuals a chance to contribute to a project or product in which they are interested, in exchange for current or future goods or services, often referred to as ‘perks’. In the most successful cases, it allows companies like the makers of the famous Pebble Watch to essentially pre-sell their product, while both securing the capital they need and testing market demand. Pebble rose to fame after their 2012 campaign raised approximately \$10.3 million from 68,929 backers over two months (average pledge of \$149).

Rewards-based crowdfunding was estimated to have raised \$2.68 billion in 2015¹¹, roughly equal to equity models, and may be categorized as either ‘all-or-nothing’ (AON) or ‘keep-it-all’ (KIA) contracts. In the former, the entrepreneur or company keeps all of the funding that they raise on the platform; in the latter, they set a goal amount and only collect funds if the target is met. A 2014 research paper

by York University and Université de Lille analyzed a sample of 22,850 campaigns from the platform Indiegogo. The platform allows companies seeking the funding to choose the fundraising type. They found that companies that chose KIA campaigns were less successful in meeting their fundraising goals, consistent with the risk-return trade-off for the entrepreneur, where KIA campaigns offer lower risk, but consequently lower returns.¹² KIA schemes were more prevalent for small, scalable projects, and AON schemes were more frequently used for large, non- scalable projects with high fixed-costs. Platforms like Kickstarter and FundedByME only offer the AON option, while others—including RocketHub—only allow the KIA model.¹³ Rewards-based crowdfunding may blur with donation-based crowdfunding in terms of the ultimate results; many backers pledge amounts less than the minimum required to get a reward, indicating that the backers simply want to support the project team and/or their product..¹⁴

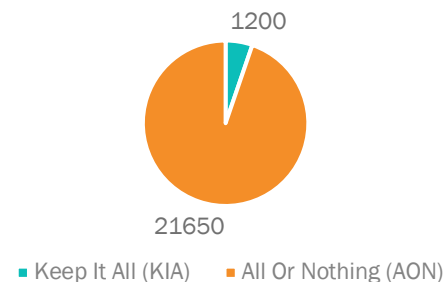


FIGURE 6. NUMBER OF CAMPAIGNS - BY MODEL .

¹⁰ Crowdfund Insider, “The Ultimate Crowdfunding Guide”. Retrieved from: <http://www.crowdfundinsider.com/the-ultimate-crowdfunding-guide/>

¹¹ Crowdexpert.com (2015). Retrieved from: <http://crowdexpert.com/crowdfunding-industry-statistics/>

¹² Cumming, D., Leboeuf, G., Schwienbacher, A. “Crowdfunding Models: Keep-It-All or All-Or-Nothing”.

(2015). <http://leeds-faculty.colorado.edu/Bhagat/CrowdfundingModels-KeppltAll-AllorNothing.pdf>

¹³ Ibid.

¹⁴ <http://www.freedman-chicago.com/ec4i/History-of-Crowdfunding.pdf>

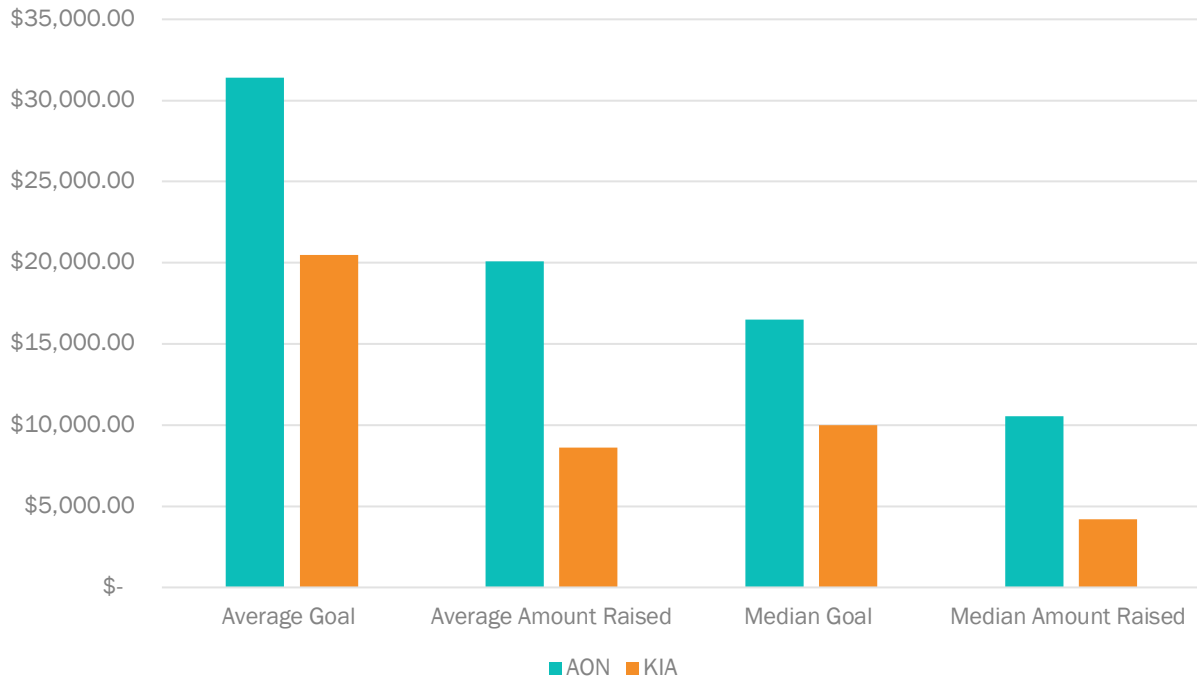


FIGURE 7. FUNDRAISING GOALS AND AMOUNT RAISED, BY MODEL (KEEP IT ALL VS. ALL OR NOTHING).^{15, 16}

Charity or ‘Pure’ Donation Crowdfunding

Charity-based crowdfunding (also referred to as ‘donation’ crowdfunding) takes place when an individual, company or organization accepts charitable donations. The first donation-based crowdfunding sites emerged in 2010, allowing small organizations to solicit donations from the crowd. Sites like GoFundMe, launched in 2010, allow users to raise funds for causes ranging from medical expenses, disaster relief, or a youth sports team. They may or may not offer tangible ‘perks’ for backers, but are generally directed at charitable causes. The total value of all GoFundMe

campaigns surpassed \$1 billion in 2015.¹⁷ Other sites have different variations on the model, including Vancouver-based Chimp, which stands for Charitable Impact Foundation, a public foundation active in the financial technology sector that manages and disburses financial gifts to registered Canadian charities. Individuals and charities may set up a free account, create groups, and set fundraising goals; donors may keep amounts in donor-advised-funds to be disbursed over time.¹⁸

¹⁵ Cumming, D., Leboeuf, G., Schwenbacher, A. “Crowdfunding Models: Keep-It-All or All-Or-Nothing”. (2015).

¹⁶ Figure 7 shows that KIA models were less successful, perhaps due to the nature of the projects as they were smaller than AON.

¹⁷ Solomon, Rob. (2015). “A \$1 Billion Year, One Million Lives Touched.” Retrieved from: <https://www.gofundme.com/blog/2015/09/24/a-1-billion-year-one-million-lives-touched/>

¹⁸ Chimp, “Crowdfunding with Giving Groups”. Retrieved from: <http://blog.chimp.net/crowd-funding-with-chimp-giving-groups/>

Debt Crowdfunding

Debt-based crowdfunding, also known as lending-based crowdfunding or peer-to-peer (P2P) lending, arose in the UK and the US in 2006. It became a vehicle for borrowers to obtain a loan at a lower interest rate than through traditional avenues (i.e., banks) and allows lenders to potentially receive a higher rate of return than through traditional investments (i.e. savings or government bonds). It continues to have the largest funding by volume compared to other models of crowdfunding and is growing rapidly.

Several studies have been completed on the risk and return of investments in P2P lending: Freedman and Jin (2008) find a positive estimated rate of return on Prosper loans. However, Singh, Gopal and Li (2009) find that despite the preference for P2P lending over government bonds, the average rate of return from P2P lending is, in fact, negative. They similarly find that Prosper.com loans offer a negative return compared to Treasury Bills, the risk-free alternative.¹⁹ However, it is important to note that the loan length per loan for all these studies differ

¹⁹ Singh, H., Gopal, R., Li, X. "Risk and Return of Investments in Online Peer-to-Peer Lending." Retrieved from:

<https://www.misrc.umn.edu/wise/papers/p1-5.pdf>

²⁰ Fundamerica (2015).

<http://www.fundamerica.com/files/Crowdfunding-Textbook.pdf>

²¹ Massolution (2013). "Crowdfunding Market Grows 81% in 2012: Crowdfunding Platforms Raised \$2.7 Billion and Fund More Than One Million Campaigns, Finds Research Firm Massolution." Retrieved from:

<http://www.prnewswire.com/news-releases/crowdfunding->

from each other and this difference contributed to the results.

At first glance, this crowdfunding model allows individuals to lend money to people and businesses that need it. In reality, due to the complexity of the law in this area, people buy into a securitized pool that in turn lends to borrowers. Borrowers in turn are liable to this lending entity and not directly to the participating lenders.²⁰ This has the potential to create the legal challenges in this model of crowdfunding that recent legislation in North America has been attempting to address.

Year	Global Funding Volume (\$USD)	Growth Multiple
2012	1.2 ²¹	N/A
2013	3.5 ²²	2.91
2014	11.1 ²³	3.17
2015	25.1 ²⁴	2.26

TABLE 1. DEBT CROWDFUNDING DATA (2012 - 2015).

Equity Crowdfunding

Equity-based crowdfunding involves investors contributing money in exchange for a tangible

[market-grows-81-in-2012-crowdfunding-platforms-raise-27-billion-and-fund-more-than-one-million-campaigns-finds-research-firm-massolution-201911701.html](http://www.massolution.com/news-releases/crowdfunding-market-grows-81-in-2012-crowdfunding-platforms-raise-27-billion-and-fund-more-than-one-million-campaigns-finds-research-firm-massolution-201911701.html)

²² Statista (2014). Retrieved from:

<http://www.statista.com/statistics/325902/global-p2p-lending/>

²³ Massolution (2015). Quoted in NCFCA:

<http://ncfacanada.org/2015-massolution-report-released-crowdfunding-market-grows-167-in-2014-crowdfunding-platforms-raise-16-2-billion/>

²⁴ Research-based estimate from the Massolution Report 2015. <http://www.reply.eu/en/content/crowdfunding-is-it-the-right-time-for-banks>

interest in the venture they are funding, most often stock.²⁵ The equity crowdfunding market is relatively new, with the first few platforms founded in 2009 in the UK (by Finnish entrepreneurs), and Canada.^{26,27} Since then, a number of reports have shown promising growth in equity crowdfunding compared to the more traditional forms of equity funding, such as funding from angel investors, private equity firms, and venture capital firms. In comparison to venture capital funding, which accounted for \$47 billion in investment in the US in 2014, the global equity-based crowdfunding market was only around \$400 million in 2013, \$1.1 billion in 2014, \$2.1 billion in 2015, and an estimated growth to \$3.5 billion in 2016.^{28,29,30} It seems that despite its growth, equity crowdfunding is not a big threat to the venture capital industry — at least not yet.

²⁵ Ibrahim, D. M. (2015). "Equity Crowdfunding: A Market for Lemons?" *Minnesota Law Review*. Retrieved from: http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2539786

²⁶ Kukkosuo, M. (2009). "Venture Capital 2.0: Grow VC Launches Private Beta" Retrieved from: <http://arcticstartup.com/article/venture-capital-2-0-grow-vc-launches-private-beta-we-have-invites/>

²⁷ Asano, C. (2014). Retrieved from: <http://ncfacanada.org/matthew-mcgrath-ceofounder-of-optimize-capital-markets-joins-ncfa-vec-vancouver-equity-crowdfunding-event-may-21-2014/>

²⁸ Note: alternate sources state that the US venture capital market was worth between \$47.3 billion and 48 billion in

2014, according to CB insights and a Moneytree report. The lower figure is used here for conservatism.

<https://www.cbinsights.com/venture-capital-2014>, <http://nvca.org/pressreleases/annual-venture-capital-investment-tops-48-billion-2014-reaching-highest-level-decade-according-moneytree-report/>

²⁹ Feit, R. (2015). "Equity Crowdfunding by the Numbers" Retrieved from: <http://www.inc.com/ryan-feit/equity-crowdfunding-by-the-numbers.html>

³⁰ Gaskell, A. (2016). "The Rise of Investment Crowdfunding" Retrieved from: <https://www.forbes.com/sites/adigaskell/2016/03/15/the-rise-of-investment-crowdfunding/#6384be2d4d9b>

Equity Crowdfunding Regulation

Small businesses and start-ups reportedly generated approximately 65% of the net new jobs in the US from 1993 to 2009³¹ and generated approximately 77% of new private jobs in Canada.³² Many of these enterprises struggle to raise the seed funding needed to be operational, and about 95% of these enterprises are funded by a mix of credit cards, personal savings, and through the entrepreneur's network of friends and family.³³ In response, governments in both the US and Canada have recently amended legislation to allow new ways for equity crowdfunding to play a part in small business and start-up financing.

Equity Crowdfunding in the United States

The US Market

As of May 2016, 176 equity crowdfunding platforms were established in the US with about 87% still operational. Over 60% of the platforms were created between 2013 and 2015 when legislation other than Title III of the JOBS Act was already effective (see below).³⁴ While the

Massolution Report indicated that the global market for equity crowdfunding was about \$1.1 billion in 2014, CrowdExpert (which maintains a database of activity across 35 equity crowdfunding platforms) estimates that the 2015 market was about \$1.2 billion in the US alone. This number only includes primary offerings and excludes real estate offerings. An additional \$900 million in 2015 US real estate equity crowdfunding was tracked, which amounted to \$2.1 billion in total US equity crowdfunding volume.³⁵ If this estimate is correct, it means that the 2015 US equity crowdfunding market alone doubled the global equity crowdfunding market of 2014.

Regulation in the United States

JOBS Act Overview

The Jumpstart Our Business Start-ups (JOBS) Act was signed into federal law by President Barack Obama after receiving bipartisan support in April 5, 2012. By assisting with capital building and funding for emerging SMEs, it aims to enable job creation and inspire innovation. It is important to note that while these start-ups create jobs, only a fraction of start-ups actually end up being successful.

31 US Small Business Administration. (2011). "SBA FAQ" <https://www.sba.gov/sites/default/files/sbfaq.pdf>

32 Chew, A. (2015). "What Makes Equity Crowdfunding in Canada So Great" <https://academicnexus.com/funding/equity-crowdfunding/what-makes-equity-crowdfunding-in-canada-so-great-4409/>

33 Feit, Ryan (2015). "Equity Crowdfunding by the Numbers" <http://www.inc.com/ryan-feit/equity-crowdfunding-by-the-numbers.html>

34 <https://crowdsurfer.com/blog/equity-crowdfunding-comparing-the-us-and-uk-markets/>

35 <http://crowdexpert.com/crowdfunding-industry-statistics/>

Although the JOBS Act was signed into law in 2012, its respective titles were brought into effect only incrementally over the following years (only three out of seven titles were effective immediately). Title II (Regulation D), concerning accredited investor equity crowdfunding, was only effective in 2013.

Title IV (Regulation A+, concerning 'mini IPO' crowdfunding for companies in Series A or B funding) was made effective only in 2015. Finally, Title III, a key section of the JOBS Act pertaining to non-accredited investors involved in seed-stage crowdfunding, which would be the lynchpin of the Act that would significantly unlock equity crowdfunding's potential, did not become effective until May 2016.

Highlights of the JOBS Act: Title III - Regulation CF

Similar to bonds and stocks, virtually anyone can take part in crowdfunding investments; they are only limited by total investment in a given 12-month period. The conditions are as follows:

- If **either** your annual income **or** net worth is less than \$100,000, then you can invest up to the greater of \$2,000 or 5% of the lesser of your annual income or net worth in the 12-month period.
- If **both** your annual income **and** your net worth are equal to or more than \$100,000, then you can invest up to 10% of the lesser of your annual income or net

worth in the 12-month period for a maximum of \$100,000.³⁶

On the other hand, issuers are only allowed to raise \$1 million in a 12-month period. Additionally, financial disclosure (among other things) required for compliance is as follows:

- \$100,000 or less – financial statements certified by the principal executive officer of the company
- More than \$100,000 and up to \$500,000 – financial statements **reviewed** by an independent public accountant. If audited statements are available, those must be provided.
- More than \$500,000 and up to \$1,000,000 – financial statements **audited** by an independent public accountant and the accountant's audit report. If it is the first crowdfunding offering for the issuer, financial statements **reviewed** by an independent accountant will suffice.

A more detailed summary of the conditions of Title III - Regulation CF of the JOBS Act on regulators, investors, intermediaries, and issuers is provided in Appendix A.

Fix Crowdfunding Act

On July 2016, Congress passed an Act amending the initial Securities Exchange Act of 1933/4 to allow crowdfunding issuers to sell shares through a crowdfunding vehicle, which is a "special purpose

36 FINRA. (2016). "Crowdfunding and the JOBS Act: What Investors Should Know"

www.nasdaq.com/article/crowdfunding-and-the-jobs-act-what-investors-should-know-cm621603

vehicle” (SPV) that aggregates crowdfunding investors into one entity or company. In addition, the act also includes an unconditional exemption to the registration of shares with the SEC (Section 12(g) of the original Securities Exchange Act) if³⁷:

- The company has a public float of less than \$75 million (defined as the number of equity shares multiplied by its selling price)
- If the public float is zero, revenues of less than \$50 million

Although the amended act that was passed was viewed to be less comprehensive than the bill that was initially drafted, it does have significant implications for how easily equity crowdfunding companies can operate. The first section of the act, dealing with SPVs, greatly simplifies how firms deal with shareholders once they have crowdfunded, as they do not need to deal with long capitalization tables and would only have to deal with one SPV in order to get anything approved by their larger number of shareholders (which is a natural result of crowdfunding ventures as they, by design, get equity from a larger number of people).

The second section rectifies another criticism of Title III, which pertains to the registration of shares with the SEC that were raised through crowdfunding. The exemptions allowed under the original JOBS Act were seen as inadequate, so this section is seen as a small, but positive step forward.

³⁷ United States. Cong. Fix Crowdfunding Act. 114th Cong. H.R.4855. Washington. Retrieved from: <https://www.congress.gov/bill/114th-congress/house-bill/4855>

There are also significant criticisms of the JOBS Act, including limits on equity that can be raised by issuers, the significant liability that is placed on crowdfunding portals to conduct due diligence in the case of misstatements by the issuers and the ability for issuers to “test the waters” by announcing a crowdfunding venture without having to disclose to the SEC. These criticisms have been left unaddressed, and only time will tell if Congress will, at least incrementally, perform the necessary fixes to the JOBS Act.³⁸

Issues of Title III

Despite the intentions behind the act, there are challenges that could hinder its impact and long-term success: its constraining limits, costs of compliance, and unintended consequences.

Constraining Limits

Equity crowdfunding rules limit the issuers to only raising a maximum of \$1 million within a 12-month period, which is a very limited amount relative to the average seed funding capital required. Since the JOBS Act was signed, the average seed funding amount invested has grown; however, with an average seed round predicted to be over \$2 million in 2016, equity crowdfunding specifically under Title III will be unlikely to fill 100% seed funding needs. According to the CEO of Crowdfunder, Chance Barnett (who was actively involved in

³⁸ Zeoli, A. (2016). “The Fix Crowdfunding Act. What it Fixes & What it Does Not. Crowdfund Insider. Retrieved from: <https://www.crowdfundinsider.com/2016/07/88536-fix-crowdfunding-act-fixes-not/>

designing the legislation),³⁹ several parties requested the SEC to adjust the regulation to a \$5 million cap to no avail.

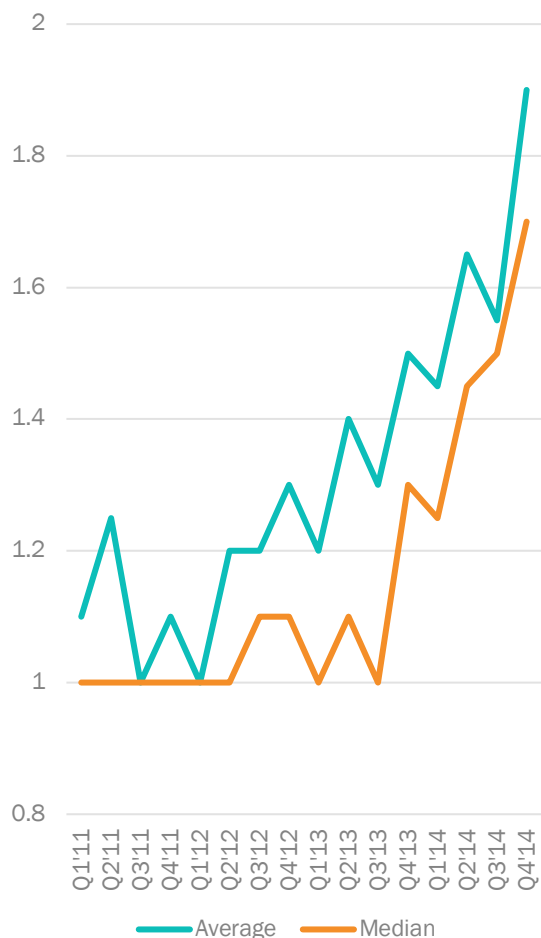


FIGURE 8. AVERAGE AND MEDIAN SEED ROUND INVESTMENT AMOUNTS IN START-UPS.^{40,41}

³⁹ Taylor, C. (2012). "What the Senate's Crowdfund Act Means for the Tech Industry Right Now"

<https://techcrunch.com/2012/03/22/crowdfunding-act-passed-impact-tech-industry/>

⁴⁰ CB Insights. (2015). "2014 Was a Giant Year for Seed VC Funding" Retrieved from:

<https://www.cbinsights.com/blog/seed-venture-capital-2014/>

⁴¹ Figure 8 shows the growth of average and median seed round amounts in early-stage companies, growing by over 50% since 2011.

⁴² Barnett, C. (2016). "Why Title III of the JOBS Act Will Disappoint Entrepreneurs" Retrieved from:

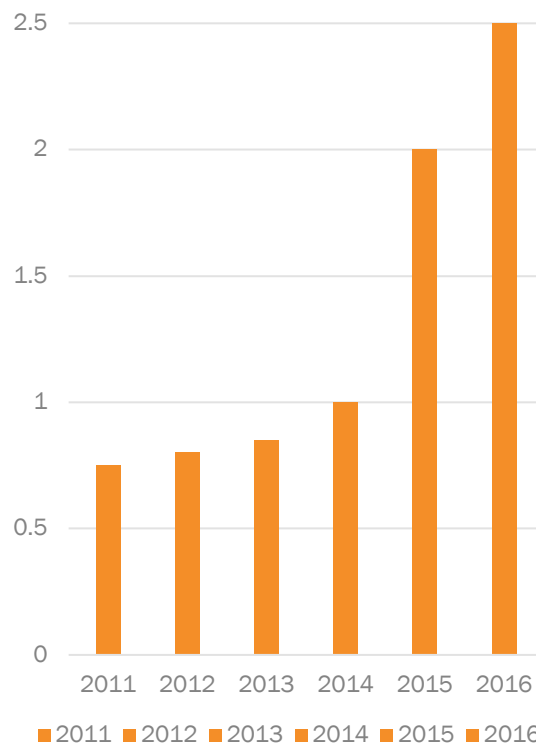


FIGURE 9. AVERAGE SEED ROUND INVESTMENT AMOUNTS (2011-2016).^{42,43}

Costs of Compliance

Compliance for Title III is significant compared to other equity financing methods. Complying with the rules and regulations of Title III will require about a conservative average of 100 work hours from in-house and independent professionals according to SEC estimates, which may cost between \$50,000

<http://www.forbes.com/sites/chancebarnett/2016/05/13/why-title-iii-of-the-jobs-act-will-disappoint-entrepreneurs/3/#14f5ea2b4f51>

⁴³ Figure 9 confirms that the average amount of money raised for seed rounds has grown dramatically since 2011, forecasted to exceed \$2.0m by 2016. Note that while Title IV of the JOBS Act or Regulation A+ has a higher cap (maximum \$50,000,000 depending on the tier), it only covers start-ups which is past the seed stage, ideally in the Series A or B stage.

to \$100,000.⁴⁴ Other sources say the cost could be around \$250,000.⁴⁵ Notably, these are upfront costs (regardless of the success of the equity crowdfunding offering) before any fixed fees and/or commissions of the crowdfunding platforms and brokers.^{46, 47}

Unintended Consequences

The new regulations from the SEC require issuers to go through a lengthier process than previous exemptions under Regulation D of the Securities Act of 1933 for those who wish to offer securities without registration with the SEC (i.e., an IPO). Raising \$1 million will cost an estimate of about \$50,000 to \$250,000 under Title III, and about \$15,000 under Regulation D—at minimum a \$35,000 difference.

Title III aimed to ease regulations for equity crowdfunding in response to the prohibition of “general solicitation” unless the issuer’s potential investors are accredited and the issuer has taken reasonable steps to verify this under Regulation D.⁴⁸ However, it leaves ordinary start-ups with high costs, lengthy requirements to comply with, and a

relatively small reward (maximum of \$1 million) for Title III equity crowdfunding. It is highly likely that the most popular and in-demand start-ups will avoid Title III and opt for traditional financing or Regulation D exemptions — leaving the crowd of investors with no or very little access to the next Uber or Facebook, which defeats one of the purposes of Title III.⁴⁹

State Legislation

The delay in the US federal government’s official and final rules of the JOBS Act led to individual states passing their own equity crowdfunding laws and rules. As of June 2016, the North American Securities Administrators Association (NASAA) compiled a summary of 45 different states in the US that have, or will have, state laws regarding equity crowdfunding.⁵⁰

Many states actually provide more favourable terms to both the investors and the issuers than the federal JOBS Act. Anthony Zeoli, a finance lawyer specializing in securities and crowdfunding law, created what he claims to be a “definitive

⁴⁴ Chance Barnett states that these hours can cost anywhere between \$50,000 to \$100,000 depending on the amount raised, if the issuer needs a review or an audit, and other fees for SEC filings.

⁴⁵ Prive, T. (2015). “Why Title III of the JOBS Act May Be a Flop” www.forbes.com/sites/tanyaprive/2015/11/03/why-title-iii-of-the-jobs-act-may-be-a-flop/#19662c7d6722

⁴⁶ The Top 10 crowdfunding sites currently charge fees that range from 5-10% of total amount raised. This figure does not include equity crowdfunders; however, it ranges similarly from 7-10%.

⁴⁷ A final cost may also be maintaining larger capitalization tables with the increase of private individuals holding equity; however, this is less likely to be material.

⁴⁸ TRaneri, M. (2015). “The New ABCs of Private Placements” <http://www.forbes.com/sites/mraneri/2015/03/11/the-new-abcs-of-private-placements-506b-and-506c/#4751d4215c03>

⁴⁹ Barnett, C. (2016). “Why Title III of the JOBS Act Will Disappoint Entrepreneurs” <http://www.forbes.com/sites/chancebarnett/2016/05/13/why-title-iii-of-the-jobs-act-will-disappoint-entrepreneurs/3/#14f6ea2b4f51>

⁵⁰ NASAA. (2016). “Interstate Crowdfunding Legislation” <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2014/12/NASAA-Crowdfunding-Index-6-10-2016.pdf>

comparative matrix” of the differences in state laws.⁵¹ Although they vary, state laws have higher caps that range from \$2 million to \$5 million and the amount that accredited and non-accredited investors are allowed to invest is higher than the federal law allows for. Ultimately, it seems as though equity crowdfunding portals themselves have the power to choose which law, state or federal, it (and its users—investors and issuers) would like to follow.⁵²

⁵¹ Zeoli, A. (2016). “Comparative Summaries of Current, Active, and Proposed Crowdfunding Exemptions” <https://crowdfundinglegalhub.com/2015/01/16/state-of-the-states-comparative-summaries-of-current-active-and-proposed-intrastate-crowdfunding-exemptions/>

⁵² Elahi, A. (2016). “New Federal Crowdfunding Rules Give Companies Another Tool to Get Cash” <http://www.chicagotribune.com/bluesky/originals/ct-title-iii-crowdfunding-illinois-bsi-20160516-story.html>

Equity Crowdfunding in Canada

Over the last four years, securities regulators in Canada have made major reforms to securities law to facilitate equity crowdfunding. The main barriers to crowdfunding had previously been the need to issue a prospectus, or official financial disclosure providing details about the investment, which was likely prohibitively expensive and time consuming for SMEs. Prior to these reforms, a number of dealers were relying on previously existing prospectus exemptions including the Accredited Investor Exemption and the Offering Memorandum Exemption (detailed in Appendix B).⁵³

The Canadian Market

As of June 20th 2016, there were 15 equity-specific crowdfunding portals operating in Canada.⁵⁴ While there is some overlap between Canadian and American campaigns in terms of investors due to the nature of the industry, the National Crowdfunding Association of Canada maintains a directory of active (or beta) Canadian crowdfunding platforms, alternative finance funding portals, and service providers. Two platforms targeting early stage/SME ventures and both accredited and retail investors with the most traction include FrontFundr, based out of Vancouver, and SeedUps, based out of Calgary.

Although defining ‘equity crowdfunding’ and what should be included can cause a challenge for assessing market size, the Canadian market for equity crowdfunding is notably smaller than that of the US. FrontFundr, while relatively successful, only has 27 listed companies as of July 2016. Currently, portals in Canada operate under the Accredited Investor Exemption and Offering Memorandum Exemption mentioned above (there are eight online funding portals offering deals relying on these two exemptions) and the Start-Up Crowdfunding Exemption, (detailed below) which are not mutually exclusive.⁵⁵ FrontFundr is an exempt market dealer offering deals under both of these exemptions as well as the Start-Up Crowdfunding Exemption. No portals operated under the new Multilateral Instrument 45-108 as of July 2016.

A 2015 report by FundingPortal estimated the value of the Canadian equity crowdfunding market to be about \$70 million.⁵⁶ Culture may create differences in the way funds are raised. In a 2015 interview for TechCrunch, Tim Ryan, the country manager in Canada for Tilt (a start-up platform serving as a way for people to raise money ahead of an event happening), noted that the dollar value of Tilt’s campaigns was higher in the US. He argued that Canadians were culturally more ‘utilitarian, more conservative, more practical’ and that funding patterns reflected this.⁵⁷

53 <http://ncfacanada.org/wp-content/uploads/2015/06/AUM-Law-In-a-Nutshell-Equity-Crowdfunding-Portals-February-2015.pdf>

54 <http://ncfacanada.org/canadian-crowdfunding-directory/>

55 http://www.osc.gov.on.ca/en/SecuritiesLaw_45-108.htm
<http://ncfacanada.org/equity-crowdfunding-regulations/>

56 <https://techcrunch.com/2015/05/20/tilts-global-ambitions-grow-as-it-seeks-to-raise-at-a-400m-valuation/#.cabctI:2v4I>
<https://academicnexus.com/funding/equity-crowdfunding/equity-crowdfunding-is-the-next-big-thing-in-canada-4684/>

57 <http://www.alixecormick.com/culture-and-equity-crowdfunding-in-canada/>

The Canadian crowdfunding industry has seen recent growth, thanks to new regulatory developments that were introduced in 2015 and 2016.⁵⁸ Canadian crowdfunding portals have proliferated in industries as diverse as real estate (Nexus Crowd Inc.), cannabis (Street Cannabis), social entrepreneurship (Ashoka) and the arts (ArtsFunding). Crowdfunding portals are concentrated in the most populous provinces, with an emphasis on the west coast—a trend that is also seen in the US.

Several new portals are focused on real estate crowdfunding, including Toronto-based Nexus Crowd Inc. Crowdfunding portals are concentrated in the most populous provinces, with an emphasis on the west coast—a trend that is also seen in the US.

Spotlight: Mining Equity Crowdfunding and Red Cloud (Prev. KlondikeStrike)

Red Cloud, the world's first equity crowdfunding platform for mining companies, was launched in 2016. Investors use the platform to buy securities in new mining companies and mining companies gain access to new forms of capital. Thanks to the use of the offering memorandum exception, unaccredited investors are able to make (capped) investments.

The market structure of the mining industry may help shape the success of *Red Cloud*. Small companies have the potential for scalable growth, often very quickly.

<https://techcrunch.com/2015/05/20/tilts-global-ambitions-grow-as-it-seeks-to-raise-at-a-400m-valuation/#.cabctl:2v4l>

“In the mining industry, this is where you make your money as an investor—getting in on the ground level and buying the small companies. They are penny stocks to begin with, after a few years [if successful] they’ve jumped to be multi-million-dollar market caps... junior mining companies, they’re right for crowdfunding; they’re small companies, you can get a lot of stock in and start on the ground floor, which is very unusual for most companies.” – From an interview with a previous associate of *Red Cloud*

Companies faced challenges in addition to the cost of the offering memorandum, such as adapting to the need to advertise on social media (partly thanks to the stringent regulations of the OSC). However, equity crowdfunding is seen as a way to expand beyond raising funds from a traditionally small group of high net worth or ‘friends and family’ investors; it enables small companies to search for more funding opportunities.

“Unless you have funds and you know the company or people who work there, you’d never even hear about these companies before. So that’s really why we wanted to bring a more democratic approach to investing in Canada and how the investors get in on the floor.” – From an interview with a previous associate of *Red Cloud*

Regulation in Canada

In Canada, securities laws are provincially legislated and apply to companies and investors based on the province in which they reside.

⁵⁸ See summary from the National Crowdfunding Association of Canada: <http://crowdfundingsummit.ca/about-ncfa/>

Crowdfunding regulatory exemptions have been adopted—into the different frameworks—in Manitoba, British Columbia, Saskatchewan, Quebec, New Brunswick and Nova Scotia. Major regulatory frameworks for equity crowdfunding in Canada exist under the Start-Up Crowdfunding regime (adopted simultaneously in participating jurisdictions by way of blanket orders in 2015) and by the Ontario Securities Commission (OSC), in a separate piece of legislation, through Multilateral Instrument 45-108 (the MI 45-108 Regime) formalized in January of 2016.⁵⁹

Similar to the US, equity crowdfunding regulatory frameworks consist of amendments to securities regulations allowing start-ups and SMEs to be exempted from the typical requirements of the issuer to either be registered or to prepare a prospectus when selling securities to the general market. Normally, these requirements ensure adequate disclosure and due diligence so investors have the information they need to make decisions and issuers know that they are accountable for the disclosure and any misrepresentations, manipulation or fraud.⁶⁰ However, as with the US, the preparation of the comprehensive document can be prohibitively expensive and time-consuming for SMEs.

Multilateral CSA Notice 45-316: The Start-Up Crowdfunding Exemptions⁶¹

59 Note that MI 45-108 is also referred to by the specific crowdfunding prospectus exemption it includes, as the Integrated Crowdfunding Exemption. See also: <http://www.tmlawyers.com/crowdfunding-exemptions-adopted-by-canadian-securities-regulators/>

The Start-Up Crowdfunding Exemptions (also known as the Start-Up Regime) refers to simultaneous regulatory amendments in British Columbia, Saskatchewan, Manitoba, Quebec, Nova Scotia and New Brunswick (the ‘participating jurisdictions’) in May of 2015 by way of local blanket orders. It is a regional mechanism with prospectus and dealer registration exemptions allowing the sale of securities without the preparation of a prospectus or IPO. It has limited offering document obligations and financial statement requirements, but heavily restricts offering size to limit potential risks to investors.

The 2015 Start-Up Crowdfunding Exemptions’ conditions are outlined in Multilateral CSA Notice 45-316 (MI 45-316). It limits an individual’s investment to no more than \$1,500 per distribution; it caps a distribution at \$250,000 per individual offering (with no more than two offerings a year, i.e., a \$500,000 aggregate cap every 12-month period).

Prior to the establishment of the Start-Up Crowdfunding Exemptions, some portals operated under the Accredited Investor Exemption or the Offering Memorandum Exemption, available in all jurisdictions across Canada. They are restricted to higher-net-worth investors and require comprehensive disclosure to regulate offerings and are detailed in Appendix B.

⁶⁰ Three policy assumptions underlie exemptions from the need to register and prepare a prospectus. See appendix B.

⁶¹ Both the BC Securities Commission and the National Crowdfunding Association of Canada refer to start-up as a hyphenated word, a method which we will follow here.

Multilateral Instrument 45-108: The Integrated Crowdfunding Exemption

The Multilateral Instrument 45-108's final form (alternately known as the Integrated Crowdfunding Exemption, the MI 45-108 Regime, or MI 45-108) was published in November 2015 after a two-year review process and came into force in participating jurisdictions in January 2016. MI 45-108 was introduced to allow businesses to benefit from greater access to capital from a larger number of investors online, through a funding portal operated by a registered dealer. It is complementary to the previously adopted Start-Up Crowdfunding Exemption, MI 45-316; in addition to higher limits for crowdfunding prospectus exemptions, it introduces a registration framework for funding portals.⁶²

MI 45-108 facilitates equity crowdfunding by offering a structure to raise both offering and investor limits on securities. This includes:

- A \$1.5 million limit on aggregate proceeds that may be raised in any 12-month period relying on the exemption by an issuer and its affiliates or subsidiaries – triple that of the Start-Up Exemptions.
- Non-accredited investors may not invest more than \$2,500 per distribution and

accredited investors not more than \$25,000.⁶³

- If the investor is accredited and a permitted client, then \$25,000 per distribution and \$50,000 for all distributions under the exemption.

The disclosure regulations under MI 45-108 are a blend of other exemption legislation.⁶⁴

- The issuer must provide a crowdfunding offering document, containing a plain language disclosure about the issuer, the distribution, the funding portal, and other relevant information.
- Financial statements may be unaudited if the issuer is non-reporting and the amount raised from all prospectus exemptions is under \$250,000.
- Unaudited IFRS financial statements with a review report are required if the issuer is non-reporting and the amount raised under all prospectus exemptions is between \$250,000 and \$750,000.
- IFRS-audited financial statements are required if the amount raised under all prospectus exemptions is \$750,000 or more, or if the issuer is a reporting issuer.

⁶² The only current exception to this overlap is British Columbia, which is not participating in the MI 45-108 Regime, but has developed a policy, Instrument 72-505 (BCI 72-505), to enable BC issuers to sell securities to individuals in provinces. See Appendix B for further details.

⁶³ In Ontario, non-accredited investors are also subject to a \$10,000 annual limit, and accredited investors subject to a \$50,000 annual limit. Ontario, however, has exempted investors from both the distribution and annual limits if they

qualify as "permitted clients" by having net "financial assets" of greater than \$5 million. See "Investment Limits" CSA *Notice of Publication of Multilateral Instrument 45-108*. http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20151105_45-108_multilateral-crowdfunding.htm

⁶⁴ http://www.osc.gov.on.ca/en/NewsEvents_nr_20151105_crowdfunding-exemption.htm

The 45-108 Crowdfunding Regime (the Integrated Crowdfunding Exemption) includes investor protection measures as well, which are detailed in Appendix B.⁶⁵

⁶⁵ See Appendix B for a total of six Canadian exemptions from issuance of a prospectus of note used for or related to crowdfunding.

Potential Benefits and Challenges of Equity Crowdfunding

With the new ease of access to equity crowdfunding comes a host of issues along with potential benefits. This section aims to address some of the potential benefits and challenges of lowered restrictions to equity crowdfunding.

Benefits

- *Encouraging innovation and job growth by decreasing barriers.* The ability to raise funds online from the public through a single funding portal potentially lowers transaction costs and increases the development of new ventures. SMEs account for about 77% of all private jobs created in Canada⁶⁶ and 65% of net new jobs in the US.⁶⁷
- *Facilitating market competition.* Lowering restrictions to businesses obtaining funding for innovation has the potential to increase competition for investment markets, reducing barriers to raise capital for SMEs, while making cost of capital

cheaper (while reducing the fees to be paid to intermediaries).

- *Filling a financial gap through the democratization of capital.* Sourcing equity from traditional sources, like venture capital or angel investor networks, relies on a small group of high net worth individuals (only approximately 1% of the population) that may not represent the entire market for securities. The investor pool through crowdfunding could include virtually anyone of legal age in the population. Funds may also go to ventures not perceived as profitable by traditional venture capital or angel investor networks, but which may have a large potential for previously excluded investors (for example, THINX, a maker of women's underwear that double as feminine hygiene products, that was able to raise funds through equity crowdfunding).^{68,69} Successful crowdfunding ventures reflect full market demand for products that may be ignored through the traditional vetting process for raising equity (VC/PE).
- *Adapting financing patterns to changing demographics.* Small investments may be attractive for younger generations, especially Millennials (discussed below), tapping into the sharing economy and pooling resources.

⁶⁶ <https://academicnexus.com/funding/equity-crowdfunding/what-makes-equity-crowdfunding-in-canada-so-great-4409/>

⁶⁷ US Small Business Administration. (2011). "SBA FAQ" <https://www.sba.gov/sites/default/files/sbfaq.pdf>

⁶⁸ <http://www.crowdfundinsider.com/2015/07/71191-crowdfunding-is-changing-the-female-entrepreneurial-landscape/>

⁶⁹ <http://www.forbes.com/sites/emmajohnson/2015/05/28/can-these-panties-disrupt-a-15-billion-feminine-hygiene-market/#2ddb7a66b78>

- *Determine market interest.* Crowdfunding platforms function as a communication tool to potential investors. They provide business owners a relatively low-cost and low-risk method of testing potential investor interest. Interest in investing in a product may exist outside the small group of angel or accredited investors.

Challenges

- *Risk to retail investors.* The crowdfunding equity model contains an obvious and significant risk of loss of the entire amount contributed—including from fraud and abuse.⁷⁰ Furthermore, retail investors have a lower level of understanding of valuation methods than sophisticated investors.
- *Heightened information asymmetry.* Allowing individuals with little or no experience with these types of investments to invest in high-risk ventures that do not have to present a full prospectus or (depending on the exemption used) audited financial statements presents a limited view of the financial position of the venture to the public and potentially increases the risk of losing the investment. This informational asymmetry could cause risks such as the issuer misrepresenting the venture's long-term financial success, or the issuer not

fully knowing what the financial position is, as it may not be necessary to disclose financials (again, depending on the jurisdiction/exemption).

- *Long-term uptake.* Regulations designed to limit this risk also limit the potential benefit to companies. It is unlikely that equity crowdfunding will become a significant portion of an SME's contributed capital when the Start-Up Crowdfunding Exemption requires a \$1.5 million aggregate cap per year in Canada and \$1 million cap under the JOBS Act in the US—not including the added costs of compliance for a relatively small amount of funding.
- *Uncertain multiplier effect.* The multiplier effect, or the impact that a new injection of spending will have on the economy, is particularly high for the high-tech industry, which makes up a large percentage of start-ups.⁷¹ The catch, however, is the multiplier effect's longevity. Statistics on the number of start-up companies that survive the first several years vary⁷². There is uncertainty surrounding the extent to which start-ups generate multiple rounds of spending through their operations, if operations only flare up for a short period and consequently die down. One of the first studies of equity crowdfunding from AltFi Data and Nabarr (a British law firm)

70

http://heinonline.org/HOL/Page?handle=hein.journals/ucinlr83&div=18&q_sent=1&collection=journals

71 <http://www.article-3.com/the-multiplier-effect-how-high-tech-jobs-will-transform-the-economy-910494.html>

72

<http://www.telegraph.co.uk/finance/personalfinance/investing/12005303/First-crowdfunding-results-70-go-bust-one-makes-money.html>

analyzed 367 businesses that secured investment from members of the public on the five largest crowdfunding websites between 2011 and 2013. They found that 80% of the initial firms were still in business, while 70 of the firms (approximately one in five) were no longer trading or were experiencing 'difficulties'. Only one firm had realized a return for investors at the time of publication of the report, although 58 firms had gone on to raise funds at higher valuations.

- *Uncertain use of funding portals.* Financial institutions may be too embedded in the securities industry for online funding portals to significantly disrupt their market. It is still not known if individuals will make significant changes to their financing decisions and invest via crowdfunding portals instead of traditional means. Crowdfunding is unlikely to be an attractive option for commercial investors as crowdfunding portals cannot easily replace these or provide the expertise, advice, networks and mentorships of traditional investing routes (especially VC/PE/Incubators) provide.
- *Challenges to capital management for the venture.* While raising small investments to gain traction in the market may be a viable funding strategy, the administrative costs of managing large capitalization tables with many shareholders may be too high for small start-ups. This may also

impact future funding offerings. The US has seen improved legislation through the Fix Crowdfunding Act, which allows the use of SPVs to aggregate investors and manage large cap tables. However, Canada is yet to see any reforms on this front.

Markets are starting to respond to some of these challenges by offering insurance models for risks from equity crowdfunding. AIG has recently debuted a crowdfunding insurance product in Canada and the UK specifically designed to protect investors on equity crowdfunding platforms from issuer fraud.⁷³ The product helps to build investor trust by shielding individual investors from the theft of assets by issuer directors, officers, or employees that could cause direct loss to the individual investor. Crowdfunding platforms may individually choose to subscribe to this insurance product to add a level of assurance and mitigate risk, which could attract more demand towards equity crowdfunding ventures.⁷⁴

Syndicate platforms are attempting to solve some of the informational asymmetries inherent in equity crowdfunding. AngelList, a US based global crowdfunding platform for start-ups, offers investors the option to either lead a "syndicate" that supports a portfolio of investments, or back an already existing syndicate. The lead commits to providing an investment thesis for each syndicate investment. Backers in turn follow the syndicate

⁷³ <http://www.insurancebusinessonline.com.au/au/featured-content/financial-focus-aig-debuts-crowdfunding-insurance-product-in-canada-uk-216731.aspx>

⁷⁴ <http://www.insurancebusinessonline.com.au/au/featured-content/financial-focus-aig-debuts-crowdfunding-insurance-product-in-canada-uk-216731.aspx>

lead by agreeing to invest in each of the leader's future deals.

This helps diversify investment portfolios in often risky start-up investments, while allowing lay investors to back a particular venture based on the expertise and success record of an already experienced lead investor (essentially riding off their coattails). A similar model could be adopted in particularly risky equity crowdfunding ventures, in tandem with equity crowdfunding insurance to reduce risk as much as possible.⁷⁵

⁷⁵ http://cmr.berkeley.edu/browse/articles/58_2/5814/

Millennial Investment Patterns and Crowdfunding

Over the next few decades, it is estimated that \$39 trillion in financial and non-financial assets will pass from Baby Boomers to their heirs in North America alone.⁷⁶ As a group, Millennials (defined as individuals coming of age around the turn of the twenty-first century) are demanding more integration of their business and values by seeking fulfilment in their careers, purchases, and investments.⁷⁷ They are considered to be the first generation to be truly global, sharing their experiences through cutting-edge technology across cultures, societies and geographies. Millennials have proven to be both conservative, valuing the importance of institutions, while also questioning the status quo, as evinced by their entrepreneurialism. This is particularly seen in their management of personal finances.

Some key statistics and information include:

- Millennials are 70% more likely to donate to a crowdfunding campaign than Generation Xs and 200% more likely than Baby Boomers.⁷⁸
- Roughly 77% of Fundly users (a crowdfunding site dedicated to helping non-profits raise money) are 44 years or younger and 50% are 34 years or younger.⁷⁹
- Millennials are more than 100% as likely as Baby Boomers to be interested in investments dedicated to solving social or environmental problems
- Millennials are 65% more likely than Baby Boomers to consider ESG factors before investing.⁸⁰
- Millennials are 67% more likely than Baby Boomers and 39% more likely than Generation Xs to seek to achieve a balance between financial return and positive societal impact.⁸¹
- In the US, 69% of Millennials considered investments a way to express their social, political, and environmental values while only 36% of Baby Boomers felt the same way.⁸²

⁷⁶ The “Greater” Wealth Transfer: Capitalizing on the Intergenerational Shift in Wealth, Accenture, June 2012.

<https://www.accenture.com/us-en/insight-capitalizing-intergenerational-shift-wealth-capital-markets-summary>

⁷⁷

<http://impactassets.org/files/FinancialAdvisingforNextGeneration.pdf>

⁷⁸ Andre Bourque, “Are Millennials the most Generous Generation?” <https://www.entrepreneur.com/article/271466>

⁷⁹ “Millennials Want to Donate to Charities, Save the World. Really”. CNBC. <http://www.cnbc.com/id/100689671>

⁸⁰ A recent report by the Responsible Investment Association (RIA) with survey data collected by Ipsos Reid found that

Millennials are significantly more likely than previous generations to show interest in responsible investments. This data was taken a survey of 11 questions between February 22nd and 29th, 2016. The survey had a sample size of 1073, with results accurate to within +/- 3.4% using a Bayesian credibility interval. <https://riacanada.ca/wp-content/uploads/2016/04/Millennials-Women-and-the-Future-of-RI-Final-1.pdf>

⁸¹ Ibid.

⁸² Researchers from the US Trust found that In the United States, research from US Trust found that 69% of Millennials “considered investments a way to express their social, political, and environmental values”.

This integration of personal values and investing has driven the rapid growth of crowdfunding. Millennials increasingly want the ability to invest in projects and ventures they believe in. Crowdfunding fulfils the demand for relatively transparent (depending on legislation and jurisdiction), interactive, peer-to-peer action when ESG implications of choices are considered to be an integrated part of decision-making, according to ImpactAssets. Crowdfunding provides an opportunity to track progress towards a goal and when it comes to investing for impact, “provides reassurance that there’s a real individual at the other end whose story aligns with their own values and desire to help”.⁸³

<http://www.campdenfb.com/article/generation-gap-why-millennials-have-hooked-impact-investing/>

⁸³ <https://www.entrepreneur.com/article/271466>

Opportunities for Impact Investing

Equity crowdfunding allows for a two-way relationship between large networks, which can make micro- investments, and start-up businesses in need of financing. The lowered disclosure requirements and global reach mean that businesses are exposed to a larger pool of investors for impact ventures; crowdfunding platforms enable start-ups to find individuals around the world who identify with the mission of the venture.

The growth in equity crowdfunding in the last few years is indicative of how the individual investor wants to be personally involved in the start-up market; there is “significant, pent-up demand”.⁸⁴ According to a survey by SeedInvest: 68% of investors said that they were more likely to invest in a start-up once the laws change; 89% would invest in multiple companies per year; and 75% expect to invest at least \$1,000 per company.⁸⁵

The Massolution Report stated that ‘Social Causes’ was the second category on the list of reasons that topped crowdfunding volume—with ‘Businesses

and Entrepreneurship’ coming out on top.⁸⁶ Thanks to the likes of Kiva, a pioneer platform in microfinance crowdfunding, crowdfunding and impact were intertwined long before the rise of equity models.⁸⁷ Crowdfunding structures that aggregate small amounts from individuals based on personal interest creates an opportunity to match investors to investments based on values. It offers social proof of the investment opportunity, more direct communication through the Internet, and is not as geographically constrained.

Examples include companies such as Brighter Schools, which provides access to education to the most promising individuals in the world, and Wunderenergy, which provides solar PV systems in UK schools. Wunderenergy raised their target of £216k within two weeks of launching the campaign, and the rate of return to investors is estimated to be 7.2- 8.3% over the 20-year life of the investment.⁸⁸ While crowdfunding for impact does face challenges, including those of impact measurement (partly thanks to lower requirements for due diligence), ticket size, and social entrepreneur protection, it also offers significant opportunities to connect individuals interested in impact investing without the significant funds

⁸⁴ SeedInvest polled 18,000 non-accredited investors about the new crowdfunding regulations and found out that there was “significant, pent-up demand to invest in start-ups and small businesses.” Feit, Ryan (2015). “Equity Crowdfunding by the Numbers” <http://www.inc.com/ryan-feit/equity-crowdfunding-by-the-numbers.html>

⁸⁵ Ibid. Survey of 18,000 non-accredited investors.

⁸⁶

http://reports.crowdsourcing.org/?route=product/product&product_id=54

⁸⁷ Kiva, the pioneer platform in microfinance utilized crowdfunding by allowing anyone loan a minimum of \$25 to a local business owner in a developing country and recently in the US. In 2013, Kiva has raised about \$466 million to over 1 million people with a staggeringly high repayment rate of 99.01%. See also “Crowdfunding for Impact” *Toniic*, <http://www.toniic.com/wp-content/uploads/2013/12/CrowdfundingForImpact.pdf>

⁸⁸ “Crowdfunding for Impact”. *Toniic*. 18.

<http://www.toniic.com/wp-content/uploads/2013/12/CrowdfundingForImpact.pdf>

required to be involved as an individual donor or investor.

Spotlight: Knives and Forks Co-op Impact Lending

Knives and Forks Community Investment Co-op operates similarly to crowdfunding for impact investment. Created to lend money to British Columbian food businesses, it allows unaccredited investors up to two RRSP-eligible shares in the co-op of \$2,400 each. The model helps to overcome administrative costs of equity regulations and address consumer demand for a ‘new generation’ of sustainable, food-related businesses.

While Knives and Forks involves loans to food-related businesses rather than direct equity in the companies, it operates under a similar model; a group of 70 to 80 investors pool their funds and collectively decide which food-related businesses to lend to at ‘pitch nights’ each year.

“The idea is that we can bring money back down to earth, if we stop investing in people we don’t know, things we don’t understand, and places we’ve never been and in fact get it back into our own communities—I think that’s a good thing both for the investor and the investee.” – from an interview with leader at Knives and Forks, Rory Holland.

Knives and Forks worked with Vancity Credit Union to develop the co-op model, which hopes to offer a blended social and financial return, ‘suggested’ at 2% and best suited to those who can invest for five

years. Holland notes that administrative costs were high: “it took us a year to accomplish with lawyers and accountants and we [were] under all sorts of restrictions, even the number of people we can have in.”

Most borrowers expect to seek between \$35,000 - \$50,000⁸⁹. The model aims to avoid one of the most common problems with equity crowdfunding, that of excessively large and cumbersome capitalization tables.

“In our case, our members rely on us fiduciaries to make the choices and decisions and maintain the relationship with the companies.” – from an interview with leader at Knives and Forks

Knives and Forks Community Investment Co-op operates similarly to crowdfunding for impact investment. Created to lend money to British Columbian food businesses, it allows unaccredited investors up to two RRSP-eligible shares in the co-op of \$2,400 each. The model helps to overcome administrative costs of equity regulations and address consumer demand for a ‘new generation’ of sustainable, food-related businesses.

While Knives and Forks involves loans to food-related businesses rather than direct equity in the companies, it operates under a similar model; a group of 70 to 80 investors pool their funds and collectively decide which food-related businesses to lend to at ‘pitch nights’ each year.

⁸⁹ See Vancouver Sun article:
<http://www.vancouversun.com/life/knives+forks+feed+local+food+economy/11499863/story.html>

“The idea is that we can bring money back down to earth, if we stop investing in people we don’t know, things we don’t understand, and places we’ve never been and in fact get it back into our own communities—I think that’s a good thing both for the investor and the investee.”

~Rory Holland, former technology entrepreneur and one of the founders of Knives and Forks

Knives and Forks worked with Vancity Credit Union to develop the co-op model, which hopes to offer a blended social and financial return, ‘suggested’ at 2% and best suited to those who can invest for five years. Holland notes that administrative costs were high: “It took us a year to accomplish with lawyers and accountants and we [were] under all sorts of restrictions, even the number of people we can have in.”

Most borrowers expect to seek between \$25,000 - \$50,000.⁹⁰ The model aims to avoid one of the most common problems with equity crowdfunding, that of excessively large and cumbersome capitalization tables.

“In our case, our members rely on us fiduciaries to make the choices and decisions and maintain the relationship with the companies.”

~Leader at Knives and Forks

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<http://www.vancouversun.com/life/knives+forks+feed+local+food+economy/11499863/story.html>

<http://www.cbc.ca/news/canada/british-columbia/knives-forks-coop-vancouver-local-food-investment-1.3325518>

Conclusion

The markets for equity crowdfunding, and crowdfunding overall, have been growing at a high rate in the last few years. Crowdfunding gives retail investors the ability to support and invest in different projects, businesses, and causes that align with their personal values. The recent amendments in the legislation in both the US and Canada attempt to open up the market for equity crowdfunding in the hopes of growing their respective economies through job creation, inspiring innovation, fostering business competition, as well as levelling the playing field for retail investors. Crowdfunding platforms were created with the intent of democratizing access to capital for ventures and to give retail investors access to more opportunities, as conversations with industry professionals from KlondikeStrike and Knives and Forks show.

Equity crowdfunding has issues and challenges. Some of the most pressing issues are: that legislation amendments may not sufficiently overcome uncertainty to attract new users; there are inherent risks to inexperienced and non-accredited investors; and the fact that equity crowdfunding may be unlikely to make up a

significant portion of new enterprises' capital raised due to the administrative costs.

Prospects for equity crowdfunding will remain limited while the majority of firms fail to create a return for investors. A major issue revealed in a study of equity crowdfunding demonstrated that 80% of the firms who initially crowdfunded were still in business, while 70 of the firms (approximately one in five) were no longer trading or were experiencing 'difficulties'. Only one firm had realized a return for investors at the time of publication of the report, although 58 firms had gone on to raise funds at higher valuations.

Despite these challenges, the Millennial generation shows promise in using crowdfunding for impact investing. As crowdfunding can tap into their desire for direct connections with the ventures they support, it facilitates direct access between impact ventures and individual investors, accredited or otherwise, interested in seeing the direct impact of their funds. If the issues (particularly the risks) are properly managed, crowdfunding may eventually become an established method to raise capital.

Appendix A – JOBS ACT: Stakeholders Affected by Title III

Regulators

There are two regulators in the equity crowdfunding space in the US: the Security Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA). The SEC implements the provisions specific to crowdfunding in the JOBS Act through Regulation Crowdfunding, and FINRA is responsible for overseeing the registration of crowdfunding portals to ensure compliance of federal securities laws.⁹¹

Investors

Similar to bonds and stocks, virtually anyone can take part in crowdfunding investments; they are only limited by total investment in a given 12-month period. These limitations are dependent on annual income and are as follows:

- If **either** your annual income **or** net worth is less than \$100,000, then you can invest up to the greater of \$2,000 or 5% of the lesser of your annual income or net worth in the 12-month period.
- If **both** your annual income **and** your net worth are equal to or more than \$100,000, then you can invest up to 10% of the lesser of your annual income or net worth in the 12-month period for a maximum of \$100,000.⁹²

In addition to these limitations, FINRA cautions investors that while they are able to transfer shares back to the issuer or some of their family members, their ability to resell investments will be limited in the first year – “and they may need to hold their investment for an indefinite period of time”.⁹³ This adds another layer of risk for investors as these investments would be relatively illiquid compared to other securities in the open markets.

Issuers (Businesses)

Issuers must comply with certain requirements to qualify for the crowdfunding exemption under Regulation Crowdfunding. They include, but are not limited to, disclosure of:

- The names of the directors, officers, and anyone holding more than 20% of the shares of the issuer
- A description of the business and the anticipated business plan of the issuer
- A description of the stated purpose and intended use of the proceeds of the offering with respect to the target offering amount
- The target offering amount, the deadline, and regular updates regarding the progress of the issuer
- The price of securities to the public and the method for determining the price

91 Security and Exchange Commission. (2015). “Final Rules” https://www.sec.gov/rules/final/2015/33-9974.pdf?utm_source=Nasdaq&utm_medium=Crowdfunding-Investor-Info_197&utm_campaign=Syndication

92 FINRA. (2016). “Crowdfunding and the JOBS Act: What Investors Should Know” www.nasdaq.com/article/crowdfunding-and-the-jobs-act-what-investors-should-know-cm621603

93 FINRA. (2016). “Crowdfunding and the JOBS Act: What Investors Should Know” www.nasdaq.com/article/crowdfunding-and-the-jobs-act-what-investors-should-know-cm621603

Issuers are only allowed to raise \$1 million in a 12-month period. Additionally, financial disclosure required is as follows:

- \$100,000 or less – financial statements certified by the principal executive officer of the company
- More than \$100,000 and up to \$500,000 – financial statements **reviewed** by an independent public accountant. If audited statements are available, those must be provided.
- More than \$500,000 and up to \$1,000,000 – financial statements **audited** by an independent public accountant and the accountant’s audit report. If it is the first crowdfunding offering for the issuer, financial statements **reviewed** by an independent accountant will suffice.

Intermediaries

Intermediaries are broker-dealers and funding portals that facilitate the exchange between the issuer and the investor. This middleman is only allowed to sell shares that have originated directly from the company.

Regulation Crowdfunding requires these intermediaries, among other things, to do the following:

- Register with the SEC
- Take measures in reducing the risk of fraud, obtain a background and history check on each officer, director, and anyone owning 20% or more of equity
- Provide communication channels that allow discussions on the platform
- Obtain a representation from investors that they understand that they may lose their entire investment and can bear such a loss
- Provide prospective investors with questions designed to demonstrate an understanding, among other things, that it may be difficult to resell the securities and of the investment risks

Appendix B – Notes on Canadian Equity Crowdfunding

Policy Assumptions for Prospectus Exemptions

Three policy assumptions underlie exemptions from the need to register and prepare a prospectus:

- If the class of securities is low risk (i.e., bank or government bonds)
- If the investor can participate in the offering due to his or her wealth/ sophistication/ pre-existing relationship to the insiders of the issuing company (i.e., accredited investor exemption, or family, friends, and business associate exemption)
- If a lesser level of disclosure is warranted given the risk, size of company, and the ability to impose suitability investment caps

The Start-up Crowdfunding Exemption and the Integrated Crowdfunding Exemption of MI 45-108 make up two exemptions based on suitability investment caps.

Accredited Investor Exemption and Offering Memorandum Exemption

The Accredited Investor Exemption allows all types of securities to be offered to investors confirmed by the Ontario Securities Commission to have an annual income of over \$200,000 (\$300,000 with a spouse) or net assets of \$5 million (or net financial assets of \$1 million not including a home). This is based on the assumption that the individuals involved will have the wealth or the experience to navigate potential pitfalls.

The Offering Memorandum Exemption allows all but securitized products and specific derivatives to be offered, but requires the filing of an offering memorandum: a legal document stating the objectives, risks and terms of an investment involved with a private placement. The offering memorandum requires IFRS audited financial statements and is a comprehensive document addressing similar disclosure needs to a prospectus. The Offering Memorandum Exemption raises disclosure requirements and has restrictions on investor eligibility and total investments per 12-month period depending on the province that the securities are offered in. SeedUps Canada is an active portal operating as an exempt market dealer via a registered third party under the Offering Memorandum Exemption.

Investor Protection Measures in MI 45-108

Investor Protection Measure	Details	Area
Investment Limits	For an investor that does not qualify as an accredited investor: \$ 2,500 per investment and (in Ontario) \$10,000 total in a calendar year.	For an accredited investor other than a permitted client: \$25,000 per investment, and in Ontario, \$50,000 in total in a calendar year. In Ontario, no investment limits for a permitted client.
Offering document	Issuers are required to provide an offering document that contains all of the information about the issuer and its business that the investor should know before purchasing the issuer's securities.	
Risk Acknowledgement Form (RAF)	Investors must complete a risk acknowledgement form requiring them to confirm having read and understood the risk warnings and information in the crowdfunding offering document before entering into an agreement to purchase securities.	
Liability for Materials	Issuers are accountable for and are subject to a standard of liability on the crowdfunding offering document and other permitted materials, and investors are provided with a related right of action.	
Advertising and Solicitation	A prohibition on advertising and general solicitation.	
Ongoing Disclosure	Non-reporting issuers must make available to investors (i) annual financial statements, (ii) a notice of use of proceeds, and (iii) in New Brunswick, Nova Scotia and Ontario, a notice of a discontinuation of the issuer's business, a change in the issuer's industry or a change of control of the issuer. Reporting issuers must continue to comply with all elements of their disclosure requirements.	
Registered Funding Portal	Issuers can only distribute securities through a single funding portal that is registered as an investment dealer, exempt market dealer or restricted	

dealer as outlined in the Rule, and must post the offering document and other permitted materials solely on that funding portal's online platform.

Funding Portal Requirements

Funding portals are prohibited from offering securities of a related issuer. A funding portal must fulfill certain gatekeeper responsibilities prior to allowing an issuer access to its online platform, including reviewing the issuer's disclosure in the crowdfunding offering document and other permitted materials for completeness, accuracy and any misleading statements. A funding portal must review information and obtain background checks on the issuer and its directors, executive officers and promoters, and deny an issuer access to the funding portal in certain circumstances.

British Columbia Instrument 72-505

Instrument 72-505 (BCI 72-505) is an exemption from a prospectus requirement for crowdfunding distributions to purchasers outside British Columbia. This requires the issuer to comply with the requirements of Multilateral Instrument 45-108 in the jurisdiction where the purchaser is located, but as BC did not adopt MI 45-108, this better connects issuers located in BC to purchasers of securities to outside the province. It is a temporary measure intended to harmonize disclosure requirements between MI 45-108 and BCI 45-535 (the Start-Up Crowdfunding Exemption) for a year until more permanent multi-jurisdictional crowdfunding legislation facilitation measures are developed.⁹⁴

⁹⁴ <http://ncfacanada.org/adoption-of-bc-instrument-72-505-exemption-from-prospectus-requirement-for-crowdfunding-distributions-to-purchasers-outside-british-columbia/>