

# CAN THE NEW CROWDFUNDING EXEMPTION BE USED FOR DEBT SECURITIES?

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On January 25, 2016 Multilateral Instrument 45-108 *Crowdfunding* (the "**Crowdfunding Exemption**") will come into force in Canada. The Ontario Securities Commission ("**OSC**") along with the securities regulators of Manitoba, Quebec, New Brunswick and Nova Scotia (collectively, the "**Participating Regulators**") published the final form of the Crowdfunding Exemption on November 5, 2015 after a long public consultation period.

Because securities laws prohibit the distribution of securities without a prospectus or an established exemption, crowdfunding has not yet been used to solicit securities investment in Ontario. Securities regulators in British Columbia, Saskatchewan, Manitoba, Québec, New Brunswick and Nova Scotia have already adopted substantially similar exemptions. Other jurisdictions, such as the US, are in the process of modifying their securities laws in order to allow equity crowdfunding on a minor scale. In the US, this was done through the 2012 Jumpstart Our Business Start-Ups Act ("**JOBS Act**"), signed into law by President Barack Obama on April 5, 2012. The JOBS Act created a crowdfunding exemption subject to regulation by the US Securities and Exchange Commission (the "**SEC**"). On October 30, 2015, the SEC announced its final Regulation Crowdfunding, which allows crowdfunding transactions for securities investments subject to certain restrictions. The Regulation Crowdfunding will take effect on May 16, 2016 with the forms enabling crowdfunding portal registration available on January 29, 2016.

While there has been some excitement in the press about the new rules, it is mostly focused on equity crowdfunding, with relatively little focus given to debt crowdfunding. Though there are many attractive features to equity crowdfunding, there are also inherent drawbacks that may deter some issuers and investors. Equity crowdfunding issuers will acquire many new shareholders who will wish to share in future profits and who may become active in decision-making, requiring annual and special meetings of shareholders. Equity crowdfunding investors will acquire shares with no ready market for resale or other means for recovering their investment.

Debt crowdfunding, either non-convertible and linked to an interest rate, or convertible to common or non-convertible preference shares, can be a less risky investment than equity in certain circumstances. It also provides greater certainty to the issuer (who has less related management responsibilities) and the investor

(who receives a predetermined return). In the Crowdfunding Exemption, the Participating Regulators have expressly included non-convertible debt securities linked to a fixed or floating interest rate and securities convertible into a common share or a non-convertible preference share in the definition of "eligible securities".<sup>[1]</sup> A debt security with a warrant attached would also be included.

With the lower risk, however, comes less potential return if the crowdfunding issuer is successful. Since the crowdfunding market shares many features with other venture markets, equity securities are likely to still attract the greater proportion of investors looking for risky but high reward investments. But for those promoters wishing to retain full ownership of an issuer, and if the issuer has or will achieve predictable cash flow, debt crowdfunding is effectively a method to solicit a loan. For issuers whose future cash flow may be more speculative, debt convertible into common or preference shares may be an attractive investment to some investors in the crowdfunding market since it provides a combination of greater security and the possibility to share in the profits of the issuer in the future.

### **SEC Regulation Crowdfunding**

Under Regulation Crowdfunding, a US company can raise up to USD \$1 million in a 12-month period through crowdfunding. Regulation Crowdfunding also places limits on the amount individual investors, with either a net worth or annual income below USD \$100,000, can invest across all crowdfunding offerings in a 12-month period. These investors may invest up to the greater of USD \$2,000 or 5 percent of the lesser of their net worth or annual income. If the personal investor's net worth and annual income are both above USD \$100,000, then during any 12-month period they may invest up to the lesser of 10 percent of their net worth or annual income up to a maximum of \$100,000 in crowdfunding offerings.

The SEC has also included disclosure requirements for issuers using a crowdfunding offering to file information with the crowdfunding platform and with the SEC. The Regulation Crowdfunding also regulates registration, reporting and disclosure obligations for crowdfunding platforms. Notably, Regulation Crowdfunding explicitly states that it places no limits on the types of securities eligible for crowdfunding – thus debt securities may be issued in the US by way of crowdfunding.

### **The Crowdfunding Exemption**

In Canada, the Participating Regulators have drafted the Crowdfunding Exemption with the main aim of protecting investors, but at the same time, allowing issuers to leverage the use of the internet and social media to raise capital. The Crowdfunding Exemption achieves its protection goal through various requirements; for example, issuers are only permitted to offer non-complex securities and investors are given a 48 hour window after the date of purchase to withdraw from the purchase agreement by providing notice to the funding portal used for the transaction. Investors are further protected with rescission and damages rights akin to those

under existing securities laws for misrepresentation in the offering document or other materials provided to the investor.

In order to list securities in a registered portal, issuers must prepare a crowdfunding offering document (Form 45-108F1). Form 45-108F1, while not as comprehensive as the prospectus requirements, prescribes relevant information about the issuer that an investor should know, such as minimum and maximum size of the offering, an overview of the issuer's business, the principal risks of the business, etc.. Issuers are restricted from offering their securities on more than one registered online funding portal. Before participating in a crowdfunding transaction, investors are required to complete a risk acknowledgment form ("RAF"). The RAF requires that the investor confirms they have read and understood the risk warnings and information in the offering document.

Issuers are required to comply with ongoing disclosure obligations, which include (i) annual financial statements, (ii) notice of how the proceeds of the crowdfunding were used, and (iii) in New Brunswick, Nova Scotia and Ontario, notice of: the discontinuation of the issuer's business, change in the issuer's industry or a change of control of the issuer.

#### *Funding Portals*

Crowdfunding transactions may only be conducted through a registered online funding portal. Since crowdfunding transactions occur under an exemption from the prospectus requirements of applicable securities laws, the registered online funding portal must be registered as either an investment dealer, exempt market dealer or restricted dealer. Registered funding portals cannot offer securities of any related issuer and must abide by certain "gatekeeper responsibilities" prior to allowing an issuer to transact through its portal. These gatekeeper responsibilities include reviewing the issuer's crowdfunding offering document and other materials to ensure that its disclosure is complete, accurate and does not contain any misleading statements. The funding portal is further required to review criminal record and background checks on an issuer seeking to list on its portal, including its directors, executive officers and promoters.

#### *Investment Limits*

Investors are subject to investment limits based on their status as an accredited investor. If an investor does not qualify as an accredited investor, he or she is limited to a maximum of \$2,500 per crowdfunding investment and, in Ontario, a total of \$10,000 per calendar year. Accredited investors, who are not a "permitted client" are limited to a maximum of \$25,000 per crowdfunding investment and, in Ontario, a total of \$50,000 per calendar year. A "permitted client" has net financial assets of more than \$5 million. In Ontario, an investor who is a "permitted client" is not subject to investment limits.<sup>[2]</sup> The amount of funds an issuer can raise in a 12-month period is limited to \$1.5 million. Securities issued under the Crowdfunding Exemption are subject to a 4

month hold period.

### *Advertising and Soliciting*

The Participating Regulators have also placed restrictions on advertising and soliciting permitted by both issuers and funding portals. The stated intention is to ensure that the benefits of the "wisdom of the crowd" and the exchange of information through social media is only made through the online platform of the regulated funding portal. All relevant information about a crowdfunding offering is only permitted to be made available through the online funding portal facilitating the distribution. An issuer may inform a potential investor that it is intending to offer securities under the Crowdfunding Exemption but is otherwise limited to referring the potential investor to the funding portal for further information. Any media, such as social media, email or text, is permissible to communicate with a potential investor that further information is available on the funding portal. A funding portal is able to advertise that it is in the business of providing crowdfunding offerings but must otherwise direct potential investors to its online platform for further information on such offerings. A funding portal is prohibited from recommending or endorsing a particular issuer or distribution, including receiving payment to highlight or showcase an issuer or distribution.

In summary, certain issuers, particularly those who are better credit risks, who are looking to the crowdfunding market for financing may be attracted to the debt crowdfunding market. The benefits to issuers of using crowd-funded debt rather than equity are similar to those outside of the crowdfunding market and include the ability to pay fixed interest and to finally retire the debt, relieving the issuer from burdensome shareholder obligations associated with issuing shares. In the crowdfunding context, issuers able to raise debt may find it more attractive than equity, particularly given the maximum investment limits and the correspondingly large number of shareholders needed to raise up to \$1.5 million. While we anticipate that the market for debt crowdfunding will not compare in size to that of equity crowdfunding, there are attractive features of debt crowdfunding for investors and issuers alike.

We invite all market participants to discuss any questions related to the new Crowdfunding Exemption with us. We are available to assist parties interested in setting up a funding portal or seeking to raise funds through crowdfunding.

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1. *CSA Notice of Publication of Multilateral Instrument 45-108 Crowdfunding*, OSC Notice MI 45-108, (2015) 38 OSCB 11.
2. A "permitted client" is defined in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*.

### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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