CERTAIN CANADIAN SECURITIES REGULATORS ADOPT CROWDFUNDING PROSPECTUS EXEMPTION FOR START-UPS

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Recognizing there is often a funding gap for early stage businesses, securities regulators in British Columbia, Saskatchewan, Manitoba, Québec, New Brunswick and Nova Scotia (the "**Participating Provinces**") have adopted substantially harmonized registration and prospectus exemptions proposed under Multilateral Instrument 45-108 – *Crowdfunding*. The exemptions aim to provide start-up and early stage companies with an alternative to raise capital with fewer disclosure requirements. The exemptions are available to non-reporting issuers and prospective investors in the Participating Provinces now and will be available for five years, expiring on May 13, 2020.

Prospectus Exemption

Securities laws require a company to file a prospectus and receive a receipt prior to distributing securities to investors. While a prospectus is a useful tool to provide information to investors, the expense and time incurred in preparing it may act as a bar to more junior companies looking to raise capital. Accordingly, securities regulators have created exemptions from the prospectus requirement where, by meeting the conditions of the relevant exemption, the regulators can be satisfied that the investors will have enough information about the company on which to make an informed investment.

The new start-up crowdfunding prospectus exemption allows non-reporting issuers who have a head office in a participating jurisdiction to distribute eligible securities[1] to investors, subject to the following conditions:

1. *Maximum Amount*. The issuer group[2] cannot raise more than $250,000 per distribution and is restricted to a maximum of two distributions under this exemption per calendar year for a maximum of $500,000 per year.
2. *Individual Limits and Rights*. Individual investors may invest up to $1,500 in a single distribution and must be provided with a contractual right to withdraw their offer to purchase securities within 48 hours of subscribing or being notified that the offering document has been amended.
3. *Online Funding Portal*. The distribution must be made through an online funding portal operated pursuant to the start-up exemption or by a registered dealer who has confirmed its compliance with the

exemption.

4. *Offering Document*. The online funding portal will provide the form of offering document, which the issuer must use. The streamlined offering document requires less disclosure than under other exemptions as its focus is on providing information about the issuer, its management, and the distribution, including the minimum offering amount required to close the distribution and how the issuer intends to use the funds raised. The issuer must amend the offering document if and when it becomes untrue.
5. *Closing the Offering*. The distribution must occur within 90 days of the date the offering document is made available through the funding portal and must meet the minimum offering amount described therein or all funds must be returned to the investors. Within 30 days of closing the distribution, the issuer must: cause the investor to receive confirmation and details of the distribution; and, file the offering document and a report of exempt distribution with the relevant securities regulator.
6. *Resale Restrictions*. Securities purchased under the exemption are subject to an indefinite hold period and can only be resold under another prospectus exemption, under a prospectus, or four months after the issuer becomes a reporting issuer.

The prospectus exemption is not available to investment funds or reporting issuers in any jurisdiction. Further, the issuer group, or any of their principals, employees or agents may not receive any commission, fee or other amount from the investor with respect to the distribution. Finally, the issuer may not use a funding portal to distribute the securities if a principle of that fund is also a promoter director, officer, or control person of the issuer.

Registration Exemption

In addition to the prospectus requirement, securities laws require a person to register and follow certain rules when trading securities. Finding it not prejudicial to the public interest, securities regulators have provided an exemption from the registration requirement for trades through Canadian online funding portals in connection with a start-up distribution provided the portal meets certain conditions as set out below.

1. *Information Forms*. At least 30 days prior to facilitating its first distribution under the start-up crowdfunding exemptions, the funding portal must deliver the required information forms to the participating regulators for review.
2. *Head Office, Residency, and Records*. The funding portal's head office must be in Canada with a majority of its directors being Canadian residents. The portal must maintain books and records accurately reflecting its financial affairs and client transactions for a period of eight years. It must also disclose certain information for each principal of the funding portal on its website.

3. *No Commission*. The funding portal may not receive any commission, fee, or any other amount from a purchaser.
4. *No Advice*. The funding portal may only facilitate distributions and may not provide advice or otherwise recommend or represent to an investor that a security is suitable, or otherwise about the investment's merits.
5. *Offering Document and Risk Warnings*. The funding portal must make the issuer's offering document and required risk warnings available online to investors. It is further required to provide a gate keeping function by allowing a subscription only after the investor has confirmed he or she has read and understood these documents.
6. *Payment for Securities*. The funding portal is responsible for receiving payment for the securities from investors in participating jurisdictions electronically through its website. It must then hold the investor's assets separate and apart from its own property in trust for the investor, and in the case of cash, at a Canadian financial institution. The funding portal may either: release the funds to the issuer after it has reached the minimum offering amount provided the 48-hour-right-of-withdrawal period has passed; or return the funds to the purchase if the minimum offering amount is not met or if the issuer withdraws its distribution.
7. *No Notice Regarding Principals*. The funding portal must not receive a notice from a securities regulator that it cannot rely on the start up registration exemption because its principals (or their past conduct) demonstrate a lack of required knowledge, financial responsibility, or integrity.

Provided it meets the requirements, a regulator will authorize a portal, allowing it to facilitate distributions without being a registered dealer. Registered dealers may also operate an online funding portal so long as they comply with their registration requirements under securities laws and confirm they meet conditions provided under the start-up crowdfunding exemption.

Practical Effect

For individual investors, this is an interesting and relatively low-risk way to invest in startup companies. With this exemption, individuals will be able to obtain an equity stake in the company, which is more substantial than the perks, rewards, and prototypes one may receive for putting up capital in the typical crowdfunding sites like Kickstarter and Indiegogo.

For start-up companies, this exemption is branded as an attractive method to raise funds because it is relatively inexpensive and accessible. Under this exemption, there are no costly and time consuming ongoing disclosure or financial statement requirements, though it is never a bad idea to keep investors up to date. Additionally, this exemption may provide a useful alternative to borrowing for startups and small businesses as the issuer may choose to distribute equity in the form of securities or debt in the form of non-convertible debt securities (interest bearing bonds and promissory notes). This may be a good option for founders who would prefer to pay interest on loans than to give up equity.

Practically, however, exercising this option to raise capital may not be worth it for all start-ups in the long run. Taking advantage of this exemption could quickly leave a previously tightly held company with a shareholder base of hundreds after just two distributions with a relatively modest aggregate raise of $500,000. In addition to having vastly increased investor relations needs, distributing a small amount of equity to a large number of investors would take away the issuer's ability to rely on the useful private issuer exemption for a larger capital raise in the future. The issuer may still be able to raise funds under the existing security holder exemption, but this exemption also has its limits.

What this start-up crowdfunding exemption, along with other recent changes, does indicate is that securities regulators understand that issuers require less cumbersome, restricted, or expensive avenues to raise funds. Recent changes may also indicate that regulators are reducing some of the disclosure requirements of issuers by placing heavier demands on registered dealers for investor protection. Finally, these changes show that social media and surrounding technology is disrupting the current capital raising methods enough to cause regulators to take notice.

In addition to this start-up crowdfunding exemption for private issuers, securities regulators in the Participating Provinces have noted their intention to adopt the proposed "integrated crowdfunding exemption" for public and later-stage private companies by summer 2015. The proposed exemption would have a higher offering limit and is intended to co-exist with and complement the start-up exemption.

Those interested in the start-up crowdfunding exemption or the proposed integrated crowdfunding exemption are encouraged to review the details in *Multilateral CSA Notice 45-316* or seek legal advice to determine if this exemption is good fit for your start-up's capital raising needs.

by Morgan T. McDonald

[1] [ps2id id='1' target=''/]Offerings under the exemption would be limited to common shares, non-convertible preference shares, securities convertible into common shares or non-convertible preference shares, non-convertible debt securities linked to a fixed or floating interest rate, and units of a limited partnership.

[2] [ps2id id='2' target=''/]The issuer group includes the issuer, an affiliate of the issuer, and any other issuer engaged in a common enterprise or whose business is founded or organized, directly or indirectly, by the same person or persons.

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.