CROWDFUNDING – COULD IT HELP FINANCE INNOVATION IN CANADA?

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On March 22, 2012, the US Senate approved legislation amending US securities laws to permit "crowdfunding" to allow entrepreneurs to raise capital over the internet. This legislation, known as the Jump Start Our Business Start-Ups (JOBS) Act, was first passed by the House of Representatives on March 8, 2012. It has now gone back to the House for approval of minor amendments introduced by the Senate. President Obama supports the legislation, so all indications are that it will soon become law in the US. This raises questions for Canadian policy makers: should "crowdfunding" be permitted in Canada? Could it be a new source of capital for small and medium business enterprises (SMEs) to promote innovation?

The crowdfunding provisions of the JOBS Act do not differentiate among SMEs, thereby making the exemption available to all start-ups, emerging businesses and small issuers. This recognizes the principle that SMEs are the backbone of the economy and create jobs. But only a small portion (in Canada, less than 5%) of firms are innovative SMEs (that is, firms which spend more than 20% of their investment expenditures on research and development). It is these relatively few entrepreneurial firms that drive innovation and, as the Drummond Commission recently recommended, they should be the focus of a revised government policy to make the business sector more productive and competitive. In other words, creating jobs is a worthy goal, but stimulating innovation is better.

Various recent studies have recognized that the lack of venture capital for innovative SMEs in Canada is impairing productivity growth. In the innovation ecosystem, it is often innovative SMEs which create and build new inventions or processes. Initial research may be performed in universities, colleges or hospitals, but it is technology entrepreneurs who pursue commercialization. The challenge of moving from laboratory to prototype to commercial production is daunting, and capital is hard to come by. Because they have higher risk profiles, innovative SMEs have even more difficulty raising capital than other SMEs, according to Industry Canada.

There have generally been four sources of capital in Canada for innovative SMEs: the entrepreneur's personal savings, angel investors, government grants and venture capital. But the network of angel investors in Canada is not well developed, as compared (for example) to the US. Government grants and other support programs

help, but they are insufficient and are often targeted at specific industries and regions (and might crowd out private sector investors). Banks do not lend to pre-cash-flow firms. That leaves venture capital, and many recent studies have concluded that the private sector venture capital market in Canada has yielded poor returns and is "broken" (according to the Business Development Bank of Canada (BDC)), underserviced (according to the Canadian Venture Capital Association) and underfunded (according to Industry Canada and the separate task forces chaired by Tom Jenkins and Roger Martin). The same studies indicate that the US private sector venture capital market is more robust and profitable than ours but, interestingly, both Democrats and Republicans in the US Congress put aside their bipartisan issues this March to expedite passage of the JOBS Act to give all SMEs in the US even easier and less expensive access to seed capital.

What is "crowdfunding"? It typically involves an on-line solicitation of pledges of small amounts of money from a community or large number of individuals. Because of existing securities laws in the US, the UK and Canada, it has not yet been widely used in those countries for investments, but rather for donations, memberships and pre-ordering of goods or services. See, for example, the websites for Kickstarter (http://www.kickstarter.com) and CrowdFunder (http://www.crowdfunder.co.uk). In the Canadian context, it has interesting possibilities for fund-raising by cooperatives. But is "crowdfunding" suitable for the issuance of shares to the public?

If ratified by the President, the JOBS Act will allow new issuers in the US to sell, without registration or reliance on any other exemptions under applicable securities laws, up to $1 million of equity, debt or convertible securities in any 12 month period, or up to $2 million if audited financial statements are provided to investors. Individual investors will be limited to investing up to 5% of their annual income for those earning under $100,000 a year, or 10% for those earning more than $100,000. Other requirements will include: mandatory warnings to investors of the speculative nature of investments in start-ups, emerging businesses and small issuers, including risks in the secondary market related to illiquidity; a minimum hold period of 12 months; notice to the Securities and Exchange Commission (SEC) of the identity of the principals and employees of the issuer; and outsourcing cash management functions to a qualified third party custodian. The JOBS Act also excludes qualified issuers from the SEC's general prohibition on soliciting investments over the internet, and excludes applicable investors from the "holders of record" calculation for determination of SEC registration requirements.

Critics of the JOBS Act argue that it is ripe for fraud. Supporters argue that the legislation requires issuers to take measures to reduce the risk of fraud, and both issuers and intermediaries are required to register with the SEC. Critics suggest that issuers putting forward a new idea at an early stage will run the risk of having the idea copied. On the other hand supporters argue that new ideas will be exposed to the "wisdom of the crowd" (that is, the inherent judgment of a wide group of potential investors) and only worthy ideas will attract investment. That dynamic may also address a criticism sometimes made of Canadian entrepreneurs, namely, that they

focus on a technology push approach, rather than a market pull strategy, for development of new technology and processes. Fundraising by way of crowdfunding may validate (or not) an early stage idea.

In Ontario, and other provinces, if policy makers wish to follow the US and permit crowdfunding by Canadian issuers, various amendments would have to be made to the registration and prospectus exemptions under applicable Canadian securities laws. National Policy 47-201, which sets out the views of the Canadian securities regulators on issuance and trading of securities using the internet and other electronic means, would also need amendment, as would certain continuous disclosure requirements. Policy makers could follow the US example, and open the opportunity to all SMEs, or they could limit the opportunity to innovative SMEs.

Crowdfunding could be a new and welcome addition to supplement existing sources of capital to finance innovative SMEs. The Drummond Commission recommended that the Ontario government review, change and consolidate its existing business support programs to better achieve the goals of improved competitiveness and productivity. Interestingly, while the Commission identified that small business owners typically rely on personal savings as a source of seed capital, the Commission did not make any suggestions as to how they might attract additional capital to successfully incubate and commercialize new technologies and processes to support productivity gains. The Commission did call for an examination of capital markets but did not support the idea of more government subsidies. The Commission's view is that direct subsidies can be inefficient and distort business decisions.

The task force headed by Tom Jenkins made different recommendations to the federal government. The task force generally agreed that innovative SMEs need help to access risk capital in the current markets. Of the specific recommendations made, two stand out. First, the task force recommended that the government reduce the refundable portion of the Scientific Research and Experimental Development (SR&ED) tax credit and redeploy the savings to fund direct support to SMEs. The federal and provincial tax incentives for research and development are the mainstay of government support for R&D in Canada (the after-tax cost of $100 spent on R&D in Ontario is about $37). But the SR&ED program is complex and more suitable for later stage firms, so redeploying savings to more early stage firms is logical. The task force's other recommendation was that the government direct BDC to allocate a larger portion of its portfolio to start-up stage financing, preferably in the form of "sidecar" funds with angel investors. While these recommendations are commendable, they involve increasing direct subsidies from government and pre-suppose that there are sufficient angel investors willing to provide seed capital. Still, no early stage SME is likely to turn down government funds, particularly if they are non-dilutive. Crowdfunding could therefore be a supplementary and market-based source of capital for innovative SMEs and, more importantly, could be accessible to technology entrepreneurs at earlier stages, even before they become eligible for government support.

In Canada, there appears to be ample risk capital available for early stage mineral or petroleum exploration and

for later stage information and communication technology and "clean tech" companies. Firms in those sectors, once they have achieved sufficient growth, are able to access the Capital Pool Company (CPC) program of the TSX Venture Exchange (the CPC program has been in existence 25 years), as well as other sources of capital. But the cost to obtain and maintain a listing in the public markets is prohibitive, and those markets are more suitable for later stage firms. Crowdfunding is unique because it could allow innovative SMEs to complete small initial offerings to closely-held groups of investors with minimal expense. BDC has stated that "a vibrant venture capital infrastructure depends on the smooth functioning of a multitude of elements that are linked together". Crowdfunding could be a valuable new element.

Of course there will be legal considerations for issuers over and above simply the initial issuance of securities. These would include, in the case of equity shares, whether the shares should have voting rights, anti-dilution protections, participation rights on sale of the business, restrictions on use of proceeds, re-purchase rights in favour of the founders, etc. There will also be ongoing administrative obligations, such as keeping accurate shareholder lists, holding shareholder meetings and reporting to shareholders on a regular basis. Will the shares be tradeable, after expiry of applicable hold periods? There will also be cross-border considerations such as, for example, will an issuer in the US be able to accept subscriptions from investors in Canada, and vice versa?

It will be interesting to see, if the US adopts the new law, whether the issuance of securities by way of crowdfunding will take off in the US. The UK government is currently studying the issue, as are the private-sector architects of web-based social networks. While its legality is unclear, an on-line investment site in the UK known as Crowdcube (http://www.crowdcube.com) is already operating. Who will emerge as the game-changer of internet based equity offerings and trading, in the same way that eBay emerged as a leader in resale of goods and Facebook emerged as a leader in social networks? What are the implications for traditional investment bankers and other intermediaries if SMEs can complete offerings directly to investors, without intermediaries? Will Ontario and other Canadian provinces be left behind as this new market unfolds? If the provinces do not allow crowdfunding, will Canadian technology entrepreneurs be more inclined to locate their start-ups in the U.S.?

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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.