TIPS FOR STARTUPS – SO YOU WANT TO CROWDFUND?

Posted on August 25, 2016

Categories: Insights, Publications

In 2012 we published an article on the future of crowdfunding and whether it could help finance innovation by providing Canadian businesses with a new source for capital. Fast forward to 2016 and interest in crowdfunding has grown immensely within the startup community. Crowdfunding can be a useful tool for startups; however it is not without its disadvantages. Given its potential value, every startup should understand both what crowdfunding is and when to use it.

What is Crowdfunding

Crowdfunding involves raising capital by soliciting relatively small amounts of money from a large number of individuals. In exchange for money funders generally receive value in return, which can be in the form of a reward, a presale, interest payments, or equity in the startup.

There are a number of benefits to crowdfunding. Often, startups pose too great of a risk to attract institutional investors, venture capitalists, and other typical financing sources. Crowdfunding can be a means to raise the necessary capital to get started, and can also complement other means of raising capital, particularly in early stages of financing such as seed rounds. Crowdfunding can also provide your business with quick cash. For example, if you need bridge money to get you through a particularly lean period between financing rounds, crowdfunding can be used to obtain those funds. You can also reach a wider range of potential investors, and the investment level required per individual is lower.

A startup may want to use crowdfunding to demonstrate business or product viability. This is particularly true if you are offering presales - if a product or service sells exceptionally well during this stage, it can indicate that there is a market for the product or service offering.

Although crowdfunding may have many benefits, it may not be the right choice for your startup. Managing a crowdfunding campaign also takes time and money, and it can be difficult to predict success. Each type of crowdfunding comes with its own specific benefits and disadvantages, and these are discussed in turn below.

Types of Crowdfunding

Crowdfunding can be categorized into different types depending on the form it takes and what the funder receives (if anything) in exchange for their money. These include: donation, rewards-based, presale, debt, and equity crowdfunding.

Donation, Reward-Based, and Presale Crowdfunding

Donation crowdfunding involves individuals, charities, or other entities soliciting donations online. In these circumstances, funders have no expectation of receiving anything in return.

Rewards-based crowdfunding involves the use of rewards to encourage people to contribute funds. For example, a startup that needs funds to create a product may offer branded merchandise in exchange for contributions. Note that many platforms will return raised money back to funders if the company does not reach its fundraising target within the specified time.

Presale crowdfunding is fairly straightforward; a startup solicits funding by selling a product or service before it has actually been produced. This allows customers to be first in line for a new product. Presales are useful when you are unsure of the demand for your product or service and do not want to spend money upfront in creating something that does not sell.

Debt Crowdfunding

Debt crowdfunding, also called "crowd lending", is similar to the concept of micro lending – a large number of people put in a relatively small amount of money with the expectation of receiving the principal plus interest back in return. There are variations to this, such as forgivable loans, whereby the money is only repaid if the business starts generating revenue. Each company determines its own specific lending terms.

Debt crowdfunding is particularly useful if a startup needs funding but wants to maintain control and equity ownership of its business. Debt crowdfunding is less risky for investors than equity crowdfunding, since they are promised a return on their money, which is steadier than with equity crowdfunding. However, given the lower risk and steady return, the payout for investors can be smaller than with equity crowdfunding.

Debt crowdfunding can also take the form of convertible debt, either to common or non-convertible preference shares, which are considered equity and discussed further below.

Equity Crowdfunding

In **equity crowdfunding**, funders receive securities in exchange for their investment. Securities can be shares (common or preferred), debentures, partnership units, and other forms of non-derivative securities. This type of crowdfunding is relatively new to the Canadian market.

Businesses selling crowdfunded securities are regulated by the jurisdiction in which they are situated – if you use equity crowdfunding in British Columbia, you must comply with British Columbia's *Securities Act*. Since the introduction of crowdfunding in Canada, several securities exemptions have been introduced for equity crowdfunding that eliminate the need to prepare an expensive and lengthy prospectus. Canada does not have one national crowdfunding exemption, and you can rely on more than one if multiple are applicable.

In British Columbia, the Startup Crowdfunding Exemption has been available via BC Instrument 45-535 – *Start-up Crowdfunding Registration and Prospectus Exemptions* since May 14, 2015 (this exemption is also available in Saskatchewan, Manitoba, Quebec, New Brunswick, and Nova Scotia); however, it cannot be relied on if the company is a reporting issuer or an investment fund. Additionally, the company's head office must be located in the jurisdiction. A startup may offer a maximum of two crowdfunded distributions per year, and may raise up to a maximum of $250,000 in each distribution. Investors are limited to investing up to $1,500 per distribution. Startups are not required to prepare a prospectus under this exemption; however, they must still prepare an offering document using 45-535 Form 1 *Startup Crowdfunding – Offering Document* and the investors must understand and acknowledge the risk warnings presented therein. The offering document must also provide basic information about the company and explain how the company will use the money raised and the minimum amount required to achieve these goals.

Startups in Manitoba, Ontario, Quebec, New Brunswick or Nova Scotia may also rely on Multilateral Instrument 45-108 – *Crowdfunding*, also known as the "Crowdfunding Exemption", which came into force on January 25, 2016. As we previously discussed, the Crowdfunding Exemption expressly includes non-convertible debt securities linked to a fixed or floating interest rate and securities convertible into a common share or a non-convertible preference.

Equity crowdfunding can be challenging for a number of reasons. To begin, a startup cannot control who purchases the shares, and may acquire a large number of shareholders. For example under BC's Startup Crowdfunding Exemption, you may raise up to $250,000.00 per offering but investors are limited to providing $1,500.00 – this amounts to potentially 166 new shareholders per offering if you raise the maximum amount. Depending on the type of shares issued, these new shareholders may receive voting rights, require annual meetings, and share in future profits. Equity crowdfunding also requires funders who are invested for the long term, since the shares may remain illiquid for some time until the startup has become more developed. Moreover, management will need to remain accountable to these newly acquired shareholders, who may be less likely to offer the same valuable advice, mentorship, management expertise, or network to the startup that angel investors or venture capitalists may provide in return.

Applicable securities exemptions restrict the amount of money that you can raise per distribution, and how often you can undertake a distribution, which can be very limiting for startups. As mentioned above, under the Startup Crowdfunding Exemption, you are limited to $250,000 per offering, two offerings per year, and a maximum of $500,000 every 12 months. Under the Crowdfunding Exemption, you may raise a maximum of $1,500,000 per year.

If, in completing an equity crowdfunding campaign, the startup has over 50 unique shareholders (excluding current and former employees) it will be required to meet ongoing compliance requirements and filings in each jurisdiction in which the company has sold securities and that of its head office. While the filings are not altogether onerous and may, for the most part, be filed electronically, certain filings (such as the report of exempt distribution) must be filed within a certain timeline after completing the financing, and these documents (including the offering document) will be available publically online. The company must also send a confirmation notice to each participating investor within 30 days of closing the distribution.

Is Crowdfunding Right for Your Company?

While crowdfunding may seem like a quick way to easy money, certain types of crowdfunding may also have significant downsides. Before launching a crowdfunding campaign, each company should consider which type of crowdfunding will help it achieve its goals. Specifically, before launching an equity crowdfunding campaign, we suggest that you consider: whether other sources of funding may be more appropriate; whether you and any other management will be able to spare the time and energy needed to run a crowdfunding campaign and also whether you have the capacity to handle the needs of shareholders and securities regulators going forward; and the amount of money and number of shares you want to raise and issue and the type and characteristics of those shares. To decide whether crowdfunding is right for your company, and to determine which form of crowdfunding to pursue, we recommend that you consult a lawyer specializing in corporate and securities law before taking any action.

by Morgan McDonald, Lindsay Dykstra, Articled Student and Brandon Deans, Temporary Articled Student

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.