fullsail

Making Headway

Reporting on the New Brunswick Securities Commission's *Fullsail* capital markets initiative

As part of its *Fullsail* capital markets development initiative, the New Brunswick Securities Commission is hosting a panel discussion on crowd funding as a way to raise equity capital for business. This issue of Making Headway is dedicated to exploring crowd funding from the various perspectives of the panelists.

The event will take place from 1:30 p.m. until 4 p.m. on Tuesday, November 27th at the Wu Conference Centre, 6 Duffie Drive, University of New Brunswick, Fredericton.

Potential investors, entrepreneurs considering raising capital, professionals, business consultants, economic development officers, academics and students are invited to participate. Pre-registration is required and can be done online: www.nbsc-cvmnb.ca/crowdfunding.

Panelist biographies and contact information are on page 7.

PANELISTS

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Stepping Out of the Crowd – Equity Crowd Funding

Norm Betts, Member, National Advisory Leadership Council, Canadian Advanced Technology Alliance, and Associate Professor, Faculty of Business Administration, University of New Brunswick

In the world of technology and social media of today most of us have encountered crowd funding in some form, whether we realize it or not. If you have purchased a good or service online, I could argue it is sales crowd funding. If you have made a charitable donation to a friend's charitable efforts online, you have used donations crowd funding. You may have bought an Atlantic Lotto product online and therefore used gambling crowd funding. Anyway, you get the point.

We have developed the technological and social media platforms for the efficient and effective gathering of small amounts of money, from a crowd of people, for a number of legitimate purposes. The question is, can we put some structure and workable regulation in place to facilitate equity crowd funding[1]? What is the difference?

Clearly, there is a difference, and one way to describe it is that of "residual interest". Once you receive a good or service, make a donation or play a lottery game, the obligation of the recipient of the money has been satisfied. With the crowd purchase of an equity interest, however small, there is an expectation of a future return. Finance 101 tells us that an "expected return" is what we *hope* to achieve, recognizing that the investment is fraught with risk, and that the *realized* return could vary widely (and be negative). It is this future expectation that creates the residual interest. My hope is that we can address the issues dealing with the reality of residual interest in an equity investment without the burden of more formalized equity oversight regulations.

The issues of separation of ownership and control (a topic academics explore in agency and trust theory) are the same whether the dollar amounts are large or small. They can be categorized, in my view, in the following way:

- Input controls (on investee & on investors)
- Governance

INPUT CONTROLS

None of us want to create a system where the next Bernie Madoff can use equity crowd funding as a platform for fraudulent schemes. Therefore, some regulatory body, like a provincial securities commission, should require some basic information of the investee – business plan, uses of funds, etc. Regulators should not review the business plan or judge it on probability of success (let the market do that) but should be a non-bureaucratic gatekeeper ensuring they know about those seeking to use the equity crowd funding platform[2].

Likewise, we need some input controls on the investor. In the large corporate world in non-prospectus offerings we limit participation to Accredited Investors (as defined) or, as in the case of the New Brunswick Small Business Investor Tax Credit program, most offerings are limited to friends and family. In the non-prospectus world of equity crowd funding, these exemptions do not throw the investor net wide enough and defeat the purpose of the technology platform.

We must be creative and think of ways of protecting the investor at the time of the investment. We could have "stepped limits" on the amount of investment – a maximum amount that anyone could invest with only identifying information provided, and larger amounts tied to income and/or assets. Again, some nimble regulatory body like the provincial securities commission could monitor this. Let's be facilitators not obstructionists.

GOVERNANCE

Governance is that well worn term that refers to mechanisms we put in place to ensure that management's interests are aligned with the best interests of the company. Companies, of course, have diverse stakeholders, including a small or large crowd of shareholders. Some type of independent oversight by someone representing the interests of minority shareholders must be established. I have lots of practical suggestions for this one but time and space will mean we address that another time.

In closing, let's ensure we do not let large corporate thinking inhibit the efficiency and nimbleness that equity crowd funding requires. There will be naysayers. We *can* get it right.

[1] I believe we should use the more descriptive term "equity crowd funding" to clearly differentiate the raising of small amounts of capital from the aforementioned fundraising activities.

[2] We have such a process in New Brunswick today with the NB Small Business Investor Tax Credit program. Prospective participants must submit a dossier to the Department of Finance and get an "investor number" before proceeding.

Securities Law Considerations in Legalizing Equity Crowd Funding in Canada

Brian Koscak, Chairman of the Exempt Market Dealers Association of Canada (EMDA) and Partner, Cassels Brock & Blackwell LLP

Equity crowd funding represents a new capital raising opportunity that can provide start-ups and small enterprises with previously unavailable capital to help them grow their businesses. The challenge is how to create a securities regulatory framework that not only protects investors but also promotes fair and efficient capital markets. This is exactly what securities regulators across Canada are trying to figure out today.

In developing a made-in-Canada framework, Canadian securities regulators need to consider various matters in striking the right balance, including the following:

Investors

- Should investors be capped at how much they can annually invest, so if they lose their entire investment the impact on their net worth is negligible? What should the annual cap be?
- Should there be a maximum investment limit per investment?
- What information should be provided by an issuer to investors before they can invest? For example, should an individual be required to watch a video, complete an online quiz, read and/or complete an online crowd fund Risk Acknowledgement Form, before they are allowed to invest?

Issuers

- Should issuers be subject to an annual limit on how much they can raise in a given fiscal year? If so, what is the dollar limit?
- Should issuers be subject to an aggregate investment limit, for example, $1,000,000, and once achieved, they can no longer rely on the exemption?
- Should issuers be subject to a minimum and maximum offering threshold?
- Should securities be limited to equity only or debt and equity?
- What information should be provided to an investor about the offering before they invest?
- What liability will an issuer's officers and directors have in the event of a misrepresentation?
- Should issuers have reporting obligations post funding? Should this be quarterly? Semi-annually? Annually?
- How does a small issuer cope with a large number of shareholders who invested under a crowd fund offering?

Portals

- What liability should a portal have?
- What due diligence is a portal required to do in connection with an issuer to prevent fraud?
- What due diligence is a portal required to do to ensure that an investor complies with the applicable requirements that permit them to invest (e.g., annual investment limits per investor)?
- Should a portal have the same registration requirements as an exempt market dealer, such as books and records, insurance, regulatory capital etc.? If not, what should they be?
- Should a portal be required to undertake any investor know-your-client, know-your-product and suitability obligations?
- What compensation can a portal receive in connection with an offering?
- Are there any restrictions on the activities that a portal can undertake in connection with an offering?
- How can portals use social media to promote crowd funding campaigns or initial crowd fund offerings? What advertising can a portal do?

Other Considerations

- What exit strategy is there for a crowd fund investor? Should crowd funded securities be free-trading shares?
- How will an equity crowd fund framework work in connection with other prospectus exemptions?

Tough questions! I wish there were easy answers, but this gives you an idea of the various considerations faced by our Canadian securities regulators in trying to create an equity crowd funding securities framework for Canada. With the United States legalizing equity crowd funding (with the regulations being drafted by the SEC, FINRA and State regulators) and likely coming into force in 2013, we need to be careful that we don't miss the boat in Canada. And it is not just the United States. Equity crowd funding is a global phenomenon, where it has been legalized in

QUESTIONS...Continued on page 4

The Role of Crowd Funding to Spur Entrepreneurship

Devashis Mitra, Associate Dean, Research and Strategic Initiatives, and Professor of Finance and Entrepreneurship, University of New Brunswick

Small businesses often face significant challenges in accessing capital. Traditional small business funding such as bank loans, venture capital or angel funds may not be available to many start-ups and other fledgling businesses. With such constraints, entrepreneurs often have to "bootstrap", relying on personal funds, credit cards, second mortgages, funds from friends and family or other means. Scarcity of capital access prompts entrepreneurs to seek alternative financing venues. This phenomenon has spurred the global growth of crowd funding. Crowd funding can be defined as the financing of a project or a venture by a group of individuals ("the crowd"). Funds are typically raised on the Internet through relatively small contributions from a large number of people. Globally, crowd funding websites have adopted a number of different models that provide platforms for entrepreneurs to raise funds. For instance, through donation sites, contributors donate funds for charities and other non-profits and sometimes for-profits as well. Reward sites offer rewards, depending on the amount of contribution. Rewards could range from notes of thank you to tokens of appreciation to having contributors' names on the credits of movies that are sought to be financed.

Sites offering a pre-purchase option enable contributors to receive the final product upon completion, often at a reduced price. Leading reward and pre-purchase sites in North America include Kickstarter and Indiegogo. Lending crowd funding sites provide loans to entrepreneurs; some, such as Kiva, do not offer interest to investors while others, such as Lending Club do. Equity crowd funding sites offer investors a share of the profits of the business they are funding. According to crowdsourcing.org, equity and lending-based platforms that provide financial returns appear to be more suited for digital applications such as computer games, films or music. In contrast, donation and reward-based models could be better suited for cause-based campaigns that appeal to funders' personal beliefs and passions. Also, equity platforms have had more success in raising funds for projects requiring greater funding.

Equity and lending sites, involving the sale of securities to investors do not exist in Canada given existing regulations. Since crowd funding platforms seek public funding, any issue of securities would require compliance with regulations of provincial securities commissions which could be prohibitively expensive. One way of being exempt from such requirements is to offer securities to accredited investors. However, the nature of crowd funding prevents this. Indeed, participation of accredited investors in crowd-funded projects with many unaccredited security-holders could have some unique challenges.

The United States enacted the Jump-*start our Business Startups* (or JOBS) *Act* earlier this year, in effect, enabling debt and equity-based crowd funding within certain limits. Should Canada adopt similar legislation? The central debate is whether potential benefits of crowd funding in terms of facilitating capital formation outweigh investor risks from business failure or fraud.

Proponents argue that a securities exemption would not open investors to new risks because they are already contributing through "non-securities" crowd funding. Under this perspective, issuing securities could potentially offer higher returns to offset those risks and allow middle-income, unaccredited investors to also participate in new enterprises.

QUESTIONS...Continued from page 3

certain jurisdictions, such as the Netherlands and Australia, and being seriously considered by many other countries such as Italy. Nevertheless, Canada cannot legalize equity crowd funding at the expense of putting unsophisticated investors – the public – at risk.

It is through continued education, dialogue and debate that the right balance may be achieved and equity crowd funding will come to Canada, however, the immediate challenge is to figure out the right securities regulatory framework.

Equity Crowd Funding - Seizing the Investor Education Opportunity

Jake van der Laan, Director of Enforcement, New Brunswick Securities Commission

There is little doubt that crowd funding works. As a result, equity crowd funding, a new form of crowd funding in which investors actually get an ownership stake in a venture, has been recently touted as the answer to the funding woes of many small businesses and entrepreneurs. In response, the *JOBS Act* was enacted in the United States.

Crowd funding will also find its way to Canada in the near future and we need to have an informed and engaged debate on how we should implement and regulate it here. While there surely is an opportunity to exploit the power of the Internet to make it easier to raise capital through equity crowd funding, any Canadian framework must effectively balance strong investor protection with a workable capital raising process for businesses.

The framework currently proposed under the United States *JOBS Act* mandates that all equity crowd funding activity must be mediated through a "portal" website, the operators of which must be registered with the United States Securities and Exchange Commission (SEC). In addition, there are limits placed on how much can be raised by a business ($1M/year) and how much an investor can invest. The details of other requirements relating to the disclosure and risk reduction obligations on portals, disclosure obligations on businesses seeking to raise capital ("issuers"), fund disbursement requirements and issuer advertising restrictions are still to be worked out in the SEC rules currently being developed.

The provisions of the *JOBS Act* have already been the subject of criticism, with some forecasting "massive amounts of fraud". Others generally support it, but find fault with the implementation specifics set out in the Act and/or the shape the SEC rules as they are currently anticipated to take shape.

In my view the United States portal-based model is reflective of how crowd funding can work well in the non-equity realm and it is likely the right model to form the basis for equity crowd funding in Canada as well. I am not convinced, however, that all provisions of the current *JOBS Act* should be adopted "as is" in Canada. There has already been much commentary that the *JOBS Act* specifics are too luke warm on effective investor protection throughout the equity crowd funding process.

I believe the adoption of an effective Canadian equity crowd funding framework must include robust investor protection and education measures. To that end, the portal-based model does offer specific opportunities which are not feasible in traditional models of capital raising. The portal model permits the centralized implementation of clear process and disclosure in the investment process. For instance, given that an investor will be required to create an account with a portal website in order to invest, the application process could (and should) include a substantive investor education component through which the investor demonstrates a minimum understanding of the investment process, the inherent risks, and what factors to consider in making an investment decision.

Given that equity crowd funding will attract a whole new segment of investors, many of whom are unlikely to have invested before, consideration should be given to a requirement that investors pass a minimum "risk and safety" test of some sort, in a manner not unlike that currently being used to license other activities such as, for instance, boating (see for example http://www.boaterexam.com/canada/). This type of education or licensing could be easily implemented online and should not be prohibitive for prospective investors to complete. Another option is to permit staggered entry to the crowd funding market for both issuers and investors, initially permitting only lower amounts to be raised or invested. There are many other possibilities.

Suffice it to say that we should take the time to be creative, to carefully and fully assess all the various challenges of any proposed Canadian crowd funding scheme, and find workable solutions to them. I am confident that with careful thought and planning we can ensure that the scheme we end up with offers the best in investor education and protection, while also providing new and much needed access to capital for small businesses. If we can achieve that, then I believe crowd funding will become a Canadian success story.

The opinions expressed in this article are those of the author alone and do not represent the views of the New Brunswick Securities Commission.

...Footnotes provided on page 6

Crowd Funding - A Business Lawyer's Perspective

Peter Klohn, Partner, Stewart McKelvey

A person enters a casino (real or virtual) and places a bet of $1,000 on a single number on a roulette wheel. The player has a general understanding of the game and its outcomes. Within seconds, the participant receives $35,000 or has lost the bet. There are widely diverse opinions about the social value of this transaction and it occurs in an extraordinarily regulated environment which is evolving constantly.

A person signs onto the Internet and discovers a request for funds from a commercial enterprise that is in its infancy. On the basis of limited information, money changes hands with a potential for gain or, most likely, since the failure rate of fledging ventures is high, likelihood of total loss. The debate in Canada is ongoing about the social value and proper regulatory environment for transactions in this proposed social media marketplace called "crowd funding". As yet, the Canadian provincial securities regulators have not weighed in on the topic notwithstanding early regulatory advances in the United States including the passage in April 2012 of the *Jumpstart Our Business Startups* (JOBS) *Act* into law.

In New Brunswick, as elsewhere, we suffer from a lack of early stage venture capital and a variety of initiatives are ongoing to respond to this deficiency. The entrepreneurs that I work with are, generally speaking, social media savvy and many, no doubt, would embrace the opportunity to appeal to the "wisdom of the crowd" for financial support. In advising them on considering this group participation, I would caution them about the challenges posed by early public disclosure of the innovation or idea which constitutes the perceived competitive advantage for their enterprise. I would ask them to consider the difficulties in communicating with large numbers of stakeholders and the risks associated with allegations of misunderstandings which rise to the statutory threshold of actionable "misrepresentations' under existing securities legislation. Entrepreneurs should reflect on the nature of their business and whether it is amenable to collective funding (because of the product, the target market, the scale) or whether strategic, informed investors who can contribute expertise and experience are a necessary first step. In addition, consideration should be given to equity versus non-equity models of crowd funding (where participant investors are given goods or services in lieu of dilutive equity).

Corporate finance is, at least in part, the art of mixing a workable concoction of private capital from various sources, government assistance, conventional and unconventional debt and business specific sources and programs. Crowd funding may well be another new ingredient in the brew but, like any good cook knows, too much in the wrong proportions or the incorrect recipe will yield poor results.

We should welcome the debate and encourage regulatory approval and action which creates a consistent and balanced framework. We shouldn't however forget that in business, as in casinos, there are winners and losers on every bet.

...Footnotes from page 5

[2] For an excellent summary and analysis of the provisions of the JOBS Act, see Bradford, C. Steven, Crowd funding and the Federal Securities Laws (March 9, 2012). Columbia Business Law Review, Vol. 2012, No. 1, 2012. Available at SSRN: http://ssrn.com/abstract=1916184

[3] See for instance Griffin, Zachary, Crowd funding: Fleecing the American Masses (March 14, 2012). Case Western Reserve Journal of Law, Technology & the Internet, Forthcoming. Available at SSRN: http://ssrn.com/abstract=2030001 or http://dx.doi.org/10.2139/ssrn.2030001

See for instance Bradford, C. Steven, The New Federal Crowd funding Exemption: Promise Unfulfilled (May 24, 2012). Securities Regulation Law Journal, Vol. 40, No. 3, Fall 2012. Available at SSRN: http://ssrn.com/abstract=2066088. See also Hazen, Thomas Lee, Crowd funding or Fraud funding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must be Conditioned on Meaningful Disclosure (May 20, 2012). North Carolina Law Review, Forthcoming. Available at SSRN: http://ssrn.com/abstract=1954040

Panellist Biographies

Norman M. Betts, Member, National Advisory Leadership Council, Canadian Advanced Technology Alliance and Associate Professor, Faculty of Business Administration, University of New Brunswick

Norm obtained his Ph.D. in Management, specializing in finance and accounting from the School of Business, Queen's University in Kingston, Ontario. He is currently an Associate Professor at UNB as well as a Chartered Accountant and a Fellow of the New Brunswick Institute of Chartered Accountants (FCA).

Norm sits on the Board of Directors of several Toronto Stock Exchange, Toronto Venture Exchange and American Stock Exchange listed companies. He is on the Board of the New Brunswick Power Corporation and Export Development Canada, and is a member of the National Advisory Leadership Council for the Canadian Advanced Technology Alliance (CATA).

From 1999 until 2003, he was a Member of the Legislative Assembly in the Province of New Brunswick, during which time he served as Minister of Finance, Minister of Business New Brunswick, and Minister responsible for Service New Brunswick.
You can reach Norm at 506 470-3777 or betts@unb.ca.

Peter Klohn, Partner, Stewart McKelvey

Peter is the leader of Stewart McKelvey's Owner Managed Business Practice Group. He has a diverse practice in corporate law, corporate finance and securities matters on a national basis. He has established a number of public companies and advises extensively with respect to the private equity and exempt markets. He has acted as a member of various corporate boards (private and not for profit), the corporate secretary of various entities (public, private and not for profit) and as a member of numerous business advisory boards.

A recognized leader in securities and corporate finance law, Peter is a member of the Advisory Committee to the Canadian Securities Transition Office (CSTO) responsible for reviewing proposals for federal regulation of securities in Canada.
You can reach Peter at 506 632-2788 or pklohn@stewartmckelvey.com.

Brian Koscak, Chairman of the Exempt Market Dealers Association of Canada and Partner, Cassels Brock & Blackwell LLP

Brian practices in the areas of corporate and securities law with an emphasis on investment funds, securities registration for dealers and advisors, private placements, public and private financings and mergers and acquisitions across a diverse range of industries and sectors.

As Chair of the EMDA, Brian has advocated for a review of the prospectus exemptions across Canada including Ontario adopting a form of the offering memorandum exemption.

Brian is actively involved in working with clients, industry participants, crowd funding associations in creating a viable framework for legalizing equity crowd funding in Canada. Brian is focussing on the securities law issues involving crowd funding portals intermediating trades in securities and working with a Cassels Brock team dedicated to this emerging area.
You can reach Brian at 416 860 2955 or BKoscak@CasselsBrock.com.

Dr. Devashis Mitra, Associate Dean, Research and Strategic Initiatives, and Professor of Finance and Entrepreneurship, University of New Brunswick

Devashis joined the Faculty of Business Administration at UNB in 1991. He obtained a Ph.D. in Finance from the University of Massachusetts at Amherst. He also holds a Fellow designation from the Institute of Chartered Accountants of India. In his role as Associate Dean, Research and Strategic Initiatives, Devashis champions new initiatives and research in the Faculty of Business Administration.

Devashis teaches in the entrepreneurship and finance areas. He is the co-author of a leading textbook on corporate finance, now in its 5th edition, published by McGraw-Hill Ryerson. Prior to pursuing an academic career, he worked for Price Waterhouse and for Indian Aluminum Company, then a subsidiary of Alcan Aluminum. He has been a visiting scholar at institutions in India and Indonesia. You can reach Devashis at 506 458-7332 or dmitra@unb.ca.

Jake van der Laan, Director of Enforcement, New Brunswick Securities Commission

Jake oversees the case assessment, market surveillance, investigation and litigation activities of the Enforcement Division. Jake has broad experience in administrative law and procedure, hearings before administrative tribunals and appellate advocacy. Prior to joining the Commission in 2006 Jake was in private practice.

Earlier this year, Jake was appointed to the North American Securities Administrators Association (NASAA) Internet Fraud Investigations Project Group which has as its current focus the identification of strategies to prevent and fight fraud in the equity crowd funding realm as a result of the *United States JOBS Act*. Jake is a former chair of the Canadian Securities Administrators' Standing Committee on Enforcement.
You can reach Jake at 506 658-6637 or jake.vanderLaan@nbsc-cvmnb.ca.

Moderator Biography

Nancy Mathis, Executive Director, Wallace McCain Institute at the University of New Brunswick

Nancy considers herself a serial "founder". Her role at the Wallace McCain Institute combines her experience as the co-founder and innovative force behind Mathis Instruments with her teaching background at UNB. The role also enables her personal mission to "build and nurture the most highly-connected community of entrepreneurial leaders in North America". Her Ph.D. in Chemical Engineering supports her calling to design practical systems, programs and frameworks necessary to undertake such a mission.

She has been recognized on a national scale with awards in innovation, entrepreneurship and engineering - as well as for supporting others in those fields. She has been engaged in economic development in the region through her support of NB Business Council, NB2026, FutureNB, 21Inc, Junior Achievement, NBITC, PropellCT, the New Brunswick Securities Commission and the Pond-Deshpande Center. You can reach Nancy at 506 721-3820 or nancy.mathis@mccain-institute.com.

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