January 29, 2014

# CROWDFUNDING: A KICK STARTER FOR STARTUPS

### Highlights

- Crowdfunding represents an emerging financing alternative for startups, micro-enterprises and small and medium-sized enterprises (SMEs). It has enormous potential as a source of funding.
- The internet has seen crowdfunding change from micro-finance and non-profit fundraising campaigns into a business financing possibility. A small amount of funds are collected individually from the public (the crowd). Proceeds are then used to fund a project and/or get a business off-the-ground.
- Several crowdfunding models currently exist including donation, reward, lending and equity; hybrid models across these areas are also present. Underpinning each of these model varieties is the exchange of a financial or non-financial contribution for some sort of strategic value proposition.
- Crowdfunding and traditional financing channels should not be thought of necessarily as substitutes, as in many cases they are complements. Each financial model serves different clientele and businesses and are used for varying purposes. Collectively, adequate access to capital can unlock the growth potential of micro-enterprises and small businesses.
- The global crowdfunding market is estimated to be worth US$3-5 billion, making it a small source of funding today. North America and Europe account for roughly 95% of the market. While data are sparse and mostly proprietary, the market appears to have grown rapidly in recent years.
- As crowdfunding increasingly enters entrepreneurial awareness, the advantages and challenges of the funding mechanism will need to be addressed. Equity crowdfunding has the greatest challenge, as the transaction is ongoing versus one-time. To address the inherent concerns, regulators in the U.S. and Canada are currently developing a framework of best practices for equity crowdfunding.
- While effective and enforceable regulation is required, there is a risk of over-regulation especially given the innovative nature associated with crowdfunding. Nevertheless, fraud, information asymmetry and crowd due diligence are structural barriers and risks that must be addressed if crowdfunding is to reach its upmost potential.

Crowdfunding could represent a fundamental transformation in the way that startups, micro-enterprises and small and medium-sized enterprises (SMEs) access funding. It can be thought of as a no-strings attached version of the typical financial transaction and is underpinned in the notion that there is wisdom in a crowd. With crowdfunding, wishful entrepreneurs can seek out people who are interested in their project and offer them a strategic value proposition in exchange for their financial or non-financial support. This approach helps support out-of-the-box ideas which, in turn, leads many to proclaim that crowdfunding encourages experimentation and innovation, the latter being a critical driver of economic growth.

In this special report, we identify the key players involved in the small, but growing, US$3-5 billion global crowdfunding market and describe some of the pros, cons and the inherent risks associated with this form of financing. Although many different types of crowdfunding exist, it is equity crowdfunding that has piqued the attention of regulators. Canadian regulators are currently mulling rules to avoid the

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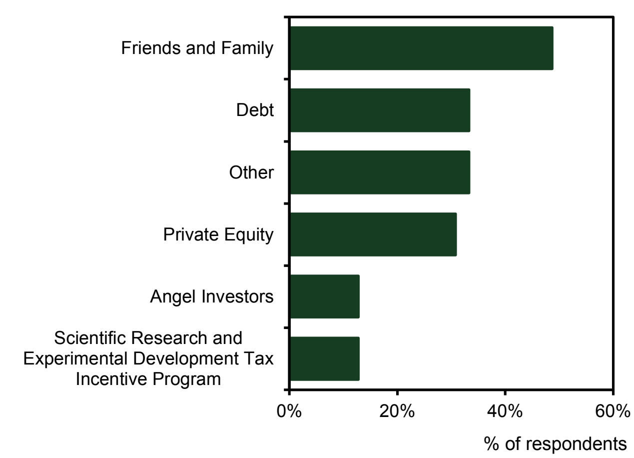
TOP SIX FUNDING SOURCES FOR STARTUPS AND ENTREPRENEURS




Source: Ideavibes and Canadian Advanced Technology Alliance (CATA).

potential for fraud, correct asymmetries of information, and address copyright and patent infringement concerns. The U.S. Securities Exchange Commission (SEC) recently lifted an 80-year ban on general solicitation, allowing businesses to publicly advertise their need for funding. Effective and enforceable regulation, education and research will help break down the structural barriers inhibiting the future success of the crowdfunding business model.

### Often no clear funding roadmap in the early days

There are approximately 420-510 million SMEs in the world, most of them informal.[1] In 2012, the global unmet demand for funding for these enterprises was US$3.1-3.8 trillion, or roughly twice the size of the Canadian economy.[1] Two-thirds of the funding gap resides in emerging economies, while SMEs in developed countries account for 70% of total lending to the sector.

The primary funding sources for entrepreneurs and startups are family and friends, personal savings, personal credit cards and home-equity lines of credit. Angel investors and venture capital are often looked to once proof of concept has been demonstrated and the monetization of revenues has been established. Incubators and accelerators are also sought out, but many of these programs are operating at maximum capacity.[2] In other cases, business owners and entrepreneurs simply do not know where to look to secure financing, seek counsel and garner support.

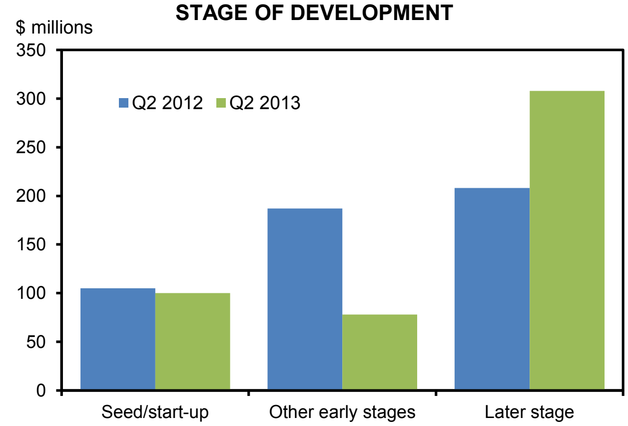
Venture capital (VC) funds and investments in Canada have been declining. Seed-stage and startups are particularly starved for funding – they obtained just 16% of all VC raised in 2007.[3] Canada's venture capital industry has been challenged by persistent low returns which have limited the amount of funds raised and, in turn, the amount of capital venture capitalists have to support businesses.[4-6]

According to the National Crowdfunding Association of Canada, startups and small businesses have particular difficulty raising capital in the range of $1-2 million. Additional evidence reiterates the challenge of access of capital. For example, in the latest Canadian Federation of Independent Business Barometer, 22% of respondents stated that a shortage of working capital is a limitation on sales and production growth.[7] In another survey targeted towards Canadian entrepreneurs, 51% respondents specified that cash flow was the number one challenge in running their business.[2]

These surveys may seem at odds with the Bank of Canada's Senior Loan Officer Survey.[8] In the latest edition, officers reported a continued easing in lending conditions for Canadian non-financial firms. However, the survey captures lending conditions for corporate businesses (those with over $50 million in loans authorized), commercial businesses (between $2-50 million in loans) and small businesses (less than $2 million in loans). As a consequence, it is difficult to decipher the lending challenges unique and specific to startups, micro-enterprises and those with little to no track record with financial institutions.

In a recent publication, Industry Canada reviewed access to financing for small businesses over the 2000-10 period.[9] During this period, 25% of small businesses looked for external financing for operational expenses every year. Those businesses who requested equity financing tended to be young, innovative, growth-oriented and, often, research and development (R&D) intensive. Of the obstacles to growth cited by small businesses, qualified labour (50% of respondents) topped the list. High insurance rates (38%), instability

VENTURE CAPITAL INVESTMENT BY STAGE OF DEVELOPMENT




Source: Venture Capital Monitor Q2 2013, Industry Canada of consumer demand (34%), government regulation (32%) and financing (20%) rounded out the top five.

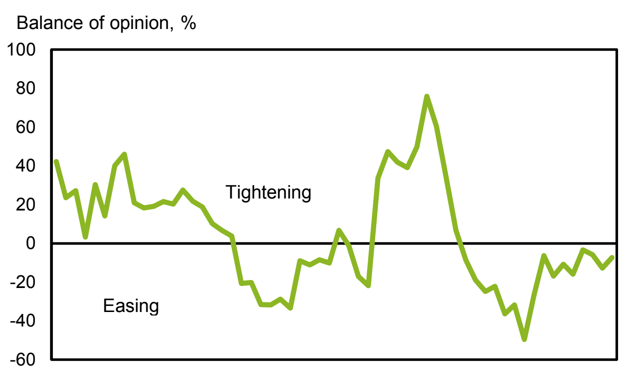
With the analysis in hand, the Industry Canada publication concludes small businesses have significant financing requirements, but were generally successful at securing the necessary funds. However, some firms do encounter challenges obtaining capital. This is a concern as many of the firms in question have high R&D and innovative intensity – a key component for spurring and sustaining economic growth. The Industry Canada report concludes by saying that public policy action could help "improve access to financing for these types of firms so that they might thrive and reach their full potential."[9]

### Crowdfunding 101 – seeking the wisdom of the crowd

Crowdfunding platforms are designed to efficiently connect those individuals with ideas to those individuals willing to invest in the business venture. Let us begin by dissecting the term 'crowdfunding.' It is a form of financing for a specific project or firm through an open call to the masses. Think of it as asking a lot of people for a little amount of money to support a worthy cause, business venture, or some hybrid of the two. A more formal definition has been established and agreed upon by the academic community: "crowdfunding involves an open call, essentially through the internet, for the provision of financial resources either in the form of donation (without rewards) or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes."[10]

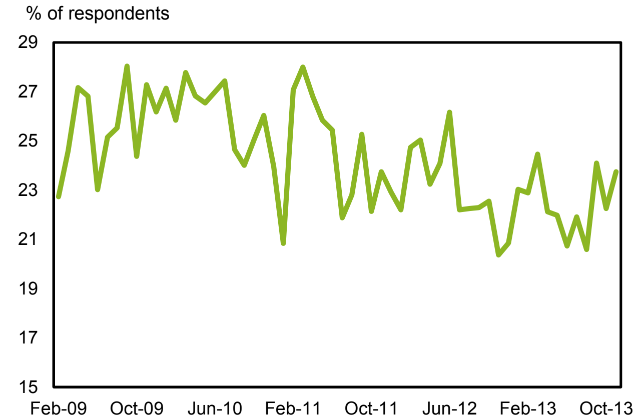
The concept of seeking funds from a crowd for a specific purpose is not new. A case in point, Mozart and Beethoven pre-funded some of their compositions using *a priori* subscriptions.[11] Citizens have also helped support projects when governments have been strapped for cash – money was collected from 120,000 Americans to help construct the pedestal for the Statue of Liberty. To accomplish the feat, the average donation for each American was 83 U.S. cents.

BUSINESS LENDING CONDITIONS IN CANADA




Note: The balance of opinion is calculated as the weighted percentage of surveyed financial institutions reporting tightened credit conditions minus weighted percentage reporting easing credit conditions.
Source: Senior Loan Officer Survey, Bank of Canada.

SHORTAGE OF WORKING CAPITAL AS A BARRIER TO INCREASED SALES & PRODUCTION




Source: Canadian Federation of Independent Business.

The ubiquitous nature and the commercialization of the internet have given crowdfunding new meaning. Web 2.0 (which includes dynamic web pages and social media) enables users to create and share content. Physical location is irrelevant, so long as parties can access the internet. Language barriers are overcome with a touch of a button thanks to online translation. In turn, matching funders with creators is an easier task than it used to be.

The non-profit sector was the first to successfully adopt crowdfunding in its present online form. Public fundraising campaigns after a natural disaster with governments matching donations dollar-for-dollar are common. The crowdfunding model is now being applied to the business community, startups in particular. To date, it has achieved significant interest and demand in the arts and creative industries (e.g., recorded music, film, video games).[12]

### Identifying the players

There are three primary players in the crowdfunding model. The first participant in the market is the **creator** (entrepreneurs, artists, business owners and others who initiate projects).[12] These individuals have an idea and are looking for financial and non-financial support to commercialize it. Creators often prefer crowdfunding to other traditional funding channels for three primary reasons: (1) the lower cost of capital online; (2) the access to non-financial support and guidance before the good has been produced or the service rendered; and (3) the ability to inexpensively, but accurately, predict market demand before production begins. Relative to traditional funding channels, creators have a lot of choice in the crowdfunding process. It is largely self-directed in that they choose to participate and in what manner they do so.

**Investors** – funders, pre-buyers, donors and contributors – represent the next participant. These individuals believe in the strategic value proposition being offered and lend their support to get the venture off the ground.

Motivation for investor participation is multi-faceted. It can be both intrinsic and extrinsic. For example, philanthropy and altruism often incent investors to participate. Some want to be attached to an opportunity which leads to social improvement in their own lives and communities. The National Crowdfunding Association of Canada says that many "social backers often support a project because they want to see a dream come to reality and be part of something bigger than themselves." In essence, they derive some value from being part of the journey, not just the final outcome.

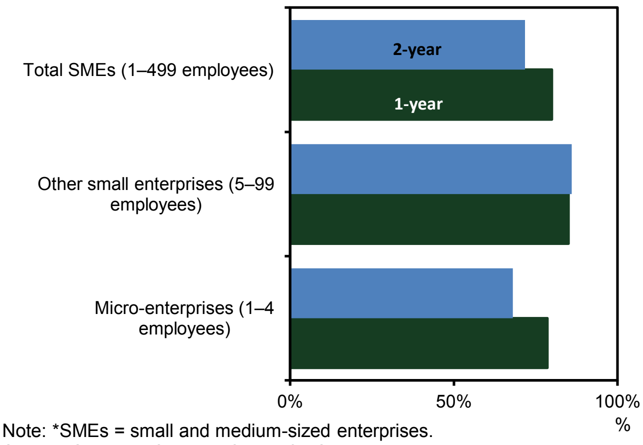
Potential business opportunities may encourage investor participation as well. For example, the entrepreneur may be a good contact to have in the investor's Rolodex. The investor can also contribute to product development in the early stages. In doing so, he/she can make the good or service more relevant to his/her own needs, his/her perception of market demand, or something he/she can benefit from.

**Platforms** are the online community that links investors with entrepreneurs. Think of platforms as the matchmaker in the crowdfunding world. Based on Massolution® data and research, there were at least 308 active crowdfunding platforms worldwide in 2012.[13] To preserve their own business model, the platform has an incentive to maximize the number and size of successful projects it oversees. Successful campaigns help the portal expand the size of the community and branch out into new categories. Triumphs also help from a marketing point of view, enabling one platform to distinguish itself from the multitude of others. It is ultimately up to the investor and the entrepreneur to choose the platform which best addresses their respective needs.

### Crowdfunding = one brand, but different labels

While the term 'crowdfunding' is used as an overarching term to define the emerging business funding model, there are a throng of types. In all cases, entrepreneurs and business owners exchange some form of strategic value proposition for financial and non-financial contributions.

**SURVIVAL RATE OF SMEs*, MICROENTERPRISES AND OTHER SMALL ENTERPRISES**




Note: *SMEs = small and medium-sized enterprises.
Source: Statistics Canada, Centre for Special Business Projects, Dec. 2012

- ***Donation/reward:*** Often includes philanthropy, social sponsorship and/or non-financial rewards. With a donation, the contribution is rooted in altruism. Non-profit organizations and charities regularly employ crowdfunding methods (e.g., annual holiday drives). In the case of a reward-based crowdfunding project, individuals receive something small in exchange for their contribution. Examples include a T-shirt or tickets to the event they help sponsor. The donation/reward type is the largest category of all crowdfunding varieties, as measured by the monies raised. According to Deloitte, the global donation/reward market is worth approximately US$1.2 billion.[14] In 2011, 93% of the crowdfunding campaigns launched and 83% of all funds raised were donation and rewards-based.[15]

- ***Pre-selling:*** identical to *a priori* subscription. It is essentially the opposite of a cash-on-delivery (COD) order. The finished product will be delivered to contributors upon completion. Pre-selling can serve the same function as market research – it can provide useful information about underlying demand, often in the early stages such that changes can be made when/if required.

- ***Investment or equity-based:*** contributors are rewarded an equity stake in a company in return for their investment. The value proposition being offered is company ownership or voting rights. Out of all crowdfunding models, equity crowdfunding typically yields the highest average amount of money raised per campaign.[15] For example, roughly 80% of global investment model campaigns raised more than US$25,000 each.

- ***Lending-based:*** includes peer-to-peer lending and peer-to-business lending and resembles the micro-financing often seen in developing economies. Payment plus interest might be returned in a lump sum or along some sort of payment schedule. In 2011, lending-based crowdfunding accounted for US$522 million in 2011, making it the second-largest category of the worldwide crowdfunding market, as measured by the monies raised.[15] Furthermore, lending-based crowdfunding campaigns meet their funding targets, on average, in half the time it takes for investment-based campaigns.[16]

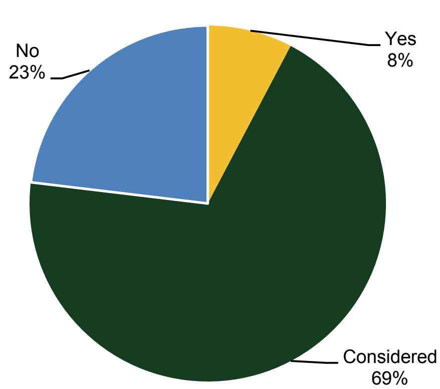
- ***Institutional crowdfunding:*** involves the connection between institutional investors and often, more established business ventures looking for financing.[17]
- ***Hybrid models:*** the models previously explored can be combined to create a blended model.

### Sizing up the global crowdfunding market

All evidence point to burgeoning crowdfunding demand. Researchers have attempted to attach a dollar figure to the market size – in order to make the leap from intangible concept to full-fledged reality. According to Deloitte, global investors contributed US$3 billion towards crowdfunding projects in 2013.[14] Massolution® estimates the tally to be higher at US$5.1 billion, an 81% increase from the year prior.[13] Researchers at the Fung Institute at the University of California at Berkeley landed squarely in the middle at US$4 billion.[18]

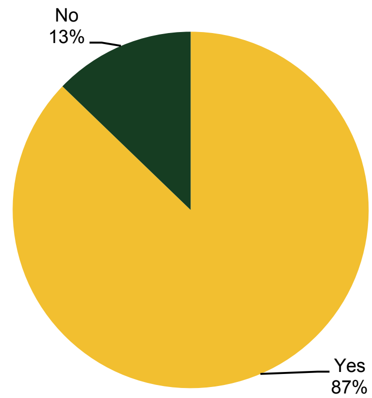
As crowdfunding demand has taken off, so too has the number of online platforms hoping to grab a piece of the action. According to the National Crowdfunding Association of Canada, there were an estimated 45 crowdfunding platforms in Canada, as of January 2013. The number has likely since increased, with Kickstarter's recent foray into Canada in September 2013. Ontario and British Columbia are home to 59% of all platforms, but represent just 52% of the Canadian population. Massolution® estimates that worldwide, the number of crowdfunding platforms increased, year-over-year, by 54% in 2011 and 60% in 2012.

HAVE YOU USED OR CONSIDERED USING CROWDFUNDING TO FUND A STARTUP?




Source: Ideavibes and Canadian Advanced Technology Alliance (CATA).

ARE YOU FAMILIAR WITH CROWDFUNDING?




Source: Ideavibes and Canadian Advanced Technology Alliance (CATA).

Crowdfunding reaches all corners of the earth, or more precisely, where the internet is available. It has truly become a global phenomenon, but North America and Europe currently dominate the market – the two continents represent 95% of the total market.[15] By volume of funds raised, North America takes the crown. However, Europe had the greater share of successful crowdfunding campaigns.

In the U.S., there are an estimated 60,000 angel investors (individuals who finance entrepreneurs and enterprises through one-time seed money).[19] Based on projections from the International Economic Development Council, crowdfunding could create 60 million new angel investors in the U.S. alone – a 1,000 fold increase from current numbers.

When it first started, crowdfunding predominately was tied to the non-profit and charitable sector. While activity has since diversified across the industrial spectrum, social causes continue to be the most active category, representing 30% of all activity.[13] General business and entrepreneurship come in a distant second with 16.9%.[13] Film and performing arts (11.9%), music and recording arts (7.5%), energy and environment (5.9%) round out the top five.[13]

Data are sparse and mostly proprietary. Improving the array of widely-accessible data will be critical to the overall success of the market. The crowdfunding model is poised to perform better when numbers themselves do the talking, as opposed to anecdotal evidence and/or one-off newspaper articles referencing a particular crowdfunding campaign that was successful. Regulators will benefit knowing the extent and magnitude of the financial transactions taking place. Policyleaders and decision makers can also gauge the business financing climate and provide additional support if/when it is needed. Last, creators and investors will have a better sense of the community they are participating in, when they have numbers at their fingertips.

### Advantages of hopping aboard crowdfunding

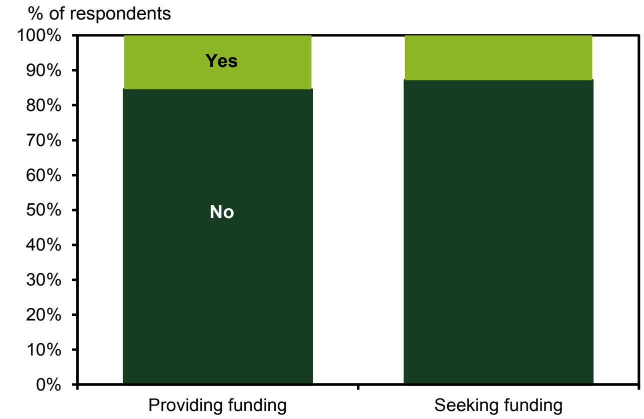
#### a) Crowds often spur diversity of thought

A gaggle of people often create diversity. Cross-pollination of thought is usually a by-product and in many cases, can create a competitive advantage for the business venture. The more people involved can lead to collaborative decision-making – compensating for individual blind spots. It can also lead to more great ideas, as opposed to just good ones. An accurate understanding of the market and underlying demand might also be enhanced through a unique vantage point (e.g., someone within the industry who is negatively impacted by a certain problem which the idea is meant to solve). With a large group of investors, risk can also be diversified. While everyone has a small piece of skin in the game, no one investor is signing up to risk everything to make the deal happen.

#### b) Crowds can provide other uses as well

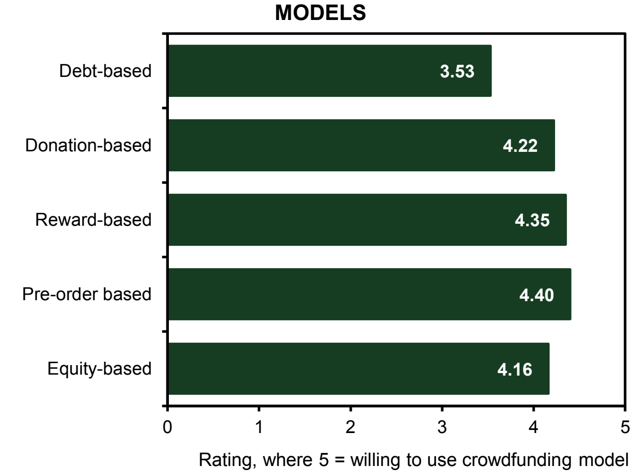
The crowd can be also a useful resource for the creator. For instance, the crowd can serve the same function as a board of directors or external company consultants. Some portals facilitate and encourage direct communication between the creator and investor. These dialogues permit the exchange of early feedback and market research. When contributing, the investor is signalling that he/she is interested in the venture doing well. This often means that the investor is willing to sign up and in some cases, extend his/her online, social and business network to achieve the desired success.

**HAVE YOU PARTICIPATED IN CROWDFUNDING IN THE PAST?**




Source: Ideavibes and Canadian Advanced Technology Alliance (CATA).

**WILLINGNESS TO USE CROWDFUNDING MODELS**




Source: Ideavibes and Canadian Advanced Technology Alliance (CATA).

#### c) Ties to innovation and breakthroughs

Many of the crowdfunding projects to date have included some form of creativity and R&D. Innovation is not something that can happen with a snap of the fingers. Studies have shown that innovation lags in a command and control environment. Instead, innovation often takes place in a gradual and iterative fashion. One good idea, leads to another, and so forth.

The instantaneous and multi-directional exchange between interested parties – brought together in an online forum – can foster breakthroughs. Many believe that crowdfunding serves the same purpose as 24-hour creative sessions which aim to conquer the 'impossible.' In these sessions, groups gather in a room for a set period of time to accomplish a particular task – the sequestration, incubation and time pressures often lead to some very unique solutions. As an example, Facebook co-founder Mark Zuckerberg came up with many ideas for the social media website using 24-hour Hackathons. It is important to stress that crowdfunding does not directly increase the chances of success. However, if a greater number of projects are funded because crowdfunding exists, more projects will succeed, all else equal.

#### d) Cheaper access to capital

Access to capital via crowdfunding can also be cheaper, as the business model attempts to streamline the activities of the market players. There are also economies of scale within the financial transactions themselves. The online nature of crowdfunding today allows entrepreneurs and business owners to reduce the communication, travel and administrative costs which often accompany traditional fundraising.

### e) Absence of geographical boundaries

A significant advantage of crowdfunding is the absence of geographical boundaries. In other words, funding via online crowdfunding is not geographically constrained. In a specific example, when Sellaband – a music website that allows fans to invest in music – offered royalty shares to investors, 86% of the monies raised came from investors who were more than 60 miles away from the entrepreneur.[20] In this fundraising campaign, the average distance between the entrepreneur and the investor was roughly 3,000 miles.[20]

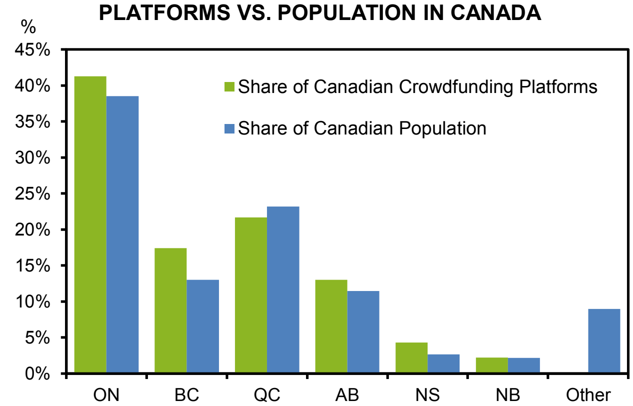
## Challenges currently surrounding the business model

As awareness of crowdfunding increases and the term 'crowdfunding' enters everyday vernacular, the challenges surrounding the viability and future of the business model will enter the spotlight. The speed at which the obstacles are conquered will undoubtedly impact the viability and size of the crowdfunding market going forward.

### a) Risk of fraud given limited crowd due diligence

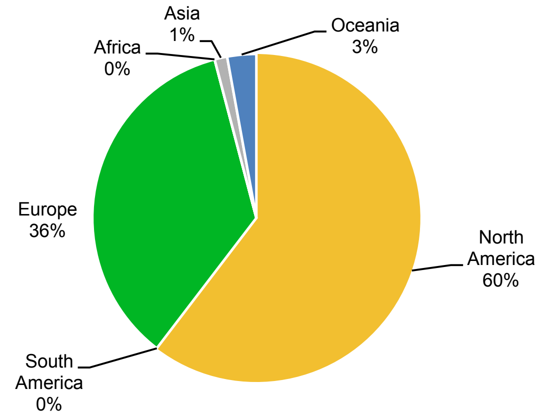
Fraud can manifest in many different ways. Misappropriation can be easy to pull off through false websites. Like with any online financial transaction, phishing schemes can be used to illegally gain access to personal and financial information, such as credit card and banking information. The funds raised can be used for purposes other than what was initially disclosed. The creator may also portray that s/he owns the idea, but this may or may not be true.

DISTRIBUTION OF CROWDFUNDING PLATFORMS VS. POPULATION IN CANADA




Source: Industry Canada Credit Conditions Survey, 2009 and 2010; Statistics Canada Survey on Financing of Small and Medium Enterprises, 2000, 2004 and 2007.

2012 WORLDWIDE DISTRIBUTION OF CROWDFUNDS RAISED IN U.S. DOLLARS




Source: Massolution®.

While each investor should be performing their own due diligence on the idea, creator and online platform, this is difficult to perform effectively for several reasons. Many of the people participating in crowdfunding are not subject matter experts, but instead, average people interested in the venture or idea. Second, formal business plans and audited statements are typically not available. Third, each investor has put up a little amount of money. In other words, there is skin in the game, but the average amount of skin per person is small. As a consequence, the investor may view the investment as a write-off or may not be fussed about maximizing their return. Fourth, risk is hard to accurately assess given information asymmetries, minimal public disclosure and few comparable benchmarks. Fifth, the multitude of people involved manifests itself into a free-rider problem, such that everybody else thinks the other will complete the due diligence and because of this mindset, no one actually does.

### b) "Crowding out" other forms of financing

Although crowdfunding is viewed as an emerging business financing model, it also has the ability to crowd out other forms of financing such as angel and venture capital investing and traditional financial institutions. If this outcome does occur, then the crowdfunding model is financing projects/businesses which would have been financed in a different manner.[18]

### c) Crowds do not always know best

Crowds are easily excited about novel things (think fads). However, interest is also a short-term phenomenon. In turn, the crowd may not be so wise after all, when it comes to what the market wants. For example, a more mundane product might be of greater benefit than an all-in-one gadget. More often than not, it's not just about the idea – it's about the idea and the team who commercialize the idea. Apple is a good example to bring this point home. In the early days, Steve Wozniak was the brains behind the Apple computer. It was only when Steve Jobs became involved, did a computer change from a cool idea to one where a lot of money could be made.

#### d) The transaction is often one-time

With the exception of equity crowdfunding, investors sign up to invest in a particular project once – it's not a lifetime commitment they are making, but instead, a speed-dating service. There are four steps to the consumer-buying process: (1) looking at a good; (2) agreeing to buy it; (3) using it; and (4) after being satisfied, you are willing to re-purchase the item. Business owners are lucky if the consumer stays with them throughout the entire process. In the case of crowdfunding, the process helps get the consumer get to step two. Steps three and four are just as big of a challenge – if not more – than is the case with traditional marketing.

Entrepreneurs and small and medium-sized enterprise owners will also have to balance the short-term influx of cash from the initial crowdfunding with the ongoing cash flow requirements to fund continuous operations.

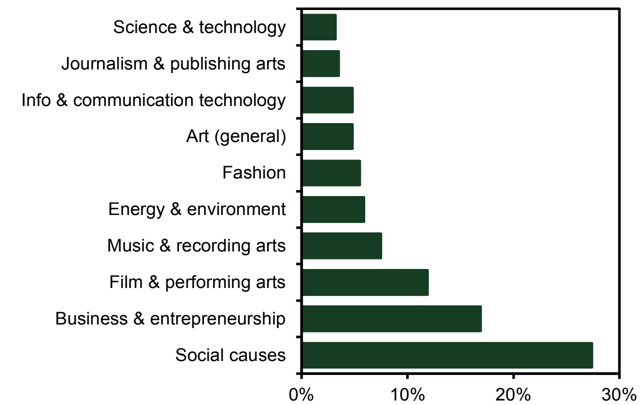
#### e) The intellectual property dilemma

Many crowdfunded projects – especially those which are rooted in a new idea or solution – involve intellectual property (IP). Examples include the plot to a story, a screenplay for a movie or a prototype for a new consumer good. The way IP is publicly shared has an impact on the legal status of ownership.[21] For example, if a patentable technology is shared such that someone can benefit from its use, a one-year countdown begins under the U.S. Patent Act. If during this period, a patent application is not filed, the owner loses the opportunity to file. If patent protection is sought outside of the U.S., many countries will demand absolute novelty. Some of the lustre may have worn off if the item was first showcased for all to see on a crowdfunding platform.

#### f) Who owns the idea?

The online communities help create an efficient exchange of information. However, the recommendations made can also lead to a question mark about correct attribution. Author Nicholas Wells points out that "even where ownership is supposedly defined in the website terms, or where ownership

CROWDFUNDING PLATFORM ACTIVITY* ACROSS THE 10 MOST ACTIVE CATEGORIES




Note: *Based on number of projects.
Source: Massolution®.

is not legally possible, a project creator who uses publicly submitted ideas without due sensitivity for this issue faces the risk that a commenter will protest and create a public relations problem or even litigate ownership."[20]

#### g) Limited follow up mechanisms

Creator promises are often placed on the table to secure funds. However, the follow up mechanisms to evaluate whether promises are met are still in the early stages. Institutional investors – who often come to the table with bigger wallets – may have the necessary clout to follow up. However, it is safe to assume that the average person will not have the resources or the time to chase after the creator.

If the creator does not live up to his/her end of the bargain, s/he risks becoming ostracized in the online crowdfunding community. Additional crowdfunding deals may also be in jeopardy if the crowdfunding platform includes some sort of rating system, such as the one that eBay has. Yet, the large number of crowdfunding portals makes this check and balance system hard to enforce. In some cases, the only obligation that creators can be held against is a moral one, particularly in donation/reward crowdfunding cases.

#### h) Shaky business foundations

Wishful entrepreneurs may not have solid business and legal foundations. Given the upfront capital required, they might shy away from hiring experts or adding consultants to their inner circle. These behaviours have important implications. Failing to set up an entity correctly could heighten the liability of the business owner in the event that their idea or invention unintentionally causes harm. Not adhering to the necessary standards may also have tax implications. A creator may claim to be a non-profit organization, but this status needs to be certified by the appropriate government agency, such as the Canada Revenue Agency (CRA) or the Internal Revenue Service (IRS).

#### i) Tax treatment in a global e-commerce environment

Tax treatment for the creator is not black-and-white. If rewards are offered in exchange for investor contribution, should they be subject to tax? What about if coming up with a dollar figure attached to the good or service is more of a guessing game rather than an exact science? Should these rewards be a taxable benefit? International tax laws are required given that fundraising is occurring across borders, but tax compliance ultimately falls to a particular government or jurisdiction. While there is no right or wrong answer to many of these questions, decisions are required. Yet, there will have to be a fine line between taxing crowdfunding and encouraging the innovative behaviour that it helps create.

### Equity crowdfunding – a framework of best practices

Equity crowdfunding has the potential to fundamentally transform the way startups are financed. It also can encourage entrepreneurship in Canada, which is generally a positive for productivity growth. Even with so much promise, a lot of questions remain about the path ahead for this particular type of crowdfunding.

To overcome some of the barriers, European researchers have proposed a framework of best practices for equity crowdfunding.[22] The report was put together in response to a call for ideas from the European Commission in 2011. Furthermore, an expert group for the Directorate General for Enterprise and Industry was specifically tasked with exploring new sources of funding that use social media.

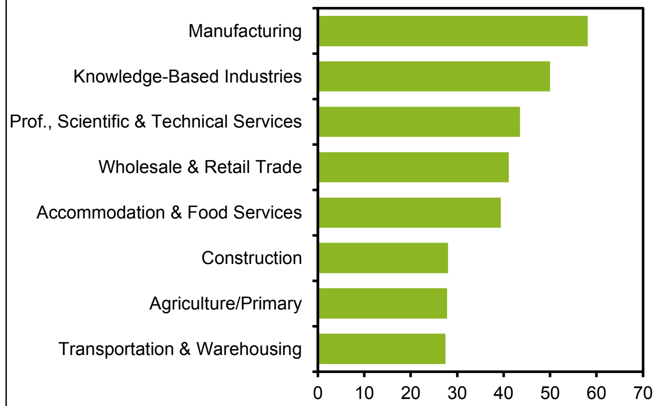
The framework of best practices consists of three pillars. While each pillar is separate in its own right, the architecture is mutually reinforcing and comprehensive:

- ***Regulation:*** legislation can help correct for market failures such as the presence of asymmetric information. It can also be written with a consumer protection focus to minimize the chance of fraud-funding and to protect the consumer from losing their savings. Last, regulation can stipulate governance, oversight and address data security.

- ***Education:*** while crowdfunding is becoming more well-known, many have not yet made up their minds as to whether they would be willing to participate. With this in mind, education continues to be an important priority for stakeholders, investors, and creators over the near-term. While "Crowdfunding 101" is an important element of the education pillar, there is also incredible value-add in dissecting crowdfunding into more manageable buckets. Not only does this approach help with the communication efforts, but it also allows for a more efficient information exchange. The strategy also recognizes the diversity of crowdfunding participants and the model itself.

- ***Research:*** this might include regular and frequent academic, industry associations and third-party publications.

**% OF SMEs* INNOVATING WITHIN THE LAST THREE YEARS BY INDUSTRIAL SECTOR, 2011**




Note: *SMEs = small and medium-sized enterprises.
Source: Statistics Canada, Survey on Financing and Growth of Small and Medium Enterprises, 2011, and calculations by Industry Canada.

Our report satisfies two of the three pillars: education and research. Much more coverage is needed. Further efforts on the research and education front will be hampered by the lack of publicly-available data. At present, all data for the crowdfunding business model (e.g., number of platforms, geographical distribution of participants and number of successful campaigns) are proprietary. Opening up the data to the public is complementary to the objectives underpinning the education and research pillars.

Moving over to the third pillar, U.S. and Canadian regulators are asking themselves what is the appropriate degree of regulation required for the crowdfunding industry. Put simply, the question they are debating is whether crowdfunding-specific legislation will do more harm than good? A balancing act is required as over-regulation may deter people from participating in the first place.

The appropriate amount of regulation can help improve transparency, structure financial transactions and assess the required amount of security in the online transaction. It can also encourage compliance across geographical boundaries and the litany of players involved. This is a near impossible task for the fragmented market to take care of itself.

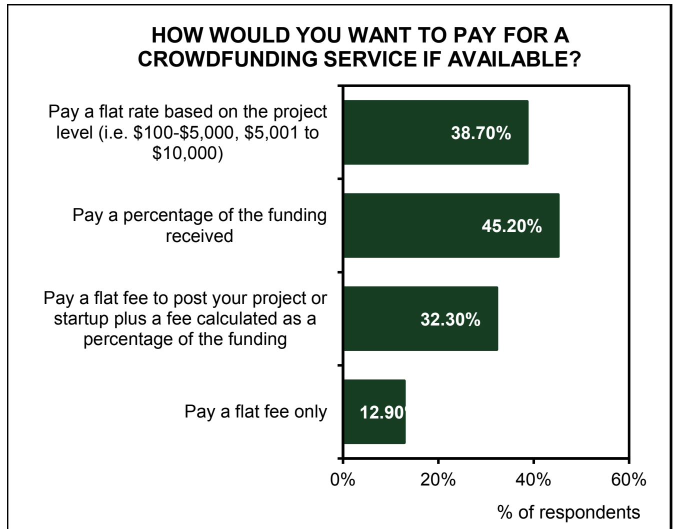
While the list of pros is long, the cons are equally important, crowdfunding is rooted in innovation. Many of the industries currently in the space are creative in nature. These same industries are often hampered when too many rules are enforced. A good analogy is forcing an artist to colour between the lines, when his/her own process is more free flowing and organic. Put another way, structure can help, particularly a new business venture or entrepreneur who is just getting off-the-ground, but rigidity can simultaneously and unintentionally serve as a hindrance.

For regulation to be a net positive, regulatory and compliance costs associated with crowdfunding must be lower than the administrative costs associated with traditional financing channels. There is also the concern of moral hazard – the lack of motivation to minimize risk when one is protected from the negative consequences. Insurance is a good example to drive the point home. If crowdfunding participants believe that regulators will replace the need for their own due diligence, participants may not be inclined to exert the effort. This would heighten the concerns of the crowd in 'crowdfunding' being more vulnerable than the traditional investor or entrepreneur.

Regulating online equity transactions is a natural place to start, given that much of the foundation already exists for publicly-traded companies which live and breathe in public marketplaces. Equity crowdfunding is currently not legally approved in Canada, but is permitted in other countries including Australia, the United Kingdom, Netherlands, France, Belgium, Germany and the United States.

The U.S. is a recent addition to the list. Prior to 2013, the Securities Act of 1933 stipulated that securities offerings must be registered with the Securities Exchange Commission (SEC). Section 2(a) (1) of the Securities Act of 1933 includes the term "investment contract" as part of the definition of a security. The U.S. Supreme Court defines an investment contract as "an investment of money in a common enterprise with an expectation of profits arising solely from the efforts of the promoter or a third party."[23] This definition prohibited the sale of crowdfunding venture without pre-registering with the SEC. Failure to do so would have meant a violation under the Act.

The Jumpstart Our Business Startups Act (JOBS Act) was signed into law by U.S. President Obama on April 5, 2012. The purpose of the JOBS Act is to boost employment creation. It is hoped that this will be achieved through improved access to capital for public and non-public companies alike. The average Initial Public Offering (IPO) in the U.S. carries a tab of several million dollars. Front end costs which accompany a SEC registration include a registration fee, underwriting compensation, and broker-dealer expenses.[24] For example, an IPO can cost a small business owner more than US$100,000 in fees, but this is a conservative estimate as there is no imputed dollar amount attached to the business owner's time.[25] In turn, SEC registration was often perceived to be an insurmountable barrier, save for the rich or those with plenty of time on their hands.



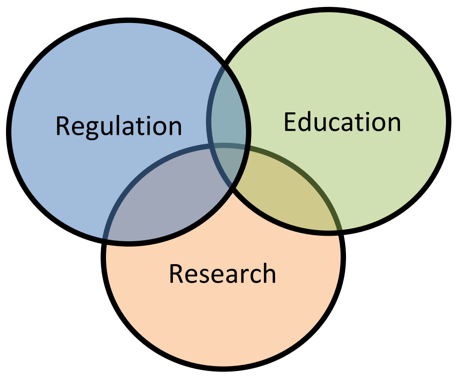
Source: Ideavibes and Canadian Advanced Technology Alliance (CATA).

The JOBS Act now exempts crowdfunding participants from the registration requirements of the Securities Act of 1933. Under this legislation, companies will be able to offer up to US$1 million in securities to the general public. However, creators must be forthcoming with material information. The quantity of information is ultimately dependent on the target amount in a fundraising campaign.

In October 2013, the SEC authorized Title II of the JOBS Act. In doing so, the U.S. regulator lifted an 80-year ban on general solicitation – a provision implemented shortly after the Great Depression in part to curb securities fraud. The green light now gives American businesses permission to publicly advertise their capital needs.

The equity crowdfunding investor must also be accredited, as defined by the SEC. To fulfil this requirement, the investor must make US$200,000 in annual income or US$300,000 if his/her spouse wants to also be considered accredited. Annual crowdfunding contribution limits have also been set up. An accredited investor can contribute no more than US$2,000 or 5% of income (whichever is greater) for people earning (or worth) up to US$100,000. Other caveats and stipulations are still pending in Title III of the Act, such as the crowdfunding participation of unaccredited investors.

PILLARS OF A PROPOSED CROWDFUNDING FRAMEWORK




Source: de Buysere, Kristof et al. (2012)

**Canadian equity crowdfunding regulatory context**

Canadian securities regulators – which are under provincial jurisdiction – have also begun to consider whether equity crowdfunding regulation is appropriate on this side of the border (other forms of crowdfunding such as donation/reward are currently permitted). To our knowledge, Ontario has been the most active to-date. In a 2012 Consultation Paper, the Ontario Securities Commission stated that it was exploring capital-raising prospectus exemptions for crowdfunding platforms.[26] The publication stated that proposals were being put forward for discussion and did not necessarily mean that an exemption would be forthcoming.

In August 2013, the Ontario Securities Commission released a follow up Progress report.[27] No decision on a crowdfunding registration exception has been made. However, the paper states: "we recognize that for crowdfunding to be a viable method of raising capital, the regulatory framework must provide investors with adequate protections, while at the same time not impose excessive regulatory costs on issuers and funding portals."[27]

**Conclusions: The path ahead for crowdfunding**

Online crowdfunding could potentially be on the precipice of something great. Many believe it has the potential to improve the financing environment for entrepreneurs and business owners of micro-enterprises and startups. Some proponents go even a step further, saying that crowdfunding will fundamentally change how business will be conducted.

An awareness of what crowdfunding is and comfort behind the transaction will be key for the market to realize its potential. While the term crowdfunding is becoming more common knowledge (87% of entrepreneurs in one Canadian study said that they were aware of the funding model), the market remains in its infancy stage.[28] In the same survey, only 15% of respondents said that they had previously supported a project and an even smaller 13% said that they had sought funding.

There are three key players in the crowdfunding market: creators, investors and the online platform. The crowdfunding model also comes in a variety of flavours with donation/reward, pre-selling, equity-based, and lending-based the most popular. The market is most developed in North America and Europe. It is estimated to be US$3-5 billion and given burgeoning demand, has been growing rapidly, particularly given the collaborative nature of Web 2.0.

Of all crowdfunding models, it is the equity variety that has garnered the most amount of attention, particularly piquing the interest of regulators. This is not surprising given the litany of risks and challenges involved, the ongoing relationship between the investor, and the large sums of money involved.

While concerns are still being addressed, the SEC just recently lifted an 80-year ban on general solicitation, allowing businesses to publicly advertise their need for funding. A made-in-Canada regulatory framework will be required, as opposed to simply copy and pasting U.S. legislation into Canadian rulebooks. There is a different landscape, investor-base and risk tolerance in Canada. In a December 2012 Consultation Paper, the Ontario Securities Commission solicited comments from the public, legal experts and key industry players on what an Ontario equity crowdfunding framework might look like. No final decision on a framework has been issued.

Due diligence and 'getting it right' is likely the prudent course of action - there is an advantage to letting others go first and refine best practices. However, Canadian regulators cannot drag their feet too long. If they do, there is the potential for entrepreneurs and enterprise owners to shift to jurisdictions that embrace crowdfunding. This leads to the potential loss of economic opportunities here in Canada. It also reduces the scope for startups and entrepreneurs. Moreover, crowdfunding would be particularly useful in Canada to bridge the gap between startups and small and medium-sized businesses, in light of the underdeveloped venture capital market.

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