

Via email

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**INTRODUCTION OF PROPOSED PROSPECTUS EXEMPTIONS AND
PROPOSED REPORTS OF EXEMPT DISTRIBUTION IN ONTARIO
Supplement to the OSC Bulletin**

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http://www.osc.gov.on.ca/documents/en/Securities-Category4/csa_20140320_45-106_rfc-prospectus-exemptions.pdf

Comments on proposed Equity Crowdfunding Exemption

The Small Investor Protection Association (SIPA) was founded in 1998 and is registered in Ontario as a national non-profit organization. Our mission is the protection of small investors. We are pleased to provide Comments on the OSC Consultation .SIPA feels the Equity Crowdfunding exemption issue is especially critical for the small investor. We appreciate that the OSC has attempted to insert a number of important investor protection provisions including use of OBSI as a dispute resolution service. That being said, our analysis has determined that Equity crowdfunding has the qualities of a casino not a vehicle for small investors to make money.

Overview

Anyone who has watched the TV program 'Dragons Den' can quickly see how many zany potential investment there are. Most small investors however do not have the skillset, experience or time to effect proper due diligence. Equity Crowdfunding is a mania in the Western world, a freight train no one seems to want to get in front of. If this exemption is granted, these "investments " will not only cause huge losses for Ontarions but will also divert much needed money away from more deserving companies. There is also no assurance that any jobs created will even be based in Ontario.

It is those investments that are unable to find funding from traditional sources that will come looking to small investors and retirees for support. Of course, there are many other problems not to mention the distinct possibility of fraud .It seems to us to be incongruent that, even as the Ontario government is exploring ways of assisting people with their retirement, that the crowdfunding initiative with its attendant ultrahigh risks should be a priority of the Commission. An Online Fraud Awareness Campaign by the FCAA confirms investors' vulnerability to internet fraud [Source: - Financial and Consumer Affairs Authority - Government of Saskatchewan

<http://www.sfsc.gov.sk.ca/Default.aspx?DN=4dbd3b54-b532-4a90-9658-a8c97bc03b80>]

The OSC has historically done an excellent job in warning investors about the fraud potentialities of the internet yet this consultation paper proposes to open them up to an even greater amount of potential fraud.

Startups are loaded with risk .For example, if a company is new, its management may be inexperienced. Small businesses may also depend heavily upon a single employee, supplier or customer whose departure would seriously damage the company's chances of success. Due to limited regulatory oversight over these types of offerings, investors may be left on their own to pursue costly private lawsuits when things go wrong. Because of these and many other risks, we strongly believe startup investing is not the place to find small investors.

To prevent deceptive or misleading advertising in these offerings, the Commission should require advertising to comply with certain standards. If the Commission does not adopt any standards, unsophisticated or unscrupulous issuers will attempt to take advantage of investors with misleading and deceptive marketing material.

There couldn't be a worse time to expose Ontarions to more risk and speculation. Many people are still reeling from the 2008 global financial crisis, a crisis that has its root in a maniacal breakdown of regulatory oversight and abandonment of common sense. Canadians are now operating at the highest level of debt to income and there is a looming pension crisis. SIPA therefore argue against the adoption of this exemption to common sense rules that are designed to protect small, unsophisticated investors. See APPENDIX I for a list of other manias and the devastating effects they have had on small investors.

SIPA believes small investors will be harmed by this Exemption

SIPA have no problem with affluent sophisticated investors dropping money on schemes with weak if any business plans But Accredited investors are up to the task of taking on risky ventures. Our concern is that pitches may come to those who are easily bedazzled by tales of another Facebook and Google -to people who don't realize just how long the odds are against such winners and who cannot absorb the losses.

The accredited investor qualifications are being relaxed now to allow lots more Ontarions, with much smaller incomes and loss capacity, to Equity crowdfund. True, as a society we allow people to buy \$2.00 Lottery tickets if they want, despite ridiculous odds. But

permitting anyone to raise up to \$10,000 (after tax money) annually from the public for untried ideas and untested managements is to abandon prudence and could in effect be considered Socially Irresponsible Regulation (SIR). [NOTE: to calibrate the \$10,000 figure, note that Canadians contribute an average of just \$3,500 annually to their RRSPs; according to Statistics Canada the total unused RRSP contribution amount is estimated to exceed a whopping \$1-trillion by 2018; in Ontario, the average earnings in 2013 amounted to roughly \$48,900 pre-tax a year; people in the retail trade made \$27,660 annually].

An OSC- sponsored study showed that most investors understood the high level of risk associated with crowdfunding and would generally invest amounts of less than \$5,000 per annum, would want unbiased disclosure and would seek professional advice before investing. In addition, the responses also raised a concern that about 1 in 8 retail investors may not fully understand the risks associated with crowdfunding. Source: <http://www.osler.com/NewsResources/Equity-Crowdfunding-OSC-Releases-Progress-Report-on-Its-Exempt-Market-Review/> It is one thing to understand the risks of an investment, it is another to assess the consequences.

Good ideas combined with experienced teams are fundable But they should never be funded with naive small investors who are playing the entrepreneurial lottery game and who can quickly lose their entire investment and end up with a sobering life-altering event. But we are realists -we conclude that some form of crowdfunding is going to occur despite our protestations. In any event, we find the proposed limits much higher than any Government should allow its citizens to be exposed to.

Many concerns with Equity Crowdfunding

It is not difficult to predict the outcome when small investors move into lightly regulated, complex investing deals. For SIPA, there is a seeming inevitability about how this exemption will evolve. Over the next few years there will be a series of highly publicized scandals. Some will be the result of blatant fraud, others will represent the triumph of uninformed exuberance over experience. Seniors will be evicted from nursing homes. The OSC who is today being denounced for their caution will then be castigated for their willful neglect, and the Ontario government will come under pressure to compensate the losers, either directly or through the various compensation schemes or welfare. Perhaps a Royal commission will be established. "New" securities regulations will be introduced that will impose controls similar to those imposed on the rest of the financial services industry and we're back to where we started. The only losers will be small investors and the people of Ontario.

Our major concerns are as follows:

Fraud

Equity crowdfunding is rooted in the internet .The OSC has prepared some excellent material warning of internet fraud e.g. *Investment fraud on the Internet*
http://www.osc.gov.on.ca/documents/en/Investors/res_fraud-internet_en.pdf

According to the CSA 2012 Investor Index
http://www.investright.org//uploadedFiles/resources/studies_about_investors/2012%20CSA%20Investor%20Index_%20FINAL_EN.pdf just over one-quarter of Canadians (27%) believe they have been approached with a possible fraudulent investment at some point in their life. Over half of Canadians (56%) agree they are just as likely to be a victim of investment fraud as anyone else. Fraud is a serious issue in Canada and internet fraud tops the list.

In late March, six GTA residents were facing charges in a massive investment scam the RCMP claims cost thousands of investors and Canadian taxpayers millions of dollars. The extensive investigation alleges that there was a group of people operating a very complex fraud investment scheme that had impacted thousands of Canadians and defrauded the federal government of over \$200 million. The RCMP allege the group sold “business losses” from various companies to unsuspecting investors, who could then claim the loss and receive a tax refund exceeding their investment. However, the problem was these were not legitimate business losses, Some of the losses were actually fictitious and generated through the manipulation of financial statements while other losses were generated by companies controlled by the accused .The group allegedly marketed itself online and also operated under companies with names such as Synergy Group 2000, IBCA 2009, and Cason Global Wealth Association, among others. The RCMP estimate people lost anywhere between \$1,000 to \$300,000 on their investment.

The Ontario Securities Commission 2013 Enforcement report shows that fraud remains the biggest source of cases against individuals - illegal distributions were the top allegations for companies. It is in this environment that crowdfunding will operate. By any measure, it seems to us that this exemption knowingly places retail investors in a perilous situation which is not the intention of the Ontario Securities Act.
<http://www.investmentexecutive.com/-/osc-launches-fewer-enforcement-cases-in-2013>

In 2013, the NASAA listed *Unregulated Third Party Service Providers* among its Top Investor Threats. Among its cautions was this one: “.Use of crowdfunding portals, while subject to some regulation, also opens the door to scams. Startup businesses, especially small local businesses, should be very careful to verify the legitimacy of a portal before engaging their services. Investors are not alone in their potential to be scammed. Using a fraudulent portal means both the business and the investor stand to lose.)

Anyone reading the PWC 2014 Economic Crimes Report

<http://www.pwc.com/gx/en/economic-crime-survey/financial-services.jhtml> will certainly be asking a lot more questions about Equity crowdfunding than are apparent in the current Consultation.

We therefore feel that Ontarions face enough fraud threats without adding to the list by allowing an exemption for Crowdfunding.

Money laundering threat

We are very concerned that Equity crowdfunding could be used by organized crime. On Nov. 5, 2012, the founder of the crowdfunding platform Gittip [announced](#) that the service had been hijacked as a vehicle for money laundering by a mysterious, anonymous user who had registered on his site about five weeks earlier.

<http://motherboard.vice.com/blog/thieves-launder-money-by-crowdfunding-themselves--2>

Crowdfunding is particularly susceptible to money laundering and other financial crimes. There are many reasons why that is the case, including that they facilitate the offering of microcap or low-priced securities which by their nature are more susceptible to fraud and market manipulation. In the securities context, financial crimes occur most frequency (by volume not dollar value) with private placements and low-priced securities. Private placements pose a money laundering risk because they are often used to generate illicit assets through market manipulation, insider trading and fraud. In addition, unlawfully acquired assets can be used to purchase securities with proceeds of crime in order to resell them and create the appearance of legitimately sourced funds. The combined effect of crowd-funded securities being low-priced, placed in offerings that are exempt from registration and not subject to the filing review process of a registered offering, makes crowdfunding open to being used as a vehicle for money laundering and other financial crimes. <http://www.lexology.com/library/detail.aspx?q=1749dfe8-8946-466c-9fe2-a920e7f83118>

The U.S. SEC is proposing that crowdfunds satisfy the Anti-Money laundering [AML] Program Requirement by implementing and maintaining a written AML Program that includes, at a minimum: (1) policies, procedures and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act [BSA]; (2) policies and procedures that can be reasonably expected to detect and cause the reporting of required transactions; (3) the designation of an AML compliance officer; (4) ongoing AML employee training; and (5) an independent test of the crowdfund's AML Program. (Source: <http://www.duhaimelaw.com/2013/11/08/sec-equity-crowdfunding-rules-first-to-include-anti-money-laundering-and-financial-crime-protections/>) We expect the OSC will apply equivalent constraints on portals.

Equity crowdfunding should not permit the financing of terrorism

The article *The Terror Finance Blog: Guantanamo detainees endorse crowdfunding*

lists some scary applications of some crowdfunding "investments". Worrisome projects include a Kickstarter [project](#) in 2012 that billed itself as "your chance to become part of the Arab Spring." If the two men who proposed the project had received the \$20,000 they sought, they pledged to "travel together to Syria and join the rebels on the front line against the dictator Bashar al-Assad." Late last year, *Forbes* [reported](#) that an anarchist launched a crowdfunded bitcoin-based "assassination market." Also last year, a would-be Canadian bounty hunter attempted to crowdfund the creation of [a private militia squad](#) to hunt down Ugandan guerrilla Joseph Kony. A convicted drug trafficker [raised 20,000 AUD](#) through a crowdfunding website from his jail cell last year. In 2012, the micro-crowdfunding site Gittip was exploited by an enterprising user [to launder money](#) stolen from credit cards. There have also been ongoing attempts [to crowdfund the legal defense](#) of blackmarket SilkRoad operator Ross Ulbricht. Source: http://www.terrorfinance.org/the_terror_finance_blog/2014/03/guantanamo-detainees-endorse-crowdfunding.html. Hopefully, the final OSC rules will have provisions that would deal with such "investments".

Concerns about Portals

The OSC has taken a crack at defining the rules for portals. As we understand it, the proposed Ontario crowdfunding rules anticipate that funding portals will need to be registered as an existing dealer or adviser category or in a restricted dealer or adviser category. Portals have obligations to identify issuer-specific risks and any conflicts of interest with deals posted to their site - similar to a registered Dealer-broker. The exemption proposal also requires that portals (our comments/concerns are in brackets):

- Act as gatekeeper to reduce the risk of fraud by conducting appropriate background and regulatory checks on directors, officers and significant shareholders of issuers; (presume cost of this comes off the proceeds of the raise and results of background checks will be posted)
- Provide all information made available by issuers to potential investor to the OSC no later than 21 business days prior to the first day on which securities are sold to any investor;
- Ensure all funds received in connection with the offering are held in escrow and only released to issuer if the minimum target amount of the offering or greater has been reached and investors have not exercised their 48 hour right of withdrawal to cancel their commitment;(we are looking for a 5 day cooling off period)
- Ensure that no investor in a 12- month period has purchased securities offered under this exemption that, in the aggregate, from all issuers, exceeds \$10,000, or in any one issuer exceeds \$2,500;(how could a portal know this information about an investor that uses another portal?)
- Take steps to protect privacy of information ;(comply with provincial privacy laws?)
- Not compensate promoters, finders, or lead generators for providing personal identifying information of personal investors; (can they receive compensation if they recommend a borrower / investor to a lending agent?) and
- Meet any other requirements the Ontario Securities Commission may prescribe (would this include web portal security standards and a Code of Conduct?).

The OSC appears to place a lot of confidence in portals to protect investors. Is it justified? Maybe, maybe not. Why not delay Ontario implementation and await the results from more daring jurisdictions as the OSC has done with embedded trailer commission and Best interests?

We agree that a funding portal cannot:

- Offer investment advice or recommendations;
- Solicit purchases, sales or offers to buy securities offered or displayed on its website or portal;
- Compensate employees and others for such solicitation or based on the sale of securities; or
- Be related to businesses making offerings through them.

Portals should also not be allowed to receive referral fees from lenders. The exact OSC rules for funding portals are still to be determined.

Self-Certification not robust

The OSC requires investors to provide a self- certification as part of its investor protection toolkit. In view of the fact there is no suitability regime, that is about the best that can be done to at least create some acknowledgment of risk. Our experience with small investors suggests that the self -certifications may not be very robust. Research has shown that retail investor overestimate their investment knowledge and risk tolerance. Their financial literacy is in fact alarmingly low as was demonstrated by the Task Force on Financial literacy and a host of other independent research. A research paper *Financial Knowledge and Rationality of Canadian Investors* by Cecile Carpentier and Jean-Marc Suret http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2038930 noted significant gaps regarding knowledge of risk and return of asset categories. Many investors do not know that if they invest in the stocks of small companies listed on the TSX Venture Exchange, they might lose all their capital. According to the researchers, the risks associated with shareholding are largely underestimated .Based on our experience Loss Capacity assessment are also beyond the scope of most retail investors. In the case of mutual fund investors, OSC testing has concluded that disclosure documents must be written at the Grade 6 literacy level in order to be understood. Obviously, legal Offering documents don't very often meet this low standard.

As far as record keeping goes, we are not confident that all investors would comply with the \$10,000 annual cap simply because they may not carefully track their contributions. This could cause a number of Ontarions life-altering harm. And seniors may well be at risk if they sign these certifications while suffering from any number of afflictions that plague the elderly so some controls are needed.

Nature of Equity Crowdfunding biased against the small investor

It is a general rule that risk and potential return have a relationship. If one expects a high return, generally one would expect to have to take some disproportionate risk. The trick retail crowdfunding investors will always be missing with the prevailing equity crowdfunding platforms is that investors cannot negotiate the companies' valuation and that makes a huge difference on potential financial returns. In the case of equity crowd funding we have a truly unusual situation. We see uninformed retail investors having an "opportunity" to invest in companies that will provide the minimum of information and be under a minimum of regulatory oversight using that well-known safe medium, the Internet. The chances of making money on a startup are very small to start with and that is why venture capitalists

with specialized skills and experience are needed to vet the significant few from the trivial many. Small investors will likely be unfamiliar with key startup investing principles e.g. implied valuation, liquidation preferences, minority protections, information rights, tagalong provisions, first refusal rights, anti-liquidation, reverse vesting, to name just a few. This will set them up for failure at the outset.

But even if a retail investor had the talent, resources and time to investigate the start ups they would be faced with an alarming number of threats. These include but are not limited to the chances that even a good business could fail, the likelihood that successive rounds of financing will dilute the holding to almost NIL for the original small investor The investor may be taken in by fraudsters. Of course there will also be issues of corporate governance, insider-trading and outright unethical misbehavior that will ensure that the small retail investor will not reap any benefits proportionate to the risk they have taken. It is for this reason , in our view, that it is not socially responsible for a securities regulator to allow such a vehicle to be exposed to Ontario small investors.

Given the remote odds of individual investor success it is apparent that hundreds of millions of dollars are in a crap shoot. We therefore recommend that if Crowdfunding is to be, that caps be reduced.

Will the OSC be resourced to regulate crowdfunding?

In June 2013 the OSC released the results of a sweep of Exempt Market Dealers and PM's. http://www.osc.gov.on.ca/documents/en/Securities-Category3/sn_20130531_33-740_rpt-results-kyc-kyp.pdf

Staff found that the sweep revealed substantive compliance breaches by PMs and EMDs and noted that certain registrants' practices were unacceptable. If these types of breakdowns are occurring with EMD's after decades of operations, what can we expect from even less regulated portals? Crowdfunding portals, like EMD's, have no SRO to provide oversight and enforcement. We remain constructively critical that portals will fulfill their obligations robustly without oversight and that the OSC, will apply the necessary incremental resources to diligently monitor portals for compliance

RECOMMENDATIONS

1. **Portals should be required to state on their website that they are registered dealers** This should be prominently displayed on the HOME page.
2. **OSC educational crowdfunding brochures should be available for small investors to read before investing.** The For Dummies folks have produced a good educational video *What is Crowdfund Investing?* <http://ca.dummies.com/how-to/content/what-is-crowdfund-investing.html> that might be of interest to the OSC as it rolls out Equity Crowdfunding materials. As for general information, the Saskatchewan Financial and

Consumer Affairs Authority provides some basic information on crowdfunding <http://www.fcaa.gov.sk.ca/SKEC> which could serve as a base model for Ontario. We view a Guide as such an important component of an Equity crowdfunding investor protection regime that we recommend it should be delivered with the Offering documentation.

3. **Organize a Roundtable.** The comment letter *NCFA-Canada-Response-to-OSC-Staff-Consultation-Paper-45-710-March-7-2013* <http://www.ncfacanada.org/wp-content/uploads/2013/03/NCFA-Canada-Response-to-OSC-Staff-Consultation-Paper-45-710-March-7-2013.pdf> from the National Crowdfunding Association identifies a number of key issues not articulated or resolved in the OSC Consultation request for comments . These issues plus a number raised by investor advocates merit broad discussion and dialogue before approval of this Exemption. We urge the OSC to organize a Roundtable involving all Stakeholders before proceeding further with an Exemption for Equity Crowdfunding, an exemption that could have far reaching implications for small investors/retirees.
4. **Address money laundering threat** .Ontario has not addressed measures in respect of:
 - Fraud, AML and other financial crimes as a matter of market or investor protection;
 - Conflicts of interest involving the platforms and the disclosure and resolution thereof;
 - Platform failures and poor administration issues; or
 - Disclosure of salient risks such as lack of secondary market for shares, potential for equity dilution and no dividends, and likelihood of business start-up failures.

The lack of concern over money laundering and other financial crimes is particularly surprising since Canada has the dubious distinction of being the only known jurisdiction where crowdfunding (non-equity) was used to raise funds to benefit organized crime. In May, 2013, a crowdfunding website successfully raised \$200,000 to pay organized crime in Toronto to acquire a video of the Mayor of Toronto allegedly taking crack cocaine. That fundraising exercise received worldwide attention, partly because it raised numerous ethical, criminal, investor protection, regulatory and money laundering issues for crowdfunding. The legacy of the so-called "crackstarter" crowdfunding campaign is that in Canada it became acceptable to raise capital for the purposes of funding the activities of a criminal gang, prompting American media to suggest that in Canada, it was crowdfunding that was on crack. Taking a position, or implementing requirements, to curb the potential for money laundering, terrorist financing, economic sanctions violations and other financial crimes would go a long way to changing the unfortunate "crackstarter" legacy and help instill confidence in the emerging equity crowdfunding regime in Canada.<http://www.lexology.com/library/detail.aspx?g=1749dfe8-8946-466c-9fe2-a920e7f83118>

5. **Restrict Payment Methods** The permitted method of payment should be Debit, cheque, digitally imaged cheque and Paypal- credit cards should not be permitted.
6. **Provide prominent warning** The WARNING header should be in a bold colour at least two font sizes greater than the core text

7. **Reduce investor caps** The B.C. approach to Equity crowdfunding caps is interesting. The BCSC also says it would limit issuers to raise no more than \$150,000 per offering and limit them to no more than two offers or up to \$300,000 per year — only a fifth as much as Ontario would allow. In addition, the B.C. commission would limit investors to \$1,500 per offering. If it is inevitable that the crowdfunding tsunami cannot be stopped, the BCSC approach should slow it down until the phenomenon can be better understood and evaluated. Accordingly, we support the BCSC caps. [The U.S. Jobs Act allows companies to raise up to \$1 million from small investors, with investors making less than \$100,000 able to invest either \$2,000 or 5 percent of their income, whichever is greater, and investors making more than \$100,000 able to invest 10 percent of their income. Offerings will be made to investors via online funding portals and broker dealers.]
8. **Establish tracking system** There is a pressing need to ensure that investors do not exceed statutory investment limits by implementing standardized reporting and communication across platforms.
9. **Tighten up self-certification** SIPA believe the Self- certification needs some additional strengthening. SIPA believe a passive approach will be inadequate to raise sufficient consciousness of the risk being taken. We suggest the following plain language questions, whereby the investor would have to pro-actively answer YES/NO:
 - Do you understand that start- up companies are very high-risk investments and that the total investment may be lost?
 - Can you afford to lose your entire investment?
 - Have you read and understood the Terms and conditions of the investment?
 - Have you read and understood the Ontario Securities Commissions' *Guide to Equity Crowdfunding* brochure?
 - Do you understand that you may not invest more than \$10,000 in start-up companies in any calendar year, including this investment?
 - Do you understand the charges associated with the investment?
 - Do you understand that no securities regulator has reviewed this offering for truth, accuracy or any aspect of the offering?
 - Do you understand that this is a long-term investment, a return may be a long time off and may be less than the amount you put in or none at all?
 - Do you understand that you will receive limited information about the issuer's performance and its ongoing progress?
 - Do you understand that this investment is not covered by any restitution or insurance fund?
 - Do you understand that investment may be difficult to sell and may reduce your ability to take benefits for your pension?
 - Do you understand that this investment is not eligible for inclusion in an RRSP, RRIF or RESP?

- Do you understand that if you die the investment may be difficult to sell and your beneficiaries may suffer financially?

You should reconsider signing up for this investment unless you have answered YES to all the Questions

10. **Introduce a Sunset provision.** In any event, we would like we would recommend a two year Sunset clause added that would review the experience with this Exemption with a view to determining whether the Exemption should cease, continue as is, or continue with modifications.

Summary and Conclusion

We understand that there is incredible pressure on the Commission to permit crowdfunding just as there was pressure to permit LSIF's and non-bank ABCP- notwithstanding in these cases the investor protection lapses. As SIPA see it, the Commission is between a rock and a hard place. If the OSC don't permit crowdfunding, their political masters will call them to task. If their investor protection concerns are too complex, they will be blamed for the failure of crowdfunding; if they are too lenient, they will be blamed for the harm to investors.

It's not a happy place to be. APPENDIX II shows that other jurisdictions are also struggling to put a square peg into a round hole. To its credit, the OSC has put in some reasonable measures that could help reduce the damage to Main Street but viewed holistically , Ontarions will still lose millions of dollars using the Crowdfunding approach to investing .It turns out that protecting small, neophyte investors from making highly risky investments is like trying to protect tourists to IRAQ. The best protection is to deny entry.

As we have laid out, equity crowdfunding moves investor protection into another dimension. Crowdfunding information is highly asymmetric with respect to what VCs and (to a lesser extent) angels obtain in diligence. Investors are susceptible to fraud or just plain incompetence. Since they're further removed, investors find it difficult to obtain the necessary data to make smart decisions. Most retail investors won't understand many of the risks associated with crowdfunding. Crazy ideas will get funded. More ideas get funded today than can possibly return capital, but with equity crowdfunding the percentage of successes markedly decreases. A lion's share of crowdfunded investments will never make money and retail investors at the bottom of the food chain will be out-of-luck. While small, fragmented investments limit the catastrophic risk to any single investor, too many failures will give the Commission a bad rap and reduce further investor confidence in capital markets.

Our recommendation is that the Exemption not be approved. In the event it is approved, we have provided a number of Recommendations that we believe will minimize the damage to people's nest eggs.

This Commentary was prepared by the SIPA Advisory Committee. Ken Kivenko, Chairperson of the Committee is a well known commentator on investor protection. Mr. Kivenko is also currently a member of the OSC Investor Advisory Panel and provides valuable input on investor issues. SIPA relies upon its Advisory Committee for their knowledge and experience.

Permission is granted for public posting.

If any questions do not hesitate to contact Mr. Kivenko or myself.

Yours truly,

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REFERENCES

1. **IP for tech start ups a real concern** A TD Research Bulletin *Crowdfunding: A Kickstarter for Startups* raises some pros and cons. <http://www.td.com/document/PDF/economics/special/Crowdfunding.pdf> A big issue raised concerns intellectual property. A very relevant con is the IP ownership issue." **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. 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 luster may have worn off if the item was first showcased for all to see on a crowdfunding platform..".
- The UK Financial Conduct Authority is trying to put some brakes on the crowdfunding steamroller. Such hesitation attracts the wrath of the enthusiasts. Barry James of the UK Crowdfunding Centre wondered aloud "whether our FCA is the worst regulator in the western world. The words that spring first to mind are inflexible, stubborn and unimaginative." **See PS14/4 - The FCA's regulatory approach to crowdfunding over the internet**, and the promotion of non-readily realisable securities by other media - Feedback to CP13/13 and final rules - Financial Conduct

Authority <http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-04> These rules came into effect April 1, 2014.

- After reading IOSCO Issues **Report on Risks and Benefits of Financial Return Crowd-Funding** | CFS Blog <http://centerforfinancialstability.org/wp/?p=3833> our concerns were further amplified. The report concluded that while Equity crowd-funding market does not present a systemic risk to the global financial sector at present, the challenges ahead will include (i) cross-jurisdictional contractual and legal harmonization, and (ii) dispute settlement and resolution issues.
- Model Crowdfunding Exemption (NASAA) <https://s3.amazonaws.com/wac6web/docs/NASAAmodel.html>
- **NASAA comment letter to SEC re Crowdfunding** <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-40.pdf> Interesting part about a membership in an SRO.
- **Crowdfunding or Fraudfunding?** Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must be Conditioned on Meaningful Disclosure by Thomas Lee Hazen http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954040
- **The Road to Crowdfunding Hell** - Daniel Isenberg - Harvard Business Review "...It is remarkable to me the lack of rational analysis about equity crowdfunding. Sure, crowdfunding "sounds like" an easy source of capital for startup entrepreneurs, leading to happy entrepreneurs, delighted investors and job creation galore. Few pundits seem to have the depth of knowledge and foresight to look far enough down the equity crowdfunding road to offer convincing predictions of the issues and problems that may arise." <http://blogs.hbr.org/2012/04/the-road-to-crowdfunding-hell/>

APPENDIX I We've been here before

There is no question Equity crowdfunding is a worldwide mania. Historically, manias have been unkind to small investors. It sure looks like Equity Crowdfunding is stampeding onto the scene. Will it be as destructive as other manias? Let's look at a few:

The Dot-com Mania

Crowdfunding seems like it will invite a replay of the disastrous tech-stock bubble of the late nineties. That mess was made possible by a historic collapse in accounting standards and lax regulatory oversight, with the great investment banks the pioneers of the collapse. In the fifties and sixties for instance, you would never take a company public that wasn't profitable at the time of the IPO, or didn't have a multi-year track record of solid revenues. When the banks stopped insisting on proven track records or real

profitability before taking a company public, there was a sudden explosion of stock-market investment into heretofore unknown internet firms. Companies with no track records went from having literally no revenues at all to having billion dollars' worth of market capitalization overnight. Banks explained that the new way to measure a company was by the quality of its ideas, not boring old indicators like revenues. The mania atmosphere considered website hits per day as a measure of value. As we later found out, of course, a lot of that value wasn't value at all. In virtually all of these schemes, the casual investor was the big dupe in the con. When the dot-com bubble finally collapsed, costing the world about \$5 trillion in losses, the major victims were small investors trying to save for retirement. We must avoid a replay of the same thing now as Crowdfunding mania develops a life of its own.

The LSIF Mania

A previous attempt to allow investors to invest in early stage companies was quite frankly an unmitigated disaster. In *The Failure of Labour Sponsored Funds* <http://www.fraserinstitute.org/research-news/news/display.aspx?id=11941> this 2007 paper points out the striking fact about labour- sponsored funds that their poor rates of return were consistently below those of risk-free investments. While it is reasonable that some of the new firms that labour- sponsored funds invest in will fail, overall, seasoned fund managers should be expected to make good decisions and generate reasonable rates of return for investors. Ultimately, the poor rate of return of labour-sponsored funds indicates they had not been successful at financing high-growth entrepreneurial businesses. Shockingly, labour sponsored funds charged investors significantly more than private funds to invest their money. Labour sponsored funds had high expense ratios despite the poor performance. According to Morningstar, the median labour sponsored fund management expense ratio was more than twice that of the average actively-managed mutual fund in Canada.

The paper concluded that ensuring that Canadian high-growth entrepreneurial firms have access to sufficient capital is critically important to the health of our economy but that Labour Sponsored Venture Capital Corporations however were not the answer. Only a handful made any money at all, even over the eight-year holding period required to avoid repaying the tax credits. And many funds suspended redemptions after the 2008 stock market crash, leaving investors on the hook for an even longer period. Labour-sponsored funds flamed out once the provincial tax credits vanished So the retail investor history is poor when unsophisticated investors get involved with start ups and the intermediaries that surround them. Wisely, Ontario has cut back on tax incentives - embracing Equity crowdfunding for the masses is clearly another example of failing to learn the lessons of history. It would be far better if regulators urged Canadians to save more for retirement.

The Business Trust Mania

The Business Income Trust mania was another case where the main victims were retail investors. In a November 2005 report on Business Income Trusts **The WORST IS YET TO COME: The \$20 billion deception that dwarfs the tax debate, respected forensic accounting**

firm Accountability Research assigned much of the blame to securities regulators for allowing misrepresentations of distributable cash, misleading IPO disclosure documents and unenforced deceptive marketing practices by brokers that caused small investors so much pain. http://www.fin.gc.ca/consultresp/flwthruent_5e.pdf

The non-bank ABCP Fiasco

In How the Ontario government facilitated the ABCP fiasco <http://ismymoneysafe.org/research/OntarioGovernmentInitiativesAffectingNonBankABCMarketWithDocs%2009112008.pdf> the authors show how a OSC regulatory exemption unwittingly created a nightmare for retail investors. In 2005, the \$50,000 minimum sale allotment test for the commercial paper prospectus exemption was changed by the Ontario Government to a test based on getting an approved credit rating from an approved credit rating firm. There was no simultaneous introduction of government quality control supervision over the credit rating agencies, who were given investor protection responsibilities in the public interest. In 2006, the Ontario Securities Commission gave exemptive relief to BMO, CIBC/CIBC World Markets and Toronto Dominion Bank to distribute commercial paper, including Non- Bank ABCP, on the basis of just one credit rating agency meeting its minimum credit rating standard, even though the other three credit rating agencies gave ratings that were below the minimum standard in the regulations. These exemptions diluted the rigour of not failing any of the DBRS, Standard and Poor's, Moody's or Fitch minimum rating standards in the regulations. On Non - Bank ABCP, DBRS was always the one credit rating agency giving top credit ratings, while Standard and Poor's and Moody's credit ratings failed the minimum standards for commercial paper set out in the regulations.

It appears to us that each time regulators take their eyes off the ball, the small investor pays the price. Prohibition of this exemption would start to change the trajectory.

APPENDIX II What other Jurisdictions are Doing and Saying

Consumer Federation of America takes a position on Crowdfunding Here's a link to their Comment letter to the SEC. They conclude that this is going to end up being an unmitigated disaster for investors.

<http://www.consumerfed.org/pdfs/CFA-crowdfunding-comment-letter.pdf>

UK FCA puts protection at the heart of crowdfunding - Every Investor

<http://www.everyinvestor.co.uk/news/2014/03/06/fca-puts-protection-heart-crowdfunding-7567/> In our view, crowd-funding is a disastrous idea and one that has wrongly embraced by the Obama administration in the so-called "Job Acts". For some intelligent commentary on that wrong-headed legislation, see: <http://www.nakedcapitalism.com/2012/03/why-you-should-hate-the-jumpstart-obamas-bucket-shops-act.html>.

The problems with equity crowdfunding and seed investment in the UK

"..Investors can have a great 'feel good' factor attached to their capital. However I would stop short of calling it an investment due to the referred concerns regarding the likelihood of financial returns. This is the key problem with equity crowdfunding - it provides entrepreneurs with access to capital resolving a real problem for entrepreneurs, but it fails to address a problem for potential investors due to a low likelihood of financial returns."

[http://www.syndicatoroom.com/blog/what-is-the-problem-with-equity-crowdfunding-and-seed-investment-\(1\)-\(1\).aspx](http://www.syndicatoroom.com/blog/what-is-the-problem-with-equity-crowdfunding-and-seed-investment-(1)-(1).aspx)

AARP speaks out on Equity Crowdfunding

In a 2012 letter <http://www.scribd.com/doc/194255647/AARP-Small-Business-Letter> to U.S. Senate Majority Leader Harry Reid, the American Association of Retired Persons said this about Crowdfunding "Even the best of the crowd-funding bills would make it possible for the least sophisticated investors to risk their limited funds investing in the most speculative small companies. These investments would be made without the opportunity for extensive due diligence that venture capital funds and angel investors engage in before making comparable investments. That may be why Columbia Law School professor Jack Coffee testified before the Senate Banking Committee that H.R. 2930 should be re-titled "the Boiler Room Preservation Act."

At best, even if Congress does everything right in terms of imposing appropriate investor protections, most of those who invest through crowd-funding sites are likely to lose some or all of their money. At worst, crowd-funding web sites could become the new turbo-charged pump-and-dump boiler room operations of the internet age. Meanwhile, money that could have been invested in small companies with real potential for growth would be siphoned off into these financially shakier, more speculative ventures. The net effect would likely be to undermine rather than support sustainable job growth. For that reason, we question the wisdom of adopting any of the proposed crowd-funding bills...

As the Senate moves forward on these proposals, we urge you to insist that any legislation intended to promote capital formation protects investors, promotes transparency, and ensures the integrity and stability of the financial marketplace. Investors still reeling from the most recent financial crisis deserve no less. "



SIPA

SMALL INVESTOR PROTECTION ASSOCIATION

A Voice for Small Investors