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Dedicated to Investor Protection

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**INTRODUCTION OF PROPOSED PROSPECTUS EXEMPTIONS AND  
PROPOSED REPORTS OF EXEMPT DISTRIBUTION IN ONTARIO  
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[http://www.osc.gov.on.ca/documents/en/Securities-Category4/csa\\_20140320\\_45-106\\_rfc-prospectus-exemptions.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category4/csa_20140320_45-106_rfc-prospectus-exemptions.pdf)

**Comments on proposed Crowdfunding Exemption**

**"The scandal's not what's illegal. It's what's legal"**- John Bogle, Founder of Vanguard funds

Kenmar welcomes the opportunity to comment on the proposals regarding the introduction of a Equity Crowdfunding exemption.

By way of introduction, Kenmar is an Ontario- based organization focused on mutual fund investor education via on-line papers hosted at [www.canadianfundwatch.com](http://www.canadianfundwatch.com). Kenmar also publishes *the Fund OBSERVER* on a bi-weekly basis discussing investor protection issues primarily for retail mutual fund investors. A subsidiary, Portfolio Analytics, assists abused investors and/or their counsel in filing investor restitution claims.

High profile corporate scandals such as ABCP, “advisor” abuse and Ponzi schemes, growing retail investor unrest and changing demographics (seniors, pensioners and retirees) suggest that investor protection demands HIGH priority attention from regulators.

**Equity Crowdfunding**

We define equity crowdfunding as the use of small amounts of capital from a large number of individuals to finance a new business venture using the internet. Crowdfunding makes use of the easy accessibility of vast networks of "friends", family and colleagues through social media websites like Facebook, Twitter and LinkedIn to get the word out about a new business and attract investors. Crowdfunding has the potential to increase entrepreneurship by expanding the pool of investors from whom funds can be raised beyond the traditional circle of owners, relatives and venture capitalists. These unsophisticated investors will invest for reasons that are not yet fully understood .More research is needed to shed light on the

characteristics of the participating individuals and the motivations that drive them to participate.

The potential of Crowdfunding sounds good in theory and is enticing but the socio-economic risks are enormous. If, as predicted by some, poor investments and fraud prevail, hundreds of millions or even billions of dollars of Canadian savings could evaporate. In the end, it is taxpayers who will have to come to the rescue, not the portals.

### **Equity Crowdfunding adds a new dimension to the word “Risk”**

Kenmar have been constructively critical of Crowdfunding for more than two years. As the OSC itself note, crowdfunding may be a highly risky investment and investors may experience a high probability of loss, even if there is no fraud. Many start-ups and SMEs are expected to fail. Canadian data shows that only 72% of SMEs that entered the marketplace in 2007 survived for two years and only 51% of SMEs that entered the market place in 2005 survived for five years. The survival rate of issuers that rely on equity crowdfunding may be lower since there is the possibility of adverse selection. Businesses with good prospects may gravitate towards donation or rewards-based crowdfunding or other cheaper sources of financing whereas less successful businesses may use securities-based crowdfunding because they are unable to raise funds from other sources.

In a June 2013 research paper *Some Simple Economics of Crowdfunding* by academics at the University of Toronto Rotman School of Management we note this remark in the Conclusion *“Although it is impossible to predict with certainty how equity crowdfunding will evolve, experimentation will surely play an important role. Crowdfunding platforms will compete on variations in market design, employing different rules for engagement and tools for reputation, crowd due diligence, and provision point mechanisms, among others. New markets for trusted intermediaries will likely emerge. Despite the best efforts of policy makers and platform designers, there will surely be spectacular failures.*

*Funders will lose significant sums, not only to fraud, but also to incompetent managers, bad ideas, and bad luck. Entrepreneurs will litigate their investors, and investors will litigate entrepreneurs. Ideas and intellectual property will be stolen due to early-stage public disclosure. The growing pains experienced by the equity-based crowdfunding industry will be even more dramatic and severe than in the non-equity setting. Throughout the mayhem, policy makers will be faced with the question of whether, in the long term, the benefit from the private gains from trade (cash for equity) as well as from the social gains due to spillovers and other externalities will outweigh these significant costs.”* [*Some Simple Economics of Crowdfunding*, <http://www.nber.org/chapters/c12946.pdf> ]

The question we ask is why are regulators willing to put investors in harms way .It is not as if Ontarions don't face enough financial challenges dealing with complex, pricey

structured products, advisors who don't act in their Best interests and well documented retirement income challenges.

A recent experience with Crowdfunding involves the story regarding the purchase of a crack-cocaine video supposedly incriminating Toronto Mayor Rob Ford. An American gossip website, Gawker, had raised about \$200,000 via crowdfunding to buy a video that allegedly shows the mayor smoking from a crack-cocaine pipe plans to donate the money to four non-profit organizations. In a note published July 2013 Gawker, editor John Cook declared the organization's efforts to buy the video was dead. For whatever reasons, Gawker was unable to acquire the video. The money was, we are told, instead given to Canadian organizations that help people deal with substance abuse. Gawker raised \$201,199 for the video through a crowd-funding effort dubbed Crackstarter. After fees were paid to Indiegogo, the website that hosted the campaign, and PayPal, which processed payments, \$184,783 remained. This is one of the main concerns, after fraud, that the money will be diverted to uses not intended by investors.

In a 2013 OSC survey of 1,500 investors

[http://www.osc.gov.on.ca/documents/en/Securities-Category4/sn\\_20130828\\_45-712\\_progress-report-b-investor-survey-report.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category4/sn_20130828_45-712_progress-report-b-investor-survey-report.pdf)

, the OSC found a majority wanted nothing to do with crowdfunding. They thought it was very high-risk. Fifteen percent who identified themselves as "low risk investors" expressed a strong interest in crowdfunding raising real concerns about their vulnerability to losses and fraud.

### **The OSC proposal seeks to limit damage**

To address widespread concern about fraud, the OSC has proposed a comprehensive set of restrictions. For example, capping the amount raised by a single entity at \$1.5-million in any 12-month period, With each investment, an investor must self-certify that he or she: is not investing more than \$2,500 in the particular investment through the portal, and will not have invested more than \$10,000 in investments under the exemption in the current calendar year after taking into account the current investment.

Crowdfunding websites, or portals, will have to be registered with securities commissions as "restricted dealers," and comply with minimum capital and insurance requirements as well as various reporting rules. They would be required to do background checks on companies and their directors or officers who are raising equity on their sites. The OSC says it will be the responsibility of a portal to shut out issuers it believes are fraudulent. The immediate threats appear to be vulnerable seniors, retirees and small unsophisticated investors. Other threats could include those associated with organized crime, money laundering, international terrorism and God knows what else. Monitoring compliance to these rules will fall to provincial regulators who, with all due respect, have a dismal track record of regulating / enforcement of EMD's/ PM's and even more routine products like non- bank ABCP. This could also lead to increased OSC overheads/fees and/ or a diversion of critical resources from mutual funds, Best interests, fund fees etc. Who will handle complaints/ disputes? Like previous manias (Dotcom, Business income trusts,

LSIF's), Crowdfunding appears to us to be a good opportunity for fraudsters, intermediaries and lawyers.

### **U.S. concerns should be heeded**

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.”

### **IOSCO defines the risks**

IOSCO has Issued a Report on Risks and Benefits of Financial Return Crowd-Funding The report analyzes financial return crowd-funding (“FR crowd-funding”), which refers to peer-to-peer lending and equity crowd-funding. According to the report, the main challenge facing regulators and governments is determining how to encourage crowd-funding, while also mitigating the risks associated with its growth and protecting investor interests.

The working paper identifies the main risks as:

- risk of default;
- platform risk;
- risk of fraud;
- risk of illiquidity; and
- risk of investor inexperience.

The report concluded that the FR crowd-funding market does not present a systemic risk to the global financial sector at present, but the challenges ahead will include (i) cross-jurisdictional contractual and legal harmonization, and (ii) dispute settlement and resolution issues. See: [IOSCO Report](#). For us, we feel these risks are too high for Main Street who have been hit with far too many shockus over the last 15 years.

## Some Questions

1) will an EBay like process be used to resolve disputes? (2) what requirements are there to ensure site/ portal security? (3) can crowdfunding losses be offset against other capital gains? (4) can shares be transferred to beneficiary in the event of death? (5) what happens if the \$10 K p.a. Cap is exceeded? (6) will investors be exposed to any personal liability? and (7), could the monies collected be diverted to purposes not revealed in offering documents? Eg development of land mines, building “activist” training camps, creating advanced suicide bomber vests...?

## Our Recommendations

Like all manias the momentum appears very difficult to contain .In the event that the Crowdfunding exemption, despite our comments, is approved, we offer the following ideas and recommendations:

- Crowdfunding Projects must not violate any laws of Canada e.g. financing terrorism
- Portals should be prohibited from receiving any direct or indirect payments from lenders
- The OSC should provide a plain language brochure on Crowdfunding
- The Investor Education Fund should provide no- nonsense educational materials on Crowdfunding on its website (The existing material on the site is limited to a brief definition of crowdfunding.  
<http://www.getsmarteraboutmoney.ca/en/managing-your-money/investing/investor-protection/Pages/The-exempt-market.aspx#.UzAVZCe9KSM> )
- Consideration should be given to establishing a database system that will monitor compliance with the \$10,000 annual cap per investor – retail investors are notoriously unreliable self certifiers
- Provisions should be added to ensure that issuers/portals don't use different regulatory exemptions to clandestinely raise funds for the same crowdfunding offering project
- Clarity that the operations of the firm must be domiciled in Canada
- The **WARNING TO INVESTORS** should be in Bold faced Red and the text should require that they certify that they will only invest money that does not affect their primary residence, pensions and living expenses.
- Portals should be required to publicly post the results of criminal record and background checks
- A rule defining the actions to be taken if the funds are used for a purpose other than that included in offering/disclosure documents
- Electronic Delivery of information should contain the information and not a link to the information
- A method be devised to confirm receipt of materials delivered electronically or by mail

- Provisions should be added re dilution protection perhaps by adding text on the certification form that subsequent rounds of financing could dramatically dilute the investor's original investment.
- Consideration that investors not be allowed to pay for the investment using credit cards
- Reveal to investors that crowdfunding investments are not eligible for inclusion in an RRSP, RESP or RRIF account.
- A "Cooling Off" period of 5 business days should be provided
- The enhanced use of TIP lines, financial incentives for truth tellers (whistle blowers), systematic information sharing and scheduled, formal meetings with the FSCO/IIROC/MFDA/AG /RCMP/OBSI et al could prove effective tools for investor protection.
- We'd also like to see more timely Investor Bulletins, "push" ALERTS and investor protection Checklists e.g. ones for Crowdfunding, SPAC's. etc

We are not in a position to assess whether or not the \$50,000 Fidelity Bond is adequate.

## **SUMMARY and CONCLUSION**

Traditionally, issuers seeking to raise capital from retail investors have been required to meet certain basic standards designed to ensure that they provide complete and accurate information on which to base an investment decision. We appreciate that these regulatory requirements impose cost on companies that many – particularly early stage start-up companies – are not able to afford. There were very good reasons for these restrictions. Experience tells us that a significant percentage of these early stage start-up companies will fail, causing their investors to lose their entire investment.

Additionally, there are many other ways for retail investors to lose money in such start-up investments, even if the company itself survives and even prospers. For example, the securities of such companies are likely to be highly illiquid, making it difficult for investors to divest their holdings if they need to or forcing them to sell at a considerable loss. Setting an appropriate initial price on the securities of young companies can be extremely difficult. Even sophisticated investors may end up over-paying. And investors who do not know how to protect their interests may find the value of their shares diluted through insider-only financing rounds, financing rounds at reduced prices or other means. Thus, OSC regulations have sought to ensure that investors in such offerings possess the financial resources to bear potential losses and the financial sophistication to understand the risks e.g. KYC-suitability.

Crowdfunding turns that investor protection concept upside down. In order to provide a new source of funding for start-up companies at the earliest stage of raising capital, equity crowdfunding opens investments in these high-risk situations/companies to anyone, including the working poor, retirees and seniors, through a new online marketplace.

Other material concerns with crowdfunding – e.g risk of fraud, the problems with self-certification; integration with other exemptions etc. add to our caution.

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In our view, this exemption undermines all the excellent investor- protecting initiatives the OSC/CSA have introduced regarding internet fraud/scams.

We appreciate that the OSC have worked hard to protect crowdfunding investors to the extent practicable but no matter the packaging, you can't make a silk purse from a sow's ear. The question remains, is this exemption in the Public Interest? We think not. How can it be socially responsible that a person living on annual social security of \$25,000 with modest or no savings could in principle lose \$10,000?

We hope we have expressed our concerns in a way that will inspire the OSC to give pause to this exemption initiative.

Kenmar urge the OSC to carefully evaluate our recommendations .In any event, we suggest that this Exemption be subject to a three year Sunset provision so the experience can be evaluated outside the prevailing Crowdfunding mania frenzy climate.

We agree to public posting of this Comment Letter.

We would be pleased to discuss our comments and recommendations with you in more detail at your convenience.

Respectfully,

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