

CHAPTER 8

Entrepreneurial Finance and Productivity in Different Institutional Contexts: Lessons from Equity Crowdfunding

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To finance growth, entrepreneurial firms need external financing. While bank finance is the most common for entrepreneurial firms,³⁴ many firms do not have sufficient collateral and/or stable cash flows to enable them to obtain or maintain debt finance. Equity finance has traditionally been available from angel investors and venture capitalists (VCs). But the presence of angels and VCs does not imply that the market for entrepreneurial finance is complete or without gaps of underserved entrepreneurs with good ideas and scant capital. In most countries around the world over the last decade, the biggest change to the landscape of equity finance for entrepreneurs has been the introduction of equity crowdfunding (Cumming and Johan, 2019).

There is substantial evidence consistent with the view that equity crowdfunding facilitates productivity growth. Equity crowdfunding deepens capital markets for startups, particularly at the most nascent stage of entrepreneurial firm development, thereby lowering costs of entry for startups. As such, equity crowdfunding is an important instrument for introducing and spreading new technology, which improves productivity. Empirical evidence is supportive. For example, large sample evidence is consistent with the view that crowdfunding improves small firm growth (Eldridge, Nisar, and Torchia, 2019; Stevenson, Kuratko, and Eutsler, 2019), enables the development of smart cities (Carè, Trotta, Carè, and Rizzello,

³⁴ See Cosh et al. (2009) for UK evidence, and Robb and Robinson (2014) for US evidence.

2018), and enables firms to get to the next level in subsequent capital raises (Signoria and Vismara, 2018).³⁵

Given the importance of equity crowdfunding to entrepreneurial finance and productivity, in this chapter we address two interrelated questions. First, is there a sufficient supply of equity crowdfunding in Canada? We address this question by examining comparative evidence across Canada, Australia, New Zealand, the UK, and the US. Second, what might explain the comparative supply of equity crowdfunding in Canada relative to other jurisdictions?

To begin, it is important to understand the institutional context in which equity crowdfunding operates in Canada. Securities regulation in Canada is fragmented by province. Each province has its own securities commission and its own set of securities laws and enforcement regime. Equity crowdfunding is of course no different, with different sets of rules in different provinces. Equity crowdfunding exemptions were introduced in Canada in the different Canadian provinces in 2016 after lengthy discussions over the preceding few years.

A key difference between the rules in the different provinces is whether or not financial statements need to be audited or not in conjunction with the use of an equity crowdfunding exemption. Under the “Start-Up Crowdfunding Exemption” model adopted in British Columbia, Saskatchewan, Manitoba, Quebec, New Brunswick, and Nova Scotia, financial statements are optional, and if they are included then they may be audited or unaudited, and use either IFRS or PE-GAAP (NCFCA, 2016).³⁶ Under the “Integrated Crowdfunding Exemption” model adopted in Manitoba, Ontario, Quebec, and New Brunswick, audited financial statements are required if the issuer raised \$750,000 or more under all prospectus exemptions, or if the issuer is a reporting issuer. If the issuer raised between \$250,000 and \$750,000, then unaudited IFRS financial statements are required along with a review report. If the issuer raised less than \$250,000, then unaudited financial statements are required.

³⁵ Cumming and Johan (2019) discuss the relation between equity crowdfunding and other sources of entrepreneurial finance and whether or not they are complements or substitutes. To date, there is some evidence of possible friction between the use of different sources, and other evidence of a complementary role. Overall, more research on the topic is needed.

³⁶ Note: IFRS refers to the International Financial Reporting Standards, or the set of rules to make financial statements comparable around the world, including fair value measurement (IFRS, Undated). PE-GAAP refers to Private Enterprise Generally Accepted Accounting Principles, which has fewer disclosure requirements such as the exclusion of management compensation (Lebow, 2010).

Industry commentators have noted that the audited financial statement requirement is regulatory overkill due to the direct costs it imposes on the company. For example, *Crowdfund Insider* stated

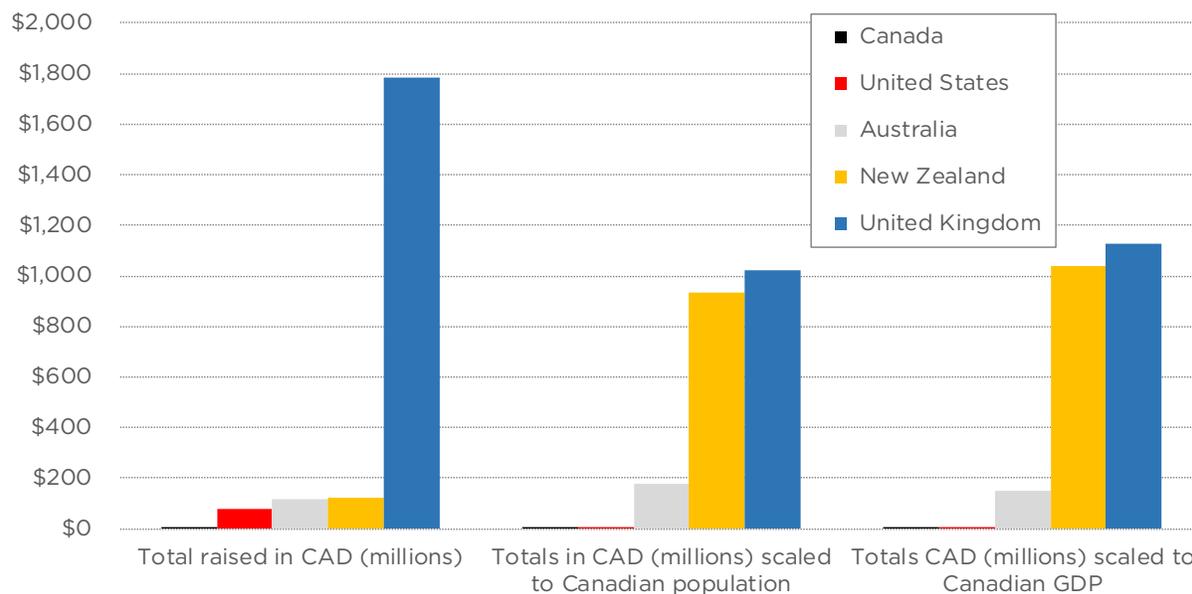
There is also little to no interest by issuers in using the integrated crowdfunding exemption to raise capital. **No one is using it.** In fact, you would need to be a crazy person to use it if you were a tech startup or non-reporting issuer. The rule requires issuers to provide financial statements which are... audited..." [emphasis in original] (Alois, 2016, July 27)

Regulatory fragmentation is an additional problem. Each of the different Canadian provinces has its own regulator, rather than a single one at the national level (Rose, 2019, June 26). On February 27, 2020, the Canadian Securities Administrators (CSA) proposed to harmonize the existing set of rules under proposed *National Instrument 45-110 Start-Up Crowdfunding Registration and Prospectus Exemptions (NI 45-110)* (CSA, 2020, February 27). On July 30, 2020, the Ontario Securities Commission introduced an interim order to reduce some of the restrictions in Ontario and come closer to harmonizing with the crowdfunding rules in other Canadian provinces. A notable change has been the items that accompany an offering document under start-up crowdfunding: "6.5 Indicate whether the issuer has financial statements available. If yes, include the following statement, in bold type:

Information for purchasers: If you receive financial statements from an issuer conducting a start-up crowdfunding distribution, you should know that those financial statements have not been provided to or reviewed by a securities regulatory authority or regulator. They are not part of this offering document. You should ask the issuer which accounting standards were used to prepare the financial statements and whether the financial statements have been audited. You should also consider seeking advice of an accountant or an independent financial adviser about the information in the financial statements." (CSA, 2020, February 27)

These changes appear to be worthwhile. Crowdfunding in Canada has largely been taking place in jurisdictions that offer the Start-up Crowdfunding Exemption model, particularly British Columbia, but 2020 has seen the beginning of deals in Ontario with the push towards harmonization and a lower regulatory burden (Kirkwood, 2020, January 27).

How does the size of Canada's equity crowdfunding market compare to its counterparts in the US, UK, Australia, and New Zealand? Figure 1

Figure 1: Total Raised Equity Crowdfunding, 2016-2019

Sources: *Canada:* Stikeman Elliott (2020, August 4); *United States:* data search at Crowd Data Track (<https://crowddatatrack.com/>); *Australia:* Statista (Undated a); *New Zealand:* Kavanagh and Muir (2017) and Craig and Muir (2019, April 25) (and 2019 data assumed same as 2018 data for New Zealand, due to absence of 2018 estimates and based on information from Schwartz (2019)); *United Kingdom:* Statista (Undated b), and Alois (2019, July 25).

provides data from 2016-2019. This four-year aggregated period is used here, as equity crowdfunding markets were first operational in 2016 in Canada and the US. These countries are similar insofar as they all follow the UK common law tradition³⁷ and have similar regulatory (World Bank, 2020) and securities regulatory structures (La Porta et al., 2006). However, they could not be more different in their approach to equity crowdfunding regulation and the outcomes.

Figure 1 shows that Canada has the smallest market overall, on a GDP- and a population-adjusted basis, with only \$3.5 million raised under retail equity crowdfunding over 2016-2019.³⁸ By comparison, in the US, \$79.2 million was raised with equity crowdfunding over 2016-2019. The

³⁷ These countries follow common law rules, with exceptions in Louisiana in the US, and Quebec in Canada.

³⁸ Unless otherwise indicated, all amounts here are expressed in Canadian dollars.

size of the US market is much larger than that in Canada, and the regulatory limits for raising capital in the US are much less stringent than in Canada. In the US, promoters can raise \$US1,070,000 in a 12-month period with crowdfunding (inflation adjusted each year) (US SEC, 2020), while in Canada under the start-up crowdfunding exemption, the limit is \$250,000 per offering, and \$500,000 every 12-month period (and only 2 offerings per 12-month period) (NCFCA, 2016). These limits in Canada are unusual, as in other countries such as the UK and Australia, the average capital raise in equity crowdfunding is normally \$300,000 or more, and the larger offerings raise over \$1 million (Cumming and Johan, 2019). In Israel, a successfully equity crowdfunded company—ReWalk—raised over \$1.3 million on OurCrowd, and within a year and a half after crowdfunding, Rewalk successfully listed on NASDAQ in the US. Such success would not have been possible under the restrictions currently in place in Canada and the US as the ReWalk crowdfunding campaign raised more than what is allowed in Canada and the US.

In Australia, equity crowdfunding has existed since the mid-2000s (Cumming and Johan, 2019), while legislation introduced in 2017 formalized its existence. The size of the equity crowdfunding market in Australia in 2016 was \$10.51 million, and with the regulatory change, it jumped to \$31.7 million in 2017 and reached \$34.0 million in 2019. Commentators have applauded the formalization of the crowdfunding market, but at the same time criticized the restrictions on capital raising for issuers (Nehme, 2017, March 22).

New Zealand, by contrast (Schwartz, 2019), has no mandatory disclosure, no individual investment limits, and no restrictions on equity crowdfunding. The results are striking. Equity crowdfunding began in New Zealand in 2014. Over 2016-2019, individuals and businesses in the country raised a total of \$122.9 million in equity crowdfunding. New Zealand's crowdfunding market is 269 (300) times larger than Canada's on a per-population (per GDP) basis.

Equity crowdfunding has been available in the UK since 2011. The UK is the leading equity crowdfunding market in the world, with a total of \$1.8 billion raised in equity crowdfunding over 2016-2019. The size of the UK market is partly related to light touch regulation, but perhaps is due more to the high reputation of world-leading platforms like CrowdCube and Seedrs. Empirical work is highly consistent with the view that platforms that carry out more due diligence are much more likely to have successful entrepreneurial crowdfunding, and attract more investors (Cumming and Johan, 2019). Moreover, the UK offers significant tax incentives that allow investors to offset their crowdfunding investments against their tax liabilities (Rose, 2019, June 26).

Equity crowdfunding rules are important as they can prevent fraud. But the frequency of crowdfunding fraud as a percentage of crowdfunding campaigns is very low (well under 1 percent) relative to the frequency of fraud among publicly traded companies as a percentage of publicly traded companies (around 2 to 7 percent per year) depending on the year and exchange.

Crowdfunding markets function in ways predicted by economic theory. Empirical evidence from a very large number of studies shows that when there is better voluntary disclosure, investors invest more; when voluntary disclosure is absent, investors tend to not invest at all (Cumming and Johan, 2019). The presence of regulation tends to limit choice for investors without changing the underlying decisions that investors make. To date, apart from the comparative evidence in figure 1, no systematic study links specific crowdfunding regulations to crowdfunding market size. There is, nevertheless, empirical evidence that relatively more fintech investment takes place in jurisdictions with less regulatory oversight (Cumming and Schwiendbacher, 2018), that inefficient crowdfunding platform policies can dampen crowdfunding activity across countries (Rossi et al., 2019), that better securities laws and trust facilitate crowdfunding (Rau, 2017), and that inefficient and more stringent crowdfunding regulation stifle crowdfunding market development (Hornuf and Schwiendbacher, 2017).

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