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• CROWDFUNDING: WILL IT BE A GOOD THING FOR START-UP COMPANIES? •

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Crowdfunding, a concept that recently has become very popular, is the term used to describe raising small amounts of money from many people, usually over the Internet.

There are several models of crowdfunding:

- the donation model—donating to a project in exchange for nothing;
- the reward model—donating to a project in exchange for some tangible reward or perk;
- the pre-purchase model—donating to a project in exchange for a future tangible reward such as a consumer product;
- the peer-to-peer lending model—where an online intermediary facilitates money lending between individuals for the funding of a project; and
- the securities or equity-based model—investing in a business in exchange for securities (*e.g.*, shares).

In this article, we describe the equity version of crowdfunding that start-ups and small and medium businesses hope will provide a mechanism for them to raise financing.

Regulatory Barriers

The equity-based model of crowdfunding must overcome a significant regulatory hurdle facing businesses that want to raise equity financing.

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When a company issues securities, whether it is a public company or a private company, the company (or, in “securities speak”, the issuer) must comply with applicable securities laws. In Canada, this means that *either a prospectus* (filed with a provincial or territorial securities administrator) must be provided to the investor (with details about the securities, the issuer, and other required information) or the securities must be issued in accordance with an *exemption* from the prospectus requirements. The preparation of a prospectus is a lengthy and costly exercise, so in many cases issuers look to find exemptions from the prospectus requirements.

There are a number of prospectus exemptions already in place, including the “accredited investor” exemption, which is available if the investors are wealthy individuals or financially strong entities. There are no limits on the amounts that issuers may raise from accredited investors and no limits on the number or amounts of investments that an individual accredited investor may make. But that group is estimated to represent only about 4 per cent of the investment community.

Issuers have limited access to the much larger pool of non-accredited investors, except for some subsets of that pool, such as “friends and family”. Correspondingly, would-be investors in that pool have few opportunities to become investors in private companies.

Crowdfunding Exemption

In March 2014, the Ontario Securities Commission (“OSC”) and a number of other members of the Canadian Securities Administrators (“CSA”)—namely, Saskatchewan, Manitoba, Quebec, New Brunswick, and Nova Scotia—published for comment a proposal for an equity crowdfunding exemption.

This crowdfunding exemption would allow reporting and non-reporting issuers (*i.e.*, public and private companies) to raise up to \$1.5 million during any 12-month period. An investor

would be permitted to invest \$2,500 in any single issuer and no more than \$10,000 in total in any calendar year in multiple issuers.

There will be a number of restrictions on the issuer and on the process it must follow, including the following:

- The issuer must be incorporated in Canada, its head office must be situated in Canada, and a majority of its directors must be resident in Canada.
- The issuer must prepare and provide to investors an offering document that includes a business plan.
- The issuer must include in or attach to the offering document certain financial information:
 - disclosure of the issuer's cash position with a third-party confirmation if the issuer has not incurred any expenditures, and cash is its only asset;
 - annual financial statements if the issuer has incurred expenditures; or
 - audited annual financial statements if the issuer has raised more than \$500,000 under the Crowdfunding Exemption or any other prospectus exemption since its incorporation and has expended more than \$150,000 since incorporation.
- The offering will be limited to a period of 90 days and must provide a minimum size of offering that corresponds with a description of the use of funds, and no funds may be released to the issuer until the minimum offering amount has been received.
- The issuer will be required to provide ongoing financial reports to investors.

In addition to *issuers and investors*, there is another participant in the process—namely, *portals*—through which the investments are made. A portal must register with the securities administrators in provinces where it proposes to carry on business and must comply with various

registrant requirements, which include minimum capital, insurance, regulatory reporting, and record keeping and retention obligations.

As part of the objective of securities administrators to protect against potential fraud, portals will also be required to

- conduct background checks on the issuer and its directors, officers, promoters, and control persons; and
- have an understanding of the nature of the securities being offered and the related risks, and review the information on the portal's website to confirm that the information adequately describes the securities, the issuer, the risks, the parties involved, potential conflicts of interest, and the intended use of funds.

If the portal believes the issuer or its offering is fraudulent, it must deny access to the portal.

The portal will also be required to provide educational materials to the investor, written in plain language, and obtain a signed Risk Acknowledgement Form from an investor.

Portals are prohibited from

- providing investment advice,
- holding investor funds, and
- investing or underwriting offerings.

Start-up Crowdfunding Exemption

In addition to their Crowdfunding Proposal, the CSA jurisdictions, other than Ontario, also proposed a crowdfunding “light” exemption for start-ups—the Start-up Crowdfunding Exemption.

The Start-up Crowdfunding Exemption is aimed at non-public issuers that are at a very early stage of development, and, accordingly, the requirements for use by issuers and by their portals are less onerous.

Some of the differences under the Start-up Crowdfunding Exemption as contrasted with the Crowdfunding Exemption are as follows:

- Issuers will be limited to using the exemption twice in a 12-month period and may raise up to \$150,000 per offering.
- Investors will be limited to \$1,500 per investment.
- Issuers are not required to produce financial statements, and there are no ongoing disclosure requirements.
- Portals will be exempt from registration but will be required to meet certain requirements, including filing a form with the applicable securities regulator at least 30 days before assisting any start-up crowdfunding distribution.

Some Concerns

Use of the Crowdfunding Exemption or the Start-up Crowdfunding Exemption by small- and medium-sized private companies will result in these companies having large numbers of shareholders, many of whom will be both unsophisticated and unknown to the founders and management of these companies. For example, an issuer seeking to raise its annual limit of \$1.5 million would need to access 600 investors at \$2,500 each.

This will pose cost and administrative issues for the companies, such as

- the cost and effort of communicating with large numbers of shareholders;
- difficulties in obtaining the consents from shareholders (whether by a simple majority, a higher majority, or unanimous vote) needed to make changes to the company's capital or governance structure;
- difficulties in attracting more sophisticated investors willing to provide more significant amounts of financing;
- conflicts between the interests of the issuer's crowdfunders and its other investors, including venture capital investors and angel investors;

- difficulties in dealing with requests from investors for the transfer of their shares because the shares of private issuers are not freely tradable; and
- difficulties in completing a sale of the company, the preferred exit strategy for investors.

Service providers such as portals, law firms, and accounting firms will have to develop cost-effective approaches to address these issues.

Next Steps

The securities administrators who have made these proposals will study the comments they received during the comment period, which ended on June 18, 2014, and publish more definitive versions of the proposed exemptions.

Since governments are motivated to respond to the needs of entrepreneurs and investors (and, in Canada, much of this motivation is driven by what Canadians read about equity crowdfunding initiatives in the United States), the proposals are expected to become a reality. Some believe this may occur in Canada as early as the first quarter of 2015. The U.S. version of equity crowdfunding continues to be a work in progress.

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• EVOLVING LAW OF TRADE DRESS IN A DIGITAL WORLD •

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In an increasingly crowded market, businesses are investing heavily into unique customer experiences to boost brand identity and loyalty. As expected, there is a growing need to protect the design and other distinguishing elements incorporated into the products, packaging, and off as well as online customer experience. Collectively, these features are known as the trade dress, or the look and feel, of the brand. The recent crackdown on 22 counterfeit Apple stores illustrates the importance of trade dress protection.

This article provides an overview of the law on trade dress in Canada and surveys the movement in the U.S. to protect the trade dress of websites, apps, and other digital properties.

Protecting Trade Dress in Canada

In Canada, trade dress can be protected as a “distinguishing guise” by registration under the *Trade-marks Act* (the “Act”),¹ which is defined as the packaging, containers, or wrapping of “wares”. Unlike regular trade-marks, trade dress can be registered as a distinguishing guise only if it has become “distinctive” or recognizable to the public, as associated with a brand or product.

Unregistered trade dress established by ordinary commercial use can still be protected under s. 7(c) of the Act, which codifies the common law tort of passing off. Broadly, s. 7(c) requires the plaintiff to show that the trade dress (1) is publicly associated with a certain brand or product in Canada, and (2) deceives the public.

In a recent decision, the Federal Court (the “F.C.”) ordered a restaurant to remove a mural painting that infringed the trade dress of a competing restaurant. The F.C. reasoned that the mural embodied the thematic concept of the plaintiff’s franchise restaurants and the mural was a prominent design feature in every restaurant location.²

Functional features constitute a significant limitation on the use of trade dress. In *Kirkbi AG v. Ritvik Holdings [Kirkbi]*,³ the Supreme Court of Canada held that the feature of LEGO bricks that allows them to snap together could not be protected as trade dress because it is primarily a functional characteristic.

The principle from *Kirkbi* applies to commercial spaces as well. For example, the U.S. Patents and Trademarks Office required Apple to remove recessed lighting, seating, and shelving from its trade dress application for its retail stores.⁴

Trade Dress for Websites and Other Digital Properties

There is considerably more trade dress litigation in the U.S. than in Canada, particularly regarding the look and feel of websites.

Most recently, the Louisiana District Court joined other U.S. jurisdictions in affirming the viability of protecting the trade dress of websites. In that case, the plaintiff claimed that the defendant copied its colours, orientation, font, list of curated external hyperlinks, and content from its website.⁵

In the U.S., trade dress claims are brought under the *Lanham Act* and must allege the following:

1. The trade dress is distinctive and identifies the source of the product.
2. There is a likelihood of confusion between the parties’ goods or services.
3. The trade dress is not functional.

In a recent New York case,⁶ a trade dress claim was dismissed because the plaintiff did not persuade the court that the elements on its website amounted to a distinctive look and feel that a viewer would associate with its business.

The court noted that simply cataloguing a website's features is insufficient to establish a trade dress. Plaintiffs must plausibly describe how the elements come together to synthesize the brand's look and feel.

While the law is still early in development in the U.S., it is clear that U.S. courts are prepared to enforce the trade dress of websites with a distinctive "look and feel" associated with its brand or product.

Conclusion

As sales and consumer interaction shifts online and into mobile applications, businesses should be more vigilant about protecting their brand identities and trade dress.

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¹ R.S.C. 1985, c. T-13.

² *1429539 Ontario Limited v. Café Mirage Inc.*, [2011] F.C.J. No. 1573, 2011 FC 1290.

³ [2005] S.C.J. No. 66, 2005 SCC 65.

⁴ Office Action Outgoing for U.S. Trademark Application, Serial No. 85,036,990 (August 23, 2011).

⁵ *Express Lien Inc. v. National Ass'n of Credit Management Inc.*, 2013 U.S. Dist. LEXIS 120209, 2013 WL 4517944 (ED La August 23, 2013).

⁶ *Parker Waichman LLP v. Gilman Law LLP and Robert Laraia*, 2013 U.S. Dist. LEXIS 103684 (E.D.N.Y., July 24, 2013).

• JOINING THE CROWD: NOVA SCOTIA AND NEW BRUNSWICK CONSIDERING CROWDFUNDING •

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Crowdfunding is an increasingly popular way for small- and medium-sized enterprises ("SMEs") and start-ups to raise capital—and it has caught the attention of Canadian securities regulators. Recently, Nova Scotia ("N.S.") and New Brunswick ("N.B.") securities regulators joined those of three other Canadian provinces to propose a regulatory framework customized for crowdfunding.

- **Crowdfunding 101.** What crowdfunding is, the legalities around it, and the reason for the recent attention from securities regulators.
- **Proposed Crowdfunding Exemptions.** N.S. and N.B. have proposed creating two new exemptions that, if applicable, would relieve companies raising capital through crowdfunding from the requirement to file a prospectus.
- **Crowd Pleaser.** If adopted, the proposed framework should facilitate regulatory compliance by SMEs and start-ups when accessing this growing source of capital.

Crowdfunding 101

Crowdfunding. Crowdfunding is a way for businesses to access capital. Individual investors—the members of the "crowd"—each provide a small amount of money to finance a project or business venture, typically through an internet platform or portal. Crowdfunding investors have traditionally received products or services in return for their contribution. However, crowdfunding is evolving with investors increasingly receiving an equity interest (such as shares) in the business they fund—and this means securities laws come into play.

Securities Laws. Every Canadian province has securities laws regulating the issuance of equity securities (*e.g.*, shares or units) to investors. One of the main purposes of this regulation is investor protection. Securities laws generally require an issuer to create and make available a prospectus—a detailed document describing a security to be issued to potential investors and disclosing other specified information—

to investors unless the issuance fits within an exemption to the requirement. A prospectus is a time-consuming and costly document to prepare, especially for an SME or start-up, so issuers frequently seek to take advantage of prospectus exemptions available to them.

Crowdfunding Exemptions. Existing securities laws apply to securities issued in the crowdfunding context, but the prospectus exemptions currently available do not work well for crowdfunding. With crowdfunding use growing and evolving to grants of equity, securities regulators are focusing their attention on developing a regulatory framework tailored to crowdfunding.

N.S. and N.B. Crowdfunding Exemption Proposal

On March 20, 2014, securities regulators in N.S. and N.B. joined those in Manitoba, Quebec, and Saskatchewan in publishing proposed crowdfunding prospectus exemptions (Multilateral CSA Notice of Publication and Request for Comment in respect of, among other things, a proposed Multilateral Instrument 45-108 – Crowdfunding and associated Companion Policy). Saskatchewan had already adopted a crowdfunding exemption in December 2013 but participated in publishing this notice to harmonize its exemption with that of the other provinces. Neither Prince Edward Island nor Newfoundland and Labrador has adopted any crowdfunding exemptions to date, and neither participated in this proposal.

The proposal would create two new exemptions from the requirement to file a prospectus, as follows:

Crowdfunding Exemption. This exemption would be available to reporting and non-reporting issuers formed in Canada

- with their head office located in Canada, and
- with a majority of directors resident in Canada.

Some key features of this proposed exemption are as follows:

- An issuer cannot have raised more than \$1.5 million under the exemption in the 12 months before the current offering.
- The offering can remain open only for up to 90 days.
- An investor can invest a maximum of only \$2,500 in any single investment under the exemption, and a maximum of \$10,000 total during a calendar year.
- Issuers must give investors an offering document identifying the minimum offering size, and must provide ongoing financial and other disclosure.
- Crowdfunding portals
 - must be registered in the restricted dealer category and comply with the requirements applicable to exempt market dealers, with certain exceptions;
 - would be prohibited from providing specific recommendations and advice to investors or soliciting purchases or sales of securities; and
 - would be required to deny access to an issuer if there was reason to believe the issuer or offering was fraudulent.

Start-up Exemption. This exemption would be available to non-reporting issuers with their head office in one of the participating jurisdictions (N.S., N.B., Manitoba, Saskatchewan, and Quebec), but not investment funds.

Some key features of this proposed exemption are as follows:

- The offering cannot exceed \$150K.
- The distribution can remain open for only 90 days.
- An investor may invest a maximum of \$1,500 in any single investment under the exemption.

- The exemption can be used a maximum of two times in a calendar year.
- Crowdfunding portals would not be subject to a registration requirement under securities law if they meet certain criteria, including the following:
 - Their head office must be in one of the participating jurisdictions, and their promoters, directors, officers, and control person must be Canadian residents.
 - They cannot provide investment advice or be related to the issuer of the securities being offered.
 - They can allow an investment only after the investor confirms online having read and understood the issuer's offering document and important risk warnings.

Next Steps. The proposed exemptions were open for public review and comment until June 18, 2014. The regulators in the participating provinces will now review the feedback received and decide whether to proceed with the proposal and if so, whether further modifications are necessary.

A Crowd Pleaser

The details still need to be fleshed out, but, generally, this has the opportunity to be a positive development for SMEs and start-ups. If implemented, the framework proposed by the regulators will be directed toward facilitating regulatory compliance by SMEs and start-ups when accessing capital through crowdfunding, by means of creating a tailored set of rules balancing the needs of both issuers and investors.

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