Extending Equity Crowdfunding Beyond Canada's Borders

How Canadian Investors Can Help Grow Social Enterprises In Kenya

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Acknowledgements

Foremost, we would like to thank Engineers Without Borders Canada for presenting us with this policy challenge and for providing their support with this project. We would also like to express our deep and sincere gratitude towards our Policy Lab coach, Dirk Druet, for his patience, motivation, continued support, and invaluable guidance. We could not have imagined having a better coach, advisor and mentor. Our heartfelt thanks.

Document Scope

This report was produced by a team of Master of Public Policy students at the Max Bell School of Public Policy at McGill University as part of their Policy Lab project. The analysis and recommendations are supported by a literature review, information from government and international organizations and reliable institutions, as well as interviews with stakeholders, industry experts and academic experts. The document aims to assist with policy making and does not constitute legal nor financial advice.

The insights and recommendations of this report are independent and do not necessarily reflect the opinions of McGill University, the Max Bell School, the sponsor organization or the individuals consulted through this process.

Executive Summary

Small and early-stage companies in many developing countries, particularly in Sub-Saharan Africa, are in need of investment to deliver impact to their communities. Underdeveloped capital markets and limited number of traditional paths to capital have left gaps in access to much-needed funding in these emerging markets. These gaps present a global opportunity for new and innovative methods of raising capital to connect investors with emerging markets.

Equity crowdfunding (ECF) is the fundraising of small amounts of capital from a large number of investors for a business venture. Investors have direct interests in the success of the companies they hold an equity stake in. Cross-border ECF is a potential pathway for capital to flow from investors in developed countries such as Canada, to small and medium enterprises (SMEs) in developing countries. It has the potential to stimulate innovation and reduce poverty in the developing world. This is an innovative mechanism that aligns with Canada's commitment to the UN's Sustainable Development agenda by leveraging support from private investors who are risk tolerant.

This brief examines the potential for cross-border ECF from Canadian investors to Kenyan SMEs as a representative case and assesses the feasibility of this type of investing for development purposes. Kenya faces significant socioeconomic challenges but has high potential moving forward owing to its rapidly growing population and place as one of the fastest-growing economies in Sub-Saharan Africa.

The regulatory landscape presents challenges for cross-border ECF, particularly in Canada. Securities regulation in Canada falls under provincial jurisdiction without a unified national regulator. Efforts to create a single regulator have been confronted with challenges concerning federalism and protecting regional capital markets. A cooperative federalism approach is constitutional, but faces challenges of legitimacy with Quebec and Alberta firmly opposed to delegating their power to a national regulatory body. Despite this, there is a degree of regulatory coordination through national and multilateral instruments.

The provincial securities commissions are self-funded and independent Crown corporations that are each accountable to their respective Ministers of Finance and to the public via the provincial legislature. Policy change is driven by the needs of Canadian investors and the regulators' primary responsibility is to protect investors from risk.

To distribute securities within Canada, issuers must publicly file a comprehensive and detailed disclosure document called a prospectus. This policy exists to ensure investors have access to all of the information they need in order to make informed investment decisions and ensure that issuers are held accountable for their disclosures. Small and early-stage businesses may not have the capacity to prepare a prospectus and comply with ongoing disclosure requirements, so regulatory exemptions exist to help companies raise funds without the time and expense of preparing a prospectus. The current

prospectus exemptions in Canada are not well suited to the needs of Kenyan SMEs. Amending the prospectus exemptions in Canada could be a potential mechanism to facilitate cross-border ECF.

Regulatory frameworks vary from country to country according to shifting priorities. Investor protections like restricted marketing and promotional offers, limited access to fundraising platforms, and other regulations to which platforms must adhere also vary across jurisdictions. Many countries worldwide, including the UK, the EU, and the US, have developed policy and regulatory frameworks that have created a more enabling CF environment. Innovation and enterprise creation have been significantly boosted in these countries as a result. In order to determine the impact of each approach on their respective markets, it is crucial to examine them. Countries can avoid creating barriers to their economic growth and development by identifying which regulations are most conducive to growth and which ones are too restrictive. There is potential for Canada to learn how to address CF regulatory barriers and gain insight into best practices.

In a similar fashion to the Canadian system, CF in the EU was underdeveloped and fragmented. In the past decade, various member states had introduced minor regulations tailored to their local markets and investor needs to encourage the use of CF services within their borders, which made cross-border investments very difficult.

Since September 2015, it was determined in Europe that crowdfunding could offer potential economic growth and increased competitiveness. European officials have then worked actively on harmonizing regulations and addressing existing barriers. The adoption of the Regulation on European Crowdfunding Service Providers (ECSP) for business in November 2020 created one of the most harmonized regulatory environments for CF. As a result of the ECSP, lending activities and equity-based crowdfunding are regulated uniformly across the EU. Furthermore, the act introduced a passport system that facilitates cross-border operations. Although the regulatory environment in the EU differs from the Canadian environment, there is potential for Canada to adopt a similar passport system.

As one of the few countries that regulate non-conventional ways of funding, the UK has the most developed ECF industry in the world and has also paved the way for loan- based crowdfunding. CF is more “principle-based in the UK,” which has allowed for its regulatory framework to evolve in collaboration with various stakeholders. Through its landmark reform legislation, the Financial Services and Markets Act 2000 (FSMA), the

UK’s regulatory body, the Financial Services Authority (FSA) (later the Financial Conduct Authority), was established and a host of other regulations which allowed for the growth and expansion of the CF market. Compared to other regulatory bodies, the FCA’s oversight of ECF is relatively relaxed.

In the US, similarly to Canada, a restrictive ECF regulatory framework has largely

prevented the expansion of their markets, especially their extreme investor protections, which had severely constrained ECF platforms. Several significant changes have been made to further advance the ECF industry. New securities regulations were adopted after the passing of the JOBS Act in 2012, by the US's regulator (the Securities and Exchange Commission (SEC)) in 2015 and recently with modifications to Regulation CF in 2020. Changes include limiting increases and "test the waters" provisions which allow companies to build crowdfunding pages where they can share information with investors before fundraising.

Kenyan SMEs, the investment recipient identified in this brief, exhibit strong potential to make a profit as they serve the country's vastly growing population. Social enterprises belong to the SME sector. They aim to address the country's socio-economic challenges alongside profits, and they are fast-growing. High unemployment rate among young people is one of these challenges. Food insecurity and lack of access to health services for residents of rural and urban slum areas are other major challenges that the country has been facing.

There is a need to empower social enterprises to solve these societal issues. Many of them have already contributed to lowering unemployment among young people by hiring and training them with employable skills such as computer usage and customer services. Moreover, start-ups with a focus on digital innovation such as telemedicine can especially make meaningful impacts.

However, a lack of capital and investment has been Kenyan SMEs biggest struggle which limits their ability to make bigger changes. It is also hard for small companies to obtain loans as banks perceive them as highly risky entities, although many of them do make a profit and create jobs. The current foreign direct investment and loan options for SMEs have been inadequate in closing the financial gap. This calls for alternative finance solutions such as cross-border ECF to help social enterprises grow and in turn better help Kenya achieve SDG Goals.

Kenya is the most active crowdfunding nation in East Africa due to its relatively advanced economy, infrastructure, internet connectivity, and mobile money use. Most of the funds in crowdfunding in Kenya comes from funders outside of the country. This indicates the appetite for diaspora investment in crowdfunding in the region. ECF, however, accounted for only 1 percent of Kenya's crowdfunding ecosystem in 2016, while donation-based crowdfunding accounted for around two-thirds of market activity.

The low uptake of the equity-based model is primarily due to the lack of a regulatory framework in Kenya. Despite the slow development of a national regulation, the Kenyan government and its Capital Markets Authority (CMA) have been favorable to the prospects of ECF. They have partnered with the foreign funded African Crowdfunding Association (AFCA) in developing 'ACfA Label Framework', a localized regulatory framework for securities-based crowdfunding. Yet, at the end of the donor funding in 2020, it is doubtful to what extent that the Label framework will be operationalized.

In the absence of a regulatory framework, ECF platforms in Kenya have operated through the de-facto tolerance of the regulator. Generally, the lack of regulation means no restrictions in investing in ECF. In 2019, CMA launched a Regulatory Sandbox, which is at the final stage of developing a Regulatory Framework for Debt-Based Crowdfunding Platform in Kenya. However, currently, it is unclear whether the in-development Regulatory Framework will encompass the equity-based model.

Overall, we found no formal regulations in Kenya that prohibits investment flow from ECF. The Kenyan government is actively seeking to draw foreign investments as part of its national development strategy of becoming a middle-income industrialized country with the 'Vision 2030'. As such, the country's Investment Policy 2019, the Companies Act 2015, the Investment Promotion Act 2004, and the Foreign Investment Protection Act 2012 were developed to create a conducive regulatory environment for foreign investment. However, these legislations do not specify provisions related to cross-border equity investments of small amounts and the extent of regulatory protection for such investment remains unclear.

To help policymakers and ECF organizers better evaluate the feasibility of cross-border ECF, this paper assesses risks and ways to mitigate them if investing in Kenyan SMEs. Overall, there is a modest, acceptable level of risk to invest in Kenyan SMEs based on a high level of investor confidence, relatively stable political system, solid legal protection for foreign investors of big- scaled investment but an unclear one for investors of SMEs.

Commonly perceived risks of investing SMEs in Kenya include limited ways to raise funds, theft by employees, low-quality management, and lack of access and insights to the global market. In addition, regulators around the world are also concerned about

failure of crowdfunding platforms, information asymmetry, and investor inexperience. To mitigate these risks, three strategies are needed to protect ECF investors: conduct due diligence of each business by carefully validating them; display everything that investors should or want to know about each business on the ECF platform, including potential risks; and encourage investors to diversify their investment and only putting down the amount that they can afford to lose.

The brief also illustrates a positive outlook of expanding the impact investment space to include Canadian retail investors, possibly through cross-border ECF. The benefits of investing in Sub-Saharan Africa are seen and taken by accredited investors, but this investment space has been limited for retail investors. Should it be open to them, it is possible that they will be interested in getting involved, as the number of retail investors tremendously grew since the COVID-19 pandemic; and that Canadians tend

to align their investment with their values and ethics and care about social impacts that companies make.

Particularly, the Kenyan diaspora is a population among retail investors that would likely invest in Kenyan SMEs through cross-border ECF. Not only do they have inherent knowledge about the overall environment in Kenya thus are competent in recognizing trustworthy enterprises, but the diaspora community is also socially and emotionally connected with their home country and has a track record of helping businesses back

home. If informed well, they could be among the first Canada-Kenya ECF investors and serve as an example for other retail investors.

Summary of Recommendations:

The research and analysis from this brief underpin the following six recommendations for policymakers, advocates of ECF and international development specialists. The recommendations target at facilitating the flow of capital from Canadians to Kenyan SMEs through cross-border ECF:

1. **Advocate for revisions to Canadian securities regulation prospectus exemption pathways in order to better facilitate cross-border ECF.** The two prospectus exemption revisions with the greatest potential to enable cross- border ECF are amending the start-up crowdfunding exemption to allow foreign
business to be eligible to use it and opening up the accredited investor exemption to allow individuals to qualify as sophisticated investors through criteria other than financial wealth.
2. To better understand what policy changes would best address the needs of Kenyan businesses, the diaspora population in Canada, and the broader Canadian public, **further and more targeted research should be conducted to assess the appetite for investment in this market and the need for fundraising in the form of ECF.**
3. To address a major concern of the regulators - information asymmetry, which is an unfair situation for investors, **ECF platforms must maximize details about each fundraising business based on due diligence assessments, inform potential investors about the risk of investing in SMEs in emerging markets**, and provide a space for investors to share experience with each other.
4. **As a way to attract investors, mitigate investment risks and sustain platform operation, advocates of the cross-border ECF should seek blended financing support from the Government of Canada and from international organizations.** Cross-border ECF fits well with the Government's approach to innovative financing (including blended financing) for sustainable development.
5. **Showcasing social impacts and reporting them back to investors are key to gain and retain investors.** More Canadian investors are taking Environmental and Social Governance into account when making investment decisions, and impact investors generally expect to see impacts after a period of time. Thus, it is important to display fine, compelling details of the businesses on the ECF platform while also establishing evaluation strategies to track their progress for reporting purposes.
6. **Donation crowdfunding catered to the Kenyan diaspora can be explored as an alternative in supporting Kenyan SMEs, while the current challenges of ECF are being addressed.** Donation crowdfunding's less complicated regulatory requirements, easier communicability, and existing familiarity within the diaspora mean that it can immediately capitalize on the Kenyan diaspora's interest to contribute to their home country through direct project investments.

1. Context

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Every year, billions of dollars of remittances and donations flow from the diaspora to developing countries. Migrant workers alone send approximately 3 to 4 times the amount of aid that flows back to their home countries.[1] In 2018, remittance flows originating from Canada rose to an estimated C$27.8 billion, up from the C$24.6 billion in the previous year.[2] Capital is flowing from Canada to East Asia and Pacific (C$9.2 billion), South Asia (C$4.4 billion), the Middle East and North Africa (C$1.5 billion), Latin America and the Caribbean (C$1.1 billion), and Sub-Saharan Africa (C$927 million) in increasing numbers.[3] Despite the COVID-19 pandemic, remittance flows have remained resilient, falling only 1.6 percent in 2020 from 2019.[4]

Yet, despite this flow of capital abroad, innovative and early-stage companies in many developing countries, particularly in Sub-Saharan Africa, remain in need of investment to deliver impact to their communities. In particular, investors with a high degree of risk tolerance are needed. Underdeveloped capital (and/or credit) markets have left a gap in their access to much-needed funding. The scarcity of traditional paths to capital and financing has made room for less conventional financial channels like crowdfunding.

Crowdfunding, as the name implies, is the use of small amounts of capital from a large number of individuals to fund different business ventures. Equity crowdfunding (ECF) provides a forum where business ideas can gain traction and have access to more potential investors by opening up the investment space to regular people—retail investors. ECF allows startup companies to raise capital by providing investors with

1 "Remittances Explorer," Canadian International Development Platform, accessed May 23, 2021, https://cid-pnsi.ca/remittances-explorer/.

2 Ibid.

3 Ibid.

4 "Defying Predictions, Remittance Flows Remain Strong During COVID-19 Crisis," *The World Bank,* May 12, 2021, https://www.worldbank.org/en/news/press-release/2021/05/12/defying-predictions-remittance-flows-remain-strong-during-covid-19-crisis.

the prospect of earning equity positions in their business ventures, essentially selling a stake in their company to numerous investors for the guarantee of investment. With a stake in the company, investors have vested interests in the success of these companies internationally.

ECF can stimulate innovation and poverty reduction in the developing world. It also has the potential to drive growth and leapfrog traditional capital market structures and financial regulatory challenges of the developed world.[5]

From a regulatory standpoint, there are restrictions in most jurisdictions on who can fund new businesses and the amount of capital that they can invest. The purpose of these restrictions is to protect retail investors from the increased risk of financial losses. Different markets around the world, such as the UK, EU and the U.S. have developed policy and regulatory frameworks that have been more conducive to crowdfunding than Canada. This has been a major catalyst for innovation and enterprise creation in these regions. In 2020, US$214.9 million was raised by equity crowdfunding in the U.S., a 105 percent increase from the prior year.[6]

In Canada, ECF is particularly challenging given the conservative investor protections in place and the lack of a single national approach to disclosure requirements for small and early-stage businesses. While policies in this space must balance the need for supporting economic growth with that of protecting investors, these barriers have considerably stagnated growth in ECF transactional values in Canada.[7]

Based on the above context, this policy brief analyzes the regulatory landscape of ECF in Canada as well as other jurisdictions and specifically examines ways to enable cross-border ECF from Canadian investors to Kenyan Small and Medium Enterprises (SMEs) and social enterprises. Although this emerging market has great potential for growth, it faces financing gaps that should be addressed. Cross-border ECF would also be an innovative way for both Kenya and Canada to meet the Sustainable Development Goals (SDGs).

5 "Crowdfunding's Potential for the Developing World," *The World Bank,* 2013, https://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf.

6 Brian Belley, "2020 US Equity Crowdfunding Stats - Year in Review," *Crowdwise,* January 3, 2021, https://crowdwise.org/funding-portals/2020-us-equity-crowdfunding-stats-year-in-review/.

7 Brenda Bouw, "Crowdfunding proponents blame regulators for slow growth," *The Globe and Mail,* December 12, 2016, https://www.theglobeandmail.com/report-on-business/small-business/sb-money/canadian-crowdfunding-is-off-to-a-slow-start/article33301643/.

1.1 Private financing for the Sustainable Development Goals (SDG)

Canada is at the forefront of supporting the Sustainable Development Goals (SDGs) adopted by all United Nations Member States in 2015. The 2030 Agenda for Sustainable Development calls for partnership with all countries to achieve 17 global goals.[8] Particularly, Canada has championed for innovative financing to achieve the SDGs since 2017, by exploring both new and traditional mechanisms to raise funds from private, public and philanthropic actors to support social enterprises and public goods. One approach that the Government of Canada has prioritized is to increase private capital in support of development outcomes and help investors engage in emerging markets in areas that benefit poor and vulnerable populations.[9] On the provincial level, non-profit and trade organizations like the Ontario Co-operative Association who represent 1,500+ English speaking Ontarian co-operatives have also shown commitment to achieve the SDGs.[10]

Cross-border ECF on an international level is an innovative mechanism that aligns with Canada's commitment to the UN's Sustainable Development agenda by leveraging support from private investors. To achieve this development aim, collaboration from all levels of government is needed to enable Canadians to diversify their investment portfolio while supporting the SDGs. The current Canadian regulatory framework restricts Canadian retail investors from contributing to the growth of emerging markets in Africa and diminishes opportunities to create new avenues of bilateral investment and trade. It also hinders potential opportunities to augment transnational social and political capital through the building of decentralized economic ties with diverse emerging markets.

8 "THE 17 GOALS | Sustainable Development," *United Nations,* accessed May 31, 2021, https://sdgs.un.org/goals.

9 Global Affairs Canada, "A Canadian Approach to Innovative Financing for Sustainable Development," *Government of Canada*, October 2, 2020, https://www.international.gc.ca/world-monde/issues_development-enjeux_developpement/priorities-priorites/fiap_fsd-paif_fdd.aspx?lang=eng.

10 "The Sustainable Development Goals," *The Sustainable Development Goals: Ontario Co-Operative Association*, Accessed May 31, 2021, https://ontario.coop/sustainable-development-goals.

1.2 Kenya in brief

Kenya is one of the fastest growing economies in Sub-Saharan Africa with a growth averaged 5.7 percent per year.[11] Being the largest economy in East Africa, Kenya exhibits tremendous value for overseas investors. With several growing private sectors including financial inclusion and agricultural technologies, the country exhibits potential for large investment return. In addition, Kenya is a country full of opportunities based on its fast-growing population. The country's population is projected to increase from an estimated 47 million in 2015 to 115 million by 2065.[12] The proportion of its youth population (between age 18 and 34) is at a high rate of 25 percent of the total population and those below 15 years constitute 43 percent of the total.[13] This shows a huge future demand for goods and services in Kenya.

Yet, the country is facing challenges such as high unemployment among young people and large social gaps between rich and poor, which social enterprises aim to help address and have made positive changes in their local communities. Close to 70 percent of Kenyan social enterprises surveyed by the British Council claimed to have used their profits for growth and social development activities in 2017, while over half of them made profits.[14] The biggest obstacle faced by small and medium enterprises (SMEs) including social enterprises at large is the lack of access to capital. Many of them rely on donations in cash or in kind which is not enough to sustain their business. This prevents social enterprises from growing and making a bigger impact. The COVID-19 pandemic further widened the financing gap as it slowed down the inflow of foreign direct investment (FDI) as well as remittances to Kenya. Thus, it is critical to support the country's small businesses, especially social enterprises through alternative financing mechanisms like ECF, to recover the country's economy and address its social inequality.

11 Samantha Payne, "SMES Are Growing Kenya's Economy," *African Review of Business and Technology*, July 14, 2017, https://www.africanreview.com/finance/business/smes-are-growing-kenya-s-economy-3#:~:text=A%20recent%20National%20Economic%20Survey,3%20percent%20of%20the%20GDP.&text=Small%20enterprises%20have%20between%20%245%2C000,and%20employ%2010%2D49%20people.

12 "Regional Analysis of Youth Demographics - Briefing Note," *African Institute for Development Policy*, UK Department for International Development, 2018, https://assets.publishing.service.gov.uk/media/5af9544740f0b622d7cc6e58/Kenya_briefing_note_Regional_Analysis_of_Youth_Demographics_.pdf.

13 Ibid.

14 "The State of Social Enterprise in Kenya," *British Council*, 2017, https://www.britishcouncil.org/sites/default/files/state_of_social_enterprise_in_kenya_british_council_final.pdf.

2. Canadian Regulatory Landscape

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2.1 Securities Regulation in Canada

Securities regulation in Canada falls under provincial jurisdiction. Canada's 10 provinces and 3 territories are responsible for securities regulations; there is no single national regulator.[15] There have been past efforts to create a national regulator in Canada, however, this "involves challenging issues concerning federalism and regional diversity."[16] There has been debate on whether a single national securities regulator should be created since the 1930s.

In 2010, the federal government published a draft Canadian Securities Act to create a single national securities regulator and referred it to the Supreme Court of Canada (SCC) to rule on its constitutionality.[17] The Alberta and Quebec Courts of Appeal challenged this, asserting that the proposed act would be unconstitutional. In a 2011 ruling (Reference re Securities Act), the SCC determined that securities regulation is a matter of provincial jurisdiction.[18]

In 2014, the federal government, along with several provinces, agreed to set up a Cooperative Capital Markets Regulatory System.[19] This approach "would pool the jurisdictional power of both levels of government to create a comprehensive scheme for regulating the securities market" and, "potentially, become national if all the provinces signed on."[20] This effort is based on the concept of cooperative federalism. Quebec, believing that the CCMR would exert undue power, challenged the constitutionality of the CCMR. However, the Supreme Court of Canada upheld its constitutionality in 2018 (Reference re Pan-Canadian Securities Regulation).[21]

Despite British Columbia, New Brunswick, Newfoundland and Labrador, Nova Scotia, Ontario, Prince Edward Island, Saskatchewan, and Yukon signing on to this effort, a Capital Markets Regulatory Authority has not yet been created. There has been little movement on this since 2015. Without the participation of Alberta and Quebec, critics

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15 See Appendix C for a list of the provincial and territorial securities commissions.

16 David L. Johnston, et. al., "National and Coordinated Approaches to Securities Regulation: The Latest Initiatives in Historical Context," *The Peter A. Allard School of Law,* 2014, https://commons.allard.ubc. ca/cgi/viewcontent.cgi?article=1142&context=fac_pubs, 663.

17 Ibid.

18 "Reference re Securities Act," *Supreme Court of Canada,* December 12, 2011, https://scc-csc.lexum.com/scc-csc/scc-csc/en/item/7984/index.do.

19 Peter S. Spiro, "The Supreme Court Rules in Favour of Creative Cooperation on National Securities Regulation," *CanLII Connects,* November 9, 2018, https://canliiconnects.org/en/commentaries/64744.

20 Ibid.

21 "Reference re Pan-Canadian Securities Regulation," *Supreme Court of Canada,* November 9, 2018, https://scc-csc.lexum.com/scc-csc/scc-csc/en/item/17355/index.do.

believe such an organization would be ineffective.[22] The position of both Alberta and Quebec has always been, and remains, that the provinces have sole jurisdiction over the issue of securities regulation and that greater centralization of securities regulation would be harmful to their regional capital markets.[23,24]

In the 2021 budget, the federal government "pledge[d] to continue funding the Canadian Securities Transition Office (CSTO), which was established back in 2009 to help guide federal involvement in the development of a co-operative national regulator."[25] However, proposals for a single national securities regulator "must deal with the jurisprudential and practical legacies of the federal/provincial division of powers in this field, as well as the political and social context that gives rise to federalism concerns in the first place."[26] With a minority government in power at the federal level, and with Quebec and Alberta firmly opposed, there is limited practicality in pursuing a national regulator.[27]

2.1.1 Regulatory Harmonization and the Canadian Securities Administrators

The fact that there are distinct regulators for each province and territory creates challenges for issuers looking to sell securities in Canada. Issuers must comply with regulators and manage the registration and any ongoing disclosure requirements in each region in which they distribute securities.

The Canadian Securities Administrators (CSA) is a working group that brings together the provincial and territorial securities regulators to share ideas and collaborate on the design of policies and regulations to have consistency across the country.[28] The CSA facilitates a degree of national harmonization within the current regulatory framework, based on cooperative federalism. While some provinces have specific requirements, a majority of securities regulation is consistent throughout Canada because it is generally

22 Peter S. Spiro, "The Supreme Court Rules in Favour of Creative Cooperation on National Securities Regulation," *CanLII Connects,* November 9, 2018, https://canliiconnects.org/en/commentaries/64744.

23 Francoise Bertrand, "Why Quebec must oppose a national securities regulator," *The Globe and Mail,* January 26, 2016, https://www.theglobeandmail.com/report-on-business/rob-commentary/why-quebec-must-oppose-a-national-securities-regulator/article28376840/.

24 James Fitz-Morris, "Securities regulator deal opposed by Quebec, Alberta," *CBC,* September 19, 2013, https://www.cbc.ca/news/politics/securities-regulator-deal-opposed-by-quebec-alberta-1.1860472.

25 James Langton, "Budget promises funding for national regulator effort: Feds pledge funding for CSTO, despite recent demise of CMAIO," *Investment Executive,* April 19, 2021, https://www.investmentexecutive.com/news/industry-news/budget-promises-funding-for-national-regulator-effort/.

26 David L. Johnston, et. al., "National and Coordinated Approaches to Securities Regulation: The Latest Initiatives in Historical Context," *The Peter A. Allard School of Law,* 2014, https://commons.allard.ubc.ca/cgi/viewcontent.cgi?article=1142&context=fac_pubs, 635.

27 Robert Yalden, Professor, Queen's University. Zoom interview with Policy Lab Team, January 20, 2021.

28 "Who We Are," *Canadian Securities Administrators,* accessed May 22, 2021, https://www.securities-administrators.ca/aboutcsa.aspx?id=77#:~:text=To%20give%20Canada%20a%20securities,securities%20regulation%2C%20policy%20and%20practice.

based on the same set of national instruments. A National Instrument (NI) is "an instrument that has been adopted in all thirteen Canadian provinces and territories" and a Multilateral Instrument (MI) is "an instrument that has been adopted in more than one, but not all Canadian provinces and territories."[29]

2.1.2 Strategic Imperatives

The Canadian securities regulatory bodies are self-funded, independent Crown corporations.[30] Funding is not from taxpayers or Government funding; it is generated by revenues from market participants and the organizations' own investment income. Each of the provincial securities commissions is accountable to their respective Ministers of Finance and, through their Minister, to the public via the provincial legislature. Policy change is often driven by the needs of Canadian investors.

The regulators' responsibility to the public is evident in their mandate and mission statements that are centrally focused on protecting investors from risk.[31] Many of the barriers to cross-border ECF exist to minimize perceived risk to retail investors specifically. Regulators are motivated to protect retail investors because they are generally seen as less informed than accredited or institutional investors.

The provincial securities commissions engage with international partners "regarding the detection, investigation and enforcement of securities offences, development of regulatory policy, and monitoring of emerging issues."[32]

CANADIAN SECURITIES REGULATORS COLLABORATE WITH INTERNATIONAL ORGANIZATIONS, INCLUDING:

- Ontario (OSC), Alberta (ASC), British Columbia (BCSC), and Quebec (AMF) are members of the International Organization of Securities Commissions (IOSCO). IOSCO, viewed as the "global standard setter for the securities sector," is responsible for the development, implementation, and promotion of "internationally recognized standards for securities regulation."[33]
- Canada's provinces and territories are represented at the North American Securities Administrators Association (NASAA). The primary goal of NASAA is "to advocate and act for the protection of investors, especially those who lack the expertise, experience and resources to protect their own interests."[34]

29 "Access Rules & Policies," *Canadian Securities Administrators,* accessed May 22, 2021, https://www.securities-administrators.ca/industry_resources.aspx?id=47.

30 See Appendix C.

31 See Appendix C.

32 "International engagement," *Ontario Securities Commission,* accessed May 24, 2021, https://www.osc.ca/en/about-us/domestic-and-international-engagement/international-engagement.

33 "About IOSCO," *International Organization of Securities Commissions,* accessed May 24, 2021, https://www.iosco.org/about/?subsection=about_iosco.

34 "Our Story," *North American Securities Administrators Association,* accessed May 30, 2021, https://www.nasaa.org/about/nasaa-history/.

2.1.3 Openness to Innovation

Given the somewhat speculative and high-risk nature of ECF and the regulators' general focus on minimizing risk for Canadian retail investors, there is a natural conflict that arises. ECF is a comparatively new investment vehicle for Canada, with the first platforms opening within the last decade. As a result, there is limited awareness about cross-border ECF among Canadian regulators. Data collection on the potential of ECF is still in its infancy, however, it has the potential for further growth and development.

THE PROVINCIAL SECURITIES REGULATORS HAVE OFFICES (LISTED BELOW) TO PROVIDE SUPPORT FOR FINTECH BUSINESSES WITH NEW INNOVATIONS WHICH ARE LIKELY TO PROVIDE TANGIBLE BENEFITS TO INVESTORS.

- The OSC Innovation Office Economic Growth and Innovation is a dedicated team "focused on initiatives that support economic growth and foster innovation in Ontario's capital markets."[35]
- The AMF Fintech Group is "dedicated to monitoring fintech innovations, contributing to work aimed at maintaining a Québec regulatory framework adapted to market realities, and helping innovative firms comply with the laws administered by the AMF."[36]
- The CSA Regulatory Sandbox "allows firms to register and/or obtain exemptive relief from securities laws requirements, under a faster and more flexible process than through a standard application, in order to test their products, services and applications throughout the Canadian market on a time limited basis."[37]

The regulators are actively identifying new opportunities and working to support innovation - this signals their openness to innovation. Engaging with regulators on their interest in supporting innovation and fintech could be helpful to address barriers to cross-border ECF. However, it is important to note that while regulators are open to supporting innovation, the scope of change is likely to be limited given the fact that Canada is generally slower and more conservative in adopting financial sector innovations in comparison to jurisdictions, as will be explored in Section 3.

35 "Innovation at the OSC," *Ontario Securities Commission,* accessed May 30, 2021, https://www.osc.ca/en/industry/innovation-osc.

36 "AMF Fintech Group," *Autorité des marchés financiers*, accessed May 30, 2021, https://lautorite.qc.ca/en/professionals/fintech-financial-technology/the-amf-in-the-fintech-ecosystem.

37 "CSA Regulatory Sandbox," *Canadian Securities Administrators,* accessed May 30, 2021, https://www.securities-administrators.ca/industry_resources.aspx?id=1588.

2.2 The Exempt Market

To distribute securities within Canada, issuers must publicly file a prospectus. A prospectus is a "comprehensive disclosure document providing detailed information about the issuer's business and the securities being offered".[38] This policy exists to ensure investors have access to all of the information they need in order to make informed investment decisions and ensure that issuers are held accountable for their disclosures. Preparing a prospectus can be costly and requires considerable time and financial resources from firms. Small and early-stage businesses may not have the capacity to prepare a prospectus, so regulatory exemptions exist to help companies raise funds without the time and expense of preparing a prospectus. Amending the prospectus exemptions in Canada could be a potential mechanism for facilitating cross-border ECF.

The current prospectus exemptions exist to provide businesses with relief from the full requirements of prospectus disclosure. Issuers bypass the prospectus requirements but must meet the requirements of the exemption used. Common prospectus exemptions under provincial securities law are summarized in Table 1 below.

The prospectus exemptions are largely consistent across all provinces and territories (pursuant to National Instrument 45-106), however, there are some differences. The Start-up and Self-certified investor exemptions are only applicable in a few provinces (see Table 1). While there are similarities in the exemptions across jurisdictions owing to them being based on NI 45-106, an issuer would still need to separately file for an exemption through each of the 13 regulators in Canada, or, make use of the passport system.

The "passport system" (MI 11-102), allows issuers to deal directly with only one or two regulators, instead of having to deal with all jurisdictions separately.[39] By using this system, issuers can seek exemptive relief in one Canadian jurisdiction and have it apply in other jurisdictions. It is important to note that Ontario, Canada's largest securities regulator, does not participate in the passport system.[40]

38 "Guide to doing business in Canada: Securities Law & Corporate Governance," *Gowling WLG,* October 1, 2020, https://gowlingwlg.com/en/insights-resources/guides/2020/doing-business-in-canada-securities-law/#:~:text=Canada%20currently%20does%20not%20have,%2C%20regulations%2C%20rules%20and%20policies.

39 "Passport System," *Thomson Reuters Practical Law,* accessed May 22, 2021, https://ca.practical-law.thomsonreuters.com/8-575-1529?transitionType=Default&contextData=(sc.Default)&firstPage=true.

40 Ibid.

TABLE 1: SUMMARY OF COMMON PROSPECTUS EXEMPTIONS IN CANADA

Prospectus Exemption	Purpose for Exemption
Accredited Investor	Allow companies to raise funds from investors who have certain characteristics that indicate an ability to withstand financial loss/obtain expert advice, such as above-average income or substantial assets.[41]
Crowdfunding	Allow Canadian companies, particularly start-ups and SMEs to raise capital online through a funding portal that is registered with securities regulators.[42]
Existing Security Holder	Allow public companies listed on the Toronto Stock Exchange, Canadian Securities Exchange, or Aequitas NEO exchange to raise funds from existing security holders.[43]
Friends, Family and Business Associate	Allow companies to raise capital from investors with whom they have close personal or business relationships.[44]
Minimum Amount Investment	Allow companies to raise funds from investment funds (not individuals) that are able to withstand financial loss/obtain expert advice.[45]
Offering Memorandum	Allow companies to raise funds from a range of investors based on an offering memorandum (disclosure document with less requirements than a prospectus).[46]
Rights Offering	Allow public companies to raise funds from investors that already hold securities of the company.[47]

41 "Summary of Key Capital Raising Prospectus Exemptions in Ontario," Ontario Securities Commission, January 26, 2016, https://www.osc.ca/sites/default/files/pdfs/irps/ni_20160128_45-106_key-capital-prospectus-exemptions.pdf.

42 Ibid.

43 Ibid.

44 Ibid.

45 Ibid.

46 Ibid.

47 Ibid.

Prospectus Exemption	Purpose for Exemption
Self-certified Investor (SK, AB only)	Allow Alberta and Saskatchewan companies to raise capital from investors who self-certify as meeting certain financial and investment knowledge criteria. Investors who do not meet the income and asset thresholds to qualify as accredited investors can instead self-certify to demonstrate that they meet a certain level of financial and investment knowledge.[48]

Exempt market dealers are registered securities dealers (also known as "registrants) that trade in prospectus exempt securities, or to exempt investors (such as accredited investors). In the case of ECF platforms, the platform itself must be registered as a dealer.[49]

To use a prospectus exemption, the issuer must file a Report of Exempt Distribution, or Form 45-106F1, within 10 days from the date of the distribution.[50] The report includes basic information including the issuer's business name, industry, type of security, price per security, and jurisdiction where the purchaser resides.[51] The fee associated with completing Form 45-106F1 varies from $25 to $500, depending on the province of filing.[52] A Form 45-106F1 filing must be completed in each jurisdiction in which the distribution occurs. For example, if securities are sold to investors in Ontario and Alberta, this form must be filed in both provinces. The requirements for additional documentation (point of sale disclosure and ongoing disclosure) vary based on which exemption is used.

The specific criteria which must be met for the most common prospectus exemptions are summarized below in Table 2. As the degree of disclosure requirements decreases, the degree of investor risk increases, so various criteria are in place to minimize this risk. For example, to ensure investors are capable of withstanding loss, accredited investors must be able to demonstrate that their income or assets meet a certain threshold. For the Start-up Crowdfunding exemption, investment contributions are capped to protect

48 Ibid.

49 "The exempt market," *Ontario Securities Commission,* accessed May 22, 2021, https://www.osc.ca/en/industry/companies/selling-securities-ontario/exempt-market#:~:text=The%20exempt%20market%20allows%20securities,and%20hedge%20or%20pooled%20funds.

50 "Private Placement of Securities in Canada 2nd Edition," *Bennett Jones*, January, 2017, https://www.bennettjones.com/-/media/Files/BennettJones/Publications/Canadian-Guide-to-Private-Placement-of-Securities-ed2-Jan-2017.pdf.

51 "Form 45-106F1 Report of Exempt Distribution," *Alberta Securities Commission,* June 30, 2016, https://www.albertasecurities.com/-/media/ASC-Documents-part-1/Regulatory-Instruments/2018/10/5116115-45-106-F1-Consolidation-Eff-May-5-2015-Repealed-June-30-2016.ashx.

52 "Private Placement of Securities in Canada 2nd Edition," *Bennett Jones*, January 2017, https://www.bennettjones.com/-/media/Files/BennettJones/Publications/Canadian-Guide-to-Private-Placement-of-Securities-ed2-Jan-2017.pdf.

investors from the risk of greater losses.

TABLE 2: CRITERIA FOR KEY PROSPECTUS EXEMPTIONS[53, 54]

Prospectus Exemption	Who can distribute?	Who can invest?	Investment Limit (CAD)	Fundraising Limit (CAD)
Accredited Investor	All companies	Accredited investors	None	None
Crowdfunding	Canadian companies	Any investor	**Average investor** $2,500 per investment, up to $10,000 annually **Accredited investor**[55] $25,000 per investment, up to $50,000 annually	$250,000 per offering, twice per year
Existing Security Holder	Public companies listed on an exchange	Existing security holders	$15,000 annually	None
Friends, Family and Business Associate	All companies	Specific friends, family & business associates	None	None
Minimum Amount Investment	All companies	Any investor that is not an individual	$150,000 minimum	None

53 "CHEAT SHEET: Private company capital-raising prospectus exemptions at a glance," *Alberta Securities Commission,* accessed May 22, 2021, https://www.albertasecurities.com/-/media/ASC-Documents-part-2/New-Economy/Small-business/Cheat_sheet_prospectus_exemptions.ashx-?la=en&hash=7A3440F8B1218C9F6CCF099DF6BDCF95.

54 "Summary of Key Capital Raising Prospectus Exemptions in Ontario," *Ontario Securities Commission,* January 26, 2016, https://www.osc.ca/sites/default/files/pdfs/irps/ni_20160128_45-106_key-capital-prospectus-exemptions.pdf.

55 See definition in Appendix B.

Prospectus Exemption	Who can distribute?	Who can invest?	Investment Limit (CAD)	Fundraising Limit (CAD)
Offering Memorandum	All companies	Any investor	**Regular investor** $10,000 annually **Eligible investor**[56] $30,000 annually	$10,000 in some provinces[57]
Rights Offering	Public companies listed on an exchange	Any investor	No	$250,000 per offering, twice per year
Self-certified Investor (SK, AB only)	AB or SK companies	Self-certified investors	No	None

The current structure of these exemptions is not overly favorable for cross-border ECF. Some of these exemptions are unsuitable for cross-border investments while others are not suitable for ECF. The following exemptions are clearly unsuitable at this time for cross-border ECF from Canadian retail investors.

- **Rights offering & existing securities holder exemptions:** Kenyan SMEs are unlikely to be listed on an exchange.
- **Minimum amount investment exemption:** Non-individual investors do not include retail investors, so this type of capital raising is not consistent with the premise of ECF.
- **Friends, Family and Business Associates exemption:** The use of this exemption is restricted to a limited group of investors which is not consistent with the premise of ECF.

The subset of exemptions which have potential for cross-border ECF, though some are not suitable at this time, are detailed in the Sections 2.2.1 through 2.2.4.

2.2.1 Offering Memorandum Exemption

The Offering Memorandum (OM) Exemption requires significant point of sale and ongoing disclosure requirements when compared with other exemptions. In order to use

56 See definition in Appendix A.

57 "Private Placement of Securities in Canada 2nd Edition," Bennett Jones, January, 2017, https://www.bennettjones.com/-/media/Files/BennettJones/Publications/Canadian-Guide-to-Private-Placement-of-Securities-ed2-Jan-2017.pdf.

this exemption, companies are required to complete an OM and provide it to investors before the sale of any securities. The OM is a legal document that includes information about the company, including financial statements, and states the objectives and risks of an investment. The exact details of what is required in the document varies based on the jurisdiction.

While an OM is not as onerous as a prospectus, it is still a comparatively challenging obstacle for many smaller entrepreneurial businesses that would be looking to benefit from cross-border ECF. In 2014, the National Crowdfunding and Fintech Association of Canada estimated the legal, accounting, and other professional services fees required to file an OM could range from C$11,500 to C$440,000, depending on the nature of the distribution.[58] Moreover, this exemption also has an ongoing disclosure requirement of audited financial statements which would require additional resources. Those audited financial statements must be made "reasonably available" to investors.[59]

There is potential in the OM exemption for Kenyan SMEs because it can be used by non-Canadian owned companies. However, the OM exemption has limited viability for Kenyan SMEs as these companies are unlikely to have the resources and access to legal expertise to meet these disclosure requirements.

2.2.2 Start-up Crowdfunding Exemption

The Crowdfunding Exemption is a highly relevant tool that has been designed for start-ups and other early-stage businesses to raise funds. However, the current implementation of this exemption in the Canadian regulatory environment poses some challenges for its use in cross-border ECF. Most notably, the exemption is explicitly defined to cover companies which are Canadian. Additionally, this exemption has seen comparatively little uptake for fundraising within Canada. Part of the reason for this low uptake can be attributed to its relatively recent introduction, and the fact that many early-stage companies in Canada are also able to readily tap into available capital from VentureCapital and other institutional investors. Lastly, there are limits placed on investment - retail investors cannot invest more than C$10,000 in a calendar year while accredited investors cannot invest more than C$50,000. Recently proposed regulatory changes have been targeted at increasing the investment limits, rather than allowing this tool to be used for cross-border fundraising.[60]

58 "How much does an Offering Memorandum Cost?" *National Crowdfunding & Fintech Association,* April 22, 2014, https://ncfacanada.org/how-much-does-an-offering-memorandum-cost/.

59 "Private Placement of Securities in Canada 2nd Edition," *Bennett Jones,* January, 2017, https://www.bennettjones.com/-/media/Files/BennettJones/Publications/Canadian-Guide-to-Private-Placement-of-Securities-ed2-Jan-2017.pdf.

60 "Summary of Key Capital Raising Prospectus Exemptions in Ontario," *Ontario Securities Commission,* January 26, 2016, https://www.osc.ca/sites/default/files/pdfs/irps/ni_20160128_45-106_key-capital-ectus-exemptions.pdf.

2.2.3 Accredited Investor Exemption

The Accredited Investor Exemption allows companies to efficiently raise funds from investors with certain characteristics, most notably, their ability to withstand financial loss and to also obtain expert advice regarding 'riskier' investments. This Exemption also comes with very few reporting requirements, easing the burden on early-stage companies looking to fundraise. This is a highly relevant exemption for cross-border ECF, however, this limits the scope of fundraising to only accredited investors. As these investors must have net income before taxes of at least C$200,000 per year, or financial assets greater than C$1 million, the scope of individuals that companies would be able to fundraise from is quite narrow. In Canada, less than 2 percent of the population would be able to qualify as an accredited investor.[61] While there is still potential for growing businesses in developing markets to succeed in their fundraising goals through the use of this exemption, they may not see value in using this for crowdfunding since a significant majority of Canadians cannot participate.

2.2.4 Self-Certified Investor Exemption

Alberta and Saskatchewan are developing and piloting a new exemption (Multilateral instrument 45-538) that is similar to the Accredited Investor Exemption, but is intended to allow more investors to participate. Investors who do not meet the high financial requirements to become an Accredited Investor may be able to qualify as a Self-Certified Investor, provided they meet requirements being set out by the provincial regulators. These criteria include either relevant educational backgrounds (law, MBA, business undergraduates), professional designations (CFA, CIM, CBV, CPA, CIWM) and/or the passing of a Canadian Securities Course.[62] While this exemption will allow early-stage companies to target a wider fundraising base for cross-border ECF, there are still other limitations to this exemption. The most significant is that the fundraising company must have its head office in Alberta or Saskatchewan, and it must also concurrently be selling securities to an accredited investor. This exemption as it is currently drafted does not allow for non-Canadian owned businesses. Therefore, it is not currently suitable for Kenyan SMEs.

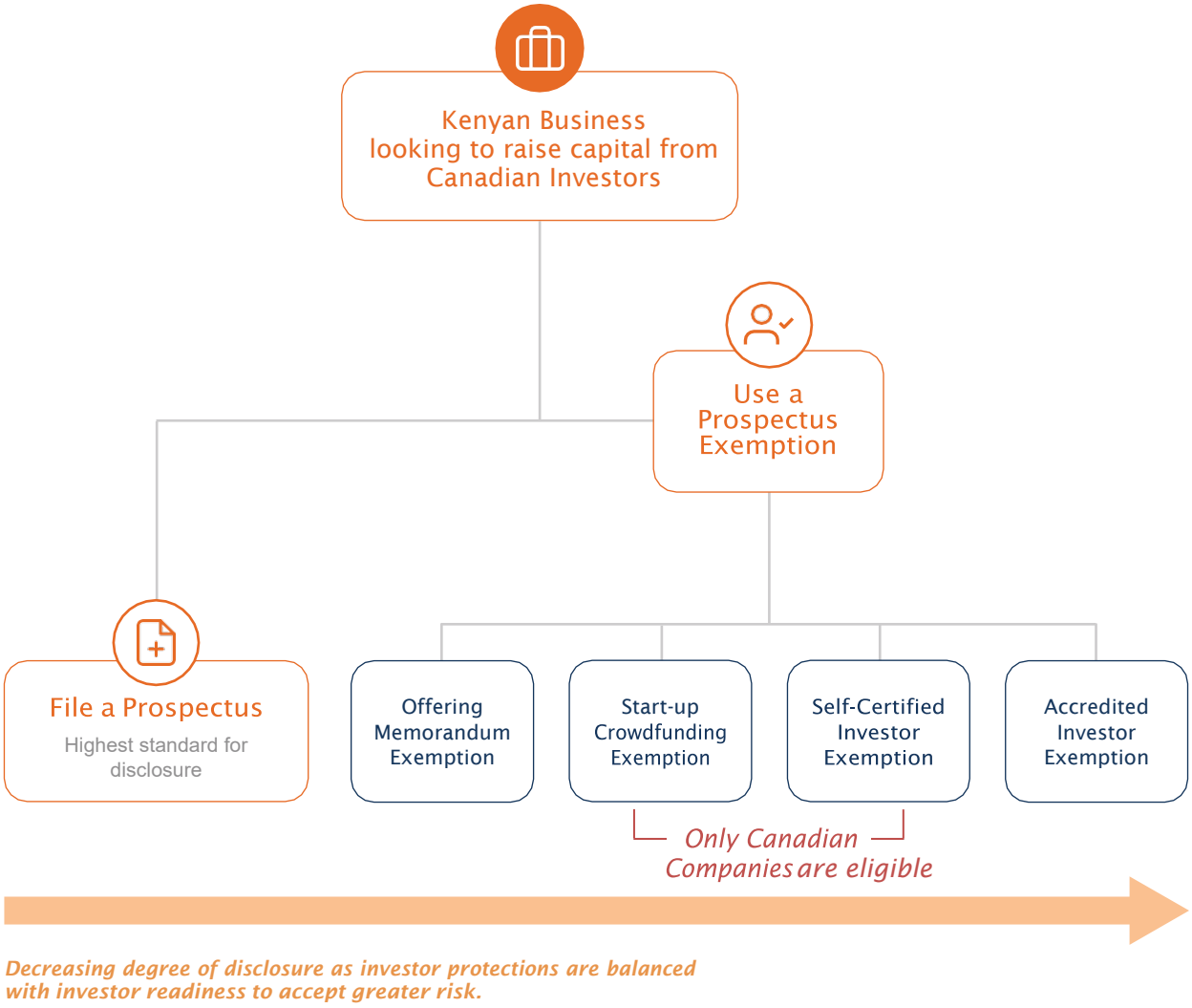
61 "Income distribution in Canada in 2018, by income level," *Statista,* March 9, 2021, https://www.statista.com/statistics/484838/income-distribution-in-canada-by-income-level/.

62 "Alberta and Saskatchewan's New "Self-Certified" Investor Prospectus Exemption," *Bennett Jones,* April 28, 2021, https://www.bennettjones.com/Blogs-Section/Alberta-and-Saskatchewans-New-Self-Certi
fied-Investor-Prospectus-Exemption.

2.3 Barriers to Cross Border ECF

The key pathways for a Kenyan business to raise capital in Canada are detailed in Figure 1. The lack of a single national regulator presents regulatory complexity. The current prospectus exemptions in Canada are not well suited to the needs of Kenyan SMEs.

FIGURE 1: KEY PATHWAYS FOR A KENYAN BUSINESS TO RAISE CAPITAL IN CANADA



3. Global Practices

3. Global Practices

In most countries that regulate ECF, funding for companies is permitted by most regulators, making this sector an ideal place for startups and early-stage business ventures to gain capital. The core of ECF is the ability to acquire financing from individual investors through online platforms. Regulatory frameworks vary from country to country in order to enable this while also ensuring investor protections.

ECF platforms in some jurisdictions are permitted to promote offers to individual retail investors, whereas in others, they are not. In other countries, access to fundraising platforms is restricted to accredited professional investors only. Added restrictions or requirements are sometimes imposed on ECF platforms depending on the knowledge level of their investors. In some cases, non-sophisticated retail investors are only permitted to invest a particular share of their wealth or income over a certain length of time. Typically, ECF platforms must adhere to a series of regulations, including clear marketing and promotional guidelines and anti-money laundering regulations (including Know Your Customer requirements). ECF platforms also often have to ensure that businesses desiring to solicit investments via their platforms meet specific eligibility requirements.

Overall, priorities differ across countries and as such, regulators diverge in their approaches. More and less prescriptive regulatory frameworks, therefore, characterize investor participation in this sector and across jurisdictions. It is essential to analyze these different approaches in order to determine their impacts on their respective markets. By determining which regulations are most conducive to growth and which ones are overly restrictive, countries can avoid creating barriers to their economic growth and development.

3.1 European Union

The regulatory environment for crowdfunding in the EU has faced similar challenges to that of the Canadian system. Fragmentation and differing regulatory frameworks across countries in the EU have also been a significant barrier for the crowdfunding market in Europe. However, the EU is presently working towards the adoption of uniform crowdfunding regulations. Although the regulatory environment in the EU differs from the Canadian environment, there is potential for Canada to adopt a similar passport system.

Compared with other major economies, the EU market for crowdfunding was underdeveloped, only recently snowballing. Several member states had already introduced different regulatory frameworks for crowdfunding services domestically over the past decade, tailored to their local market and investor needs. The fragmentation of regulations, divergent disclosure and licensing requirements, and lack of standard

conditions of operation for crowdfunding platforms have long been a barrier to expanding ECF in the EU and across borders.[63] In turn, this has led to high compliance and operational costs, which have made it difficult for crowdfunding platforms to scale their services effectively.[64] As a result, small and often innovative businesses have faced a limited pool of financing options. The application of prospectus rules and national exemptions prohibiting active cross-border marketing of securities have limited their activities. Investors have also faced more significant uncertainty and fewer choices for cross-border investments.[65] It has been challenging for retail investors to determine the rules applicable to cross-border crowdfunding services, as they are notoriously complex.

Efforts to harmonize regulations and address existing barriers for crowdfunding in the EU only began in September 2015 when the potential for economic growth and competitiveness in this industry was identified. The European Commission's Fintech Action Plan explicitly references this goal within the first launch of the EU's Capital Market Union (CMU) and the mid-term review of the capital markets union action plan.[66,67] In December 2019, the EU Parliament and Council agreed on an interim agreement for regulating crowdfunding platforms and officially adopted regulations allowing them to operate throughout the EU in July 2020.[68,69] The European Parliament adopted the Regulation on European Crowdfunding Service Providers (ECSP) for business in November 2020, creating one of the most harmonized regulatory environments for crowdfunding in the world.[70] The new directives will apply across the EU from November 2021, following a 12-month transition period. A fundamental objective of the ECSP is to enable SMEs in Europe to access financing and remove barriers to cross-border investment activity in the continent.

Through the ECSP, lending and equity-based crowdfunding services are uniformly regulated across the EU. It also established a passport system for platforms that facilitates cross-border operations.

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63 "Crowdfunding," *European Commission*, January 5, 2021, https://ec.europa.eu/info/business-economy-euro/growth-and-investment/financing-investment/crowdfunding_en.

64 Ibid.

65 Ibid.

66 "FinTech Action Plan: For a More Competitive and Innovative European Financial Sector," *European Commission*, August 1, 2018, https://ec.europa.eu/info/publications/180308-action-plan-fintech_en.

67 "Mid-Term Review of the Capital Markets Union Action Plan," *European Commission*, September 16, 2020, https://ec.europa.eu/info/publications/170608-cmu-mid-term-review_en.

68 "Capital Markets Union: Presidency and Parliament Reach Preliminary Agreement on Rules for Crowdfunding Platforms," *European Council*, December 19, 2019, https://www.consilium.europa.eu/en/press/press-releases/2019/12/19/capital-markets-union-presidency-and-parliament-reach-prelimin- ary-agreement-on-rules-for-crowdfunding-platforms/.

69 "Capital Markets Union: Council Adopts New Rules for Crowdfunding Platforms," *Consilium*, July 20, 2020, https://www.consilium.europa.eu/en/press/press-releases/2020/07/20/capital-markets-union-council-adopts-new-rules-for-crowdfunding-platforms/.

70 European Union, "European crowdfunding service providers for business, and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937." *Official Journal of the European Union*, L347, European Union, 2019, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R1503.

MORE SPECIFICALLY, THE ADOPTED REGULATIONS INCLUDE[71]:

- **A high level of investor protection, particularly for non-sophisticated investors.** The investor protection framework provides clear and transparent disclosure requirements for project owners and platform operators. Investor protections include an entry knowledge test, which helps determine whether and which crowdfunding services are suitable for non-sophisticated investors, and an evaluation of investors' ability to bear losses (calculated as 10 percent of their net worth).
- **Harmonized governance and risk management regulations for platform operators,** especially in areas of regulatory uncertainty, such as conflicts of interest and investor relations. Among regulations for platform conduct, is an investment threshold for exemption from a prospectus requirement for crowdfunding platforms of five million euros for annual and project investments.
- **The elimination of barriers that prevent platforms from operating cross-border,** achieved through harmonization of minimum operation requirements. Furthermore, project owners have to produce a simplified key investor information sheet in lieu of a lengthy prospectus, allowing investors to make knowledgeable decisions.
- **The establishment of effective supervisory powers for national authorities** overseeing the operations of crowdfunding platforms.

One of the loopholes in this regulatory framework is that this regulation does not cover taxation practices. Some EU member states offer tax incentive schemes to investors and companies utilizing crowdfunding, while others do not.

In a similar fashion to the Canadian system, the regulatory environment for crowdfunding in the EU has faced fragmentation and diverging regulatory systems. A passport system, eliminating the barriers preventing platforms from operating in more than one jurisdiction, could be highly beneficial to the Canadian government despite the difficulties in adopting a national crowdfunding regulatory system.

3.2 United Kingdom

There are very few countries around the world that regulate non-conventional ways of funding. In many ways, the UK has been a pioneer in the field of equity and loan-based crowdfunding. The UK has a more "principle-based" crowdfunding regulatory environment that has allowed for the evolution of crowdfunding policy in collaboration with its various stakeholders. The growth and expansion of the UK crowdfunding market make its regulatory environment a model to follow.

71 Azad Ali and Christopher Hobson, "Crowdfunding Regulation: Major Reform in the EU, No Change in the UK," *Insights | Skadden, Arps, Slate, Meagher & Flom LLP*, accessed May 26, 2021, https://www.skadden.com/insights/publications/2021/04/crowdfunding-regulation.

The UK has the most developed ECF industry in the world. With the highest market volume per capita in crowdfunding in Europe and a market share that reached 81 percent in 2015 with EUR 4.412 M, the UK's crowdfunding market is still in expansion. As the second-fastest-growing sector in the UK economy, ECF is up 295 percent from £84 million (2014) to £332 million (2015).[72]

Through the landmark reform legislation, the Financial Services and Markets Act 2000 (FSMA), the UK's regulatory body, the Financial Services Authority (FSA), was officially established. After the FSMA was enacted, some parts were repealed and others modified, with the facilitation and development of crowdfunding as one of its primary goals. These changes led to the Financial Services Act of 2012, the Bank of England and Financial Services Act 2016 and the transformation of the FSA into the Financial Conduct Authority (FCA). The FCA inherited the FSA's responsibilities, gained additional authority and powers and the responsibility of better championing consumer rights. In addition to the FCA regulator, the UK Crowdfunding Association (UKCFA) was established in 2013 as a self-regulatory trade body with the primary goal of protecting investors.[73]

The FSMA set up a regulatory framework for overseeing and managing insurance, investment and banking services in the UK. By law, businesses had to make sure that all their activities were compliant with this legislation. Through this Act, the Financial Ombudsman Service was also created for dispute resolutions outside the court system.

In the UK, all investment-based crowdfunding platforms are regulated by the FCA. The FCA first introduced crowdfunding regulations in March 2014, intending to protect consumers, attract more investors and lenders, improve the UK financial sector, and promote healthy and effective competition. FCA oversight of equity crowdfunding is relatively relaxed compared to other countries.[74]

For example, the FCA does not explicitly outline the due diligence procedures that issuers must follow.[75] This means that the risk of failure is highly dependent on ECF platforms' ability to adequately screen companies. However, even despite the UK's light-handed regulations, ECF platforms are known for thoroughly screening the companies that use their services. A platform has every incentive to build trust with investors by developing a reputation for quality. The UK's success can be attributed more to these commercial realities than to prohibitive or heavy-handed regulations.

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72 Bryan Zhang et al., "Sustaining Momentum: The 2nd European Alternative Finance Industry Report," *The Cambridge Centre for Alternative Finance* (2016).

73 "UKCFA," *UKCFA*, accessed May 26, 2021, https://www.ukcfa.org.uk/.

74 Azad Ali and Christopher Hobson, "Crowdfunding Regulation: Major Reform in the EU, No Change in the UK," *Insights | Skadden, Arps, Slate, Meagher & Flom LLP*, accessed May 26, 2021, https://www.skadden.com/insights/publications/2021/04/crowdfunding-regulation.

75 Ibid.

AMONG OTHER STIPULATIONS, THE REGULATIONS IN PLACE INCLUDE:

- **The need for platforms to be licensed or to have regulated activities managed by authorized parties.**
- **Efficient screening processes to determine investor type** (sophisticated and unsophisticated). Platforms must also conduct appropriateness assessments to ensure that investors possess sufficient knowledge and experience of investment-based equity crowdfunding to comprehend the investment opportunities offered.
- **Regulations concerning the communication of investment offers and disclosure of risks.** Specifically, the disclosure requirements require that platforms provide sufficient information to investors regarding the risks to which they are exposed, the nature of the investment opportunity, the fees, and the role of the platform itself (i.e. the service it provides). The FCA has not prescribed a format for these disclosures.
- **Requirement for investors to certify** that they will not be investing more than 10 percent of their net worth in crowdfunding projects per year.

The FCA is in the process of concluding a post-implementation review of its crowdfunding regulations. The process began in July 2016. The interim report (published in 2016) focuses primarily on loan-based crowdfunding and touches briefly on disclosures in investor communications for loan and investment-based crowdfunding.[76]

Also contributing to the UK market's growth is a special tax incentive offered through the Seed Enterprise Investment Scheme (SEIS), specifically designed for early-stage companies, and the Enterprise Investment Scheme (EIS), exclusively targeting more mature start-ups.[77,78] Both tax breaks were established to encourage investments in SMEs and stimulate the economy. By investing in eligible crowdfunding companies, investors can offset their existing tax liability through these incentives.

In March 2017, the UK began the process of leaving the EU, which was finalized on 21 January 2020. The transition period is still underway. UK-based crowdfunding platforms may have to obtain authorization from EU member countries for access to the EU market.

As a result of its "principles-based" and much less onerous crowdfunding regulatory environment, the UK has evolved its crowdfunding policy in close collaboration with several stakeholders. In the UK, platforms are rewarded for doing a substantial part of the heavy lifting in screening companies efficiently. Similarly, Canada can benefit from incentivizing platforms by allowing more flexibility in the crowdfunding regulation

76 Financial Conduct Authority, "Asset Management Market Study Interim Report," *Financial Conduct Authority*, 2016, https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf.

77 "Seed Enterprise Investment Scheme (SEIS)," *SEIS.co.uk*, accessed May 26, 2021, https://www.seis.co.uk/.

78 "Use the Enterprise Investment Scheme (EIS) to Raise Money for Your Company," *GOV.UK*, accessed May 26, 2021, https://www.gov.uk/guidance/venture-capital-schemes-apply-for-the-enterprise-investment-scheme#how-to-apply.

framework. Tax breaks promoting ECF investments may also be beneficial for Canada. Given the growth and expansion of crowdfunding in the UK, its regulatory environment serves as a model to follow.

3.3 United States

The United States is often considered one of the most innovative countries in the world vis a vis alternative finance. However, it was not until the signing of the Jumpstart Our Business Startups Act (JOBS Act) that the crowdfunding market significantly grew.[79] Similarly to Canada, the restrictive regulatory framework of U.S. crowdfunding has prevented the expansion of their market. Recent modifications to their regulatory landscape were made in an attempt to grow the crowdfunding market further.

In the United States, ECF platforms were severely constrained due to restrictions placed on internet sales of securities by the Securities and Exchange Commission (SEC) because of rising concerns over the possibility of fraud and the need to protect investors.[80]
For the most part, it was only high-net-worth, accredited investors who met wealth requirements that were allowed such investment opportunities. Although the JOBS Act, passed by Congress in 2012, and the new SEC regulations passed in 2015 would finally allow the U.S. legislature to establish interstate ECF officially in the country.[81] The JOBS Act had directed the SEC to adopt new regulations to ease securities restrictions for SMEs in the U.S. and facilitate their access to funding.

Regulation Crowdfunding (CF), also known as Title III ECF, was passed in 2016. These regulations opened the doors to non-accredited retail investors and allowed US-based start-ups to raise $1.07 M each year through ECF.[82] This relatively low amount of capital permitted limited ECF to early-stage companies. In addition, CF created a newintermediary entity--the funding portal. In order to operate, companies were obliged to use intermediaries, such as broker-dealers or funding portals approved by the SEC, to ensure compliance with securities laws.[83] Foreign (non-US) companies cannot raise funds using Regulation CF. For foreign investors, securities can only be purchased from U.S. companies in compliance with the securities laws of their home countries.
Generally, for ECF, the reporting and filing of disclosure requirements vary depending on the amount of funding required. Regulation CF also provides a high level of investor protection, particularly for non-sophisticated investors. Retail investors face limits on the

79 Toby Clarence-Smith, "Has the US Equity Crowdfunding Market Lived up to Expectations?" *Toptal Finance Blog*, April 12, 2017, https://www.toptal.com/finance/fundraising/us-equity-crowdfunding-market.

80 "Regulation Crowdfunding," *U.S. Securities and Exchange Commission*, accessed May 24, 2021, https://www.sec.gov/divisions/corpfin/guidance/reg-crowdfunding-interps.htm.

81 "Jumpstart Our Business Startups Act," *U.S. Government*, accessed May 24, 2021, https://www.govinfo.gov/content/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf.

82 "Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers," *U.S. Securities and Exchange Commission*, July 14, 2017, https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm.

83 Ibid.

amount they can invest over 12 months, determined by annual income or net worth.[84]

In the US, funding platforms also face stringent regulations, including the prohibition from offering investment advice and from their handling of investor funds or securities. Recent modifications to Regulation CF (2020) have meant limit increases, "test the waters" provisions allowing companies to build crowdfunding pages where they can share information with investors before fundraising and allowing the creation of special purpose vehicles (SPVs), which are subsidiaries created by parent companies.[85]Among the different types of SPVs, there are trusts, limited partnerships, and corporations, but the most common type is a limited liability company. The creation of SPVs allows companies to securitize assets, form joint ventures, and conduct other financial transactions[86].

Since the JOBS Act was passed and even before the SEC rulings, numerous U.S. states have enacted or are drafting legislation to enact their crowdfunding exemption laws for the intrastate offering of securities exempt from federal regulation. A study reported that by October 2016 indicates that 35 states had either enacted separate intrastate crowdfunding exemptions or amended existing blue-sky legislation to allow some intrastate crowdfunding. U.S. crowdfunding has been hampered by its restrictive and fragmented regulatory framework, similar to Canada. Recently, regulatory changes were made to the regulatory landscape to grow the crowdfunding market further. Canadian regulators should conduct more "test the waters" or "sandbox" experiments to evaluate the effects on the market of even minor changes in the crowdfunding regulatory environment.

84 Ibid.

85 Giovanna Soto and David Stockton, "The SEC Adopts Amendments to Regulation Crowdfunding," *JD Supra*, November 25, 2020, https://www.jdsupra.com/legalnews/the-sec-adopts-amendments-to-regulation-68123/.

86 "SPVs (Crowdfunding Vehicles) vs Custody: What's the Best Solution to Manage Your Shareholders?" *StartEngine*, February 21, 2021, https://www.startengine.com/blog/spv-vs-custody/.

4. Kenyan SMEs and Social Enterprises

4. Kenyan SMEs and Social Enterprises

SMEs make up a key sector that creates jobs in Kenya, constituting 98 percent of businesses in the country. They created 30 percent of jobs in 2017 and contributed to 3 percent of the nation's overall GDP growth of 6.4 percent.[87] A vital componentof the SME sector is social enterprise. These include organizations that use business or commercial strategies to create social impact for the society or the environment, alongside profits.[88] The British Council estimated around 44,000 social enterprises operating in Kenya in 2016,[89] and the number has likely grown since then.

Social enterprises in Kenya are fast growing.[90] Based on the 183 organizations that the British Council analyzed in its report called "The state of social enterprises in Kenya", 55 percent of them made a profit, and 69 percent used the profits for development activities. This growth is expected to create a multiplying effect in attracting new clients and customers.[91]

The following subsections explain socio-economic challenges in Kenya, opportunities for SMEs and social enterprises to address them, as well as the financing gaps that hinder their growth.

4.1 Socio-economic challenges

The COVID-19 pandemic has significantly affected Kenyan households. Restrictions of international travel, the nationwide curfew and other virus containment measures impacted socio-economic activities in Kenya. The gravity of the negative impacts increases the importance of social enterprises and presents opportunities for them to get involved and improve the current condition. Below are some of the areas where the society needs help the most especially during and after the pandemic:

4.1.1 Unemployment among young people

The vast majority of unemployed Kenyans are under 35 years old.[92] Specifically, the youth (age 15 to 24) unemployment rate has always been higher than the overall unemployment rate in Kenya.[93] Although online research and data on youth unemployment rates in the country have been inconsistent due to un-unified definitions

87 Payne, 2017.

88 Social Enterprise Society of Kenya, "Mission," *Social Enterprise Society of Kenya*, 2021, https://www.socialenterprise.or.ke/#:~:text=A%20social%20enterprise%20is%20an,maximizing%20social%20impact%20alongside%20profits.

89 British Council, 2017.

90 Ibid.

91 Ibid.

92 Stephanie Cantor, "LSE Blogs," *LSE Blogs* (blog), London School of Economics and Political Science, 2019, https://blogs.lse.ac.uk/africaatlse/2019/11/05/meaningful-employment-kenya-youth/.

93 British Council, 2017

of "youth" and "unemployment"[94], most have highlighted the need for society to pay attention to Kenya's high youth unemployment rate, given the country's large percentage of young people.

The pandemic has further increased unemployment in Kenya. As of November 2020, only 57 percent of the nation's population was employed, compared to 71 percent in 2019. The unemployment rate was five times higher during the pandemic. According to the World Bank, the sharp drop in employment has hugely affected the urban sector, and economic recovery will be slow.[95] The highest proportion of unemployment appearedwithin the 20 to 29 years of age group. Among these statistics, the rise of long-term unemployment is the most concerning as it is harder to recover and could increase poverty. In 2020, youth (age 20 – 24) long-term unemployment rate reached a high record of 7.9 percent.[96]

4.1.2 Food insecurity

People living in urban slums and rural Kenya had already faced food insecurity before the COVID-19 pandemic.[97] Inthe slums of Nairobi, 20 percent of residents had one or fewer meals per day and closeto 40 percent had only two meals per day due to poverty, prior to the pandemic.[98] In rural areas, food prices in local markets increased due to climate change induced natural disasters, making food unaffordable to residents. Although many residents work in the agriculture sector, events like droughts would kill livestock and floods would disrupt transportation, which caused income and food shortage for rural residents.[99]

The pandemic has worsened food insecurity. In 2020, 25 percent of households in the country did not have enough food supply. The situation is worse among female-headed and poor households. This directly impacts Kenyans' health status and quality of living.[100] Low-income families such as those living in the slums are hit even harder. Through a survey of 200 families in Mukuru, a large cluster of informal settlements in Nairobi, 88 percent of households reported not getting enough food due to loss of income during the COVID lockdown.[101] In addition, this decrease of demand in food has also disrupted the

94 Vincent Ng'ethe, "Analysis: How Many Young Kenyans Are Unemployed? A Look at the Numbers," Africa Check, November 18, 2020, https://africacheck.org/fact-checks/blog/analysis-how-many-young-kenyans-are-unemployed-look-numbers.

95 The World Bank, "Socioeconomic Impacts of COVID-19 in Kenya," November 2020, https://documents1.worldbank.org/curated/en/384651613652984513/pdf/Socio-Economic-Impacts-of-COVID-19- in-Kenya-Results-Update.pdf.

96 Xinhua Net, "Kenya's Unemployment Rate Doubles to 10.4 Pct in Q2 Due to COVID-19," *Xinhua News*, September 2020, http://www.xinhuanet.com/english/2020-09/02/c_139337407.htm.

97 Matthew Shupler and Dan Pope, "Kenya's COVID-19 Lockdown Is Forcing People to Make Difficult Food and Household Energy Decisions," *Phys.org,* April 26, 2021, https://phys.org/news/2021-04-kenya-covid-lockdown-people-difficult.html.

98 International Institute for Environment and Development (IIED), "Informal Food Systems and Food Security in Rural and Urban East Africa," *IIED Publication Library*, 2016, https://pubs.iied.org/sites/default/files/pdfs/migrate/17336IIED.pdf.

99 Ibid.

100 The World Bank, 2020.

101 Matthew Shupler et al., "COVID-19 Impacts on Household Energy & Food Security in a Kenyan

supply chain for farmers and small, independent food transporters, as they are not able to sell their products such as fruits and vegetables, causing their income to drop.[102]

4.1.3 Lack of access to health services

One of the major social issues in Kenya is the disparity between rural and urban areas, especially in terms of access to health care. Due to a severe shortage of medical staff in rural areas, rural Kenyans lack critical services. The World Bank found that in 2015,"only 5 percent of infants were delivered at a health care facility in the remote north- eastern Wajir County, whereas more than 80 percent were delivered in such conditions in the more central Kirinyage County''.[103] Inadequate access to primary care also exists in urban slums of Nairobi, especially families that are headed by women.[104]

The COVID pandemic has further exacerbated the lack of access to health services, such as prenatal check-ups and immunizations, which can have negative effects on people's long-term health. Thirty percent of households nationwide reported having to cut down their access in 2020.[105] In a global health research, health workers reported that the national government had issued guidelines on COVID-19 prevention and access to care for cases but did not guide on continuous provision of non-COVID-19 illness. A nurse who served a slum in Nairobi explained that emergency resources for health facilities were mostly diverted to COVID and not other diseases. For example, routine growth monitoring for children under 5 years was suspended during the lockdown in 2020.[106] Moreover, pharmacies in the slum areas were either not functioning or only providing minimal services during this period.

One positive finding was that mobile consultations with health workers through phones are offered to people for non-COVID, non-communicable conditions. Also, a private-public partnership provided pregnant women with emergency taxi service to transfer them to a health facility at night during curfew hours.[107] This shows the potential of mobile medical consulting services to enhance health care provision in Kenya.

Informal Settlement: The Need for Integrated Approaches to the SDGs," *Renewable and Sustainable Energy Reviews,* 144 (2021), https://doi.org/10.1016/j.rser.2021.111018.

102 Timothy Njagi Njeru and Miltone Were Ayieko, "Why COVID-19 Is Another Blow for Kenya's Food Security," The Conversation, January 14, 2021, https://theconversation.com/why-covid-19-is-another-blow-for-kenyas-food-security-135567.

103 Oxford Business Group, "The Report - Kenya 2017," Google Books, 2017.

104 Otieno Peter et al., "Access to Primary Healthcare Services and Associated Factors in Urban Slums in Nairobi-Kenya," *BMC Public Health*, 2020, https://bmcpublichealth.biomedcentral.com/articles/10.1186/s12889-020-09106-5.

105 The World Bank, 2020.

106 Syed Ahmed and Rita Yusuf, "Impact of the Societal Response to COVID-19 on Access to Healthcare for Non-COVID-19 Health Issues in Slum Communities of Bangladesh, Kenya, Nigeria and Pakistan: Results of Pre-COVID and COVID-19 Lockdown Stakeholder Engagements," *BMJ Global Health*, 2020, https://gh.bmj.com/content/5/8/e003042.info.

107 Ibid.

4.2 Opportunities to address societal challenges

Given the nature of social enterprises which is to make positive changes to socio-economic hardships, the societal challenges present opportunities for these organizations to create meaningful impact. The majority of them carry missions of creating employment opportunities and/or responding to local needs, which contribute to reducing the youth unemployment rate and inequality gaps in Kenya.[108] As the COVID-19 pandemic further exacerbates societal challenges, it is essential to support social enterprises to provide relief to the communities. The sub-sections below demonstrate areas of opportunities for social enterprises to make impacts.

4.2.1 Unemployment reduction

Social enterprises exhibit several potentials to address unemployment among young people. According to the British Council, 65 percent of these enterprises are led by people between 25 to 44 years of age.[109] They also tend to hire young people, which can in turn contribute to reduction of the youth unemployment rate. Enterprises with a training aspect for its beneficiaries exhibit even more value because they advise on employable skills such as customer services, provision of high-quality goods and computer-related training, which beneficiaries can utilize for later employment or starting their own businesses. These job training can also improve beneficiaries' income to be above minimum wage, should they master the skills.[110]

One of the social enterprises interviewed for this study who provides such training is Information and Communications Technology for Development Kenya (ICT4D-Kenya). This enterprise was established in Kilifi, a town on the coast of Kenya near Mombasa, to empower youth and women in rural Kenya through technology. It provides courses on IT skills for different areas such as agribusiness, health care, education and entrepreneurship.[111] Founded in 2010, ICT4D-Kenya has trained 2,500 people. Of the young trainees, 75 percent have secured employment in the field of IT, according to the business owner.[112] For example, a trainee from rural Kenya started his own project by digitizing paper documents and storing the digital version for residents. Another trainee created a web application that helped farmers find buyers before harvesting season which improved the chance of profiting for the farmers.[113] Therefore, not only did ICT4D-Kenya help with employment for its young trainees, but it also indirectly generated a positive impact for communities through these trainees.

108 British Council, 2017.

109 Ibid.

110 Joy Muthanje Mwaniki, "The Impact of Social Enterprise on Labor Market Structure: A Case Study of Social Enterprises in Nairobi," ETD Home (University of the Western Cape, 2018), http://etd.uwc.ac.za/xmlui/handle/11394/6596.

111 ICT4D Kenya, "Courses," *ICT4D*, 2021, https://ict4d-kenya.org/all-courses/.

112 Mativo Jonathan, Founder, ICT4D Kenya. Zoom interview with Policy Lab Team, March 20, 2021.

113 Ibid.

4.2.2 Digital innovation for social causes

Before the pandemic, Kenya had become a leader in digital innovation in Africa prior to the pandemic, especially in mobile money. In 2019, KSh4.4trn ($41.3bn) was transacted through mobile platforms. The growth was led by the Safaricom-owned M-Pesa, a mobile money service for money transfer, bill payment and loan applications via SMS across the continent.[114] The development of M-Pesa also encourages broad mobile internet access in Kenya, with a penetration rate of almost 109 percent[115] in 2021, which is an 11 percent increase from 2020. Almost 73 percent of Kenyans aged 15 and above havea mobile money account.[116] In addition, wide use of the mobile payment system boostedthe e-commerce market. In 2020, 15.59 million Kenyans shopped online. These factorsexhibit a positive environment to leverage digital innovation for poverty reduction such as providing better food security. As the COVID-19 pandemic disrupted the food supply chain, which increased the risks of poverty for farmers, the World Bank is partnering with 15 Agriculture Technology start-ups by leveraging digital technologies to help farmers overcome constraints and facilitate product delivery.[117] Further, necessity-driven innovation in areas of food delivery for vulnerable communities and reduced traffic congestion in urban areas present an opportunity to improve Kenyans' lives, which is another area of opportunity for social enterprises.[118]

Digital solutions are also sought to improve health care for rural and poor populations in Kenya. Telemedicine is a viable option to provide care to remote communities without requirements for doctors to travel to the areas, thus helping to close the gap of health service shortage. One study has conducted a cost-benefit analysis of setting up a telemedicine system where oncologists anywhere in Kenya can see patients in rural areas online as they go to an outreach clinic in their region. Each clinic can be facilitated by just one local person. The cost and time being saved through this system would be significant.[119]

On a similar note, TIBU Health is a Kenyan start-up that flourished amid the pandemic by offering health services booking through its online platform. The service matches patients with 15 health care professionals who partner with TIBU Health, as they offer services such as vaccination and check-ups at patients' homes. This business has made

114 Oxford Business Group, "Innovative Industry Aids Kenya's Covid-19 Response," *Oxford Business Group*, December 22, 2020, https://oxfordbusinessgroup.com/news/innovative-industry-aids-kenya-s-covid-19-response.

115 The percentage figure exceeds 100 percent of the total population because many people have more than one mobile connection as they have multiple SIM cards.

116 Paula Gilbert, "Kenya Internet Usage Lags Mobile Penetration," *Connecting Africa*, April 2021, http://www.connectingafrica.com/author.asp?section_id=761&doc_id=768744.

117 The World Bank, "World Bank's Response to COVID-19 (Coronavirus) in Africa," *The World Bank News*, April 8, 2021, https://www.worldbank.org/en/news/factsheet/2020/06/02/world-banks-response-to-covid-19-coronavirus-in-africa.

118 Joleen Young, Partner, KPMG Canada. Zoom interview with Policy Lab Team, February 10, 2021.

119 S Mbunya et al., "Telemedicine: Bridging the Gap Between Rural and Urban Oncologic Healthcare in Kenya," Journal of Global Oncology, 2018, https://ascopubs.org/doi/10.1200/jgo.18.91500.

health care accessible to more than 10,000 patients during the pandemic.[120] While the business benefits the urban population, the owner of TIBU Health finds it difficult to extend services for rural residents due to distance, lack of health seeking behaviours and other infrastructure issues. Operating with a slightly different model, a more prominent company from Egypt called Vezeeta expanded its business to Kenya in 2020. Vezeeta can provide instant teleconsultation to underserved and rural communities,[121] which shows possibilities for local Kenyan start-ups to provide similar health services to more Kenyans.

Digital health service is still a new area in Kenya, yet it exhibits great value in solving the issue of health care shortage. Although the country is competent in digital innovation with high mobile penetration, not many start-ups can successfully operate such businesses due to a lack of financial backers. This calls for a need to explore ECF as a new funding mechanism to support social enterprises and solve socio-economic challenges in Kenya.

4.3 Financing gaps

SMEs would not succeed without financial support. Kenyan SMEs, especially the micro-sized ones with ten staff or less, struggle to survive partly due to inadequate capital and investment. Approximately 400,000 Micro SMEs (MSMEs) in Kenya, including social enterprises, do not celebrate their second birthday.[122] The COVID-19 pandemic has further brought unprecedented losses to MSMEs; 61 percent of them do not have financial reserves to help them overcome this emergency.[123]

The FDI inflow to Africa had already fallen before the COVID-19 pandemic in 2019. During the pandemic, FDI to Kenya dropped by a significant 18 percent to US$1.3 billion in 2020, despite the establishment of new projects in IT and health care.[124] Under this decline, the United Nations Conference on Trade and Development mentioned theneed to diversify investment flows to Africa in the longer term.[125] This calls for a need to explore alternative finance such as cross-border ECF.

SMEs are often perceived as high-risk by investors because of the slow speed or seemingly low growth potential, even if they make a profit and create jobs.[126]

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120 Jason Carmichael, Founder, TIBU Health. Zoom interview with Policy Lab Team, April 27, 2021.

121 "Vezeeta continues to bridge the gap between patients and providers across Kenya through cutting-edge digital healthcare solutions," *Techarena,* October 30, 2020, https://www.techarena.co.ke/2020/10/30/vezeeta-kenya/.

122 Payne, 2017.

123 Diana Siddiqui et al., "Impact of the COVID-19 Pandemic on Micro, Small, and Medium Enterprises (MSMEs)," Microsave Consulting (Swiss Capacity Building Facility, July 2020), https://www.microsave.net/wp-content/uploads/2020/07/Impact-of-COVID-19-pandemic-on-MSMEs-Kenya_V2.pdf.

124 UNCTAD, "Investment Flows in Africa Set to Drop 25% to 40% in 2020," *UNCTAD*, June 16, 2020, https://unctad.org/news/investment-flows-africa-set-drop-25-40-2020.

125 Ibid.

126 Diana Mitlin et al., "The SME Finance Gap in Kenya: How Are Investors Missing the 'Missing Middle'?," Institute of Development Studies, March 11, 2019, https://www.ids.ac.uk/opinions/the-sme-finance-gap-in-kenya-how-are-investors-missing-the-missing-middle/.

Likewise, social enterprises present risks because the ecosystem is relatively young.[127] Due to this perception and lack of credit, access to capital, equity and debt is the main barrier that social enterprises face, which hindering their ability to make significant social impacts. It is also challenging for small firms to obtain loans from Kenyan banks. On top of risk perception, it is expensive for banks to monitor loans and perform due diligence on small enterprises – a category that many social enterprises belong to. As a result, only five percent of social enterprises surveyed by the British Council had access to commercial loans. The majority of them, supported by donations. One in four organizations receives no financial support at all.[128]

Local, small social enterprises suffer the most from the financing gap. These enterprises often provide low-cost to free services to the base of the economic pyramid (BoP) but rarely identify themselves as social enterprises, reducing their chances of getting investors.[129] For instance, 48 percent of social enterprises operate in the agriculture sector located in rural Kenya, whereas funders are based in urban centres of Nairobi, Mombasa and Kisumu. Thus, many agricultural social enterprises may not have access to the funder networks nor angel investment provided by these networks.[130]

In recent years (in 2019), digital loans like Stawi were founded to support SMEs in Kenya, specifically. Backed by five major banks in the country, Stawi is a mobile phone-based lending service that provides loans valued between KSh 30,000 to KSh 250,000 (US$277 to US$2,315). The service uses customer transaction data to access the creditworthiness of the enterprises.[131] While Stawi reflects the country's improvement of helping SMEs ease some financial pressure and proving their creditworthiness, the loans are not enough to close the financing gap, with an additional burden that borrowers must pay an annual interest rate of nine percent on the loan.[132] Thus, there is a need to increase overseas investing, especially social enterprises. This would enable Kenya to achieve SDG Goals, particularly Goal #1: End poverty; #3: Good health and wellbeing; #4: Quality education; #5: Gender equality; #8: Decent work and economic growth and #10: Reduced inequality. Cross-border ECF is a way to close the financing gap, especially for small-sized social enterprises.

127 British Council, 2017.

128 Ibid.

129 Cristina Navarrete Moreno et al., "Social Enterprise Ecosystem Country Profile KENYA," *Endeva*, 2017, http://dev.endeva.org/wp-content/uploads/2017/08/wb_kenya-country-profile_apr14.pdf.

130 Emily Barran et al., "Social Enterprises as Job Creators in Africa," *Siemens Stiftung*, 2020, https://www.siemens-stiftung.org/wp-content/uploads/2020/10/studie-socialenterprisesasjobcreatorsinafrica-part2-siemensstiftung.pdf.

131 George Obulutsa, "Kenyan Lenders Target Small and Medium Businesses with Digital Loans," *Reuters*, November 6, 2019, https://www.reuters.com/article/us-kenya-banks-idUSKBN1XG283.

132 Ibid.

5. Crowdfunding and ECF in Kenya

5. Crowdfunding and ECF in Kenya

Developing countries in Africa have been among the slowest adopters of crowdfunding in the world. The crowdfunding market in Africa, estimated to be around US$70 million, accounted for about 0.5 percent of the global market and 21 percent of the emerging market.[133] Crowdfunding is a new concept in East Africa where unconducive national regulatory environments for equity and debt-based crowdfunding, low utilization of e-commerce, and significant commitment of time and resources are among the barriers in its greater adoption. Despite the challenges, given the global trend of expansion and improved technological infrastructure, crowdfunding is increasingly becoming an alternative source of funding for African SMEs. In 2016, there was a forecasted growth of 117 percent of crowdfunding flows in and out of East Africa.[134]

Among East African countries, Kenya has been experiencing an uptake of crowdfunding and alternative financing models.[135] The presence of a large number of SMEs and their relatively high percentage of financial sourcing from non-bank financial institutions indicate the appetite and potential for growth of the crowdfunding sector. De Vries (2017) estimates that more than 50 percent of all SME finance is generated from non-traditional methods.

Indeed, Kenya is already the most active crowdfunding nation in the region, with around US$22 million raised in 2015 and a rapid projected annual growth of 50 percent, pre-COVID-19. The vibrant crowdfunding ecosystem in the country is due to its relatively advanced economy, infrastructure, internet connectivity and mobile money use.[136] Furthermore, the high penetration of mobile internet access and mobile money service M-pesa has provided a new means for facilitating the Kenyan notion of Harambee. This Swahili term means "Let us pull resources together."[137] Harambee embodies the Kenyan spirit of community support through collective effort and fundraising to finance and establish schools, hospitals and churches.[138,139]

Kenya is home to M-Changa, Africa's largest online crowdfunding platform, which has utilized Kenya's conducive digital infrastructure to link urban and non-rural pool of

133 World Bank, "Crowdfunding In Emerging Markets," *Openknowledge.Worldbank.Org*, 2015, https://openknowledge.worldbank.org/handle/10986/23820.

134 FSD Africa, "East Africa Crowdfunding Landscape Study," *Fsdafrica.Org*, 2016, https://www.fsdafrica.org/publication/east-africa-crowdfunding-landscape-study/.

135 Ibid.

136 FSD Africa, "East Africa Crowdfunding Landscape Study," *Fsdafrica.Org*, 2016, https://www.fsdafrica.org/publication/east-africa-crowdfunding-landscape-study/.

137 Frankline Bradly Matanji, "Whatsapp And Mobile Money Towards Successful Crowdfunding And Social Change: A Kenyan Case," *Africana Studies Student Research Conference*, Bowling Green State University, 2019, https://scholarworks.bgsu.edu/cgi/viewcontent.cgi?article=1151&context=africana_studies_conf.

138 Dinfin Mulupi, "M-Changa: Modernising Traditional Fundraising In Kenya," *How We Made It In Africa*, June 8, 2015, https://www.howwemadeitinafrica.com/m-changa-modernising-traditional-fund-raising-in-kenya/49464/.

139 Anne Gathuo, "Kenyan Women and the Harambee: Community Development or Unpaid Work?" Trotter Review: Vol. 12: Iss. 1, Article 11 (2000), http://scholarworks.umb.edu/trotter_review/vol12/iss1/11.

potential donors by cutting down the logistical needs and costs associated with physical Harambees.[140] The platform has successfully raised millions of dollars through online fundraisers on medical support, drought relief and biofuel pumps, among others.[141] The case of M-Change points to the general acceptance and potential of crowdfunding initiatives in Kenya.

It is noteworthy that FSD Africa states that most funding for crowdfunding in Kenya comes from funders outside of the country. Indeed, Kenya is the leader among African countries in receiving funding from foreign crowdfunding platforms with US$13.0 million in 2016, followed by Rwanda US$8.7 million.[142,143] M-Changa, raised about 35 percent of their funds from the members of the Kenyan Diaspora in 2016.[144] This broadly indicates the appetite and potential for diaspora investment in crowdfunding in the region in general.

ECF, however, accounted for only 1 percent of Kenya's crowdfunding ecosystem in 2016.[145] The lack of a regulatory framework is cited as the primary reason behind the low adoption of the equity-based model. Donation-based crowdfunding accounted for around two-thirds of market activity, while the rest came from non-financial return-based lending models. ECF accounts for 1 percent of Uganda and Rwanda's crowdfunding ecosystem as well, with similar absence of regulatory framework in these countries.[146] This minimal share of ECF in these countries suggests that the model is at its very early stage in the region, while the current absence of regulations has not supported its growth. This is in contrast to the relatively developed crowdfunding ecosystem of South Africa. Unlike Kenya, the country has specific licensing provisions for equity crowdfunding platforms under the Financial Advisory and Intermediary Services Act No. 37 of 2002. The legal framework might be a reason behind the relatively higher share of ECF, 6 percent in the overall crowdfunding market in the country.[147]

Despite the absence of regulations in Kenya, 69 percent of the Kenyan debtors and equity-based platform owners found the existing state of the regulations adequate for their operations.[148] This suggests that existing platforms have adapted and are functioning to some extent in the regulatory void.

140 M-Changa, "Understanding Digital Fundraising In Kenya: A Case Study With M-Changa," M-Changa, 2019, https://sibelkusimba.files.wordpress.com/2019/10/m-changa.2019.pdf.

141 "M-Changa: Secure, Transparent & Convenient Fundraising!" *M-Changa*, accessed May 23, 2021, https://www.fundraising.co.ke/the-most-successful-m-changa-campaigns-of-all-time/.

142 FSD Africa, "Crowdfunding In East Africa: Regulation And Policy For Market Development". *Cambridge Center for Alternative Finance*, 2017, https://www.jbs.cam.ac.uk/wp-content/uploads/2020/08/2017-05-eastafrica-crowdfunding-report.pdf.

143 de Vries, 2019.

144 Ibid.

145 Ibid.

146 FSD Africa, 2017.

147 de Vries, 2019.

148 Cambridge Centre for Alternative Finance, "The Global Alternative Finance Market Benchmarking: The Report," Cambridge Centre for Alternative Finance, 2020, https://www.jbs.cam.ac.uk/wp-content/uploads/2020/08/2020-04-22-ccaf-global-alternative-finance-market-benchmarking-report.pdf.

5.1 Crowdfunding and ECF Regulatory Framework in Kenya

The World Bank (2015) highlighted the necessity of creating regulations that allow for the expansion of crowdfunding services, including equity-based crowdfunding.[149] The report also emphasized the need for clear guidelines to facilitate greater utilization of equity-based platforms by African projects and enable investors' access in Africa and international markets. For the growth of ECF, such guidelines should include provisions for intermediaries to conduct due diligence and ensure credibility among the investor communities.

Kenya suffers from an absence of legislation or regulatory framework to facilitate crowdfunding. The Capital Markets Authority (CMA) and the Central Bank of Kenya (CBK) regulate the development of alternative finance in the country. In the absence of strict governing legislation, CBK and CMA can endorse new crowdfunding models. CMA is under the legislation of the Capital Markets Act 2012 and its 2019 amendment that stipulates activities involving securities.[150] Under the Act, a public offer is made when an offer of securities is made to the public. According to FSD (2017), ECF investors can 'either be able to take advantage of an exemption in order to avoid submitting a prospectus to the CMA, or fall within the definition of a private offer and submit a short-form information notice as required by the CMA.' Such private securities offers are limited to members or employees of a company, family members of any such members and persons who are believed to be sufficiently knowledgeable of the risk involved with the offer.

In Kenya, there have been calls for institutions such as CMA to play a proactive role in brokering trust. Intuitional signals of trust can be crucial in the market in developing the early-stage credibility of crowdfunding. A strong partnership between industry associations and regulatory bodies is also necessary for the growth and sustainability of investment-based crowdfunding.[151]

One positive sign is that the Kenyan government is generally favorable to the prospects of equity-based crowdfunding. Particularly, CMA has been co-operative with the African Crowdfunding Association (AFCA) in creating a regulatory framework, 'ACfA Label Framework,' to assist the launch of securities-based crowdfunding in Kenya.[152] ACfA was founded in 2015 with the support of the UK's Department for International Development and FSD Africa to harmonize crowdfunding regulations across Africa through the adoption of the ACfA Label Framework.[153] The Framework can be adapted by any African regulatory authority that seeks to develop crowdfunding as a capital

149 World Bank, 2015.

150 Capital Markets Act (2012), Vol. 485. Kenya: the National Council for Law Reporting.

151 Patricia Odero, "Trust As Capital: Growing Investment-Based Crowdfunding In Kenya". *Issuu*, 2020, https://issuu.com/cambridgejbs/docs/2020-mstsi-researchsummary-odero.

152 Elizabeth Howard, CEO, ACfA, Zoom interview with Policy Lab Team, January 20, 2021.

153 "African Crowdfunding Association," *ACFA*, accessed May 31, 2021, https://africancrowd.org/.

markets tool in its jurisdiction. ACfA issues a license, 'ACfA Label' to crowdfunding intermediaries under this framework, authorizing them to operate in the jurisdiction. Kenya has adopted thelabel, while Rwanda, Uganda, Ghana and Malawi expressed interest to implementthe framework. [154] Yet at the end of the donor funding in 2020, there is doubt about the extent that the Label Framework will be operationalized in the countries.

IN THE ABSENCE OF A REGULATORY FRAMEWORK, ECF PLATFORMS CAN TAKE ADVANTAGE OF THE FOLLOWING TWO MEANS WHEN OPERATING IN KENYA:

1. **De-facto tolerance of the regulator:** Generally, the lack of regulation means no restrictions in investing in ECF. Elizabeth Howard, CEO, ACfA mentioned that an email from ACFA to CMA authorities informing them of a particular crowdfunding operation served the purpose. This is applicable for both Kenya and foreign based platforms.

2. **CMA Regulatory Sandbox:** The Regulatory Sandbox allows for innovative services, such as ECF platforms, to operate in a tailored regulatory environment to test out the product, solutions and services in a limited scale. It has been accepting applications since 2019.

Regulatory Sandbox Policy Guidance Note mentions that the provision accepts application ideas for live-testing developed to the level of operational testing from fintech firms and innovators to the Regulatory Sandbox for 12 months. To apply, companies must be incorporated in Kenya or the other East African States. At the same time, a foreign company licensed by a securities market regulator in its jurisdiction is also eligible to apply as long as the solution can deepen Kenya's capital markets following successful exit from the Sandbox. This might open doors for Canadian ECF platforms that would want to operate within a Kenyan regulatory framework that enables financial flow to Kenya through cross-border ECF.

Once selected, the participants must comply with certain minimum regulatory requirements prescribed by law and applicable to all capital market participants as further specified by the Authority in a safeguard and supervision plan, which forms a part of the test plan. The Safeguards Plan is to prevent money laundering, counter-terrorism financing, and other illicit activities and to address the unique risks presented by the Regulatory Sandbox test. CMA assesses regulatory requirements to be temporarily modified during a Regulatory Sandbox test on a case-by-case basis.

Notably in October 2020, CMA has recently granted a 'No Objection' to Pezesha Africa, a debt-based crowdfunding platform, to operate in the Kenyan capital markets, after a successful one-year testing period in the Regulatory Sandbox.[155] The No Objection is

154 Elizabeth Howard, CEO, ACfA, Zoom interview with Policy Lab Team, January 20, 2021.

155 "Pezesha Exits From The CMA Regulatory Sandbox," *Capital Markets Authority*, October 12, 2020, https://www.cma.or.ke/index.php?option=com_content&view=article&id=666:press-release-pezesha-exits-from-the-cma-regulatory-sandbox&catid=12&Itemid=207.

conditional to Pezesha's compliance with a set of requirements, including an appropriate financial risk management framework and adequate local capital market transaction control procedures. A comprehensive regulatory framework to operate a debt-basedcrowdfunding platform in Kenya is also in the pipeline.

5.2 Cross Border Investment and Equity Crowdfunding

Understandably ECF is very different from debt-based crowdfunding, and it is unclear to what extent the in-development Regulatory Framework will encompass the equity-based model.

As per our findings, there are no formal regulations in Kenya that prohibit cross-border investments related to equity crowdfunding. Indeed, there are generally no requirements for approval of foreign investments in Kenya.[156] The government is actively seeking to draw foreign investment in the country aligned with its national development strategy of becoming a middle-income industrialized country with the 'Vision 2030'. In 2019, the Investment Policy was launched to enhance investment transparency and clarity for national and foreign investors with an institutional framework for monitoring and coordinating investment activities.[157] The policy revises the previously required minimum capital for foreign investors of US$100,000 for receiving incentives to allow for flexibility in minimum requirements based on sector, including low-capital sectors such as ICT.

Foreign investment in Kenya is primarily governed by the Companies Act, the Investment Promotion Act, and the Foreign Investment Act. Kenyan businesses looking to advertise on a Canadian platform will be liable to the Kenya Companies Act 2015.[158] The Act stipulates equity securities allocation to a person given that the securities are "nearly as practicable equal to the proportion in nominal value held by the person of the ordinary share capital of the company". In case of contravention, the company or personnel at default "are jointly and severally liable to compensate any person to whom an offer should have been made in accordance with those sections for any loss, damage or expenses that the person has sustained or incurred because of the contravention." The Foreign Investment Promotion Act 2012 protects foreign investors by highlighting that "no approved enterprise or any property" and "no interest in or right over such enterpriseor property" owned by anyone, including foreign individuals, can be forcefully acquired.[159]In case of violation, the person 'having an interest' has the right to

156 Jacqueline Nyabwa and Wangui Kaniaru, "Doing Business in Kenya: Overview," *Thomson Reuters Practical Law*, January 1, 2019, https://uk.practicallaw.thomsonreuters.com/w-007-2231?transitionType=Default&contextData=%28sc.Default%29&firstPage=true.

157 "Kenya Investment Policy Draft," *Kenya Private Sector Alliance,* April 7, 2017, https://kepsa.or.ke/download/kenya-investment-policy-draft/.

158 Elizabeth Howard, CEO, ACfA, Zoom interview with Policy Lab Team, January 20, 2021.

159 Kenya Foreign Investment Protection Act (2012), http://admin.theiguides.org/Media/Documents/ForeignInvestmentsProtectionAct35of1964.pdf

resort to the High Court for determination of his/her interest or right, and to obtain prompt payment of compensation. Despite the legislative protection, the question remains as to what extent these will apply to small, cross-border equity investments, and whether the investors will be pursuant of legal means to seek compensation, given the time and money required to pursue cross-border equity issues.

With Canadian platforms, Kenyan SMEs will be subject to 30 percent tax on profits (currently reduced to 25 percent due to Covid-19), 3 percent turnover tax for any entity making above Ksh 500,000 (US$ 4,590) (currently 1 percent turnover tax for entities making above 1 million shillings due Covid-19), as well as VAT if the company has a turnover of above Ksh 5 million (US$45,900) annually.[160]

5.3 Regional Regulatory Framework

For a regional regulatory framework, regional trading blocs such as the East African Community (EAC)[161], comprising Kenya, Rwanda, Tanzania, and Uganda, and Burundi, have the potential to play a key role in initiating an integrated general and equity-based crowdfunding policy. EAC has made progress by introducing a single currency and free internal trade and has implemented World Bank-supported Financial Sector Development and Regionalization Project (EAC - FSDRP) to harmonize financial laws and regulations, among others.[162,163] Furthermore, Common Market for Eastern and Southern Africa (COMESA), including 21 African nations, including Burundi, Kenya, Malawi, Rwanda, and Uganda, aims for economic prosperity through regional integration and offers an option in regional regulation.[164] Though these networks suffer from slow progression and lack of strong integration, they can play continent- wide or region-wide regulatory roles.

160 Mwenda Tevin Gitonga, "Kenya's Burden – the Effects of Digital Taxes on Smes," *KICTANet Think Tank,* July 22, 2020, https://www.kictanet.or.ke/kenyas-burden-the-effects-of-digital-taxes-on-smes/.

161 "East African Community," *Eac.Int*, accessed May 23, 2021, https://www.eac.int/.

162 Global Impact Investing Network, "The Landscape For Impact Investing In East Africa," *Global Impact Investing Network*, August 2015, https://thegiin.org/assets/161025_GIIN_EastAfrica_FULL_REPORT%20(002).pdf.

163 "EAC Financial Sector Development and Regionalization Project," East African Community, accessed May 23, 2021, https://www.eac.int/financial/financial-sector-development.

164 "The Common Market for Eastern and Southern Africa," *Common Market for Eastern and Southern Africa COMESA*, accessed May 23, 2021, https://www.comesa.int/.

6. Investing in Kenyan SMEs:
Key Considerations

6. Investing in Kenyan SMEs: Key Considerations

6.1 Overall risk assessment

In general, it is risky to invest in SMEs, including social enterprises, as some of them have a higher chance of failure due to various reasons, such as lack of proper training, shortage of clients, lack of funding and so forth.[165] However, with many young employees, there is also lots of room to grow for SMEs and social enterprises, especially those with a digital innovation focus. To assess the feasibility of cross-border ECF, it is important to look at the level of risks to invest in Kenya and its SMEs and social enterprises. This section speaks to the overall investment risks in Kenya from the broader aspect of investor confidence, political stability and legal environment. It also outlines common risks of investing in SMEs in Kenya and ways to increase investors' trust levels by mitigating risks.

6.1.1 Investor confidence

International investors are more confident about business prospects in Kenya than most of Sub-Saharan Africa. The globalEDGE, a knowledge center by Michigan State University, gave an "acceptable risk" overall rating to Kenya's business climate, based on its economic leadership in Africa, moderate COVID-19 recovery, relative political stability, yet high budget deficit.[166] Moreover, Kenya is the most attractive impact investing destination in East Africa. Close to half of impact investment in this region flows to Kenya, totalling around US$3.65 billion. Since 2014, the country transitioned from being a lower-middle-income country to a middle-income country because of its GDP growth per capita.[167] In 2019, the World Bank ranked Kenya as the second easiest place to conduct business in Sub-Saharan Africa.[168]

On the contrary, the young, inexperienced environment of social enterprises may bring doubts to investors, thus shaking their confidence to invest. As such, there are fewer success stories to draw from to attract investment. However, this would not affect investors who actively seek early-stage investment opportunities and are risk-tolerant.[169]

165 Stephen Kagwathi et al., "Risks Faced and Mitigation Strategies Employed By Small and Medium Enterprises in Nairobi, Kenya," *Research Gate*, 2014, https://www.researchgate.net/publication/314891240_Risks_Faced_and_Mitigation_Strategies_Employed_By_Small_and_Medium_Enterprises_in_Nairobi_Kenya.

166 Global Edge, "Kenya: Risk Assessment," *globalEDGE: Your source for Global Business Knowledge*, accessed May 31, 2021, https://globaledge.msu.edu/countries/kenya/risk.

167 British Council, 2017.

168 The World Bank, "Rankings," *The World Bank*, accessed May 31, 2021, https://www.doingbusiness.org/en/rankings.

169 British Council, 2017.

6.1.2 Political stability

Kenya is relatively stable politically compared to other Sub-Saharan African countries. Growing political stability brought by the new Constitution in 2010 mitigates the risk of investing in Kenya. One of the constitutional factors that enhances this stability is the diffusion of power from the national government to local ones in economic development, health care and education. The purpose was to empower local government and reduce inequality between regions.[170] This creates a positive environment for social enterprises as many of them serve local communities.

However, caution should be placed towards possible electoral violence associated with the upcoming 2022 election period in Kenya, which could damage businesses.[171] This type of violence has a likelihood of recurrence, as it ties with elections which are recurring events. Kenya experienced brutal electoral riots in 2007, which caused the physical destruction of businesses around the country. In the city of Kisumu, 184 stores were looted.[172] Such violence occurred again in western Kenya and parts of Nairobi during the 2017 election.[173] As a hard lesson learned from the violence and to mitigate the fear of loss from both entrepreneurs and their investors, Kenya launched a political violence and terrorism insurance in 2008 to insure companies against such violence.[174] Under this protection, insurance companies cover stock in trade, loss of profit, buildings, machinery and vehicles that could be damaged during a political riot.[175]

6.1.3 Legal environment for investor protection

Kenya has a favourable legal landscape for large-scale foreign investment, as legal protections are in place to make Kenya a safe investment environment. As for SMEs,while they are regulated, legal protection for investors of this kind is unclear.

In alignment with Vision 2030 to attract foreign investment, the Nairobi Centre for International Arbitration (NCIA) was established in 2013 to administer international commercial arbitration.[176] The country is a member of the International Council of Settlement of Investment Disputes (ICSID), which is a forum for investor-state dispute settlement, and a member of the Multilateral Investment Guarantee Agency (MIGA) of

170 Oxford Business Group, "Kenya's New Constitution Brings Political Change," Oxford Business Group, June 14, 2017, https://oxfordbusinessgroup.com/overview/moving-forward-new-constitution-has-ushered-era-political-change.

171 Carey Baraka, "Kenya's 2022 Elections Have Already Begun," *Foreign Policy*, September 2, 2020, https://foreignpolicy.com/2020/09/02/kenya-2022-elections-already-begun-cycle-violence-chris-msando/.

172 Maike Voigt, "Entrepreneurship in Times of Post-Election Riots: a Case Study of Small Business Owners in Kisumu, Western Kenya," *African Identities* 18, no. 3 (2020): pp. 313-328, https://doi.org/10.1080/14725843.2020.1779025.

173 Jina Moore, "Violence Flares and Tensions Rise After Kenya Presidential Vote," *The New York Times*, October 28, 2017, https://www.nytimes.com/2017/10/28/world/africa/kenya-election-uhuru-kenyatta-raila-odinga.html.

174 Ibid.

175 First Assurance, "Political Violence, Terrorism and Sabotage Insurance," *First Assurance*, March 29, 2019, https://firstassurance.co.ke/products/political-violence-terrorism-sabotage-insurance/.

176 JMiles & Co, "The Landscape of International Arbitration in Kenya," *The In-House Lawyer*, 2018, https://www.inhouselawyer.co.uk/legal-briefing/the-landscape-of-international-arbitration-in-kenya/.

the World Bank, which offers political risk insurance and credit enhancement guarantees.[177] In addition, the Constitution of Kenya and the Foreign Investments Protection Act protect foreign investments in general.[178] However, this protection mechanism has not been widely applied to investors of small businesses.

SMEs who registered as a business are regulated under the Companies Act just like other types of businesses. Registration to become a private company under the Act is easy in Kenya, with no minimum requirement of members per company. This encourages young people to become entrepreneurs. In 2012, the government enacted the Micro and Small Enterprise Act to protect, grow, and regulate the country's Micro SME (MSME) sector. The act defines MSMEs as companies that make less than KSh500,000 (~US$4,500) annually and have less than ten employees.[179] The legal mandate was to regulate the operations of micro enterprises, facilitate access to funds and markets, as well as to resolve disputes.[180] The aim is to ensure fairness in the business environment so that market interests are publicly regulated instead of favoring those with vested interests. However, it is worth noting that although this Act creates an enabling environment for MSMEs, there is no law that governs SMEs that are slightly larger and profit up to KSh100 Million per year.[181] Therefore, the tax treatment of these SMEs and non-SMEs is almost the same. In addition, the Social Enterprise Society of Kenya - the most prominent civil society organization for this industry has not been actively pushing for benefits such as tax exemption for its community.

While there is a regulatory framework for SMEs, there is no legal protection for its foreign investors. The Capital Markets Authority (CMA) in Kenya has specified that it is the shareholders' responsibility to conduct risk assessment and understand market, liquidity and inflation risks.[182] Nonetheless, since Kenya is an investment hub in Sub-Saharan Africa, investors' trust level is higher for Kenya than for other African countries. Therefore, legal protection may not be perceived as a determining factor of investment decisions, especially for risk-tolerant foreign investors who understand the high-risk nature of investing in small businesses overall.[183]

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177 "Political Stability & Favorable Investment Policy," Kenya Investment Authority, accessed May 31, 2021, http://www.invest.go.ke/why-invest-in-kenya-2/political-stability-favorable-investment-policy/.

178 "Kenya - Foreign Investments Protection Act," *UNCTAD Investment Policy Hub*, accessed May 24, 2021, https://investmentpolicy.unctad.org/investment-laws/laws/100/kenya-foreign-investments-protection-act.

179 Cathy Mputhia, "Why Kenya Needs a Standalone SMEs Law," *Business Daily*, September 19, 2020, https://www.businessdailyafrica.com/bd/lifestyle/personal-finance/why-kenya-needs-a-stand- alone-smes-law-2296854#:~:text=streamlined%20and%20organised.-,There%20is%20no%20clear%20cut%20definition%20of%20SME%20in%20Kenya,no%20standalone%20law%20on%20SMEs.&text=However%2C%20SMEs%20are%20defined%20according,is%20where%20most%20businesses%20lie.

180 Evelyne Milgo, "Effect of the Micro and Small Enterprise Act 2012 on the Growth of Youth Owned SMEs in Nairobi," *University of Nairobi, School of Business*, 2014, http://erepository.uonbi.ac.ke/bitstream/handle/11295/103299/Milgo_Effect%20Of%20The%20Micro%20And%20Small%20Enterprise%20Act%202012%20On%20The%20Growth%20Of%20Youth-Owned%20Smes%20In%20Nairobi%20Cbd,%20Kenya.pdf?sequence=1.

181 Mputhia, 2020.

182 CMA, "Shareholders Rights and Responsibilities," *Investors Information - Capital Markets Authority*, 2020, https://www.cma.or.ke/index.php?option=com_phocadownload&view=category&id=45&Itemid=222.

6.1.4 Common risks

Before demonstrating ways to mitigate risks of investing in Kenyan SMEs through innovative mechanisms like ECF, it is necessary to first lay out some commonly perceived risks. While a lack of research quantifies the risks that MSMEs or social enterprises face, a study conducted in 2013 surveyed 62 Kenyan SMEs with 10 to 100 staff. The risks outlined in this study could also apply to social enterprises. Below are the five most significant factors, listed from the most severe to the least.

TABLE 3: COMMON LY PERCEIVED RISKS OF INVESTING IN SMES IN KENYA

Type of Risk[184]	Description
Capital market risks	There are limited ways to raise funds which prevent expansion of business operations; high interest on loans have also hindered access of additional capital
Operational-economic risks	Theft by employees and customers is a common problem; frequent price fluctuations; lack of full commitment to duty by employees
Customer relations risks	Lack of technological expertise by management resulting in loss of profit; customer retention; lack of product variety limits the number and types of customers
Global view risks	Access to global markets through internet by customers that greatly reduce local demand; lack of exposure to global markets which hinder expansion of the business
Regulatory risks	Costly registration fee for business; expensive annual license renewal

183 Herbert Kisara, East AfricaProgram Manager, Engineers Without Borders Canada. Zoom interview with Policy Lab Team, April 29, 2021.

184 Kagwathi, 2014.

n the context of ECF, it is also crucial to outline its specific risks in the eyes of securities commissions. The International Organization of Securities Commissions surveyed 23 commissions around the world in 2015, when ECF was still in its infancy. The below were risks that concern the regulators in different jurisdictions:[185]

- Failure of crowdfunding platforms;
- Fraud and money laundering;
- Lack of liquidity;
- Information asymmetry and investor inexperience

In addition to the above, cross-border ECF adds another layer of concern for Canadian regulators as they express unfamiliarity to security regimes of other jurisdictions and are unsure of the level of protection that Canadian retail investors may obtain if investing in Kenyan SMEs.[186]

6.1.5 Risk mitigation strategies to protect ECF investors

Despite jurisdictional differences, most investments carry risks. Investing is best learned by doing. Individuals will eventually gain capabilities to assess the risk levels of each investment on their own after accumulative experiences.[187] For SMEs like the Kenya-based TIBU Health and the Ethiopia-based agricultural supplier Greenpath Food, individuals who invest in them at earlier stages are willing to take risks and see their potential for long-term social impact.

While the freedom to invest needs to be recognized, ECF organizers such as funding platforms and government regulators still play a crucial role in ensuring that risks are mitigated for investors to avoid critical loss. This section emphasizes three risk mitigation strategies that ECF organizers should actively pursue: perform due diligence, maximize details on the platforms and encourage portfolio diversification.

CONDUCT DUE DILIGENCE

A critical risk-mitigation step is to conduct due diligence processes on businesses that plan to raise funds through ECF. It is particularly essential to assess SMEs in Kenya as they are deemed high-risk. To address common risks illustrated in the previous section, the business' management team should complete a critical assessment. Owners and managers must be well connected with the community that they serve. For example, the owner of TIBU Health demonstrated his commitment by exhibiting three years of

185 The International Organization of Securities Commissions, "Crowdfunding 2015 SURVEY RESPONSES REPORT," *The International Organization of Securities Commissions Library*, December 2015, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD520.pdf.

186 Elliot Mak and James Leong, Senior Legal Counsel, BC Security Commission. Zoom interview with Policy Lab Team, April 15, 2021.

187 Christian Novak, Professor of Practice, McGill University. Zoom interview with Policy Lab Team, March 10, 2021.

research and preparation work prior to operation.[188] Further, owners of digital innovation businesses must have strong technological expertise. For instance, the owner of ICT4D Kenya demonstrated his credentials by winning an ICT competition organized by the Safaricom Foundation and secured primary funding there. He is also a fellow of Ashoka, a global changemaking institution.[189] Other assessments include, but are not limited to, the integrity of employees with a preferred no history of theft, evaluation of existing debt situation and the ability to extend products to maximize impacts and number of customers.

One point that the BC Securities Commission expressed regarding investor protection is to ensure that the business does not provide misleading information.[190] Thus, it is essential to have on-the-ground experts who can conduct on-site visits or in-person meetings with the business when needed to validate information that they provide. This is important to prevent fraud, money laundering and terrorist financing. An additional verification step for impact investing is to monitor the positive change that the social enterprise causes in its community, thus aligning with investors' expectation to see impacts from their investments.[191]

MAXIMIZE DETAILS ON THE FUNDING PLATFORMS

To address information asymmetry and investor inexperience concerns, funding platforms should be obligated to display as much information as possible about each business posted on their platforms. The purpose is to transparently inform investors on what they buy and enable them to assess risks on their own. Some details to disclose include founders' and managers' portfolios, such as their level of expertise in the field they specialize in, their affiliation with the targeted beneficiaries, quality of the products plus other key factors from the due diligence process.[192] In addition, platforms should encourage investors to conduct thorough research on the sector and the country that they plan to invest in because it is their responsibility to understand market liquidity and the inflation risks associated with their investment.[193] In terms of investing in social enterprises, platforms should display detailed information about potential and/or existing benefits that the company or organization provides for the community that they serve. It is also the platforms' responsibility to ensure that no information or language displayed is subject to any discrimination.

More importantly, the message about high risks of investing in SMEs and social enterprises in an emerging market should be highly visible on the platform. WeFunder, a popular ECF platform in the U.S, is an excellent example by displaying messages on their homepage that ECF is a "much riskier" stock market and that investors can "win

188 Carmichael, 2021.
189 Jonathan, 2021
190 Mak and Leong, 2021.
191 Kisara, 2021
192 Young, 2021
193 CMA, 2020.

big or lose it all".[194] Moreover, it has a FAQ section that explains risks straightforwardly, whichhelps investors set the right expectations on ECF investments.

ENCOURAGE PORTFOLIO DIVERSIFICATION

Another strategy is to diversify investments. This is particularly effective when investing in smaller businesses in emerging markets. Also, due to the high-risk nature, investment for each business should be relatively small.[195] From the regulator's perspective, setting a cap on the investment amount would meet their mandate of protecting investors by ensuring that people do not drastically lose their assets from investing.[196] Therefore, ECF platforms should encourage investors to diversify their portfolios and only invest an amount per business that would not impact their overall financial status. WeFunder describes in their FAQ section to their investors that "if you decide you can safely invest US$5,000 per year in startups, it'll be less risky to make ten US$500 investments insteadof a single one of US$5,000. You should never invest more than you can afford to lose."[197]

6.2 Potential investors

One area that we try to assess is the potential for Canadians to invest in Kenya SMEs through ECF since there is massive room for growth for Canada's social impact investment (SII)[198] in the world. The OECD reported in 2019 that global SII assets under management reached US$228.1 billion; 56 percent of them are allocated to emerging markets.[199] In Canada, while total impact investment has grown in the recent five years, the proportion of support to developing countries has been negligible. In 2019, C$2.05 billion was invested in Emerging and Frontier Markets (EFM), which only constitutes about 14 percent of the country's total impact investment. The other 86 percent invested domestically. For Canada to achieve its sustainable development objectives around the world, it needs to commit more capital from private investors.[200,201] In the following subsections, we describe the current impact investors in Canada, analyze the likelihood of retail investors expansion in Canada, especially for impact investment, andthe potential for African diaspora to invest back home through ECF.

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194 "Wefunder Homepage," *Wefunder*, accessed May 31, 2021, https://wefunder.com/.

195 Novak, 2021

196 Mak and Leong, 2021

197 "Wefunder FAQ," Wefunder, accessed May 31, 2021, https://help.wefunder.com/#/investor/risks.

198 SII defines financial provision to organizations that address social or environmental issues with measurable returns, to achieve the SDGs.

199 "Social Impact Investment 2019 - The Impact Imperative for Sustainable Development," *OECD*, 2019, https://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/Social-Impact-Investment-2019.pdf.

200 Canada Forum for Impact Investment and Development, "Report on Canadian Impact Investing in Emerging and Frontier Markets," *The Responsible Investment Association*, 2019, https://www.riacanada.ca/research/report-on-canadian-impact-investing-in-emerging-and-frontier-markets/.

201 Eugene Ellmen, "The Future of Canadian Impact Investing in Developing Countries," *Oikocredit Canada*, January 17, 2020, https://www.oikocredit.ca/updates/blog-post-page/2020/01/17/The-future-of-Canadian-impact-investing-in-developing-countries.

6.2.1 Current impact investors in Canada

The majority of Canadian impact investors are non-profit organizations and private sector organizations, with a minority of foundations and a public sector investor. Most of these experienced entities operate more than one funding model including private equity, debt and venture capital. Among privately sourced capital, there is a lack of focus on retail investors. Most organizations designed products for accredited investors and institutions; only two of them have retail investment products.[202] But this may be a global phenomenon rather than a Canadian one: the current investments for social enterprises in Kenya are mostly made by High Net Worth individuals, Sophisticated and Professional Investors, international organizations and multinational companies, with little mention of retail investors.[203]

Sub-Saharan Africa is one of the most commonly targeted markets by Canadian impact investors. Most of them recognize the region's fast-growing economy and society as well as its expanding opportunities for social and environmental impacts. Investors are predominantly interested in agriculture/agri-business, financial services/ inclusion and renewable energy. They are also interested in health, education, water and employment.[204] These interests largely align with Kenyan social enterprises' operations, although not many of them receive investments.

Among funding models, blended financing, where organizations strategically use development and philanthropic funds to attract private capital for sustainable development, has been popular. Two-thirds of the organizations surveyed by the Canadian Forum for Impact Investment and Development (CAFIID) engage in such a structure. International organizations like the OECD also encourage blended finance as a good way to fill the financing gap and maximize impact.[205]

6.2.2 Canadian retail investors

The number of Canadian retail investors has grown tremendously since the COVID-19 pandemic. Five hundred thousand online brokerage accounts were opened in the first quarter of 2020, three times more than previous years.[206] The demographics of retail investors range from teens to people in their 50s from a variety of professions. More importantly,Canadian retail investors are paying more attention to responsible investment, a preference to incorporate social, environmental and governance (ESG) factors in their investment decisions. According to the RBC Global Asset Management survey in 2020,63 percent of Canadian investors showed interest in building responsible investment

202 Canada Forum for Impact Investment and Development, 2019.

203 British Council, 2017.

204 Ibid.

205 "Blended Finance," *OECD*, accessed May 31, 2021, https://www.oecd.org/dac/financing-sustainable-development/blended-finance-principles/.

206 Victor Ferreira, "'Money to Be Made': Meet the New Retail Investors Flooding the Market amid the Pandemic," *Financial Post*, July 6, 2020, https://financialpost.com/investing/money-to-be-made-meet-the-new-retail-investors-flooding-the-market-amid-the-pandemic.

portfolios, while 86 percent want the companies that they invest in to act in a socially responsible way.[207]

The rationale behind this growing interest is that socially and environmentally responsible actions reflect Canadians' values. They prefer to invest in a business that reflects their personal ethics and concerns, as people are more conscious about organic, fair-trade products.[208] As Canadians tend to align investment with their personal ethics, businesses realize the value of retail investors as capital providers and brand ambassadors.[209] They can promote businesses that they invest in among their networks, thus fostering brand loyalty and increasing customer trust.

While the impact investing outlook seems optimistic, there exists an information gap among Canadian retail investors, which hinders the expansion of this emerging mechanism. 50 percent of investors did not know where to find reliable information on responsible investment and 45 percent of them have no knowledge of impact investing.[210,211] To address this gap, a report from McMaster University suggests a need to educate investors about impact investments. Advocates should provide sufficient information about the quality and quantity of impact that investors can make both financially and socially in order to attract people with shared values, while also being transparent about risks. Investors should also understand that a trade-off of impact to low return is not a requirement in this type of investment. Success stories around existing investment need to be told to improve perceptions around investment effectiveness.[212] Meanwhile, as retail investors believe that they cannot afford impact investment and this market is not accessible to them, it is important for both government regulators and the private sector to extend impact investment to retail investors.

To summarize the existing circumstance, impact investment is practised by organizations and accredited investors who are high net worth individuals. This mechanism is quite limited for Canadian retail investors, although there is a growing interest in impact investment from Canadians in alignment with their personal values. The current public sentiment demonstrates potential interest from Canadian retail investors for cross border ECF, should it be enabled. Meanwhile, since the level of knowledge on impact investing is low among Canadians, ECF advocates and organizers should work to close the

207 RBC Global Asset Management, "Nearly Two-Thirds of Canadian Retail Investors Are Interested in Allocating More Funds to Responsible Investment, RBC Global Asset Management Survey Finds," *Cision*, January 15, 2020, https://www.newswire.ca/news-releases/nearly-two-thirds-of-canadian-retail-investors-are-interested-in-allocating-more-funds-to-responsible-investment-rbc-global-asset-management-survey-finds-861859926.html.

208 Terry Cain, "Why Interest in 'Impact Investing' Is Taking Hold," *The Globe and Mail*, September 24, 2019, https://www.theglobeandmail.com/investing/globe-advisor/advisor-news/article-why-interest-in-impact-investing-is-taking-hold/.

209 "Retail Investors Are Becoming More than Shareholders," *National Crowdfunding & Fintech Association of Canada*, October 29, 2020, https://ncfacanada.org/retail-investors-are-becoming-more-than-shareholders.

210 RBC, 2020.

211 J. Gormaly and B. McKnight, "Retail Demand for Impact Investing," Responsible Investing - Degroote School of Business, McMaster University, February 2018, https://responsibleinvesting.degroote.mcmaster.ca/wp-content/uploads/sites/56/2020/10/Impact-Investing-Feb-8-Mar-22-Edit.pdf.

212 Ibid.

information gap by informing potential investors about impact investment and ECF. This process of public education will take time; therefore, it may take a while before a visible amount of investment is seen from Canadian retail investors.

6.2.3 Kenyan diaspora investment

Canada is a popular destination for migration for Kenyans, with a growing number of Kenyan-Canadians present in Canada. According to the 2016 census 27,150 individuals in Canada identified themselves as Kenyan immigrants.[213] Members of the diaspora pose the most potential for crowdfunding, as diaspora communities' inherent knowledge of the local socio-economic conditions, business environment and cultural competency enable them with a nuanced understanding of local needs and solutions.[214] They are also more willing to invest in small-scale but beneficial initiatives that foreign investors might otherwise consider high-risk.[215] Diaspora investments can mitigate the effect of capital flight and brain drain, while also creating a validating effect for non-diaspora investors unsure about cross-border equity crowdfunding.[216]

Diaspora communities also bring in the advantage of social trust, and friend and family network, which extends to their overall social networks. Such networks create informational advantages about the quality of the project and its creator of the business, which can be favorable for investment through crowdfunding.[217] Diasporas' emotional and social commitment also enables them to disregard weaknesses in the regulatory regimes, while their skills enable them to recognize trustworthy enterprises and impose informal contracts in the absence of regulatory protection.[218]

Much of the above findings have been confirmed and validated in our interview with the governing body members of the Kenyan Canadian Association (KCA). The members also stated that ECF is well attuned with the Kenyan notion of Harambee, the tradition of community self-help fundraising initiatives. The diaspora association mentioned that they have informally raised funds to support particular diaspora members in Canada for health support. KCA expressed strong enthusiasm for investing in Kenyan enterprises through Canadian platforms, should the opportunity arise. However, KCA stressed the importance of adequate marketing, diaspora community outreach, community education and due diligence by the Canadian ECF platforms for the success of ECF among the diaspora communities.

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213 "Census Profile, 2016 Census" *Statistics Canada*, accessed May 31, 2021, https://www12.statcan.gc.ca/census-recensement/2016/dp-pd/prof/details/page.cfm?Lang=E&Geo1=PR&Code1=01&Geo2=PR&Code2=01&SearchText=Canada&SearchType=Begins&SearchPR=01&B1=Immigration%20and%20citizenship&TABID=1&type=0.

214 Shawn Teresa Flanigan, "Crowdfunding and Diaspora Philanthropy: An Integration of the Literature and Major Concepts," *VOLUNTAS: International Journal of Voluntary and Nonprofit Organizations* 28, no. 2 (2016): pp. 492-509, https://doi.org/10.1007/s11266-016-9755-7.

215 Jennifer M. Brinkerhoff, "David and Goliath: Diaspora Organizations as Partners in the Development Industry," *Public Administration and Development* 31, no. 1 (2011): pp. 37-49, https://doi.org/10.1002/pad.587.

216 FSD Africa, 2017.

217 Ajay Agrawal et al., "Crowdfunding: Geography, Social Networks, and the Timing of Investment Decisions," Journal of Economics & Management Strategy 24, no. 2 (2015): 253–74. https://doi.org/10.1111/jems.12093.

218 Brinkerhoff, 2011.

7. Policy Recommendations

7. Policy Recommendations

RECOMMENDATION 1
Address limitations in the existing prospectus exemptions to betterfacilitate cross-border ECF.

Advocates of ECF should urge the Canadian regulatory authorities to pursue revisions to the existing prospectus exemptions to better enable cross-border ECF. There is potential to engage with the regulators to pursue changes in their existing policies which would make it easier for Kenyan businesses to raise Canadian capital.

Advocacy for change should engage the provincial financial regulators and focus on demonstrating how changes to the prospectus exemptions could address the needs of Canadian investors, diaspora populations living in Canada, and foreign early-stage businesses.

These changes should be targeted at the prospectus exemption mechanism. This is the main method through which early-stage companies are able to raise funds owing to their lack of finances and access to Canadian professional legal and accounting services. The two exemption pathways that are recommended as potential areas of focus are the start-up crowdfunding exemption and the accredited investor exemption.

- The start-up crowdfunding Exemption is a highly relevant tool that has been designed for start-ups and other early-stage businesses to raise funds. However, in its current form, the exemption is explicitly limited to use by Canadian companies. Introducing regulatory change to allow this tool to be used for cross-border fundraising would be highly useful for the facilitation of cross-border ECF.
- As a complement to revising the start-up crowdfunding exemption, the accredited investor exemption should be revised to allow individuals to qualify as sophisticated investors by criteria other than financial wealth (similar to the Alberta & Saskatchewan Self-Certified Investor Exemption). This would help to democratize the investing space by allowing individuals who are not high net worth a pathway to demonstrate they are willing and capable to make investments with a higher perceived risk.

The creation of a single national regulator would require buy-in from the provincial regulators of Quebec and Alberta, which would be a significant challenge as they are ideologically opposed. A national regulator is not recommended at this time, as the lack of flexibility in the prospectus exemption criteria would still present significant barriers limiting the potential for cross-border ECF even if a national regulator were in place

RECOMMENDATION 2
Evaluate the demand for policy change in this space from both Canadian investors and potential Kenyan issuers by conducting further research and sandbox experiments.

To better understand what policy changes would best address the needs of Kenyan businesses, the diaspora population in Canada, and the broader Canadian public, it is recommended to conduct further and more targeted research to assess the appetite for investment in this market and the need for fundraising in the form of ECF.

The provincial and territorial regulators serve Canadians and have a policy mandate to minimize risk to Canadian investors. Increasing access to capital for Kenyan SMEs does not fall within their mandate. As this brief has established, there is a growing interest in impact investment among Canadian investors. Further evidence must be gathered in order to convince regulators that policy change in this area is desired by Canadian investors. This is a critical activity as it would demonstrate to the regulators that there is a need from Canadians to change this regulatory space.

Gauging the impact that crowdfunding regulatory changes will have on the market is an important first step to building momentum for regulatory change in this space. Canada's regulatory authorities should be encouraged to conduct more "sandbox" and "test the waters" experiments.

These experiments are a "structured form of regulatory flexibility" intended to allow businesses to test innovative products and services (with some regulatory latitude) in a controlled environment, insulating consumers from the impact of these changes. The benefits of sandbox experiments include:

- facilitating the market entry of new products and services,
- opening doors to funding alternatives for innovative firms,
- increasing knowledge-sharing opportunities between regulators and firms, and
- providing regulators with the evidence required to make informed decisions.

Surveying Kenyan diaspora populations living in Canada about their willingness to invest in cross-border ECF could help to illustrate the potential market for this type of investing. While the KCA has expressed strong interest to participate and invest in cross-border ECF, the survey can help to further validate the interest of the broader diaspora. It can also identify their preferred sectors of investment and perceived challenges, and find the ideal means of community outreach, marketing and education for the diaspora's effective participation in the ECF projects. Measurements of interest in participating in cross-border ECF could serve as supporting evidence in a proposal for regulatory change.

RECOMMENDATION 3
ECF platforms should maximize its public display of details about the fundraising businesses and risks of investing in them.

Given the new concept of cross-border equity crowdfunding and the need to educate retail investors about impact investment, ECF organizers like funding platforms should be responsible for providing details about the concept as well as information about each business who issues equity. Our research has shown that empowering investors with information and knowledge is key to protecting investors from critical loss when/if investing in an emerging market. Therefore, information provision, to the largest extent, is a risk mitigation strategy. It also helps meet regulators' mission to protect investors. Basic elements to display through funding platforms include but are not limited to:

- Notify investors about high levels of risks when investing in SMEs, including social enterprises in emerging markets such as Kenya. Investors should be informed to conduct thorough research on their own about the sector they would like to invest in and understand that they run the chance of losing their investment should the business defaults. These messages should be highly visible not just in the offering document, but also on multiple web pages of the funding platforms. A risk assessment section of each fundraising business would further help investors make decisions.
- Platforms should strongly encourage investors to diversify their ECF portfolios and only invest an amount they can afford to lose. This message should also be highly visible and be delivered to all investors.
- Disclose all important assessments of each business from the due diligence process. These include commitment and competency of the management team; their affiliation with the community that they serve; absence from fraud, money laundering or theft from employees and history of debt, among other criteria examined through due diligence.

In addition, it is recommended that the funding platforms enable investors to support each other in this emerging area of investment mechanism by setting up an online forum for investors or a commentary area for each ECF posting. These functions give investors an opportunity to communicate and learn from one another and allows them to share their values and their own impact investing experiences. Some investors are strong brand ambassadors for businesses that they believe in and would recommend others to invest in the same business. A shared commentary space would thus attract more investors for enterprises that carry great causes and growing potential.

RECOMMENDATION 4
ECF advocates should pursue blended financing to mitigate investment risks and to attract private capital in support of cross- border ECF projects.

In recent years, the World Bank, the UN as well as national governments like the Government of Canada are encouraging the private sector to adopt the blended financing model as a way to fill the financing gap for developing countries. The basic concept of this model is to use development funds from public and philanthropic funders to attract additional finance from private investors, to achieve sustainable development in developing countries. The International Finance Corporation (IFC) of the World Bank indicates that their operations using blended finance have grown to about a billion dollars of funds from donors, which supported 200 projects between the fiscal years 2010 – 18. This instrument especially helps high-impact, yet high-risk development projects get off the ground.[219]

Moreover, Global Affairs Canada has also used this innovative financing mechanism through a number of their development initiatives.[220] For example, Canada has contributed $19.17M (CAD) from 2016 to 2021 to a global network - Convergence Blended Finance for its development initiatives to address financing gaps in developing countries. The contribution was found effective in catalyzing private capital in environmental sustainability, including clean water solutions, land management and sustainable agriculture.[221]

Cross-border ECF in support of Kenyan social enterprises fits well with the purpose of blended financing defined by international organizations and the Government of Canada, which is to mobilize private capital to support Kenyan social enterprises, helping the country end poverty (Goal 1), hunger (Goal 2), reduce inequality (Goal 10) and achieve other SDG goals. Depending on how matching funds from development agencies and governments are distributed, they can mitigate investment risks for private Canadian investors by partly addressing emerging businesses' financial needs and increasing their chance of success. The funds can also support funding platforms' operation, thus reducing their risk of failure.

While the federal government has committed to mobilize private investors for sustainable development through innovative financing models, it has not considered providing blended financing support for cross-border ECF. One of the possible reasons to explain

219 Hiroyuki Hatashima and Unurjargal Demberel, "What Is Blended Finance, and How Can It Help Deliver Successful High-Impact, High-Risk Projects?" World Bank Group - Independent Evaluation Group, January 27, 2020, https://ieg.worldbankgroup.org/blog/what-blended-finance-and-how-can-it-help-deliver-successful-high-impact-high-risk-projects.

220 Global Affairs Canada, 2020.

221 Global Affairs Canada, "The establishment of the Convergence Blended Finance platform (RDFI phase III)", Global Affairs Canada - Evaluation Reports, April, 2020, https://www.international.gc.ca/gac-amc/publications/evaluation/2020/rdfi_phase3-phase3-irfd.aspx?lang=eng

this absence is that security regulation pertaining to ECF falls under the responsibility of the provincial governments, not the federal government.

Hence, advocates of cross-border ECF must seek support from Global Affairs Canada in development finance and explore ways to receive matching funds to attract private investors' interests. Meanwhile, advocates should urge the federal and provincial governments to collaborate on enabling cross-border ECF so that Canada can leverage this great opportunity to democratize its impact investment space and contribute better to its foreign assistance objectives.

RECOMMENDATION 5
ECF platforms and fundraising businesses should showcase social impacts and establish impact evaluation strategies to report to investors.

Our research indicates that more Canadians align their personal value and ethics with what they invest in and consider environmental and Social Governance factors when making investment decisions. Further, willingness to support communities back home is a key mindset that will draw investment interest from the diaspora population. Hence, the amount of investment interest to be generated largely depends on how issuers (i.e. businesses) display on the funding platform their contributions for the communities that they serve and whether those impacts appeal to investors.

Showcasing social impact is an essential marketing effort to execute in crowdfunding. By observing projects displayed on Kickstarter - a reward-based crowdfunding platform, it is not hard to realize that businesses with more than 500 backers are generally those who exhibit dynamic content and fine details about themselves. Many of the popular pages are accompanied with high-quality videos and several photos, vivid descriptions of the project and its social impacts, a clear layout of the objectives, action plans and demands from supporters, showcase of team members, among other compelling information. Innovation and technology-based businesses also display the technical specifications of their products. These are crucial content elements that can also apply to ECF pages to increase trust from potential investors, thus influencing their investment decision. In addition, diaspora communities like the Kenyan Canadian Association could play an essential role in maximizing the promotion of different ECF projects.

Moreover, impact investors generally expect to see issuers' accomplishment in making positive change. Thus, monitoring and evaluation are essential steps to report back impacts and gain investors' trust. Advocates of the ECF should set an evaluation strategy for each selected issuer at the due diligence stage and gather metrics along the way for reporting purposes. Elements of the strategy include but are not limited to determining key performance indicators for a monitoring scorecard and mapping out a theory of change to track progress along.[222] ECF advocates who are non-profit or international

222 Ivy So and Alina Staskevicius, "Measuring the 'Impact' in Impact Investing," *Harvard Business School*, 2015, https://www.hbs.edu/socialenterprise/Documents/MeasuringImpact.pdf.

development organizations and who already have such evaluation capacity are better positioned to monitor and assist issuers throughout the reporting process. Should conditions allow, development organizations could even train businesses on capacity building before and during their ECF campaign.

However, it is important to note that reporting of impact may only be realistic once issuers who are early-stage businesses meet its funding goal/amount, which allows them to operate their business for impact. Also, investors should be made aware that success takes time, and their patience is required.

RECOMMENDATION 6
Explore donation crowdfunding as an immediate alternative to ECF

As the paper elucidates, cross-border ECF in Canada is at a nascent stage. There are still considerable challenges to overcome, including the communication of scope and modality, attracting foreign investment in high-risk early-stage SMEs in developing countries, and overly restrictive securities regulations. Investors are generally risk-averse and focused on the potential of profit. Cross-border ECF, however, remains a highly untested and risky endeavour where the prospects of profit are often unclear. It is also noteworthy that despite Kenya's relatively advanced crowdfunding market, ECF occupies a minimal share. This signifies that the concept is yet to be fully embraced by Kenyan entrepreneurs. Thus, in the current nascent stage of ECF in Kenya, there is little evidence of the potential of immediate business success through ECF in Kenya. Addressing the limitations and regulatory barriers to facilitate cross-border ECF will be a considerable time and resource-consuming initiative without a guarantee of immediate success.

At the same time, as highlighted by the KCA, there exists strong interest among the Kenyan-Canadian diaspora to give back and contribute to supporting Kenyan enterprises and development initiatives in the spirit of ***Harambee***. This unwritten law of generosity and the diaspora's emotional and social commitment to Kenya enable the diaspora to donate or invest in Kenyan initiatives without the anticipation of a monetary return, as in the case of equity investment.

Under the current circumstances, donation crowdfunding can be explored as an immediate alternative in supporting Kenyan SMEs. Donation crowdfunding, essentially synonymous with ***Harambee***, is the most popular form of crowdfunding in Kenya and Canada. KSA has already been using individual donations in a non-institutionalized manner to support diaspora community members. This highlights their familiarity with the model. This crowdfunding model is relatively easier to communicate to a wide range of investors within the Kenyan diaspora and beyond. Donors or investors in donation crowdfunding do not expect or are less concerned with the return of investment but contribute based on their willingness to support their communities and enterprises in Kenya. This enables the model to overcome the challenges of risk-aversion of the

investors of the ECF model.

Donation crowdfunding's less onerous regulatory requirements mean that it can immediately capitalize on the Kenyan diaspora's interest in contributing while circumventing ECF challenges. Canadians are not prohibited or restricted from contributing to donation-based crowdfunding campaigns. According to our findings, the government of Kenya has actively sought to draw foreign investment, and believes that the regulatory environment presents little barrier to donation-based investment in SMEs.

While the donation crowdfunding market is crowded in Canada, such initiatives directed at Kenyan diaspora or diasporas, in general, remain quite under-explored. In alignment with recommendation #2, targeted research to assess the appetite for donation crowdfunding can further validate the interest expressed by KCA. Thus, donation-based crowdfunding, catered to the Kenyan diaspora, can be a feasible and immediate alternative to achieving EWB's original objective of creating an avenue for the diaspora to contribute to their home countries through direct project investments to help catalyze social and economic change, especially while immediate challenges to ECF are addressed

8. Conclusion

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Billions of dollars in remittances and donations will continue to flow to developing countries each year from the diaspora. While capital is flowing abroad increasingly, innovative and early-stage companies in many developing countries, especially in Sub-Saharan Africa, still require more investments, particularly from non-risk averse investors, to positively impact their communities.

In developing countries, ECF has the potential to stimulate innovation and reduce poverty. It can also boost growth by eliminating the constraints of traditional capital market structures and regulatory challenges.

This policy brief analyzed the CF regulatory landscape in Canada and other jurisdictions and specifically focused on how Canadian investors could support Kenyan SMEs and social enterprises.

Kenya's SMEs contribute to the creation of jobs alongside a rapidly growing social enterprise sector. A pandemic like COVID-19 with such wide-reaching consequences has revealed the importance of social enterprises in this country. Furthermore, this pandemic has opened up new opportunities for Kenyan SMEs and social enterprises to support local Kenyan communities. Even though this market has excellent growth potential, it still faces serious funding gaps.

Canada's regulatory framework for ECF faces particular challenges because of the conservative investor protections and the lack of uniformity across provinces with regard to business disclosure requirements. Regulators in this space must strike a balance between the need to support economic growth and the need to protect investors. Canada does not have the same regulatory and policy frameworks as the UK, EU and the US, making crowdfunding more challenging. These barriers have significantly slowed growth in Canadian ECF transactional values and prevented Canadian retail investors from contributing to the growth of emerging markets in Africa.

Nevertheless, there is excellent potential in Canada for regulatory change. By addressing limitations in the existing prospective exemptions, evaluating demand for policy change in this sector, enforcing transparent communication between funding platforms and investors, pursuing blended financing and establishing a system to showcase and evaluate social impacts, Canada is poised to make great strides in this area. In addition to aligning with Canada's commitment to UN Sustainable Development goals, cross-border ECF is an innovative way to support emerging markets everywhere.

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Appendices

Appendix A: Informational Interviews

As part of our research, the Policy lab team conducted informational interviews with the following individuals.

- Alexandra Lee, Senior Policy Advisor | Autorité des marchés financiers
- Amanda Ramkisson, Senior Regulatory Advisor, Office of Economic Growth & Innovation | Ontario Securities Commission
- Jonathan Yeung, Senior Business Advisor | Ontario Securities Commission
- James Leong, Senior Legal Counsel | British Columbia Securities Commission
- Elliot Mak, Senior Legal Counsel | British Columbia Securities Commission
- Josianne Beaudry, Associée | Lavery
- Maurice Jean-François, Associée | Lavery
- Robert Yalden, Stephen Sigurdson Professor in Corporate Law and Finance | Faculty of Law, Queen's University
- Sonia Laszlo, Associate Professor | Department of Economics, McGill University
- Christian Novak, Professor of Practice | Institute for the Study of International Development, McGill University
- Chris Ragan, Director, Max Bell School of Public Policy | McGill University
- John Derry-Collins, Founder & Chairman | I-FACT Limited
- Joleen Young, Partner, Advisory Services, Management Consulting | KPMG Canada
- Yolanda Banks, Director, Corporate Affaires | FinDev Canada
- Nicholas Tommarello, Founder & CEO | Wefunder
- Sarah Burns, CEO & Founder | Nia Crowdfund
- Herbert Kisara, Fellowships Program Manager - East Africa | Engineers without Borders
- Elizabeth Howard, Ag. CEO & Board Member | African Crowdfunding Association
- Ephraim Mwaura, President | Kenyan Canadian Association
- Jason Carmichael, CEO & Co-Founder | TIBU Health
- Jonathan Mativo, Founder & CEO | ICT4D Kenya

Appendix B: Canadian Securities Law Terminology

Accredited Investor: Under National Instrument 45-106, an accredited investor is an individual with:

- "Net income before taxes was more than $200,000 in each of the two most recent calendar years and is expected to be more than $200,000 in the current calendar year
- Net income before taxes combined with a spouse was more than $300,000 in each of the two most recent calendar years and their combined net income is expected to be more than $300,000 in the current calendar year
- Financial assets, alone or with a spouse, of more than $1 million before taxes but net of related liabilities
- Net assets, alone or with a spouse, worth more than $5 million."[1]

Institutional investor: A company or organization investing on behalf of others (includes pension funds, mutual funds and insurance companies).[2]

Issuers: Companies or investment funds that sell securities to investors. [3]

Retail investors: individuals investing their own money. [4]

Eligible investor (for the Offering Memorandum prospectus exemption): An individual with:

- "Net assets, alone or with a spouse, in the case of an individual, exceeds $400,000
- Net income before taxes exceeded $75,000 in each of the two most recent calendar years and who reasonably expects to exceed that level in the current calendar year
- Net income before taxes, alone or with a spouse, in the case of an individual, exceeded $125,000 in each of the two most recent calendar years and who reasonably expects to exceed that income level in the current calendar year." [5]

1 "Summary of Key Capital Raising Prospectus Exemptions in Ontario," Ontario Securities Commission, January 26, 2016, https://www.osc.ca/sites/default/files/pdfs/irps/ni_20160128_45-106_key-capital-prospectus-exemptions.pdf.

2 "Who's who in Canadian Markets," Ontario Securities Commission, accessed May 22, 2021. https://www.getsmarteraboutmoney.ca/protect-your-money/investor-protection/regulation-in-canada/whos-who-in-canadian-

3 Ibid.

4 Ibid.

5 "Summary of Key Capital Raising Prospectus Exemptions in Ontario," Ontario Securities Commission, January 26, 2016, https://www.osc.ca/sites/default/files/pdfs/irps/ni_20160128_45-106_key-capital-prospectus-exemptions.pdf.

Appendix C: Canadian Securities Commissions

Jurisdiction	Securities Commission	Organization Type	Mandate/Mission
Ontario	Ontario Securities Commission	"The Ontario Securities Commission (OSC) is a self-funded Crown corporation, accountable to the Ontario Minister of Finance."	"To **provide protection to investors** from unfair, improper, or fraudulent practices, to foster fair and efficient capital markets and confidence in capital markets, and to contribute to the stability of the financial system and the reduction of systemic risk."
Alberta	Alberta Securities Commission	"Industry-funded statutorily created corporation … it is accountable to the Minister of Finance and, through the Minister, to the Alberta Legislature."	"We aim to be a practical, intelligent, best-in-class regulator and we strive to **protect investors** from improper, misleading or fraudulent practices."
British Columbia	British Columbia Securities Commission	"As a self-funded Crown corporation, the BCSC is accountable to the provincial legislature and the public through the Minister of Finance."	"The British Columbia Securities Commission's mission is to **protect and promote the public interest** by fostering a securities market that is fair and warrants public confidence, and a dynamic and competitive securities industry that provides investment opportunities and access to capital."

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Quebec	Autorite Des Marches Financiers	"The AMF is financially self-sufficient through the fees and dues paid by the persons and firms governed by the legislation it is charged with enforcing." Accountable to the Minister of Finance.	"[M]andated by the Québec government to regulate Québec's financial markets and **assist consumers** of financial products and services."
Saskatchewan	Financial and Consumer Affairs Authority of Saskatchewan	Crown corporation. Established through legislation and reports to the government through a minister.	"Financial and Consumer Affairs Authority (FCAA) **protects consumer and public interests** and supports economic well-being through responsive marketplace regulation. We protect Saskatchewan consumers by regulating financial products and service providers in an effective, efficient and balanced manner."
Manitoba	Manitoba Securities Commission	"[R]eports to the legislature through the office of the Minister of Finance."	"The mandate of The Manitoba Securities Commission is to act in the public interest to protect Manitoba investors and to facilitate the raising of capital while maintaining fairness and integrity in the securities marketplace."

Jurisdiction	Securities Commission	Organization Type	Mandate/Mission
New Brunswick	Financial and Consumer Services Commission of New Brunswick	Self, funded, independent Crown corporation. "[A]ccountable to the government through the Minister of Finance."	"**Protect consumers** and enhance public confidence in the financial and consumer marketplaces through the provision of regulatory and educational services. We recognize the importance of setting an example in the areas of transparency and effective governance."
Nova Scotia	Nova Scotia Securities Commission		"The Nova Scotia Securities Commission was established to **provide investors with protection** from activities that undermine investor confidence in the fairness and efficiency of Nova Scotia capital markets and where not inconsistent with investor protection, to foster capital formation."
Northwest Territories	Office of the Superintendent of Securities		"The Office of the Superintendent of Securities **protects the investing public** by licensing securities dealers and advisers, and by requiring full disclosure of the activities and finances of companies wishing to sell shares or other securities to the general public."
Newfoundland and Labrador	Securities NL		

Jurisdiction	Securities Commis-sion	Organization Type	Mandate/Mission
Prince Edward Island	Office of the Attorney General		
Yukon	Office of the Yukon Superin-tendent of Securities		
Nunavut	Superin-tendent of Securities		

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JULY 2021