InvestRight
by BC Securities Commission




THE PRIVATE PLACEMENT MARKET

FOR RETAIL INVESTORS

WELCOME

TO THE INVESTRIGHT GUIDE TO INVESTING IN

THE PRIVATE PLACEMENT MARKET FOR RETAIL INVESTORS

Both public and private businesses in BC raise a significant amount of money in the private placement market, which enables them to play an important role in supporting economic growth and job creation. The vast majority of those who use this market are investment funds and public companies. Mining and utilities head up the list.

A small percentage of this capital is raised to finance start-up businesses. These companies may pose a risk to retail investors because they have limited disclosure obligations, they are susceptible to failure, and investors cannot easily sell their securities.

This Guide is for retail investors who are considering investing in the private placement market. It sets out how this market differs from the public markets, which have more disclosure and protections for investors. It explains how the private market works, and sets out the risks of business failure and the risk of fraud within this market.

It's important to note that some retail investors have done very well investing in start-up businesses. But it is usually because these investors have done their homework and learned that the company has a good business plan, excellent management and leadership, and a product that produces profits in a timely way.

We welcome your questions and encourage you to contact the British Columbia Securities Commission's (BCSC) Inquiries team for help researching a private placement market or any other investment opportunity.

PRIVATE VERSUS PUBLIC MARKETS

The private placement market is also known as the "exempt" market because those who use it do so under exemptions from the requirement to give full disclosure about the investment in a prospectus.

The prospectus is a document that describes, in detail, the company, its business, how it intends to use your investment, the company's financial position (including audited financial statements), and all relevant risks of the investment. The prospectus must be verified by a registered investment dealer who has legal responsibility to you and all investors for the disclosure. The prospectus must be filed and reviewed by the BCSC before it is provided to you. You have certain rights under the prospectus; for example, if the prospectus contains a misrepresentation, you have the right to sue the company and its management as well as the registered investment dealer to get your money back.

Companies that sell securities through a prospectus offering are known as public companies. A public company is required to provide the public with regular and timely disclosure about its business and financial position, including audited financial statements. Public companies generally will have their securities listed for trading on a public market or stock exchange, meaning the public can always buy and sell those securities. If you purchase securities through a prospectus, generally those securities will trade freely on a public market or stock exchange. This means you will always know the market value of your shares and you can sell them when you want.

A private placement investment may be offered to investors by either a public or a private company, limited partnership, or other form of legal entity. Securities offered through private placement investments may be one of countless investment types, including shares, limited partnership or trust units, promissory notes, bonds, investment funds, and interests in land or mortgages. This guide uses the terms "company" and "shares" to refer to the full range of legal entities and investment types available in the private placement market.

THE RISK OF BUSINESS FAILURE AND THE RISK OF FRAUD

The failure rate of start-up businesses is very high compared to established businesses with a history of successful operations. Business failure may be the result of a poor business plan or economic factors beyond the business owners' control. Whatever the cause, a failed business is unlikely to return your capital, let alone give you a return on your investment.

It's also possible for fraudsters to exploit investors who don't understand this type of investment. Unlike legitimate business operators, fraudsters lie to investors, very often selling something that's a complete fabrication. Bad as it is to lose money in a legitimate investment, those who have been defrauded report a much more devastating impact—loss of health, relationships, and very often trust in themselves and others.

WHAT IS
PRIVATE PLACEMENT MARKET INVESTING?

An investment made through the private placement market will not offer the protections available through a prospectus offering.

- You will not get detailed disclosure about the company and the investment that has been verified by a registered investment advisor and reviewed by the BCSC.
- You may not get audited financial statements from the company before you invest.
- You may not get ongoing and timely disclosure from the company either before or after you invest.
- The shares you purchase may not be listed on a stock exchange and therefore you may never be able to sell them. Even if shares are listed on a stock exchange, the shares will be subject to resale restrictions limiting your opportunity to sell them until a period of time has passed.

You may have been approached by someone, perhaps even a friend or relative, trying to raise money for a private or start-up company. Or you may be frustrated with the disappointing returns on your investment portfolio and wonder if you would do better by moving your investments away from publicly-traded stocks or bonds to alternative investment types.

Alternative investment types offered in the private placement market often appear attractive because they promise returns that are typically higher than those available in the public markets. But watch out:

1. High Returns = High Risk
2. Private placement shares have strict resale restrictions and may not trade freely.
3. You could lose ALL your investment.

Without a prospectus, you must conduct your own due diligence and gather important information about the company to make an informed decision.

HOW IT WORKS

Companies may sell their shares under various exemptions from the prospectus requirement. These exemptions are set out in securities legislation and stipulate the conditions companies must meet to operate within the law.

For example, companies may sell shares under certain exemptions that require the investor to be a qualified investor. Qualifications may include that the investor have a relationship with the management of the company or that the investor has certain net worth or income.

Shares sold under most private placement exemptions are subject to strict resale rules. If you invest in the private placement market, then these resale restrictions mean you may not be able to sell your shares and get your money out when you need or want to. You may never be able to sell your shares.

CAN ANYONE INVEST IN THIS MARKET?

In a word, no.

Securities laws require companies in the private placement market to ensure that their investors are eligible to purchase their shares using the correct exemption. Exceptions to this rule are the offering memorandum and start-up crowdfunding exemptions, which do not require their investors to be eligible. In all scenarios, however, it's up to you to protect your own interests by knowing what exemption the company is using to sell you its shares.

Be hard-nosed about all the reasons not to invest. There's no need to feel flattered that someone sees you as the kind of person who can appreciate and afford to invest in this market. Private placement market companies often offer high commissions for recruiting investors. Ask the person inviting you to participate if they will receive a payment or other benefit if you invest.

BUYER BEWARE: THE SALES SITUATION

You should know that investment advisors in British Columbia who are in the business of buying and selling securities must be registered by the BC Securities Commission and must work for a firm that is also registered.

Prior to registration, would-be advisors are vetted for their education, training, and experience, and are subject to bankruptcy and criminal record checks. Once registered, they are monitored to ensure compliance with securities laws. All registered advisors have an obligation to ensure that the investments they sell are suitable for their clients. The firms they work for must have a complaints process and, in the event of a client-advisor dispute, also make available the Ombudsman for Banking Services and Investment if needed.

People who sell private placement market investments are generally required to be registered under securities laws, although limited exemptions from this requirement exist. Always ask someone offering you an investment if they are registered. If the answer is no, then ask why and do not deal with someone who is not registered or acting under a valid exemption from registration. If you do, then understand that you will not have the added layers of protection that come from working with a registered advisor at a registered firm.

You should also be aware that, in some specific situations, securities laws permit unregistered advisors to introduce private placement securities to potential investors. In these cases, they cannot provide suitability advice. Nor can they actively promote these investments. This means that if someone is really trying to sell you a private placement investment, and telling you how good it would be for you to own, they are breaking the law.

Changes to private placement exemptions in 2013 may change the sales situation for private placement investors. Contact BCSC Inquiries for the most current information.

WHAT ARE THE STANDARD EXEMPTIONS?

Companies using the private placement market to raise capital typically graduate from one exemption type to another as they grow. There are five exemptions that companies typically use to sell securities to investors.

1. Private issuer exemption

A company that meets the definition of a private issuer may sell its securities to fewer than 50 qualified shareholders—that is: directors, officers, or major shareholders ("principals") of the company; close family, friends, or business associates of a principal; accredited investors; and current shareholders.

Companies using this exemption are not required to file any reports with the BC Securities Commission until they exceed the 50-shareholder limit or sell shares to an unqualified investor. If you're dealing with a company claiming this exemption yet apparently having more than 50 shareholders, or unqualified shareholders, report it to BCSC Inquiries.

> If you are told that you have to invest more than you're comfortable with, don't invest.

2. Family, friends, and business associates exemption

A company may sell its securities to you if you are a close relative, close friend, or a close business associate of a director, executive officer, or major shareholders of the company. The definition of who qualifies under this rule is very strict:

- A close relative is defined as a spouse, grandparent, sibling, child, grandchild, or in-law. You don't qualify as a close family member simply because you are a cousin of a principal.
- A close friend is someone who has known a principal of the company for enough time to be able to judge that person's capabilities and trustworthiness. The relationship must be direct. It's not enough to belong to the same organization, association, or religious group, or to be a friend-of-a-friend of a principal.
- A close business associate is someone who has enough prior business dealings with a company principal to be able to judge that person's capabilities and trustworthiness. You don't qualify just because you are a customer or former client, and definitely not if you're someone who has been approached to invest after a brief acquaintance with a principal.

3. Accredited investor exemption

A company may sell its securities to you if you qualify as an "accredited investor". This means you have at least one of the following financial qualifications, or qualify in some other way:

- At least $1 million in financial assets (cash and marketable securities) before taxes, net of any debts. Neither your home nor any other real estate you own are considered financial assets.
- Net income before taxes of more than $200,000 consistently over the past two years ($300,000 when combined with a spouse's net income).
- Net assets of at least $5 million. Net assets exclude all liabilities.

4. Start-up crowdfunding exemption

Under certain conditions, a start-up company or small business may sell anyone its shares using the start-up crowdfunding exemption.

In order to raise money through start-up crowdfunding, a company must first complete an offering document outlining its idea and make it available online through a funding portal.

The offering document contains basic information about the project, including the minimum amount of money that needs to be raised for it to go ahead.

The maximum a business can raise from each investor for a project is $2,500. However, if the offering is being conducted through a registered dealer, you may be able to invest up to $10,000 in the project if the dealer has determined that the investment is suitable for you. The company is required to file the offering document with the BCSC, but the BCSC does not review it before it goes to investors.

5. Offering memorandum exemption

A company may sell its securities to anyone using the Offering Memorandum (OM) exemption.

An OM is a legal document like a prospectus, but much shorter and less detailed. It must describe the company's business, provide annual financial statements, discuss the relevant risks, and tell how the company will use the money it raises. The company is required to file the OM with the BCSC, but the BCSC does not review it before it goes to investors.

For more information, visit the Private Placement Market webpage at InvestRight.org

IMPORTANT NOTE: ACKNOWLEDGING RISK

Under some exemptions, securities laws will require the company to give you a Risk Acknowledgement Form that you must complete and sign before the company can sell you shares. If you are buying securities through a funding portal, you will be asked to confirm electronically that you have read and understand the offering document.

In both cases, you are acknowledging the risks you are about to undertake and that you could lose all the money you invest. The BCSC requires companies to give you this risk warning – consider it a warning sign if you are told that this is merely a formality.

IS THIS COMPANY WORTH INVESTING IN?

It depends. You have to do your homework.

1. Management team

Get the full legal names of the company's directors and officers. Be skeptical of company documents claiming that these people have held certain positions elsewhere if specific details are not included. If the person offering you the investment can't explain the business in concise terms that you can clearly understand, then it's not for you.

Go to InvestRight.org to check if they were ever disciplined for bad business practices. Look them up on the internet and social media sites like LinkedIn and Facebook. If anything you learn leaves you feeling uncomfortable, call BCSC Inquiries.

2. Financial situation

Anyone who wants you to invest in a private company should be able to provide you with a comprehensive set of financial statements showing the company's financial position, operating history, and cash flow. Ideally, these should be audited. This should be true of all exemptions, except for the start-up crowdfunding exemption. The start-up crowdfunding exemption does not require financial statements because many start-up companies don't yet have financial statements and may not be able to afford an audit at this stage of their development.

If a private company cannot provide you with financial statements, they should include, at a minimum, a balance sheet, income statement, statement of changes in financial position, and detailed supporting notes.

If you're told that this documentation is not available, you should probably stay away—at least until they are willing and able to provide it.

If you're not comfortable and proficient with financial statements, consult with someone who is. This person should not be connected to the investment in any way. For help in understanding company materials, including financial statements, visit the Informed Investing pages at InvestRight.org.

You will also want to know for what purpose the company is raising money and whether its planned fundraising is adequate to cover those costs. Is there a "minimum offering" amount? If not, then the company can spend the money as it comes in, rather than waiting for the full amount to be raised. Be cautious about "final closing dates". You may not want to invest in a company that keeps extending their "final" closing date.

3. Viability as a business

Make sure you receive detailed information about the company. Watch for unsupportable claims about the investment's strengths and speculation about future results. There may be fine print, in the form of explanatory notes, and it's important that you read and understand it all before you decide to invest.

What's the business plan? How will the company grow? How will it make money, and within what period? No revenue potential means no return on your investment.

Remember that securities laws do not require companies in the private placement market to provide ongoing disclosure. Except in certain limited circumstances, provincial and federal corporate laws require annual financial disclosure, which all investors are entitled to receive.

Beware of the promise that the shares will soon be listed on a stock exchange. Going public can be a long and expensive process, and many companies that apply are not accepted.

4. Financing activity

BC companies and companies from another jurisdiction using any exemption to sell securities in British Columbia must file an exempt distribution report with the BC Securities Commission after they have raised the capital. Go to the BCSC website before you invest to gain insight into the company by reviewing its exempt distribution reports for previous capital raising. After you invest, check to make sure that the financing was carried out as the company said it would be.

Sometimes the best investment you make is the one you walk away from.

Like a house or a car that's out of your price range, an investment that carries risks greater than you can afford is probably not for you.

Our research shows that people who fall into an investment fraud do so when they break the rules they have always lived by. More important than investment knowledge or business acumen is what you do when faced with an exciting investment. If it seems too good to be true, it is. If someone tells you they can get you a high return with little or no risk, they aren't telling the truth. High returns come with high risk.

Be wary of anyone trying to pressure you into buying, especially when they also encourage you to invite your friends and family to join in. Imagine how you would feel if your amazing investment turned out badly and, in addition to losing your own money, you caused others to lose theirs as well.

That said, if you know you are qualified to invest in this market, have calculated your risk tolerance, and are prepared to do a lot of homework before handing over your money, read on.

RISK NOTES

Borrowing to invest

We urge you to never invest more money than you can comfortably afford to lose. Beware of any encouragement to take out a line of credit, borrow against the equity in your home, or unlock your RRSP savings to increase your investment amount in the hope of increasing your potential return. Borrowing to invest increases the risk of any investment; it can make an already risky private placement market investment dangerous.

The purchase agreement

You will be asked to sign a subscription or purchase agreement. This is an important legal document, not just a formality. Take the time to read it. It asks you to indicate what exemption applies to you as an investor. If you don't meet the criteria for any exemption, don't sign. If someone else fills out a form for you and tells you just to sign the document, beware. Never leave the exemption line blank. If you don't receive such an agreement, walk away and contact BCSC Inquiries.

How you pay

Never write a cheque payable to an individual associated with the company or to their personal corporation. Your cheque should always be payable to the company in which you're investing, or a lawyer's trust account with specific instructions.

RISK NOTES

Protecting your own interests

Think carefully about your risk tolerance and what you can afford to lose if the investment doesn't turn out as expected. Read everything carefully before you sign and consider the cons before you consider the pros. Get a second opinion from a lawyer, accountant, investment advisor, or business colleague who has no connection with the company.

Record keeping

Keep copies of everything you receive—company documents, the purchase agreement, proof of payment, emails, letters, newsletters, etc. If you attend meetings, ask questions and keep notes. If something goes wrong with your investment, you'll want to have complete records to lodge a complaint or report suspected wrongdoing.

Additional reading

If you are seriously considering a private placement market investment, and you receive an offering memorandum, we strongly recommend you supplement your reading with Guidance for Preparing and Filing an offering memorandum under National Instrument 45-106. Although a regulatory document for companies, it's useful for investors because it sets out common problems that Canadian regulators find with OMs. Consider it a warning sign if an OM you have been given has any of the problems set out in the guidance.

Report investment fraud

Run, don't walk, from any investment that promotes no risk/high return or claims to be tax-free, offshore, or a special deal just for you. If you see or suspect investment fraud, report it to BCSC Inquiries.

This guide is published by the British Columbia Securities Commission (BCSC) through its InvestRight investor education program. The BCSC is the independent Crown agency responsible for regulating BC's capital markets. We protect investors by overseeing the Securities Act. Our job is to ensure compliance with the Act, take enforcement action when it is breached, and educate British Columbians about how to protect their savings from unsuitable and fraudulent investments.

The Guide provides information for educational purposes only and does not constitute either investment or legal advice. The BCSC is not responsible for any losses or inconveniences suffered by persons using this information. We encourage readers to seek investment advice from a registered advisor, or independent legal advice, as necessary.

Guide to Investing: The Private Placement Market for Retail Investors.

HOW TO CONTACT BCSC INQUIRIES

British Columbia Securities Commission

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