GUIDE TO INVESTING:

THE PRIVATE PLACEMENT MARKET
FOR RETAIL INVESTORS



BC SECURITIES COMMISSION | investRIGHT

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 pose a high risk to retail investors. They have limited disclosure obligations, investors cannot easily sell their securities, and they are susceptible to failing.

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 BCSC inquiries 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 securities laws that govern public markets and companies.

In the public market, companies are required to use a prospectus to sell securities and regulators must review the prospectus before the company can sell its share to investors. The prospectus details the company's financial situation (including audited financial statements), and all relevant risks. It also qualifies the shares to trade freely on the stock market.

You may have been approached by a friend or relative trying to raise money for a start-up company. Or, you may be frustrated with the disappointing returns on your investment portfolio and wonder if you'd 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 securities market. But watch out:

1. High Returns = High Risk
2. Private market shares have strict resale restrictions and do not trade freely
3. You could lose ALL your money

Read everything that follows in this Guide with these basic facts in mind.

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.

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?

Most people think of a security as a stock or bond that trades on an exchange. This is correct, but many other investments are also securities, including those available in the private placement market like limited partnerships, syndicated real estate and pooled mortgages, and investment funds.

When a company raises money in a public market, it must file a prospectus with the securities commission in every province or territory where it plans to sell its securities. The prospectus is a document that contains detailed information about the company offering the shares, its financial situation, and the risk factors that may affect its business.

A private placement investment may be offered to investors by either a public or private company, limited partnership, or other form of legal entity that wants to raise money for its operations by issuing securities *without* a prospectus. These securities do not trade on a public stock exchange and may be one of countless investment types, including shares, limited partnership or trust units, promissory notes, bonds, interests in land or mortgages, etc.

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.

HOW IT WORKS

Companies may sell their securities under various exemptions from prospectus and continuous disclosure requirements. Like the rules that govern public market fundraising, these exemptions are set out in securities legislation and stipulate the conditions companies must meet to operate within the law.

For example, companies may only sell their securities to qualified investors according to the requirements of each exemption. Qualifications include the investors' relationship with the company and its principals, their net worth, or their ability to invest a large sum.

Securities sold under an exemption are usually subject to very strict resale rules. If you invest in this market, then these restrictions mean you may not be able to get your money out when you need or want to. **You may never be able to sell your shares.**

Without the prospectus that regulators require from public companies, you must conduct your own due dilligence and gather important information about the company to make an informed decision.

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 securities using the correct exemption. It's up to you to protect your own interests by knowing what exemption the company is using to sell you its securities.

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. Exempt 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. For the most part, registered advisors trade public company securities and tend not to involve themselves in the private placement market. 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, must provide access to arbitration if needed.

People who sell private placement market investments may be eligible for an exemption from the registration requirement and therefore might not be registered. Always ask someone offering you an investment if they are registered. If the answer is no, 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 securities 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 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.

If you are told that you qualify for the $150,000 investment exemption, be careful. A company cannot use that exemption to sell securities to individuals.

2. Close relatives, 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 shareholder (a "principal") 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 friend is someone who has enough prior business dealings with a company principal to be able to make a sound judgement about 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 lease $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.

4. Start-up crowdfunding exemption

Under certain conditions, a start-up company or small business may sell you its securities using this exemption. When a company uses this exemption in British Columbia and other participating jurisdictions it does not have to file a prospectus or financial statements.

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 $1,500. However, if the offering is being conducted through a registered dealer, you may be able to invest up to $5,000 in the project if the dealer has determined that the investment is suitable for you. Securities laws require companies to file their offering document after the financing, not before approaching 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. It must be filed with a regulator. Securities laws require companies to file their OM after the financing, not before approaching investors.

If you purchase shares under the OM exemption, you can choose how much you want to invest.

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

IMPORTANT NOTE: ACKNOWLEDGING RISK

If you purchase shares either under the OM exemption or qualify as an accredited investor because you meet one of the financial qualifications listed above, the company must give you-and you must sign-a Risk Acknowledgement form. If you are buying securities through a funding portal under the start-up crowdfunding exemption, you must confirm electronically that you have read and understand the offering document. In either case, you are acknowledging the risks you are about to undertake and that you could lose your entire investment, 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, listen to your instincts and 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 postion, operating history, and cash flow. Ideally, these should be audited financial statements. If not, 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". Companies you don't want to invest in may extend the closing date again and again, sometimes indefinitely.

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. If a company provides no documentation at all, report it to BCSC Inquiries.

Beware of the promise that the shares will soon be listed on a stock exchange. Going public can be a long and expensive process. Many companies that apply are not accepted and it's illegal for a company to say it will soon be listed on an exchange.

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 decision 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 the amount of your investment 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. 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

Get 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 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 by understanding risk, making suitable investments, and avoiding investment fraud.

ISSN 2291-2258 Guide to Investing: The Private Placement Market for Retail Investors.

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