



British Columbia
Securities Commission

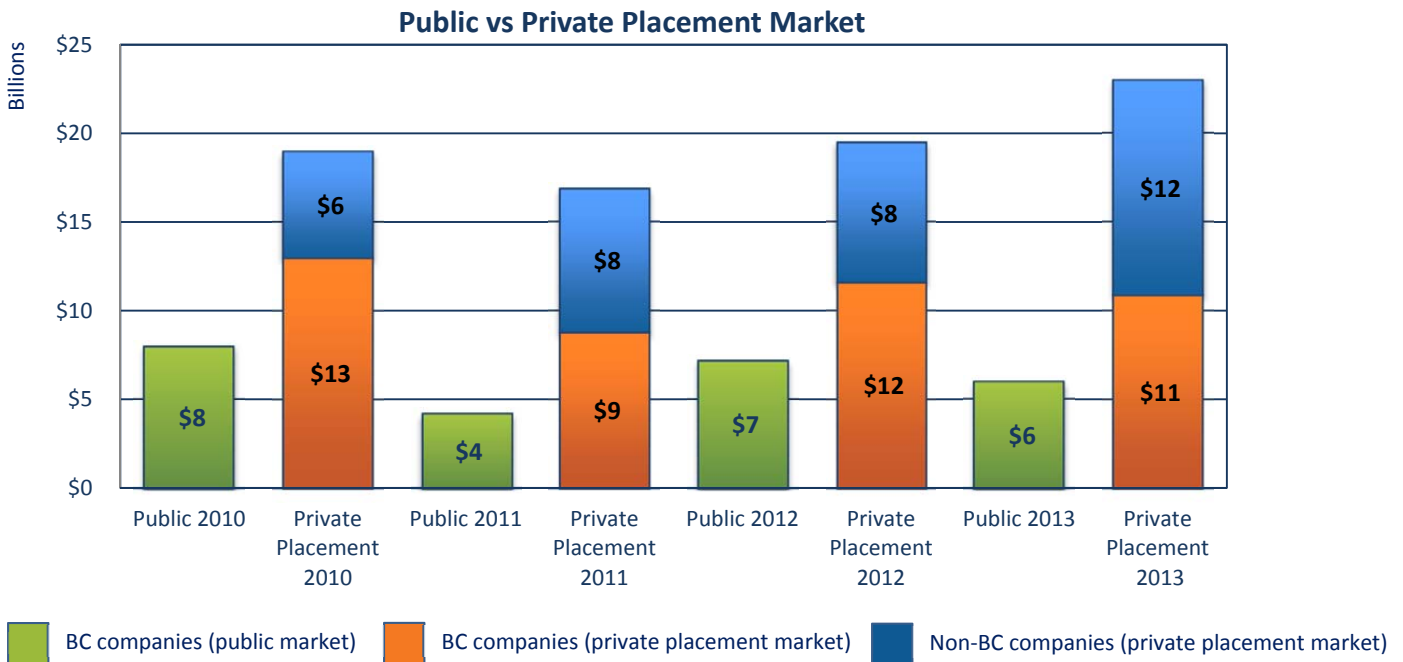
Private Placement Review Program 2014

British Columbia Securities Commission

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What is the Private Placement Review Program?

Over the last several years, the amount of money raised in British Columbia’s private placement market (also known as the exempt market) exceeded the amount raised in the public market. From 2010 to 2013, companies reported that they raised \$45 billion in BC’s private placement market versus \$25 billion in the public market. The amount raised in BC’s private placement market over this period rises to \$79 billion when you include companies from outside of BC.

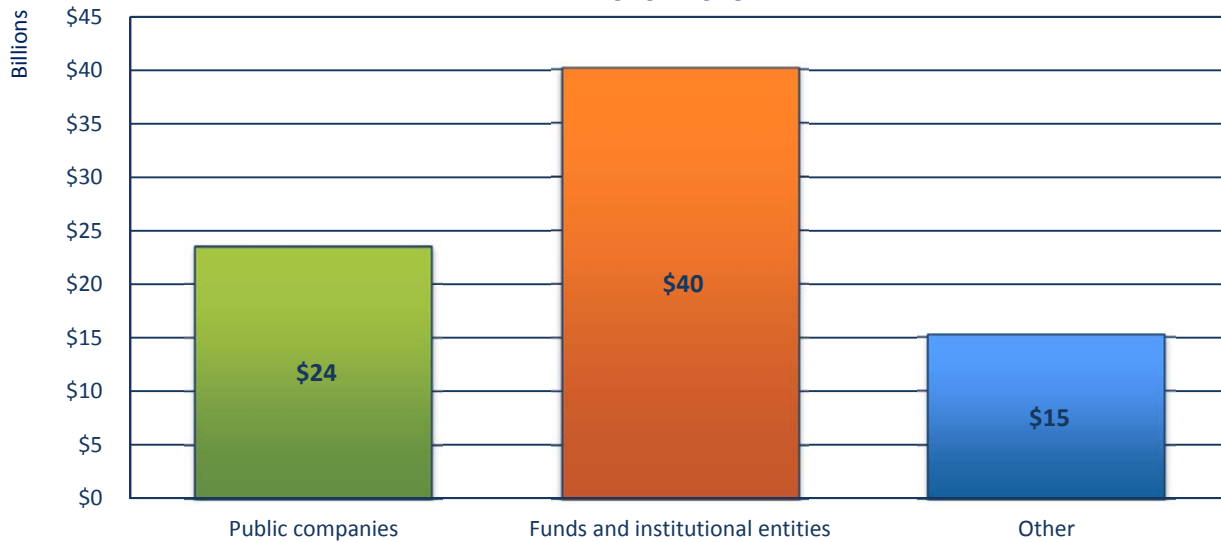


Recognizing the significance of this growing market, the BC Securities Commission (BCSC) set out to better understand it, and strengthen oversight in this challenging area.

In April 2010, the BCSC created the first Private Placement Review Program (PPRP) in Canada. While companies operating in the public market have been subject to regulatory compliance reviews, prior to the PPRP, there was no similar oversight of the private placement market.

The PPRP focuses on companies (represented in the chart below as Other) that are not subject to other compliance review programs, or those staff does not consider low risk. This group of companies raised \$15 billion in BC’s private placement market from 2010-2013. The PPRP excludes public companies and entities such as mutual funds and financial institutions, which reported raising \$24 billion and \$40 billion, respectively, through private placements for the comparative period.

Private Placement Market 2010 - 2013



The companies selected for review comprise both BC-based companies and companies outside BC that raise money from BC investors. The PPRP seeks to protect investors by reviewing whether:

- Companies sell only to qualified investors.
- Investors have sufficient information to make informed investments.

What is a Private Placement?

A private placement is a transaction in which a company offers securities to qualified investors rather than to the public under a prospectus that the BCSC reviews. Private placement securities are sold under exemptions from the prospectus requirement in the *Securities Act*. Both public and private companies sell securities in the private placement market.

Why did the BCSC start the Private Placement Review Program?

The private placement market has grown to the point where aggregate financings exceed those in the public market. As the amount of money raised in the private placement market continued to increase, the BCSC became concerned about some of the risks of investing in this market and recognized the importance of strengthening oversight.

Unlike the public market, where offerings are reviewed prior to the sale of securities, private placements are not vetted by the BCSC. Companies conducting private placements file distribution reports after the securities have been sold, or not at all.

In addition, where private companies are concerned, there are no ongoing financial or other disclosure requirements, and a limited ability to resell securities. In some cases, private placement securities are high-risk investments and are often sold to retail investors.

For these reasons, the BCSC established the PPRP to protect investors in this market.

How does the Private Placement Review Program work?

The BCSC has compliance programs in place that look at two categories of companies:

1. Public and private companies that access the private placement market using exemptions **that require them to report to the BCSC** after they have issued the securities (these reports are called exempt distribution reports). The exemptions used include the offering memorandum exemption, family, friends and business associates exemption, and accredited investor exemption.
2. Public and private companies that sell securities without a valid exemption and **that may not report their activities to the BCSC**.

The PPRP focuses on private companies in the first category. Companies in the second category usually come to staff's attention by an investor complaint. Companies in either category may be the subject of enforcement action.

The objectives of the PPRP are to make market participants aware that the BCSC is monitoring the private placement market, confirm compliance with securities rules, and improve the quality of the disclosure that investors are receiving.

The PPRP consists of four functions – **monitor** private placements; **review** companies; **enforce** the rules; and **educate** the companies operating in this market.

1. Monitor

When the PPRP was introduced, staff developed a method for reviewing each incoming exempt distribution form to identify high-risk companies that may warrant an in-depth review. The objective is to intervene, in a timely manner, to prevent or correct private placement market misconduct.

2. Review

Most of our reviews fall into two categories:

1. Offering Memorandum: An offering memorandum is designed to be a short, simple disclosure document used by companies to raise capital as an alternative to preparing a prospectus. Staff reviews offering memorandums to ensure that they include the required information and do not contain false or misleading information.
2. Family, Friends and Business Associates exemption and the Accredited Investor exemption: Staff determines if the company is interpreting and applying the exemptions correctly, and whether there is any indication that the company is providing investors with false or misleading information.

3. Enforce

In the course of our reviews, staff sometimes uncovers evidence of illegal conduct or very poor disclosure. Depending on the severity of the misconduct staff may:

1. Cease trade the company: If a company has failed to file a required document, or has completed it improperly, staff may issue a cease trade order (CTO) to prevent further trading in the securities until the company makes the filing, or corrects the document . The CTO protects investors by preventing non-compliant companies from raising additional money.

Staff will consider issuing a CTO if:

- the company's offering memorandum disclosure is so deficient that purchasers could not have made an informed investment decision when they purchased the company's securities, or
 - a company did not have an exemption available for the sale of its securities and did not file a prospectus.
2. Rescission: If the offering memorandum used to raise money is false or misleading, in appropriate cases staff will require the company to provide investors with a new offering memorandum and provide them with an opportunity to rescind their investment.
 3. Referral to Enforcement: When staff finds serious misconduct, or if stronger sanctions are required to protect the public, staff will refer the matter to Enforcement.

4. Educate

Staff assumes that most non-compliance is unintended. During a review, staff routinely brings matters to the attention of a company in order to improve its disclosure.

Results

Since 2010, 2,400 private companies filed exempt distribution reports. After performing a preliminary analysis of all of those reports, staff completed 284 (12%) in-depth reviews on these companies. These companies reported \$2 billion(12%) of the \$15 billion in capital raised by private companies in the PPRP and represented a cross-section of the industries involved in this market.

Actions taken include:

- 15 files were referred to Enforcement, and 17 files were referred to other divisions in the BCSC and other securities regulators. Enforcement opened several cases, with one resulting in a BCSC hearing and findings of fraud, illegal distributions and breach of a CTO, and another ending in a settlement where the issuer agreed to pay \$10,000 to the BCSC. Several cases are ongoing.
- 42 CTOs were issued. Of these, 21 have since been revoked because the deficiencies identified were addressed. The 21 companies that remain cease-traded have shown no progress in having the cease trade order revoked, were likely higher risk, and are no longer raising money from investors.
- Eight companies completed rescission offers to their investors.
- In April 2012, the BCSC participated with regulators in other Canadian jurisdictions to create and publish guidance around preparing and filing an offering memorandum, and preparing and filing exempt distribution reports.

New developments

1. Private placement risk model

In January 2014, the BCSC launched a private company risk model that supports staff's surveillance efforts. The risk model uses fielded data from all exempt distribution reports since January 2011, together with data from a variety of internal and external databases, and analyzes each new exempt distribution report using a set of **38 risk indicators** to identify high-risk companies. The risk indicators include:

- The amount of money raised and number of investors (six risk indicators, e.g., total capital raised in the last year)
- The exemptions used (11 risk indicators, e.g., a significant amount of distributions to a large number of people under the Family, Friends and Business Associates exemption)
- Past interactions with the issuer (five risk indicators, e.g., there have been CTOs on the issuer)
- Details about the issuer's directors and officers (five risk indicators, e.g., high turnover of directors and officers in the last year)
- Details about the issuer's finders and promoters (seven risk indicators, e.g., individual on disciplined persons list)

- Investor demographics (four risk indicators, e.g., significant numbers of investors from small communities)

In the first three months, 50 cases were opened on unregistered finders, as well as five enforcement cases related to issuers.

2. Industry education

Staff has developed the Capital Raising for Small Business program. The goal of this program is to reach entrepreneurs who are in the early stages of building a business and who could unintentionally run afoul of capital raising rules. Staff developed a guide, made a number of presentations to small business groups, and produced a webinar and a video. During the year ended March 31, 2014, staff reached over 100 small businesses live, and thousands online.

Conclusion

Since the PPRP was launched, BCSC staff has found the quality of information provided to investors in offering memorandums has improved. BCSC staff attributes this, in part, to the cease trade orders, deficiency letters sent to companies, and discussions staff has had with companies and their professional advisors.

Overall, the PPRP revealed that most companies intend to comply with the rules. However, staff found that companies have a poor understanding of the exemptions, do not keep adequate records of their private placements, and use professional advisors who do not have specialized knowledge of the securities industry and the private placement market.

The BCSC's monitoring and regulation of the private placement market through the PPRP, together with its continuing education and outreach efforts, should help to raise the level of understanding and compliance in the private placement market.