British Columbia
Securities Commission

Capital Raising for

Small Business

British Columbia Securities Commission

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INTRODUCTION

Small businesses make a significant contribution to BC's economy and create jobs. They need money to start, maintain, and grow their operations. A large portion of small business funding comes from entrepreneurs themselves and traditional funding sources such as bank loans. However, at some point, many businesses will turn to private investors.

This Guide is for any small business, whether it be a start-up or an established business, that wants to raise money from private investors. It sets out how raising money from private investors differs from raising money in the public markets and it explains some of the securities laws that facilitate efficient and timely financings.

If you intend to raise money directly from investors, then the BCSC wants you to know how to do it right. This Guide will get you started, and a call to BCSC Inquiries at any point along the way can save you from making costly mistakes.

Why we care what you do

As the agency responsible for regulating capital raising, securities trading, and investor protection in BC, the BCSC expects small businesses that use the private placement market to conduct their financings in a way that respects and promotes market integrity. At the same time, we want to help them find legitimate ways to raise money in a timely and efficient way and avoid delays that can stem from misunderstanding how things work.

What is a security?

Generally, a security is any document that allows the holder to profit from the efforts of others and that represents the holder's interest in an entity. The most common example of a security is a share or stock of a company. However, many other documents such as promissory notes, options, and profit sharing agreements are also considered securities.

What are the key principles of securities laws?

There are two key principles of securities law:

1. ***most trades of securities require disclosure in the form of a prospectus, and***
2. ***most trades of securities must be made through a registered dealer***

This Guide focuses on the prospectus requirement and the situations in which your small business does not need to use a prospectus (the "exemptions" from the prospectus requirement).

What is the difference between the public market and the private placement market?

If your small business decided to raise money in the public market, you would have to file a prospectus with the securities commission in every province or territory where you plan to sell your securities. Your company would have to file ongoing reports, including audited financial statements, to keep investors informed about changes in your business that could affect the value of their investment (we call this "continuous disclosure"). Your company's securities may also be traded on a stock market.

By contrast, your small business can raise money privately without a prospectus and the requirement for continuous disclosure. Your small business would be relying on exemptions from the prospectus requirement. Like the rules that govern public market funding, these exemptions are set out in securities legislation and list the conditions companies must meet to operate within the law. Most small businesses *only* raise money in the private placement market. Securities sold in the private market are generally less liquid (unable to be sold) than in the public market.

What are the standard exemptions?

There are several exemptions that your small business can use to raise money in the private placement market. When your business first starts raising money in this market, you will usually be able to rely on the private issuer exemption. However, when your small business is no longer a private issuer, there are still a number of other exemptions that you can rely on.

1. The private issuer exemption

Your small business is a "private issuer" if you have less than 50 security holders (excluding employees) and your formative documents or security holders' agreements (for instance, your articles of incorporation or parternship agreement) contain restrictions on the transfer of securities. As a private issuer, some of the key types of people you can raise money from are:

- Your directors, officers, employees, and major shareholders
- Close family members of your directors, senior officers, or major shareholders
  Close family members are only your spouse, parents, grandparents, siblings, children, grandchildren, or in-laws. Other family members such as cousins and uncles are not considered to be close family members.
- Close friends of your directors, senior officers, or major shareholders
  Your close friend is someone who has known you for enough time to be able to judge your capabilities and trustworthiness. The relationship must be direct (that is, a close friend of your close friend is not your close friend). A person is also not your close friend simply because they belong to the same organization, association, or religious group, or because they are "facebook friends".
- Close business associates of your directors, senior officers, or major shareholders
  Your close business associate is someone who has had enough prior business dealings with you to be able to make a sound judgment about your capabilities and trustworthiness. A person is not your close business associate simply because they are your customer or former client. A person is also not your close business associate if you have approached them to invest after only a brief acquaintance.
- Accredited investors
  An accredited investor is a person who meets at least one of the following financial qualification tests, or qualifies in some other way:
    - At least $1 million in financial assets (cash and securities) before taxes, net of any debts. Neither the person's home nor any other real estate the person may 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) with a reasonable expectation to continue to exceed that net income level
    - Net assets of at least $5 million

If your small business uses the private issuer exemption, you are not required to file a report with the BCSC. As long as your business continues to meet the definition of private issuer, your security holders can transfer their securities to one of the types of people listed above, provided the directors consent to the transfer of shares. No other transfers of securities are permitted.

2. Exemptions if your small business is no longer a private issuer

Once your business is no longer a private issuer (for instance, you have more than 50 security holders), you must find other exemptions from the prospectus requirement to raise money.

If you are no longer a private issuer, there are exemptions available for you to sell to all of the people discussed under the private issuer exemption above (directors, officers and employees, family, friends and business associates, and accredited investors).

Two other common exemptions are as follows:

Start-up crowdfunding prospectus exemption

Your small business may raise up to $250,000 up to two times per year using the start-up crowdfunding exemption. In order to do so, you will need to make an offering document available to the public through a funding portal. Depending on the circumstances, you may choose a funding portal that is exempt from registration or is operated by a dealer registered with the BCSC.

The offering document is a legal document like a prospectus, but much shorter and less detailed. It must describe your business and management, including the relevant risks, and tell how your business will use the money it raises. You do not need to include audited annual financial statements with the offering document.

The minimum offering amount disclosed in the offering document must be raised within 90 days of the offering document being first made available on the funding portal's website. Each investor may only invest up to $1,500. However, this amount can be increased to $5,000 if the start-up crowdfunding distribution is facilitated by a funding portal operated by a registered dealer that has determined that the investment is suitable for the investor.
The investor must electronically acknowledge that they have read and understood the offering document and the risks of investing.

If the start-up crowdfunding campaign is successful, the offering document must be filed with the BCSC within 30 days of the issuance of the securities.

Additional reading: If you are considering using the start-up crowdfunding exemption to raise funds for your small business, we strongly recommend you read *Start-up Crowdfunding Guide for Businesses*.

Offering Memorandum exemption

Your small business may also raise any amount of money from anyone using the offering memorandum exemption (OM exemption). Like an offering document under the start-up crowdfunding exemption, an offering memorandum is a legal document that is also shorter and less detailed than a prospectus. It must describe your business and management, including the relevant risks, and tell how your business will use the money it raises. You must include audited annual financial statements in the offering memorandum. Your small business must also give any purchaser under the OM exemption a Risk Acknowledgement form and make sure the purchaser signs it. You do not need BCSC approval before you use the OM exemption, but the offering memorandum must be filed with the BCSC within 10 days of each sale under the OM.

Additional reading: If you are considering using the OM exemption to raise funds for your small business, we strongly recommend you read *Guidance for Preparing and Filing an Offering Memorandum under National Instrument 45-106*. This document sets out common problems with offering memorandums.

Reporting

One key difference between the private issuer exemption and the other exemptions described above is that these exemptions require you to file a report with the BCSC (we call this a report of exempt distribution). The report must be filed within 10 days of each sale and there is a filing fee based on the amount raised. The only exception is the start-up crowdfunding prospectus exemption, which requires the report to be filed within 30 days after the securities are issued.

ARE YOU IN THE BUSINESS OF TRADING?

Your small business is exempt from the requirement to register as a dealer if you are "not in the business of trading". In order to qualify for this exemption you must have an active business unrelated to the sale of securities. This registration exemption applies to officers, directors, and employees of your small business that are involved in raising money through the sale of your securities, unless they:

- are principally employed to sell your securities
- spend most of their time selling your securities
- are paid to sell your securities

If your small business pays someone else to sell your securities, they may be "in the business of trading" and need to be registered.

INVESTOR EXPECTATIONS

Read our *Guide to Investing: The Private Placement Market for Retail Investors* to understand the level of information we encourage private investors to seek when investing in this market. This and other useful guides are available at www.investright.org.

Some of the information we suggest investors seek before investing in a small business includes:

- the full legal names of the company's directors and officers so that they can conduct background checks
- a comprehensive set of financial statements showing the company's financial position, operating history, and cash flow (ideally audited)
- the purpose for which the business is raising money and whether the planned fundraising will provide sufficient funds
- a business plan including how the company will make money and within what time period

You should be aware that some investors may request this type of information from your small business.

FOR MORE INFORMATION

As you can see from this Guide, there is more to capital raising than perfecting your pitch and accepting money. Consult a lawyer or other appropriate professional advisor before raising money to understand all the requirements.

You can also contact the BC Securities Commission at 1-800-373-6393, email to: inquiries@bcsc.bc.ca, or go online and check out the BCSC website.

The information in this Guide is for educational purposes only and does not constitute legal advice. The BCSC is not responsible for any loss or inconvenience suffered by persons using it.

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