

In Module 6: Taking Stock of Start-Ups, we discuss the rules and issues that surround investing your money in a start-up company.

Investments in start-up ventures are speculative and risky under any circumstances, but you can reduce your risk by understanding the rules for raising money. When you invest in a start-up company, the only “sure thing” is your risk. Know the rules before you risk your money.

The topics covered in this module are:

- a) Securities
- b) Securities of Start-Ups
- c) Rules for Raising Money
- d) Tactics
- e) Protecting Yourself

Securities

Some Facts about Illegal Sales of Securities in Canada

Investments in start-up ventures are speculative and risky under any circumstances. But investments that don't comply with the rules governing the sale of securities are especially dangerous. They are illegal, and some are out-and-out fraudulent.

Investing in Risky Businesses

Most companies raise capital legally and honestly. They file a prospectus with the necessary securities regulators and sell their securities through a registered dealer. Many start-ups are legally exempt from these requirements because they meet specific criteria set out by law. However, some companies don't play by the rules. There are very real risks of investing in start-up ventures, and these risks increase when companies break securities law.

When it comes to buying and selling stock, people usually think of stock brokers, stock exchanges, and public companies. But many shares are sold outside of stock exchanges, and without the advice of a broker or financial adviser, by companies that are not public. Across Canada, millions of these securities are issued every year, mostly by start-up companies.

Often, investors are approached by promoters to “get in on the ground floor” and provide “seed capital” to new ventures. These salespeople promise fast profits as soon as the company goes public or the “sure-fire money maker” takes off. In truth, many investors end up losing their hard-earned money.

AS AN INVESTOR, YOU CAN PROTECT YOURSELF BY UNDERSTANDING THE RISKS AND LOOKING OUT FOR SIGNS THAT SOMETHING IS WRONG WITH AN INVESTMENT.

Securities of Start-up Companies

When any company wants to raise money by selling its securities, it must follow the rules of the

applicable provincial or territorial securities legislation. This applies to both public companies, which are listed on a stock exchange or quotation service, and private companies, which are not.

When you are asked to put your money into a business opportunity in which the success of the business depends on others, you are purchasing a security. People often think of securities as shares, but these investments also take many other forms, such as bonds, debentures, promissory notes, loan agreements, limited partnership units, mortgage interests, and investment contracts.

Most start-up companies are private. This means that their securities do not trade on the open market and you cannot sell them if you change your mind or need your cash back. Also, private companies are not required to disclose information on their operations and financial situation to regulators and the public. Therefore, if you invest in a private company, you will probably not be kept informed of how it is doing and what has happened to your investment unless you can get this information from the company on your own.

Rules for Raising Money

When a company goes public to raise money, it must file a prospectus with the securities commission. This is a public document that contains comprehensive information about the investment and its risks. Private companies do not have to file a prospectus to sell their securities as long as they comply with specific rules that limit how and to whom they can sell. These rules are in place to protect investors. The rules are complex and they are not identical in all Canadian jurisdictions. Even the definition of certain terms used in these rules, such as “accredited investor”, may also vary from one jurisdiction to the next. There is no guarantee that an investment in any company will be safe, even when the company follows all the rules. But start-up ventures are always riskier, so it is a good idea to review the transaction with a qualified financial adviser before you decide to invest.

If you decide to invest in a start-up venture, 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 rule applies to you as an investor. If you do not fit into any of the categories as described in the rules, you should not sign the agreement.

Tactics

Red flags:

Certain Statements Promoting an Investment are Against the Law

There are specific rules about what a company can and cannot say to encourage an investor to buy its securities. A company and its representatives cannot:

- say the company will refund all or some of the investment or buy back the securities
- make promises that the value or price of the securities will be higher at a future date

If those promoting an investment make such statements, they are violating securities law. The following are other warnings signs that should alert you that something may be wrong with the investment:

High pressure sales tactics

A common example is: “Now is your chance to get in at \$1.00 a share. Next time around the share price will be \$4.00.”

Companies based offshore

Where a company is incorporated or based is important. It is easier to research or contact companies based in Canada. Also, companies incorporated in other countries may have less strict legal obligations to shareholders.

Assurances that the company is about to go public

Applying for a public listing on a stock exchange is a very lengthy, difficult and expensive process. There is no guarantee that a company will be successful in getting listed. If a company says it is pursuing a public listing, it should be able to provide proper evidence that it has applied to do so.

Protecting Yourself

Check out an investment before risking your money

Make sure you understand what rule the company is relying on to sell its securities to you.

Are you being supplied with an offering memorandum? If not, do you fall within the specific categories of investor from whom a company can raise money without providing an offering memorandum? Ask the company what rule it is using to sell its securities to you and assess whether you fit into that category as defined by law.

Ask for an offering memorandum and read it.

Before you invest, you should understand the investment. An offering memorandum provides factual information that you can evaluate and verify. If you are unsure of what this document should look like, you can check the securities regulator's website or call the regulator to find out.

Ask questions.

If you do not receive an offering memorandum, try to find out as much information as possible about the investment. For example, ask about the background of the company's principals and their experience in the particular industry. Even if you are related to one of the principals, ask about the others involved in the business. Remember that in some cases the securities regulators have investigated, the principals' own family members lost money. Ask if there are financial statements that can help you and your adviser judge how the business is managed. If the company's representatives dismiss your questions or do not give you satisfactory answers, consider this a red flag and stay away from the investment.

Read the risk warning and subscription agreement forms carefully.

The risk warning form that accompanies an offering memorandum and the subscription agreement you must sign before investing your money are not just pieces of paper. They are key legal documents designed for your protection. It is very important to read these carefully and understand their implications before you sign.

Get independent advice.

Don't rely on the opinion of the company's representatives about whether this is an appropriate investment for you, even if they are close friends or family members. Consult with an independent financial adviser, lawyer or accountant, or with a trusted friend or relative who can be relied on to give you an objective opinion.

Don't invest more than you can afford to lose.

Investing in start-up companies is very risky. Even if a company has good intentions and follows all the rules in selling its securities, there is no guarantee it will be successful.

Remember that high potential means high risk.

Investments in private start-up ventures are usually based on the anticipation of significant future returns. But even large, well-established companies cannot predict their financial future. Keep in mind that "if it sounds too good to be true, it probably is."

Do some checking of your own.

It is easy to check on a company and its representatives to see if they have had previous securities violations. Securities regulators can provide investors with this kind of information. Contact the regulator by phone, or visit its website, to see if the company or any of its principals or representatives have been disciplined for securities violations in the past. Another measure you can take is to find out where the company is incorporated and verify that it has a legitimate physical location.

Be aware that you may never be able to sell your shares in a private company.

Securities of private companies are not traded on the public market. Therefore, it will be difficult, or impossible, to get your money back if you need it or change your mind about the investment.

This concludes Module 6: Taking Stock of Start-ups and is the final module in the series. We hope that this program has improved your knowledge of and confidence in investing. Please review the material presented in the program at any time and recommend it to friends who may also want to know more about the Canadian capital markets.

Thank you for watching.