



Industry
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Self-Study Guide

STEP 5: Build an Investment Proposal

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Canada

STEP 5: Build An Investment Proposal

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5.1 Build an Investment Proposal - Introduction

The investment proposal is your calling card that introduces your company to potential investors who could finance your expansion. If you present a persuasive proposal, you'll have a better chance of clinching that first meeting with investors. We'll show you how to pull together the right information and package it into a first-rate professional document.

In This Step

You'll learn how to assemble a proposal that will appeal to investors and put your company's best foot forward. The key concepts for building a successful proposal are described in the pages that follow:

- Why the Investment Proposal Is Important
- How to Get the Investors' Attention
- Why the Executive Summary Is Important
- What Should Be in the Proposal
- How to Build a Winning Proposal
- What Legal and Regulatory Issues to Consider
- Action Items

The New Tech Story

Follow the fictional company New Tech Distributors Corp. (New Tech) as it pursues venture financing. This case example gives you a feeling for the "real" data and strategic decisions you'll be facing.

Tip

Look Back to Previous Steps

The investment proposal should be an attractive package of information about your financial needs, your investment potential and your management capabilities. These concepts are explored thoroughly elsewhere in this program.

5.2 Why the Investment Proposal Is Important

Without an investment proposal, risk capital investors won't even consider granting you a meeting. They're just too busy. So it's more efficient for them to scan your proposal (along with the dozens of others piling up on their desks) for a worthwhile investment opportunity. That's why you provide them with just enough information to pique their interest and secure that first meeting.

Five Minutes to Make Your Pitch

With many investment opportunities to consider, investors need to size up your company fast — in about five minutes. If you present "the deal" quickly and concisely, and they like it, they'll dig deeper into the document. But you have to hook them in those first few minutes. Otherwise, your proposal will probably be ignored.

Investors will spend less than one minute on each of the areas below.¹ Then they'll probably scan the proposal looking for product literature, graphs, unusual exhibits, samples, letters of recommendation and letters of intent.

What Investors Want to Know

As you begin to prepare the proposal, try to see your document through the investors' eyes. Consider whether you already have company information in written form that you could use to address these investor concerns:

- Characteristics of the Company and the Industry
- Terms of the Deal
- Balance Sheet
- Calibre of the People in the Deal
- What's Different About This Deal

Characteristics of the Company and the Industry

	<i>Can We Answer This?</i>	<i>Information Already Available (Y/N)</i>	<i>Company Documents to Use as Source Material</i>
Why should we be interested in this industry? In this technology?			
Is this company public or privately owned?			
Will this company be saleable?			
What were the sales revenues and profits last year?			
Where is the company located?			

Terms of the Deal

	<i>Can We Answer This?</i>	<i>Information Already Available (Y/N)</i>	<i>Company Documents to Use as Source Material</i>
What percentage of the company is being sold?			
What is the price?			
How much financing is being sought?			
What is the value of the business now?			
Are existing owners re-investing			

in this company today?			
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Balance Sheet

While the most recent balance sheet exposes facts, and all projected balance sheets are based on hopes, investors will only look at the most recent balance sheet to get answers to these questions:

	<i>Can We Answer This?</i>	<i>Information Already Available (Y/N)</i>	<i>Company Documents to Use as Source Material</i>
What is the liquidity position of this business?			
What is the debt-to-equity structure?			
What is the worth of this business?			
What are the assets (the real, tangible ones) and the liabilities (who are the lenders)?			

Calibre of the People in the Deal

	<i>Can We Answer This?</i>	<i>Information Already Available (Y/N)</i>	<i>Company Documents to Use as Source Material</i>
Who are the founders, the members of the board of directors, the current investors, and the outside professionals (accountants, lawyers, bankers, consultants, directors)?			
What is their reputation?			
What is their track record?			
What is the calibre of the management team?			

What's Different About This Deal

	<i>Can We Answer This?</i>	<i>Information Already Available (Y/N)</i>	<i>Company Documents to Use as Source Material</i>
Is there an unusual feature in this			

product or service?			
Does the company have a patent, an unusual technology or a significant lead over its competitors?			

¹ Joseph R. Mancuso, *How to Prepare and Present a Business Plan* (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1983), p. 14

Tip

You never get a second chance to make a good first impression. Your proposal must be powerful, complete and concise.

5.3 How to Get the Investors' Attention

Now that you know what investors will be asking, you need to consider how you can get and keep their attention. Much of the information contained in your investment proposal can be drawn from your detailed business plan. Your marketing materials may be another good source. Previous proposals you have written for other purposes may provide more raw material for you and your management team to work with.

As you pull the components of your investment proposal together, however, keep your readers — the investors — firmly in mind. Here's a checklist to keep handy as you consider whether to include something you've gleaned from another source. And keep in mind the difference between an investment proposal and a business plan.

Your investment proposal must:

- address your investors' specific information needs;
- explain how your customers will benefit from your products and services, and provide strong evidence of their marketability;
- demonstrate that your management team is experienced and has complementary management and business skills;
- contain a convincing executive summary that clearly differentiates your investment proposal from others;
- provide insight and meaningful information about how your investors will capitalize on this opportunity;
- prove that you have done your homework;
- present believable financial projections with the more important data and assumptions explained and documented;
- show how investors will be able to cash out successfully in three to seven years; and
- provide an objective analysis of your company's strengths and weaknesses, and the risks and opportunities it faces.

5.4 Why the Executive Summary Is Important

The executive summary is a unique component in the investment proposal. It is a synopsis, placed near the beginning of the proposal, of all the information contained in the rest of the proposal. The other parts of the proposal will be covered in more detail later in this Step.

The executive summary should be designed primarily to capture the investors' interest and to entice them to read the following sections of the proposal. It gives an overview of the company and provides the highlights of your investment proposal.

Keep It Short, Keep It Snappy

- Limit your executive summary to two to four pages.
- Write it as a stand-alone document.
- If the executive summary is vague, investors won't read it.
- If investors don't read it, they'll never make it through the rest of the document. And you'll have missed a golden opportunity.
- Charts, graphs and tables are a great way to display large volumes of information, especially in the executive summary.

See the **New Tech Case Example** for a sample executive summary.

Executive Summary Must-Haves

Company Description

Describe your company. Give an overview of its structure and major players. Briefly describe your company's purpose in the marketplace, your products and services, and your management team.

Investment Needed

State how much money your company needs, when you need it and what it's needed for.

Financial Track Record

Give your company's key financial results, both historical (two years) and projected (three to five years).

Exit Strategies

Outline potential exit strategies for investors.

When you've prepared a draft, read it over from the investors' point of view. Here's a checklist to help you evaluate your draft.

Key Questions

Want to see your executive summary through investors' eyes? Check out this list.

Executive Summary Checklist

Be sure to address the four critical conditions that investors are sure to look for. Have you:

- showed investors how much they can expect to earn from the deal (an acceptable rate of return)?
- given evidence that your team members have the business and management skills to carry the project through to a successful conclusion (confidence in management)?
- provided measures to help them protect their interest (the ability to monitor and control their investment)?
- given investors a viable exit strategy and options to realize their investment?

Tip

What Makes You Different?

Highlight what sets your company and products apart from other businesses competing for investment capital.

5.5 What Should Be in the Proposal

A typical investment proposal contains the following sections. (See the Appendix for more information about each section, except for the summary. Section 5.4 (above) presents details about the summary.)

Executive Summary	The executive summary must cover the company, its products and track record and the terms of the deal. It must also give a synopsis of your funding needs and the exit strategies you are offering investors.
Company and Ownership	This section gives your company's history, including milestones. Potential investors need to evaluate where your business has been before they can evaluate where it may go.
External Environment	This section describes your company's industry, markets and competitive environment. This information helps investors to decide whether your company can succeed with its plans (given the external forces that you can influence but not control).
Products and Services	This section explains what business you're in. It describes your current and future products and services, and explains how you'll market them. Here is the kind of information you should include.
Management Team	This section shows investors that they are dealing with a diversified management team that can contribute to the success of your business venture. Emphasize the experience and competence of each key member of your team.
Financial Plan	The financial plan is the most referred to part of the investment proposal. It should include:

	<ul style="list-style-type: none"> • your company's financial history; • your projected financial statements for the next five years; • your financial assumptions; and • your funding requirements.
Financial Structure and Valuation	There are advantages and disadvantages to covering the financing structure and to disclosing your valuation/pricing in your investment proposal.
Operational Plans	<p>This section describes your company's plans and strategies for capitalizing on the growth opportunity. Focus on these items:</p> <ul style="list-style-type: none"> • a description of the growth opportunity and why you feel your company can capitalize on it; • a description of the specific actions needed to carry out the strategic plan; and • the effects of these actions on the key operations of your business (marketing, production, etc.).
Appendixes	Using appendixes is an effective way to present detailed information without cluttering up the main body of the document.

FAQ

How long should the investment proposal be?

There are no rules. In general, the longer the investment proposal, the less likely it will be read. So, limit yourself; provide just the key information that investors will need to make their decision. And keep the executive summary to fewer than four pages.

5.6 How to Build a Winning Proposal

Share the Workload

Preparing a top-notch investment proposal is a major undertaking. One person needs to be in charge of the task to ensure the consistency and quality of the writing, the calibre of information and the attractiveness of the packaging. Choose your best writer and organizer for this overall job, and give the person a title: Editor-in-Chief.

Delegate the writing of detailed sections to others in the organization who know the subject areas well. Give them firm deadlines for completing their research and first drafts, and for getting them in to the editor. And set a deadline for the editor for pulling all the sections together and giving the complete document a consistent look and style. To help you hand out these writing and editing tasks, use this Proposal Assignment List.

Proposal Task	Responsible	By Date
Editor-in-Chief: final proposal		
Executive Summary		
Company and Ownership		
External Environment		
Products and Services		

Management Team		
Financial Plan		
Financial Structure and Valuation		
Operational Plans		
Appendixes		

Reflect on Your Reading Experience

Have you been on the receiving end of written proposals other people submitted for your consideration? Some of those proposals probably engaged your attention and persuaded you. Others may have ended up on the pile of documents you intended to read but never really got around to. What's the difference? Your experience as a reader of these documents can help you keep your proposal from landing in the slush pile.

Pay Attention to the Language and the Look

The language — even in the technical sections — should be written plainly so that investors unfamiliar with your business will understand your message. Use the active voice. And remember that your aim is to persuade investors. Check for spelling, grammar and math errors.

Obtain Feedback

Ask outside advisors, especially those who have successfully raised money, to review and comment on your investment proposal. Ask a lawyer to give you advice regarding the impact of the disclosure of certain items and legal compliance with applicable provincial securities legislation. Seek an accountant for review on your financial projections. Ask others to comment on the presentation of information and readability of the investment proposal.

Ensure Confidentiality

The product description, market and financial information would be very useful to your competitors, saving many hours and thousands of dollars required for gathering the same information. Your treatment and handling of the proposal should reflect its value to you and to your competitors.

You'll want potential investors and anyone else advising you on the investment proposal to treat it in a confidential manner. Indicate on the cover of your investment proposal "confidential" and account for each copy in circulation.

Consider having each party receiving a copy of your investment proposal sign a confidentiality agreement. This agreement would:

- prohibit the person reviewing your investment proposal from disclosing the information contained in the document to other parties not covered by the confidentiality agreement; and

- protect your company if your investment proposal contains sensitive information that is vital to potential investors but that, if divulged to others, could hinder your company.

Have a lawyer draft a confidentiality agreement to ensure it is consistent with applicable provincial and federal statutes and regulations.

Tip: Convey a Professional Image

Think back to an earlier activity in this Step where you examined your own standards for the appearance of proposals. You probably considered such aspects as covers, binding, appearance of the text, and so on. These and other factors determine whether your reader, the investor, gains the impression that your company is professional. This checklist will help ensure that you convey a professional image.

- Use a clear, legible font, and a high-quality printer.
- Make sure your company name, or founder's name, and address are on the proposal.
- Prepare a table of contents. Insert an index/tab for each section of the investment proposal for easy reference. Make sure all major topics, figures, charts and exhibits are properly identified in the table of contents.
- Use colour, charts, graphs, diagrams and other visual aids to enhance the readability and appearance of the document.
- Package the plan in a loose-leaf binder or spiral-bound binder to facilitate revisions of certain sections. Also, indicate the dates on all revisions to ensure that you are always dealing with the most recent version.
- Insert a glossary of terms at the end of the investment proposal. The glossary will be useful, particularly if you're presenting technical information.
- Package appendixes appropriately (they should be reproduced, bound and covered in the same manner as the body of the investment plan).

Tip

The thinking that goes into preparing your investment proposal must come from you and your management team. You and your team have to be intimately involved in putting the proposal together so that you can respond to detailed questioning from potential investors.

FAQ

Will investors be impressed by technical lingo? No, and here's why.

Too Technical Is a Turn-Off

Don't assume that making your investment proposal highly technical will create more confidence in potential investors. On the contrary, you're more likely to turn investors off because the more technical an investment proposal becomes, the more difficult it is to understand. So write clearly and concisely. That way, investors can easily understand the investment proposal contents. If you have to include technical terms and concepts, include them in a glossary at the end of the document.

5.7 What Legal and Regulatory Issues to Consider

Legal and Regulatory Issues

When you seek debt or equity financing, you may be subject to certain legal and regulatory requirements that govern, among other things, the nature, format and content of your investment proposal. Before contacting potential investors, seek legal advice to ensure you are in compliance with all the legal and regulatory requirements that may affect you in raising financing.

Securities Regulation in Canada

In Canada, securities regulation is governed by provincial jurisdiction. So each province has legislation pertaining to securities-related matters. That means you'll need to determine how your province's specific securities legislation affects your financing proposal. Consider seeking independent legal advice.

For instance, in Ontario, you may be exempted from providing a prospectus. This exemption comes under the seed capital exemption or private placement exemption of the *Ontario Securities Act*.

For a discussion of the legal issues, assumptions and implications to you, your company and potential investors, review the Legal and Regulatory Overview.

Provincial Securities Commissions

Securities legislation is administered by the authority designated in the applicable securities act.

Alberta, British Columbia, Manitoba, Nova Scotia, Ontario, Quebec and Saskatchewan have securities commissions. In the remaining provinces, a designated official administers the acts.

Refer to *Provincial Securities Commission* in the Appendix for the addresses of the authorities administering the respective acts.

5.8 Action Items

In this Step you've looked at the importance of the executive summary, the key sections of the investment proposal, and the type of information to include in each section. You've also considered how the overall appearance and presentation of your proposal can affect an investor's impression about your company.

The following checklist will help you to:

- assess your understanding of the ideas covered in this Step;
- gauge your progress; and
- plan your company's approach.

Checklist

<i>Have you...</i>	Status	Target Date	Responsibility
assigned an Editor-in-Chief to take charge of the overall production and quality of the proposal?			
assigned your most knowledgeable team members to prepare the appropriate key components of the proposal?			
considered how you will gain and keep investors' attention with your proposal?			
thought about how you can draw on the written company information you already have to build your investment proposal?			
prepared an executive summary that provides a compelling, attractive snapshot of the rest of your proposal?			
included the key components that a successful investment proposal should have?			
ensured the proposal is written in attractive, straightforward language?			
paid attention to the details of appearance and presentation that will make your proposal look like a highly professional effort?			

Appendix

Take a Closer Look - Why You Need an Investment Proposal and a Business Plan (see section 5.3)

Similarities

Both are planning documents.
Both deal with similar information.

Differences

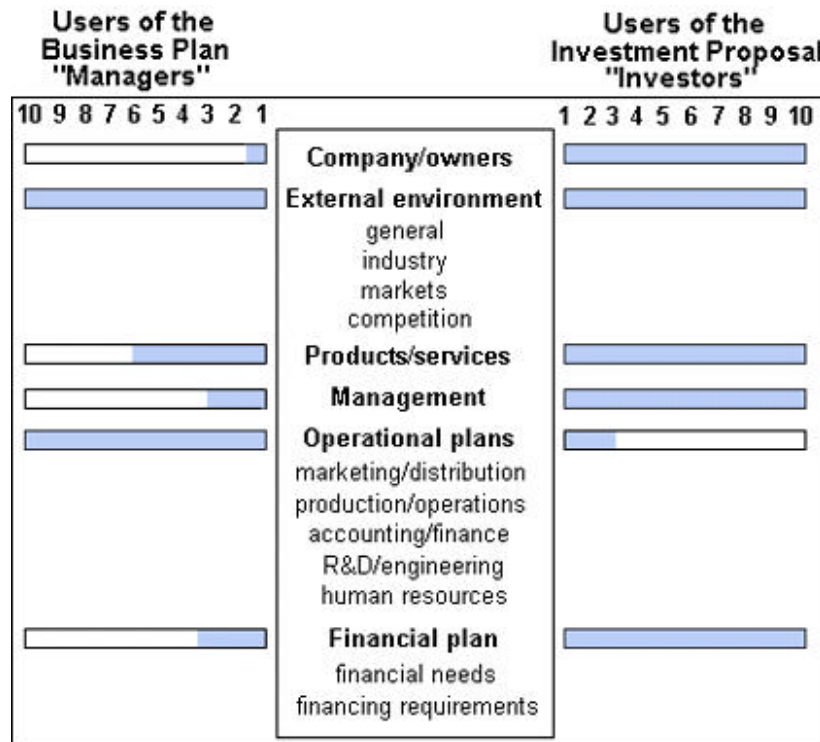
The Business Plan

Its purpose: to help managers coordinate resources and activities.
The business plan is used internally by managers to plan business activities and to measure your company's success. It provides a blueprint of how your company is going to go about implementing your plans.

The Investment Proposal

Its purpose: to raise funds from risk capital investors.
The investment proposal (prepared by management) is used externally by lenders and investors to judge whether your company is worth investing in. It summarizes for these outsiders the nature of your business, your company's historical activities and growth potential, and your company's financial needs and funding options to realize your goals.

Different Uses of Business Plan and Investment Proposal: Information Depth that Should be Included



This diagram shows the depth of information that should be included in each major element for each type of document. Each element is rated along a scale of 1 to 10, where

1 = "irrelevant" and 10 = "highly relevant." You can see, for example, that the investment proposal should contain extensive information on the company and owners whereas the business plan needs very little of this information.

Take a Closer Look – What Should Be in the Proposal (see section 5.5)

Company and Ownership

This section should include:

- a chronological history based on major milestones (when the business was founded, key product introductions and successes, financial milestones — break-even point, sales levels, history of investments, etc.);
- its form of ownership (public or private company, date of incorporation);
- for a public company, the details (authorized and issued shares);
- the names and addresses of founding shareholders and directors;
- a copy of letters patent or a corporate charter and by-laws; and
- the company's major successes or achievements in the field to date.

Try summarizing milestones in chart form as follows.

Year	Description of Event	Comments

The history of your company should be connected to the company's current need for financing.

- If, for example, the past history of your business is not a strong indicator of future performance (because of management changes, or product or service changes), this should be mentioned in the history section and reinforced in other sections of the investment proposal.
- If, for example, the growth opportunity involves the launch of a new product or expansion into new markets, this should be spelled out clearly in the investment proposal.

External Environment

This section includes information on these four key components:

- general environment;
- industry characteristics;
- market dynamics; and
- competitive climate.

Present a Third-Party Opinion

A third-party opinion will add credibility to your sales estimates (it gives investors more confidence in your conclusions). Sources include government and industry publications and private research studies.

Products and Services

- Describe current products/services (and their key attributes) and outline marketing, customer service and distribution strategies for these products/services. Include similar comments for any new products or services that you are planning to market. Where possible, compare and contrast your products and services with those of your competitors.
- Emphasize the characteristics that distinguish your products/services from others in the marketplace (low cost, versatility, higher quality, patent protection, etc.). Potential investors will want to know your distinct competitive advantages at the outset.
- Where applicable, describe your company's new product development process.
- Use charts and tables to describe your products' attributes and to compare them to competing products.

Tip

Perhaps you'd prefer to give a synopsis of your products. You could include details in an appendix or present them after the initial meeting — particularly if you want to protect the proprietary aspects of your products.

Management Team

- Describe the experience and skills of key members of your management team. Include a short biography on each person. (Provide résumés in an appendix.)
- Describe weaknesses in your management team (if any) and how these deficiencies will be dealt with.
- Provide an organizational chart showing the key members of your management team and employees by functional area and responsibility.
- Provide information on key employees, particularly those instrumental to your business such as skilled production labour, supervisors, plant managers and designers.
- Give some general information as to the number of employees and labour requirements of the business. This information may include the number of hourly versus salaried employees, average hourly wage rates, fringe benefits, number of employees by functional areas, existence of a union, history of labour relations, etc. (Provide details in an appendix.)
- Describe key management practices and the employee benefits package, if applicable.

Financial Plan

Financial History

This section includes a summary of income statements, balance sheets and cash flows.

For each year presented, comment on major year-to-year fluctuations for key financial segments (sales, gross margin, operating income, working capital, debt, etc.). Be sure to

explain any inconsistencies between your past performance and future ability to carry out your plans.

Financial Forecasts

This section outlines the financial results that your company expects to achieve if it successfully carries out its plan. Financial forecasts allow investors to assess the expected rate of return on your new venture. Include income statements, balance sheets and cash flow statements for the next five years (monthly for two years and annually for three more years). Make sure your forecasts are believable.

Assumptions

Be sure to comment on the assumptions you used to prepare your financial forecasts. What assumptions did you use to arrive at these and other items?

- Sales estimates in units
- Prices for each product
- Expenses related to cost of goods sold
- Selling expenses
- Administrative expenses
- Capital expenditures (amount and timing)
- Inventory level
- Accounts receivable and accounts payable
- Interest rates.

Your Forecasts

The forecasts included in your investment proposal must be realistic; otherwise they may generate a certain level of skepticism on the part of your potential investors. Any deviations from industry norms should be explained and supported with reasonable assumptions.

Financial forecasts may be used as benchmarks for agreements in the negotiation stage. As such, you may be required to stand by them.

Include a Sensitivity Analysis

Consider inserting the results of a sensitivity analysis of your forecasts. Although potential investors will likely perform their own analysis, they will be impressed that you have considered the effects of such an analysis.

Ensure Your Forecasts Comply With Government Regulations

The financial forecasts in your investment proposal may be subject to securities regulations. These are covered in future-oriented financial information (FOFI) in securities offering documents. Review with a legal advisor to ensure that you are in compliance with federal and provincial regulations.

Funding Requirements

This section of the proposal outlines the amount of financing you need based on what is being funded and your company's preferred financial structure (amount of debt versus equity) and requested terms (flexibility in payment, exit strategy, etc.).

When summarizing your funding requirements, ask for slightly more (a cushion) to cover short-term deviations from expected results. Be realistic and be prepared for the unexpected.

Financial Structure and Valuation

There are advantages and disadvantages to covering the financing structure and to disclosing your valuation/pricing in your investment proposal.

Financial Structure

The proposed financial structure may affect the number of potential investors who respond favourably to your investment opportunity. It could also affect the final pricing, deal structure and valuation received, and may have significant tax implications.

Valuation

You should be cautious about disclosing your valuation parameters or your expected price. Although it may speed up the investors' decision as to whether to pursue your investment opportunity, it could lead to a quick rejection. If your price is too high, or if you give away too much by setting a low price, you may have to face serious financial consequences. In any case, your range of value or pricing, whether specifically disclosed in your investment proposal or not, must be realistic and defensible.

Before including your range of value or pricing, you should ensure that the form and content of your investment proposal is consistent with relevant legal and securities regulations. Be careful! Some forms specifically include pricing considerations; others require exclusion.

Operational Plans

Marketing Plan

Investors will want to know how your marketing goals and strategies will be realized. Make sure your investment proposal answers questions like these:

- What is your product strategy?
- What is your pricing strategy?
- What is your distribution strategy?
- What is your promotional strategy?
- What sales revenue will you realize for each product or service? For each geographic market? By customer segment? By channels of distribution?
- What market share do you expect to capture over the planning period?
- Will new markets be created as a result of your strategic growth plan?
- Will your customers be drawn from an expansion of the overall market or taken from competitors identified above?
- How are your competitors expected to react to your entry or expansion into the market or market segment? How will you respond to them?

- Will new competitors be drawn into the market as a result of your entry? How will you react to them?

Production Plan

Investors will want to know your production goals and strategies, particularly your manufacturing operations and production processes (where applicable).

Summarize the nature, extent and quality of manufacturing facilities, and comment on these areas:

- distribution systems;
- education and training requirements of employees;
- patented processes;
- state of technology (level of technology being used);
- type of equipment used;
- plant capacity;
- key suppliers and availability of raw materials;
- skilled labour requirements;
- occupancy arrangements (i.e. leased or owned premises);
- key strengths; and
- production limitations (and how these may be solved).

Place detailed information (floor plans, photographs, flowcharts) in an appendix.

Research and Development (R&D) Plan

- Identify, when applicable, specific goals and strategies for the period covered during the planning period and the assignment of responsibilities for R&D activities.
- Outline where your R&D efforts are being focussed, that is, whether the thrust is new product development, improved product quality, increased production output or reduced production costs.
- Provide information on the background and skills of your key R&D players. Describe your R&D facilities and identify the person who is responsible.
- Describe the decision-making process within your R&D, e.g., when a new product is ready to be marketed or when cost-saving technology is ready to be introduced to the production facility.

Human Resources Plan

This plan should consider whether or not the required categories of labour (skilled, semi-skilled, unskilled) are available. The plan should demonstrate clearly that at the start of production every important technical position would be filled by qualified staff.

Provide information on items such as these:

- personnel required (by function) with organizational chart;
- number and category of workers required;

- training needs and costs;
- compensation program (fringe benefits, health insurance, paid holidays, accident insurance);
- working conditions;
- turnover and morale;
- company's labour relations policies; and
- identification of new positions that may be required as the company grows and diversifies.

Appendixes

Place these and other items in the appendixes:

- financial statements;
- results of market research studies;
- corporate or product brochures;
- management résumés;
- summaries of key agreements;
- letters patent; and
- plant layout and production process information.

Take a Closer Look – What Do You Like Reading? (see section 5.6)

Imagine yourself, sitting at your desk, picking up a proposal someone has just submitted for your consideration. Based on your experience, how does each of the following aspects of the document affect you? What keeps you interested, actively involved and reading along?

Factors	Not Important	Somewhat Important	Very Important
The overall appearance of the document: its size, binding, cover, paper, use of colour and graphics, etc.			
The cover page information: the name or title of the proposal, details about the sender, submission details, etc.			
The appearance of the text: the style of type and size, use of headings and subheadings, length of paragraphs, number and appearance of diagrams, charts, etc.			
The organization of the material: clear structure, logical order, consistency.			
Level of detail: main points are backed up, references are given for additional sources, extra details are included in appendixes.			
Accuracy: correctness of grammar and spelling, accuracy of figures and calculations, information is up-to-date.			
Writing style: formal or informal? Everyday wording or more technical language?			
Synopsis: main points are summarized for easy reading, executive summary gives overview, overall request stands out.			

Take a Closer Look – Provincial Securities Commissions (see section 5.7)

Securities legislation is administered by the authority designated in the applicable securities act. The jurisdictions of Alberta, British Columbia, Manitoba, Nova Scotia, Ontario, Quebec and Saskatchewan have securities commissions. A designated official administers the acts in the remaining provinces. Listed below are addresses of the authorities administering the respective acts.

Alberta

Alberta Securities Commission
20th Floor, 10025 Jasper Avenue
Edmonton, Alberta
T5J 3Z5
Tel: (403) 427-5201
Fax: (403) 422-0777

4th Floor, 300 - 5th Avenue S.W.
Calgary, Alberta
T2P 3C4
Tel: (403) 297-6454
Fax: (403) 297-6156
E-mail: inquiries@seccom.ab.ca
Web site: <http://www.albertasecurities.com>

Manitoba

Manitoba Securities Commission
1130 - 405 Broadway Avenue
Winnipeg, Manitoba
R3C 3L6
Tel: (204) 945-2548
Fax: (204) 945-0330
E-mail: securities@cca.gov.mb.ca
Web site: <http://www.msc.gov.mb.ca>

Newfoundland

Newfoundland Securities Division
Department of Justice
2nd Floor, West Block, Confederation Bldg.
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British Columbia

British Columbia Securities Commission
P.O. Box 10142
Pacific Centre
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Vancouver, British Columbia
V7Y 1L2
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New Brunswick

Office of the Administrator of Securities
Department of Justice
133 Prince William Street, Suite 606
P.O. Box 5001
Saint John, New Brunswick
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Northwest Territories

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Department of Justice
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P.O. Box 1320
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Nova Scotia

Nova Scotia Securities Commission
2nd Floor, Joseph Howe Building
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Web site: <http://www.gov.ns.ca/nssc>

Ontario

Ontario Securities Commission
20 Queen Street West
Suite 1903
Toronto, Ontario
M5H 3S8
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Toll Free: 1-877-785-1555
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Quebec

Commission des valeurs mobilières du Québec
Stock Exchange Tower
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Yukon

Registrar of Securities
Corporate Affairs (J-9)
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2134 - 2nd Avenue
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Whitehorse, Yukon
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Nunavut

Government of Nunavut
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Prince Edward Island

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Tool – Legal and Regulatory Overview (see section 5.7) Overview of Prospectus-Exempt Financings: A Legal Perspective

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**The issues addressed in this paper are complex and fact specific, and may vary in application from jurisdiction to jurisdiction. This paper is intended to provide only an overview of the concepts introduced here, and does not offer professional advice for any particular situation, nor does it address the issues completely or address all legal issues which may be related to the matters described here. The reader is urged to consult with an advisor who is knowledgeable in the area of the legal implications of conducting financings and, moreover, is familiar with the requirements of the specific provincial jurisdictions which apply to the offering.*

Introduction and Overview

There are three fundamental principles of securities legislation: the efficiency of capital markets, the integrity of capital markets and investor protection. These principles are very much interrelated in that the integrity and efficiency of the capital markets are fostered, if not maintained, when investors are entitled to rely upon adequate and appropriate safeguards in making their investment decisions. The method and extent of these safeguards vary somewhat, depending upon the route taken by an issuer in gaining access to the capital markets. Under no circumstances, however, does the maxim "let the buyer beware" have any application. The questions, rather, are what is the appropriate gaining in the circumstances of the particular offering, and how to balance an investor's ideal wish for a guaranteed winner and the issuer's desire to raise capital without being exposed to liability in the event things do not turn out as hoped.

Securities legislation in Canada essentially provides three ways of distributing securities:

- (a) pursuant to a prospectus which is filed with, and cleared by, the securities regulatory authority (typically a securities commission) in the relevant jurisdiction;
- (b) by relying upon one or more statutory exemptions from the prospectus requirement (generically referred to as "private placements") in circumstances where the disclosure document, if any, is not required to be reviewed by the securities regulators (but is required to be filed); or
- (c) by obtaining exemptive relief from the relevant securities regulator.

Securities regulation in Canada is a matter of provincial jurisdiction and, accordingly, each province of Canada has its own legislation regulating securities-related matters. Nevertheless, many of the principles and substantive provisions of the legislation in the various provinces are similar in approach.

The Concept of Trading or Distributing Securities

A "trade" in securities is defined broadly and includes any sale or disposition of securities for valuable consideration—but does not include a purchase of securities. In this way, the applicable securities legislation regulates the vendor of securities, but does not regulate the purchaser of securities. Trade is also defined to include any act, advertisement, solicitation, conduct or negotiation directly or indirectly in connection with a sale of a security. For the purposes of the applicable securities legislation, "distribution," where used in relation to trading in securities, includes a trade in securities of an issuer by that issuer (e.g., from treasury).

Commonly Used Exemptions from Prospectus Requirements

In describing a distribution of securities effected pursuant to a prospectus exemption, the term "private placement" is often used. While these different types of offerings are frequently referred to, collectively and generically, as private placements, the different prospectus exemptions result in different practical implications.

The policy behind certain exemptions from the prospectus requirements being permitted is that in certain situations investor protection does not require the detailed disclosure of the proposed investment or its prior review by the securities regulators. This is frequently because the sophistication of the investor (or the "deemed" sophistication of the investor arising from the size of the investment) suggests that the investor does not "need to know" the information which would ordinarily be contained in a prospectus (i.e., that such an investor is in a position to dictate what protections are appropriate to, or necessary for, that particular person).

The use of certain prospectus exemptions can be beneficial for a number of reasons. First, the delay and the costs inherent in preparing a prospectus can often be prohibitive. Second, in certain circumstances a disclosure document may not need to be prepared. Third, even if such a document is required, the information to be provided in an offering memorandum is generally left to the discretion of the issuer and its counsel, provided that anything included or omitted does not amount to a "misrepresentation." Nevertheless, in some jurisdictions reliance upon certain prospectus exemptions necessitates the preparation of an offering document containing prescribed information.

Statutory exemptions are essentially self-policing, and each element must be reviewed to be satisfied that the issuer is entitled to rely upon a particular exemption. Since many exemptions are based upon the type of investor or facts which relate to the investor, part of this review typically includes obtaining statutory declarations or representations and warranties from the investor as to such facts. Issuers should not, however, blindly rely solely upon such declarations and representations (particularly if the circumstances of the situation suggest that the issuer knows or ought to know that they are likely to be incorrect), but should make reasonable enquiries and investigations to ensure that this reliance is appropriate.

Private Company Exemption

For very early stage financings where the promoter is relying exclusively on family, close friends and pre-existing business associates, one frequently relies upon the prospectus exemption under the applicable securities legislation which exists when one is issuing securities of a "private company" to persons who are not considered to be members of the "public" for the purposes of securities legislation. A "private company," which is defined more specifically in the particular province's securities legislation, is generally considered to be one which has, in its articles of incorporation restrictions on the transferability of its securities, a provision limiting the number of security holders to not more than 50 (not including employees and certain former employees) and a prohibition against inviting the public to subscribe for its securities. There is generally no definition in the legislation as to which investors are considered to be members of the public for these purposes, and the courts and securities commissions have developed an extensive body of case law and precedent addressing the issue. A number of factors will be considered in making the determination, including the number of persons to whom the issuer tried to sell securities, the number of ultimate purchasers, the sophistication or investment expertise of the purchasers or their access to advice (including their capability to evaluate the merits and risks of the prospective investment), the net worth or ability of the purchasers to risk a complete loss of their investment, the relationship of the purchasers to the vendor, the manner in which the offering is made, the purpose of the offering and the circumstances relating to the vendor. In many cases, the courts and securities commissions have applied the "need to know" rule, whereby they consider a person not to be a member of the public if he or she does not need the type of knowledge about the issuer and the security ordinarily available in a prospectus. No one of the foregoing considerations will be determinative but, rather, the overall circumstance will be evaluated. The determination of who is or is not a member of the public is plagued with uncertainty, and the ultimate determination will be based upon a review of the salient facts—which determination and examination will always be viewed in hindsight often having regard to the views of the judge or the regulators as to whether protection should be extended to the investor.

If an investor is considered to be a member of the public (and, therefore, entitled to the more detailed protections of securities legislation), the trade to such person must be conducted in a manner which allows it to be exempt from the general prospectus requirements of the applicable securities legislation.

Seed Capital Exemption

The "seed capital exemption" is generally used in the relatively early stage of financing of companies in circumstances where the private company exemption is considered to be unavailable (because, for example, the offering is being made to members of the public). The applicable securities legislation should be reviewed to determine the specific eligibility criteria, including whether there is a minimum subscription required (which, for example, under a specific exemption in the British Columbia legislation, requires a minimum subscription of \$25,000), whether a specified form of offering document must be prepared, the number of persons to whom an offer may be made, the sophistication requirement of the purchasers, the number of persons who may purchase in reliance upon the exemption and the period of time during which the offering may be made. For

example, in Ontario some of the conditions imposed under that province's securities legislation are that:

(a) solicitations may be made to not more than 50 prospective purchasers and result in sales to not more than 25 actual purchasers, each of whom must purchase as principal (such numbers being in respect of solicitations and sales in all jurisdictions, including Ontario); and

(b) each purchaser must have "access to substantially all the same information concerning the issuer that a prospectus" filed under that province's securities legislation would provide and must either be:

(i) an investor who, by virtue of net worth and investment experience or by virtue of consultation with, or advice from, a person who is not a promoter of the issuer and who is a registered advisor or a registered dealer, is able to evaluate the prospective investment on the basis of information respecting the investment presented by the issuer; or

(ii) a senior officer or director of the issuer, or the parent, brother, sister, child or spouse (common-law or otherwise) of a senior officer or director.

Clearly, the policy behind the seed capital exemption is that an investor who is sophisticated, as evidenced by net worth, business experience, independent advice or close personal bonds of association with the issuer, is deemed to be capable of protecting his/her own interests and, by implication, is not in need of the same kind of investor protection as other investors.

Minimum Subscription Private Placement Exemption

The private placement exemption which is frequently referred to specifically as a "private placement" is based upon a minimum amount of the securities purchased by the investor which, depending upon the particular jurisdiction, varies from \$97,000 to \$150,000. Since it may be relied upon any number of times without a specific need for the investor to be provided with, or even have access to, any documentation or information, it is one of the most popular exemptions available. Under the applicable securities legislation, the only qualification of the exemption that generally applies is that the purchaser must purchase, as principal, securities having an aggregate acquisition cost of at least the specified amount. Certain securities commissions are of the view that neither corporations or syndicates, nor partnerships or other forms of unincorporated organizations should be created solely to permit purchases by groups of individuals whose individual share of the aggregate acquisition cost is less than the specified amount.

Disclosure Considerations: Documents and Concerns

Exempt Offerings: Offering Memoranda

There are no requirements governing disclosure documents for use in connection with securities issued in reliance upon the private company prospectus exemptions. Moreover, no filings must be made with applicable securities regulators in respect of such financings.

Written material delivered to investors in connection with the seed capital exemption and the minimum subscription private placement exemption will frequently constitute an "offering memorandum" for the purposes of the applicable securities legislation. Business practice often dictates that comprehensive material be prepared for delivery to prospective investors to induce them to acquire offered securities. Each province's securities legislation should be reviewed to determine what the specific requirements within that province are as to the need to prepare an offering document and what, if any, are the required contents of such a document. Moreover, the specific legislation should be reviewed to determine what, if any filings must be made with, and fees paid to, the applicable securities regulator as a result of the financing.

For the purposes of the Ontario securities legislation, for example, an offering memorandum is a document which:

- (a) purports to describe the business and affairs of an issuer;
- (b) has been prepared primarily for delivery to and review by prospective investors to assist those investors in making an investment decision; and
- (c) is prepared in connection with a distribution being conducted in reliance on particular statutory prospectus exemptions, including that province's \$150,000 private placement exemption and the seed capital exemption.

A document does not need to be identified as an offering memorandum in order to be treated as such for the purposes of the applicable securities legislation. It could be identified as business plan or an investment proposal or otherwise. Technically, each separate document which fits the foregoing definition constitutes an offering memorandum for the purposes of the Ontario legislation (or, at least, all documents taken together will constitute an offering memorandum). Excluded from the definition of offering memorandum are documents setting out current information about an issuer for the benefit of prospective investors "familiar with the issuer through prior investment or business contacts." Also excluded from the definition, in certain cases, are the annual reports, information circulars, prospectuses and other documents the contents of which are prescribed by statute or regulation. These exceptions will not be discussed here.

When a security is distributed in conjunction with an offering memorandum in reliance upon the Ontario \$150,000 private placement exemption or the seed capital exemption, it is generally required that the purchase be given a contractual right of action for rescission or damages in respect of any "misrepresentations" contained in the offering memorandum. These rights are to be described in the offering memorandum and generally correspond to those which a purchaser of securities under a prospectus would have. Moreover, in situations where one is relying upon the seed capital exemption in Ontario, the Ontario legislation requires that the investor have access to substantially the same information concerning the issuer that a prospectus filed under the Ontario

securities legislation would provide; this is frequently satisfied by including such information in an offering memorandum.

In some jurisdictions outside of Ontario, the legislation prescribes what must be contained in an offering memorandum delivered in reliance upon certain of the prospectus requirements in such legislation. Neither the Ontario securities legislation nor the Ontario Securities Commission prescribes what an offering memorandum should contain. Given the self-policing nature of offerings pursuant to the seed capital exemption and the private placement exemption, such a decision is thought to rest more appropriately with issuers and their advisors.

The prohibition on an offering memorandum containing a "misrepresentation" implies, having regard to the definition, that the offering memorandum cannot:

- (a) contain an untrue statement of a material fact; or
- (b) omit a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

The term "material fact" means a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of the securities being offered. Accordingly, once a decision is made to deliver an offering memorandum to prospective investors, it cannot contain only selective information. One cannot, for example, merely highlight the positive aspects of the issuer's business or deal only with certain areas of the business.

Clearly a prospectus standard of disclosure is not required in the offering memorandum, and something short of that is acceptable. Nevertheless, it is not unusual to find that the offering memorandum frequently resembles the format and appearance of a prospectus for practical, although not legal, reasons.

While the securities legislation does not provide that an offering memorandum be reviewed by staff at the applicable securities commissions, there is often a requirement that it be delivered to the securities commissions after completion of the offering.

It should be recognized that the legislation does not contemplate delivery of a draft offering memorandum. Each document (or version thereof) delivered to each investor (including various versions of the offering memorandum) constitutes an individual and separate offering memorandum which must include a contractual right of action.

Use of Future-Oriented Financial Information

It is not always necessary or appropriate to include in the offering document future-oriented financial information (FOFI) consisting of forecasts or projections. Nevertheless, the securities regulators have established a FOFI policy with respect to the inclusion of FOFI in certain specified types of offering documents. The FOFI policy is not generally

considered to apply where the offering of securities follows the private company exemption.

A "forecast" is essentially FOFI prepared using assumptions which reflect the issuer's planned courses of action for the period covered, given management's judgment as to the most probable set of economic conditions. A "projection," by comparison, is FOFI prepared using assumptions that reflect the entity's planned courses of action for the period covered, given management's judgment as to the most probable set of economic conditions, together with one or more hypotheses (i.e., assumptions that assume a set of economic conditions or courses of action that are consistent with the issuer's intended course of action and represent plausible circumstances).

The policy relating to FOFI specifies the manner in which FOFI may be prepared, disclosed, pre-cleared, dated and subsequently compared with actual results, and also addresses the involvement of auditors with such documents. The FOFI policy applies to disclosure documents such as prospectuses and to offering memoranda prepared for use in connection with the seed capital exemption and the private placement exemption, but does not apply to offerings where the minimum acquisition cost under the offering memorandum is at least \$500,000.

The requirements of the policy in connection with the preparation of FOFI are implicitly a list of why many issuers may find that they may not effectively rely upon FOFI in connection with their offerings. Among the requirements are the following.

- (a) FOFI shall be in the form of a forecast. Notwithstanding this, projections may be used for issuers engaged in a business with less than 24 months of relevant operating history or in certain other limited circumstances. A forecast or a projection may be used, but not both.
- (b) The period covered by the FOFI shall not extend beyond the time for which such information can be reasonably estimated (normally the end of the next year i.e., a maximum of 24 months).
- (c) FOFI prepared in accordance with the FOFI policy must be prepared in accordance with the CICA Handbook together with any additional requirements in the policy.
- (d) The need to pre-clear FOFI with the securities commissions in a province prior to filing a preliminary prospectus varies from province to province. Frequently, the requirement to pre-clear before the preliminary prospectus is filed only exists in connection with an initial public offering or in circumstances where an issuer is conducting its first public offering in the particular province. Otherwise, the FOFI is reviewed after the preliminary prospectus is filed and during the normal review process for the remainder of the preliminary prospectus.

(e) FOFI must be accompanied by an auditor's report, which shall not contain any reservations of opinion.

(f) The FOFI policy provides that FOFI (other than FOFI in an offering memorandum) shall be reviewed each time the issuer is required to file historical financial statements with the securities commission under its continuous disclosure requirements (i.e., both quarterly and annually) to identify material changes resulting from events that have occurred since it was issued. The FOFI policy also deals with updating the FOFI when a change occurs in the events or in the assumptions used to prepare FOFI that has a material effect on such FOFI. The securities regulatory authorities must approve of the withdrawal of FOFI when it is not being replaced by updated FOFI.

Most companies do not necessarily have expectations that their financial results will be particularly impressive within the 24-month period which is generally the outside date for the FOFI. As a result, the use of FOFI is not generally practical for use by such issuers.

Statutory Liabilities

Criminal Liability

The Criminal Code of Canada provides that every one who, "by deceit, falsehood or other fraudulent means," defrauds the public or any person, whether ascertained or not, of any property, money or valuable security is guilty of an indictable offence and on conviction is liable to imprisonment for 10 years where the value of the subject matter of the fraud exceeds \$1,000 and lesser penalties where the value is under \$1,000. The Criminal Code of Canada specifically provides that every one who, "by deceit, falsehood or other fraudulent means," affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public, is guilty of an indictable offence and, on conviction, is liable to imprisonment for a term not exceeding 10 years.

Quasi-Criminal Liability

The securities legislation of certain of the Canadian provinces provides that a director or officer who "authorized, permitted or acquiesced in" certain activities, including a breach by an issuer under the legislation (such as the issuance of securities without the preparation of a prospectus in circumstances where a prospectus exemption was not available), commits an offence and, on conviction, is liable to a fine and imprisonment. In Ontario, for example, the fine is up to \$1,000,000 and the imprisonment is up to two years, or both.

Conclusion

At some stage in a company's development, it will likely be necessary for the founders to seek additional funding for the company's operations by attempting to get access to the capital markets. Securities regulation generally presumes that an offering of securities by an issuer must be made pursuant to a prospectus unless an exemption from the prospectus requirement is available. This paper has outlined some of the considerations for an issuer pursuant to an offering by way of private placement. The method by which the issuer gains access to the capital markets and the types of prospectus exemptions which are relied upon will have a dramatic impact upon the requirements which are imposed upon

(and the issues which should be addressed by) the issuer and its senior officers and directors before and during the offering, as well as on an ongoing basis.