

Demystifying the regulations on private placements

Serge Fecteau, chairman of Fecteau Côté Manocchio

Introduction

In Canada, securities regulations require that a person soliciting funds from the public must file a prospectus containing a description of the issuer and securities proposed for issuance and that these securities must be distributed by registered persons. This process is long and expensive and is not suitable for many smaller businesses that have financing needs that cannot justify such costs.

To allow access to the capital markets, the Canadian securities authorities have established complex regulations allowing securities to be issued without having to prepare a prospectus. These rules are contained in Regulation 45-106 respecting prospectus exemptions. The exemptions are numerous and cover a wide range of possible situations.

Individual Investors

Generally, securities benefiting from a prospectus exemption may be sold to accredited investors. Below are the main requirements in defining an accredited investor at the individual level:

- (i) *an individual who, either alone or with a spouse, beneficially owns financial assets having an aggregate realizable value that, before taxes but net of any related liabilities, exceeds \$1,000,000\$.*
- (ii) *an individual whose net income before taxes exceeded \$200,000 in each of the 2 most recent calendar years or whose net income before taxes combined with that of a spouse exceeded \$300,000 in each of the 2 most recent calendar years and who, in either case, is reasonably expected to exceed that net income level in the current calendar year.*
- (iii) *an individual who, either alone or with a spouse, has net assets of at least \$5,000,000.*

If one of these tests is met, the person qualifies to invest without the issuer having to produce a prospectus, because the investor is considered

to have sufficient financial resources to take greater risks.

The financial assets test set forth in (i) above is a defined term which essentially primarily includes cash held in bank accounts, certificates of deposits, savings bonds, stocks, securities which can be quickly converted into money and finally insurance policy's cash surrender values. It is important to know that RRSPs and RRIFs held by individuals are eligible to be included in this test, but private employer pension funds are not.

In addition, it is important to know that movable properties and real estate assets such as a house or a rental property does not constitute financial assets for the \$1,000,000 test in (i). However, it can be considered for the \$5,000,000 latter test in (iii).

Corporate Investors

A large proportion of entrepreneurs and professionals who can consider investing in private placements do so through a holding company. Many allocate a good part of their savings in a holding company. The rules regarding prospectus exemption are different from those of an individual and do not necessarily apply in the same way.

Hereunder are the tests applicable to companies which are hereinafter defined as a "person":

- (i) *a person, other than an individual or an investment fund, that has net assets of at least \$5,000,000 as shown on its most recently prepared financial statement.*
- (ii) *a person in respect of which all of the owners of interests, direct, indirect or beneficial, except the voting securities required by law to be owned by directors, are persons that are accredited investors.*
- (iii) *Minimum amount investment. The prospectus requirement does not apply to a distribution of a security to a person if all of the following apply:*

- *that person is not an individual.*
- *that person purchases as principal.*
- *the security has an acquisition cost to that person of not less than \$150,000, paid in cash at the time of the distribution.*
- *the distribution is of a security of a single issuer.*

does not apply to a distribution of a security to a person if the person was created, or is used, solely to purchase or hold securities in reliance on the exemption from the prospectus requirement.

The first test in (i) above applies to companies whose net worth (assets – liabilities) exceeds \$5,000,000 without taking into account the personal assets of the shareholders.

Frankly, we must say that the second test in (ii) as it is written is difficult to understand to ordinary people! In reality, this means, in the majority of cases, that to qualify, all shareholders of a company must be accredited investors (see individual investors' tests).

The motivation behind it for the Securities regulators is to protect minority shareholders by requiring that all investors be an accredited investor, but we must also realize that this has the consequences to prevent a controlling shareholder from investing in a private placement with the company's funds. We must therefore fall back on the \$5,000,000 test or the minimum amount investment to qualify.

For the application of the last test in (iii), a company must invest a cash amount that is equal or exceeds \$150,000 in a single issuer (this exemption does not apply to an individual)

Family Trusts

For this type of investor, the exemption test is as follows:

- *a trust established by an accredited investor for the benefit of the accredited investor's family members of which a majority of the trustees are accredited investors and all of the beneficiaries are the accredited investor's spouse, a former spouse of the accredited investor or a parent, grandparent, brother, sister, child or grandchild of that accredited*

investor, of that accredited investor's spouse or of that accredited investor's former spouse.

In most cases, the exemption is available to the family trust if the majority of the trustees who have authority to manage the trust are accredited investors (see individual investors' tests) and the beneficiaries are members of the same family.

Investment Funds

The exemption test is very simple:

- (i) *an investment fund that is advised by a person registered as an adviser or a person that is exempt from registration as an adviser.*

The term adviser here means a portfolio manager registered with Canadian securities regulators and does not mean an investment advisor or stockbroker. In this case, we accept the adviser's investment discretion, because the persons and firms registered in this capacity are subject to numerous compliance rules and have a fiduciary responsibility to their clients.

Private Issuer

A private issuer is generally a company who are subject to restrictions on ownership transfer that are contained in their constituting documents and who are beneficially owned by not more than 50 persons (both direct and indirect ownership).

The prospectus exemptions applicable to this type of issuer are somewhat different from those for public companies.

The prospectus requirement does not apply to a distribution of a security of a private issuer to a person who purchases the security as principal and is:

- (a) *a director, officer, employee, founder or control person of the issuer;*
- (b) *a director, officer or employee of an affiliate of the issuer;*
- (c) *a spouse, parent, grandparent, brother, sister, child or grandchild of a director, executive officer, founder or control person of the issuer;*

- (d) *a parent, grandparent, brother, sister, child or grandchild of the spouse of a director, executive officer, founder or control person of the issuer;*
- (e) *a close personal friend of a director, executive officer, founder or control person of the issuer;*
- (f) *a close business associate of a director, executive officer, founder or control person of the issuer;*
- (g) *a spouse, parent, grandparent, brother, sister, child or grandchild of the selling security holder or of the selling security holder's spouse;*
- (h) *a security holder of the issuer;*
- (i) *an accredited investor;*
- (j) *a person of which a majority of the voting securities are beneficially owned by, or a majority of the directors are, persons described in paragraphs (a) to (i);*
- (k) *a trust or estate of which all of the beneficiaries or a majority of the trustees or executors are persons described in paragraphs (a) to (i);*
- (l) *a person that is not the public.*

In summary of the above, private issuers can naturally issue securities with their family members, their directors and senior officers as well as their current holders.

These issuers can also issue their securities with very close friends as well as business partners. These tests are based on objective grounds and must be supported by evidence in order to apply.

Finally, the private issuer can sell their securities to individual accredited investors (see individual investors' tests) and to holding companies whose majority of the votes are held by accredited investors. This last point differs from an issuer not having the status of private issuers, because the test applies to the majority of votes instead of all the shareholders as we have seen previously.

Offering Memorandum

An Offering Memorandum is a document which is similar to a prospectus and whose content is regulated but will not be reviewed by

any securities regulators before issuance as it is the case in a distribution made by way of the prospectus. Similarly, to a prospectus, the investor will benefit from the issuer's certificate signed by directors confirming the true, plain and complete nature of disclosure and also provides the purchaser with a 48-hour contractual right to cancel the agreement to purchase.

Securities traded on the stock exchange resulting from a distribution by means of an Offering Memorandum carry resale restrictions of 4 months and one day as it is the case for other conventional private placements. It should be noted that if the securities are not listed on any stock exchange, the resale restriction becomes permanent, and the holder will only be able to dispose of its holding by way of another private placement.

The investor who purchases securities by means of an Offering Memorandum, benefits from a legislative framework which contain a right of action against the issuer for rescission or damages which is not the case with an investment made in other conventional private placements.

In the context of a distribution by Offering Memorandum, there are various categories of eligible investors who can qualify under various categories, including if the purchase in prior years has had either 1) \$75,000 or more in pre-tax net income or profit or 2) has a minimum of \$400,000 worth of net assets. Please note that these thresholds are lower than those applying in a traditional private placement.

It must be said that the Offering Memorandum system is not very popular with issuers, because it involves numerous obligations, is much more expensive than a conventional private placement and does not offer significant advantages to them.

Soliciting Investors

In our regulatory system, an issuer cannot extensively solicit investors to raise funds unless it does so with a limited number of

persons, without making significant efforts and when it does not pay fees to unregistered intermediaries to do so.

L'Autorité des marchés financiers considers that persons who solicit potential investors as part of a fundraising activity must be a registered person supervised by registered firms who are subject to a strictly established regulatory and compliance framework.

Exempt Market Dealers may solicit investors with regards to securities issued as part of a private placement. It is expected that, in the course of their work, registered representatives of the dealer will ensure the investors qualify for a prospectus exemption and the proposed investment is suitable for them.

To ensure the investment's suitability, the representative has a duty to know his product as well as the intrinsic characteristics of the securities offered (KYP). The representative must also know their client with regards to their financial situation, their investment objectives and their risk tolerance (KYC) and be able to confirm the suitability of both.

Conclusion

When an issuer plans to raise capital from the public to finance a project, or for expansion or to pursue an acquisition, it will have to comply with complex regulations and would be well advised to retain the services of competent professionals to ensure that its financing is done legally.

Many entrepreneurs are simply unaware of the significant problems and risks they are assuming in attempting to do the work themselves. An Exempt Market Dealer will be able to guide the issuer in its fundraising process in addition to offering it access to a broader network of investors looking for investment opportunities corresponding to their needs.

*Références : Autorité des marchés financiers, Regulation 45-106 respecting Prospectus Exemptions (V-1.1, r. 21);
Autorité des marchés financiers, Regulation 31-103 respecting Registration Requirements, Exemptions and Ongoing
Registrant Obligations (V-1.1, r. 10).*