



BORDEN  
LADNER  
GERVAIS

# SECURITIES LAW CONSIDERATIONS FOR INVESTMENT TRANSACTIONS

Jeremy S.T. Farr

November 2009

Borden Ladner Gervais LLP



# Overview

-  Alternate Forms of Investment
-  Sources of Capital
-  The Principal Exemptions used for Investment Transactions
  -  Accredited Investor
  -  Private Issuer
  -  Founder, Control Person and Family
  -  Employees and Consultants
-  Offering Memorandum, Reports and Fees
-  Resale Provisions

# 1. Alternate Forms of Investment

## a) Common Shares

- full participation in “equity” (ie residual value after satisfaction of creditors and preferred shareholders)
- generally have voting rights
- generally have discretionary dividend rights
- can have multiple classes of common shares to allow for differences in voting entitlements; avoid dilution of paid up capital; allow for difference in dividend entitlements etc.



# 1. Alternate Forms of Investment

## b) Preference Shares

- generally see a preference on liquidation (ie a priority on return of capital ahead of more junior shares)
- preference may be a multiple of original investment amount (ie 2x liquidation preference)
- generally have voting rights
- generally have fixed cumulative dividend entitlement, that accrues, and is paid out on redemption or liquidation
- common to provide for a conversion feature which allows for conversion of preferred shares into common shares (allows investor to enjoy liquidation priority prior to conversion (ie exit) event)



# 1. Alternate Forms of Investment

- often mandatory conversion on qualified IPO, or with approval of special majority of holders of preferred shares
- need to carefully consider application of class vote and dissent rights when structuring multiple preferred share classes



# 1. Alternate Forms of Investment

## c) Term Debt

- traditional borrowing or debt facility
- blended payments of principal and interest, or interest only until maturity
- can be secured against assets to provide priority over unsecured trade creditors and shareholders
- can be accompanied by equity “kicker” (ie warrants or options on equity to provide financial incentive to lender)
- no voting rights associated with debt
- common to negotiate operating approval restrictions (ie negative covenants)



# 1. Alternate Forms of Investment

## d) Convertible Term Debt

- alternative to convertible preferred share
- major difference is ability to enjoy position as secured creditor prior to conversion
- common to use convertible debt vehicle for bridge financings prior to closing of preferred share financing round
- interest vs dividend return
- no voting rights



## 2. Sources of Capital

- ① Friends, family and associates
- ② Founders and Employees
- ③ Private “Angel” Investors
- ④ Institutional Debt Investors
  - chartered banks
  - BDC, RoyNat etc.
- ⑤ Institutional Equity Investors
  - seed venture investors
  - Series B venture investors
  - private equity participants



### 3. The Principal Exemptions used for Investment Transactions

Legislative scheme provides exemptions from the prospectus disclosure requirements of applicable provincial securities laws (“Exemptions”) for certain types of securities issuances or resales based on the nature of the purchaser, the vendor or the transaction.

In September 2005 National Instrument 45-106 was originally adopted in all provinces, creating for the first time a harmonized Exemptions regime across Canada.

In September 2009 National Instrument 31-103 was adopted, creating a new scheme of registration for those engaged “in the business” of trading in securities (intermediaries/employees receiving compensation for sales activity).



### 3. The Principal Exemptions used for Investment Transactions

a) Accredited Investor (Section 2.3 NI 45-106)

- Exemption from prospectus requirement if purchaser purchases security as principal and is an accredited investor
- “accredited investor” defined in section 1.1 NI 45-106 to include:
  - a) Canadian financial institutions
  - b) registrants under securities legislation
  - c) governments and municipalities



### 3. The Principal Exemptions used for Investment Transactions

- d) individual, who alone or with a spouse, owns “financial assets” (cash, securities, deposits, not real estate) with aggregate realizable value, before taxes but net of related liabilities, (liabilities incurred in financing ownership of assets or secured by assets), in excess of \$1,000,000
- e) individual with net income before taxes in excess of \$200,000 in two most recent calendar years (\$300,000 if combined with spouse) and, in either case, reasonably expects to exceed net income level in current calendar year
- f) individual, alone or with spouse, with net assets (ie: includes real estate) of at least \$5,000,000



### 3. The Principal Exemptions used for Investment Transactions

- g) person, other than individual, that has net assets of at least \$5,000,000 as shown on most recently prepared financial statements
- h) person in respect of which all the owners of interests, direct, indirect or beneficial, are persons that are accredited investors



### 3. The Principal Exemptions used for Investment Transactions

#### b) Private Issuer (Section 2.4 NI 45-106)

- Exemption if purchaser purchases security as principal, security is a security of private issuer, and purchaser is one of enumerated participants set out in section 2.4(2) NI 45-106
- “private issuer” defined to mean an issuer:
  - a) that is not a reporting issuer or an investment fund,
  - b) securities (other than non-convertible debt) are subject to transfer restrictions in constating documents or securityholders agreements,
  - c) securities are beneficially owned, by not more than 50 persons, not including employees or former employees of the issuer or its affiliates, and
  - d) issuer has distributed securities only to enumerated participants



### 3. The Principal Exemptions used for Investment Transactions

- Enumerated participants include:
  - a) director, officer or employee of issuer or affiliate of issuer, founder or control person of issuer,
  - b) immediate relatives of director, executive officer, founder or control person,
  - c) close personal friend or close business associate of director, executive officer, founder or control person,
  - d) existing securityholder,
  - e) relatives of selling securityholder,
  - f) accredited investors,
  - g) persons controlled by, or trust or estates in which the beneficiaries are, these enumerated above, or
  - h) a person that is not the public.



### 3. The Principal Exemptions used for Investment Transactions

- c) Founder, Control Person and Family (Section 2.7 NI-45-106)
  - Exemption if purchaser purchases security as principal and purchaser is:
    - a) a founder of the issuer,
    - b) affiliate of a founder,
    - c) immediate relative (spouse, parent, sibling, grandparent or child) of an executive officer, director or founder of the issuer, or
    - d) a control person of the issuer.



### 3. The Principal Exemptions used for Investment Transactions

- “founder” means person who acting alone, in conjunction or in concert with one or more persons, directly or indirectly, takes the initiative in founding, organizing or substantially reorganizing the business of the issuer, and, at the time of the trade is actively involved in the business of the issuer.
- “director” means:
  - a) member of the board of directors of a company or individual who performs similar functions for a company, and
  - b) with respect to a person that is not a company, an individual who performs similar functions to those of a director of a company.



### 3. The Principal Exemptions used for Investment Transactions

- “executive officer” means individual who is:
  - a) chair, vice-chair or president,
  - b) a vice-president in charge of a principal business unit, division or function,
  - c) an officer of issuer or subsidiary who performs policy-making function in respect of the issuer, or
  - d) performing a policy-making function in respect of the issuer
- “control person” means any person or combination of persons that holds, alone or in combination,
  - a) a sufficient number of securities so as to affect materially control of the issuer, or
  - b) more than 20% of the voting securities except where evidence that holding does not affect materially control of the issuer.



### 3. The Principal Exemptions used for Investment Transactions

#### d) Employee and Consultant Exemptions

- i) Employees, executive officer, director and consultants (Section 2.24 NI 45-106)
  - Exemption for trade by issuer in a security of its own issue or by control person of issuer in security of issuer (including option to acquire) with employee, executive officer, director or consultant of issuer or related entity of issuer or their permitted assigns provided participation in the trade is voluntary.



### 3. The Principal Exemptions used for Investment Transactions

“consultant” means person, other than employee, executive officer or director, that is:

- a) engaged to provide services to the issuer or related entity of the issuer (other than services related to a distribution),
- b) provides services under a written contract, and
- c) spends or will spend a significant amount of time and attention on the affairs of the issuer or related entity.

Includes for individual consultants corporations or partnerships in which individual is employee, shareholder or partner.



### 3. The Principal Exemptions used for Investment Transactions

“permitted assigns” includes (a) trustee, custodian or administrator for individual or spouse (b) holding entity (person controlled by individual for individual or spouse (c) RRSP or RRIF for individual or spouse

“voluntary” if trade is not induced by expectation of employment, appointment or engagement or continued employment, appointment or engagement



## 4. Offering Memorandum, Reports and Fees

### (a) Offering Memorandum

(i) OSC Rule 45-501 contains substantive requirements where an Offering Memorandum is used in connection with a distribution of securities made under certain exemptions contained in NI 45-106, including:

- 1) accredited investor,
- 2) private issuer, or
- 3) founder, control person, family.



## 4. Offering Memorandum, Reports and Fees

“offering memorandum” defined in section 1(1) of OSA to mean a document purporting to describe the business and affairs of an issuer that has been prepared primarily for delivery to and review by a prospective purchaser so as to assist the prospective purchaser to make an investment decision in respect of securities being sold in an exempt distribution, but does not include a document setting out current information about the issuer for the benefit of a prospective purchaser familiar with the issuer through prior investment or business contacts.

Offering memorandum does not include a “term sheet”, described as a skeletal outline of the features of a distribution without dealing extensively with the business and affairs of the issuer of the securities being distributed (See Section 5.6 Companion Policy 45-501CP)



## 4. Offering Memorandum, Reports and Fees

If an offering memorandum is used:

- (1) statutory rights of action for misrepresentation against issuer and selling security holder described in section 130.1 OSA apply, unless purchaser is an accredited investor that is a Canadian financial institution, schedule III bank, Business Development Corporation or a subsidiary thereof
- (2) if the issuer or a selling securityholder delivers an offering memorandum the rights of action in section 130.1 OSA must be described in the offering memorandum
- (3) if forward looking information is included (ie projections or forecasts) it must be prepared on the basis proscribed in Part 4 A and 4B of NI 51-102 – Continuous Disclosure Obligations (ie reasonable assumptions and projection period; risk factor warnings; consistency in accounting policies)
- (4) copy of offering memorandum is required to be delivered to OSC within 10 days of the distribution



## 4. Offering Memorandum, Reports and Fees



### Reports

- i) If an issuer distributes a security of its own issue it must file a report on form 45-106F1 on or before 10 days after a distribution under certain exemptions, including:
  - a) accredited investor (section 2.3), unless a debt security or debt and equity security, issued to a Canadian financial institution or schedule III bank.
- ii) If a report is to be filed issuer must obtain consent of subscriber to collection and disclosure of personal information under freedom of information legislation (usually done through acknowledgement in subscription agreement).





## 4. Offering Memorandum, Reports and Fees

### (c) Fees

- i) OSC Rule 13-502 imposes activity fees in respect to a variety of transactions and filings, which are set out in Appendix C to that rule.
- ii) An issuer that is not subject to a participation fee under the Rule (generally reporting issuers and registrants pay participation fees) is required to pay a fee of \$500 on filing a report of an exempt distribution on form 45-106F1.



## 5. Resale Provisions

-  Resale provisions applicable to securities initially acquired pursuant to a prospectus exemption are governed by National Instrument 45-102 “Resale of Securities”.
-  Generally, securities issued under exemptions and involving an issuer that is not a reporting issuer may not be resold except in accordance with an exemption. In the event the issuer is a reporting issuer at the time of resale, resales will be exempt from the prospectus requirement following the expiry of a “restricted period” or “seasoning period” as applicable under section 2.5 or section 2.6 of NI 45-102. Special resale restrictions apply to a control person in accordance with section 2.8 or Ni 45-102. Resales which do not satisfy the conditions set for in NI 45-106 may always be resold to the extent an exemption is otherwise available.

Lawyers · Patent and Trade-mark Agents



BORDEN  
LADNER  
GERVAIS

Thank you.