Raising Capital For Business Clients Private Placement Exemptions

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Most new companies eventually face the need for additional capital that cannot be funded, or "bootstrapped", by the founder. The principals of these bootstrapped companies must then begin to consider the pros and cons of raising capital from the broader capital markets and the various ways this can be done.

Generally speaking, Canadian securities law requires that any securities being sold must be qualified by the filing of a prospectus, unless an exemption is available from the prospectus filing requirements.

Securities law also requires that persons engaged in the business of trading in securities must be registered. Generally speaking, a company that sells its own securities on an infrequent basis and does not hold itself out as being in the business of trading in securities will not be considered to be "engaged in the business of trading" and will not have to register as a dealer. However, if the company engages someone to assist with the sale of its securities, then that person likely could be considered to be engaged in the business of trading in securities, and would have to be registered, unless an exemption from the registration requirements is available. In Manitoba, after March 27, 2010, exemptions from the dealer registration requirements will be available for persons or companies engaged in the business of trading in securities in respect of certain exempt transactions (the accredited investor, family, friends and business associates, offering memorandum and minimum investment amount exemptions), subject to complying with a number of specific requirements.

The process of raising capital in reliance upon an exemption from the prospectus requirements is often colloquially referred to as a "private placement transaction" or an "exempt market distribution", and the securities being offered as "exempt securities", all of which mean simply that the company issuing the securities is effecting a trade in its securities pursuant to an exemption from the prospectus requirements under securities law.

With some exceptions for local rules, the regime for exempt distributions is set out in National Instrument 45-106 – Prospectus and Registration Exemptions (NI 45-106). All of the general prospectus exemptions are set out in Part 2 of NI 45-106.

The four most common of these exemptions are the:

- private issuer exemption,
- friends, family & business associates exemption,
- accredited investor exemption, and
- minimum investor amount exemption.

We will review briefly these common exemptions.

Private Issuer Exemption

The private issuer exemption allows a company that is not a reporting issuer or investment fund and whose securities are subject to the so-called "private company restrictions", to raise capital by selling its securities (most often shares or debt instruments), provided that the securities are sold only to a fairly narrow group of individuals. Typically, any company whose shares are not publicly traded or have not been sold through a prospectus would not be considered a reporting issuer.

A company is subject to the private company restrictions when its Articles restrict the number of shareholders to not more than 50 people (not including employees), its securities are subject to resale restrictions either in its Articles or by agreement, and its securities have been issued to a limited class of persons.

The private issuer exemption permits the sale of securities without the need for a prospectus to such people as the directors, officers, employees, founders or control persons of the issuer (called "inside persons"), spouses, parents, grandparents, brothers, sisters or children of the inside persons, close personal friends of the inside persons, close business associates of inside persons, and various other permutations of these relationships; but all have the common element that they are so intimately connected to the principals of the company that they will be protected by virtue of the nature of the relationship itself.

The other class of permitted investors for a private issuer exemption is an "accredited investor", which is a defined term in securities law and includes Canadian financial institutions, the government of Canada, provincial and municipal governments, certain types of pension funds and charities and individuals who meet certain tests designed to establish they have high net worth (discussed in detail below). Unlike the closely connected individuals, these persons have no connection at all to the principals of the company but they are presumed, by virtue of their worth, experience or resources, to be able to assess the merits of the investment on their own.

Securities regulators provide guidance on the meaning of various terms used in the exemption. For example, in order to qualify as a "founder", the person has to have taken the initiative in starting the business and has to be actively involved in the management of the business at the time of the trade.

A close personal friend of an inside person is someone who knows the inside person and has known them for a sufficient period of time to be in a position to assess their capabilities and trustworthiness. The relationship must be direct, not through another person. For example, an individual will not be considered a close personal friend of an inside person because he is a close personal friend of a close personal friend of the inside person. Likewise a close business associate is an individual who has had sufficient prior business dealings with the inside person to be able to assess their capabilities and trustworthiness. An individual is not a close business associate because he is a client or customer or former client or customer of the issuer. Again, the relationship between the individual and the inside person must be direct. Degrees of separation are not acceptable.

Lastly, except for a distribution to an accredited investor, no commission or finder's fee may be paid to any director, officer, founder or control person in connection with the distribution.

So, what are the benefits and drawbacks of relying on the private issuer exemption? The first clear benefit is that the rule allows a company to access capital without creating onerous disclosure requirements, and usually fairly rapidly. Investors will have the statutory protections afforded to shareholders under The Corporations Act (Manitoba) and, while not required, the company can and probably should contractually agree to provide financial period information to its investors.

There are some drawbacks to this exemption. The transfer of securities by investors will be limited because the rule requires that transfer restrictions be imposed. Typically, the restriction takes the form that any transfer requires the consent of the company's board of directors. Secondly, the number of shareholders is limited to not more than 50 (not including current and former employees) so, depending on how much money each investor decides to invest, the company may run out of room to raise sufficient capital under this exemption alone. Finally, although the exemption allows the inclusion of accredited investors, it is likely that at this stage of development, the company is just too small to attract much interest from these sophisticated investors and accordingly, unless the "closely connected" have lots of money to invest, the company may quickly exhaust the pool of capital available under this exemption.

Friends, Family & Business Associates Exemption

The friends, family & business associates exemption permits trades to a slightly narrower group of inside persons than is the case with the private issuer exemption, and also is subject to the proviso that no commission or finder's fee may be paid to any director, officer, founder or control person in connection with the distribution.

The advantage of this category of exemption is that it can be utilized in circumstances where the private company restrictions are not in place.

Accredited Investor Exemption

Under the accredited investor exemption, a company can distribute securities to persons who meet one of the criteria set out in the definition of "accredited investor".

We have already considered in general terms what type of investors make up this class of purchasers (governments and the like). However, the more frequently used accredited investor exemptions are those based upon the investor having a high net worth. The qualifying tests generally are:

1. individuals who beneficially own (alone or with a spouse) financial assets (excluding the value of real property assets) with an aggregate realizable value (before taxes but net of related liabilities) in excess of $1 million dollars;

2. individuals with a net income before taxes in the past two years in excess of $200,000 in each year (or combined with a spouse, $300,000) and who in either case reasonably expects to exceed that level in the current year;

3.individuals who (alone or with a spouse) have net assets of at least $5 million;(d) a non-individual other than an investment fund that has net assets in excess of $5 million as shown on such entity's most recently prepared financial statements of net assets.

The financial thresholds are bright line tests (they must be strictly complied with) that have to be satisfied at the time of the trade. Financial assets consist of cash, securities or a contract of insurance or a deposit that is not a security.

There are rules that relate to how you calculate the thresholds. For example, the value attributed to assets must reasonably reflect their fair market value. There must be clear beneficial ownership of the financial assets. Assets held in trust would raise questions. However, securities held in a self-directed RRSP for the sole benefit of the individual are considered to be owned by the individual. There are other rules related to spousal RRSPs.

Minimum Amount Exemption

The minimum amount exemption is limited to those persons who can invest more than $150,000, again operating on the premise that such a person is sophisticated enough to know what information to obtain from the company and has the leverage to access it.

This exemption is available where a person purchases the securities as principal and the security has an acquisition cost to the purchaser of not less than $150,000 paid in cash at the time of the trade. The trade must be in the security of a single issuer and the purchaser must not have been created or used solely to purchase securities in reliance on the exemption.

The minimum amount exemption may be suitable if the company has in mind one or two investors willing to invest a fairly large amount, but if they are willing and able to do this, then they likely are close personal friends or close business associates of the principals of the company and/or accredited investors as well.

General

Let me just mention a couple of general points.

A very common situation that arises in the course of raising capital through an exempt offering is that the Manitoba issuer finds a potential investor located in another jurisdiction. A Manitoba issuer conducting a trade in its securities with a purchaser resident other than in Manitoba must comply with the securities law requirements in each jurisdiction in which the trade is deemed to occur. If that other jurisdiction is a Canadian province, then the issuer must comply with NI 45-106, as well as with the local rules in Manitoba and in that other jurisdiction.

Responsibility for ensuring that the particular exemption you are seeking to rely upon is available to you, rests with the person trading in the securities, namely the issuer. The issuer may rely on representations from the purchaser that facts exist to support the availability of the exemption, but the issuer must have reasonable grounds for believing that the representations are true. That means that the issuer has to have reasonable evidence of the facts being relied upon. For example, where the purchaser is said to be a close personal friend of a director or officer of the issuer, the issuer should require the purchaser to deliver a declaration describing the purchaser's relationship with the director or officer; likewise for an accredited investor representing a close business relationship with a director or officer. It may not be sufficient for the issuer to have the purchaser simply declare that he or she is an close personal friend or a close business associate of the inside person, without also providing some evidence of the facts being relied upon to support that position.

Lastly, securities purchased through a private placement transaction may be subject to a resale restriction, and the trade may be subject to a reporting requirement, depending upon the particular exemption being relied upon

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