

Financing Start-up Ventures

By Larry Markowitz and Johanne Duchesne

One of the greatest challenges facing start-up ventures is finding the capital they require to fuel their initial growth. Such businesses are often based on new and untested concepts or technologies which pose a higher-than-average risk level for investors.

The founders of such companies typically begin their search for financing by knocking on the doors of family, friends and close business associates, eventually moving on to angel investors and venture capitalists and, ultimately, proceeding to an initial public offering (IPO) of the company's securities and the listing of those securities for trading on a stock exchange.

Securities legislation provides a framework for each of these stages of financing. In Canada, securities regulation is a matter of provincial jurisdiction. Each province has its own Securities Act or similar legislation, although all such laws bear a resemblance to one another.

There are essentially two ways to distribute securities to the public in Canada:

- pursuant to a prospectus which is filed with the Securities Commission or equivalent regulatory authority in the province (or provinces) in which the issuer wishes to distribute its securities; or
 - by relying upon an exemption from the requirement to file a prospectus. Such an exemption is either provided for in the applicable Securities Act or may be obtained following an application to the relevant provincial securities regulatory authority.
2. the right to transfer shares is restricted; and
 3. the company is prohibited from making a public distribution of its securities, meaning that the distribution of securities must be restricted to subscribers who know the company well and do not need the type of information contained in a prospectus to make an informed investment decision.

Private Company Exemption

Typically, in the early stages of its development, a company is constituted as a "closed" company, which means that its articles of incorporation provide that:

1. there may be no more than 50 shareholders, excluding current and former employees of the company;

A closed company is only permitted to sell securities to its directors and members of senior management ("Senior Executives") and their close family members, friends and business associates. As soon as a company attempts to solicit funds from a broader group in a given jurisdiction, it is considered to be making a public distribution of its securities and the Securities Act of that jurisdiction applies.

Seed Capital Exemption

Once a company has reached a growth stage where it wishes to seek capital from parties that are not closely related, the company will amend its articles of incorporation to make itself an "open" company.



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As an open company that is soliciting funds from the public, the company is subject to the provisions of the Securities Act of any jurisdiction where prospective purchasers of its securities may reside.

One way for a start-up company to raise funds at an early stage of its development is to rely upon the seed capital exemption that is set out in the securities legislation of most provinces. Under this exemption, the company can avoid the expensive and time-consuming process of preparing and filing a prospectus. Instead, the company prepares an offering memorandum, which is essentially a shorter and less detailed version of a prospectus, and files it with the Securities Commission in each of the appropriate jurisdictions.

Under the seed capital exemption in Quebec, for example, an issuer that has not yet offered securities to the public under a prospectus ("non-reporting issuer") may distribute its securities to no more than 25 subscribers. In addition, the transaction must meet the following conditions:

- a) each subscriber must be acting for his own account;
- b) the securities must be distributed only to persons who are able to evaluate the prospective investment by virtue of their financial experience or advice received from a registered securities dealer other than the promoter, to senior executives of the issuer or of an affiliated company, or to persons associated with such executives;

- c) each transaction must be evidenced in writing and the contract must contain certain prescribed provisions;
- d) the distribution must be completed within 6 months after it has begun;
- e) the distribution must be made without advertisement or promotional fees;
- f) the promoter of the transaction must not have taken part in a seed capital distribution within the previous 12 months; and
- g) the issuer must never before have availed itself of the seed capital exemption.

Exemption for Minimum Subscription Private Placements

A popular exemption, which is favoured by issuers due to its simplicity, is the prospectus exemption for investments of \$150,000 or more (\$97,000 or more in certain provinces). This exemption may be relied upon as many times as a company wishes and the company is not required to provide the investor with any sort of documentation. The only requirement is that the investor must purchase the securities as principal for his own account. A group of investors is not permitted to pool funds in order to reach the \$150,000 minimum.

Sophisticated Purchaser Exemption

An exemption from the prospectus requirements is provided under the securities legislation of most jurisdictions for purchasers who are deemed to be "sophisticated." Various types of sophisticated purchasers are enumerated in the legislation. They typically include Crown corporations, chartered banks, financial services cooperatives such as Caisses populaires, insurance companies, municipalities, registered investment dealers and pension funds.

Exemption for Distribution to Shareholders, Employees or Senior Executives

Issuers may also benefit from a prospectus exemption for the distribution of securities to their shareholders, employees and Senior Executives. This exemption provides an efficient way to raise funds at a moderate cost. An offering memorandum describing the main features of the distribution must be provided to any shareholder or employee who invests. This exemption is commonly used by companies for the distribution of securities under a stock purchase or stock option plan as an incentive for their employees and Senior Executives.

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Conditions for the Resale of Securities

Securities purchased under the above-mentioned exemptions may not be resold before either 4 or 12 months following their subscription, depending on the size of the issuing company, and provided that the issuing company is or is deemed to be a reporting issuer under the applicable securities legislation of the province where the subscriber resides and satisfies the reporting obligations of a reporting issuer during the 4- or 12-month period, as the case may be. In general, a company becomes a reporting issuer by making a distribution of its securities under a prospectus. From then on, the company is subject to the continuous disclosure requirements of those jurisdictions where it is a reporting issuer.

The advantage of the above-mentioned exemptions is that the securities of the issuer may be offered to investors by company management rather than through a market intermediary such as a brokerage firm, as would be required for securities offered through a prospectus. The issuer can therefore avoid having to pay a broker's commission on the proceeds of the distribution.

New Regime for the Regulation of Exempt Market Distributions in Ontario

The Ontario Securities Commission has adopted Rule 45-501 which came into effect on November 30, 2001. Under this Rule, the \$150,000 exemption and the seed capital exemption are replaced in Ontario by two new exemptions:

1. the "closely held issuer" exemption and
2. the "accredited investor" exemption.

Under the closely held issuer exemption, a company having no more than 35 securityholders may raise up to \$3,000,000 from a limited number of investors in any number of financings. Current or former officers, employees or consultants of the issuer, as well as accredited investors (as described below), are not included as part of the 35 securityholders.

The accredited investor exemption expands upon the existing sophisticated purchaser exemption by adding certain new categories of investors who qualify to invest under an exempt offering. The new types of investors eligible to purchase securities on an exempt basis in Ontario will include, among others:

- an individual having financial assets with an aggregate net realizable value of \$1,000,000;
- an individual whose net income exceeded \$200,000 in each of the last 2 years or whose joint income (with his or her spouse) exceeded \$300,000 in each of those years and who has a reasonable expectation of exceeding the same net income in the current year;
- a company, limited partnership, trust or similar entity, other than a mutual fund or non-redeemable investment fund, that had net assets of at least \$5,000,000 as of the date of its most recent financial statements;
- a fund that distributes its securities only to accredited investors; and
- a mutual fund that discloses in its prospectus that it may purchase securities under the accredited investor exemption.

The provinces of Alberta and British Columbia are in the process of adopting rules governing exempt market distributions that will be similar to Ontario Rule 45-501.

Even at the early stages of its development, a start-up company should ensure that it distributes all of its securities in accordance with the applicable securities legislation. When an issuer eventually proceeds to an IPO, the regulatory authorities will examine all prior distributions of securities to ensure that they were conducted in conformity with applicable securities laws and regulations. In addition, the securities legislation provides that the regulatory authorities may assess a fine against a party that proceeds to an illegal distribution of securities. Moreover, an investor who has subscribed for securities under an illegal distribution may apply to have the transaction rescinded or the subscription price revised, an occurrence which of course would be detrimental to the issuer.

The Securities Law team at *Lavery, de Billy* can help you finance your business ventures by using these exemptions. For further information, please contact Larry Markowitz at (514) 877-3048 or Johanne Duchesne at (514) 877-3045.

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