

DO SECURITIES LAWS APPLY TO PRIVATE ONTARIO COMPANIES?

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First, the bad news: many private companies^[1] operate under the false assumption that securities laws only apply to public companies listed on stock exchanges. In fact, securities laws apply to any issuer of securities, whether it is a public or private company. An "issuer" is simply a company that issues securities and securities laws apply from the moment of that company's inception. In short, your private company is an "issuer". Now, the good news: in many cases, private companies can take advantage of exemptions that relieve them from complying with prospectus and reporting requirements under securities law when issuing securities.

Below is an overview of the most common exemptions that can relieve private Ontario companies of certain obligations in connection with their capital raising efforts.

Overview of Basic Securities Rules – The Prospectus Requirement

The issuance of securities in Ontario is based on the relatively simple "default" rule that every person or company that distributes a previously unissued security to investors must file a prospectus with the Ontario Securities Commission ("**OSC**") and obtain a receipt for it (the "**Prospectus Requirement**"). The Prospectus Requirement is meant to protect investors by providing them a prospectus, a disclosure document containing the information believed to be necessary to make an informed investment decision.

While the Prospectus Requirement serves to protect investors, the OSC recognizes that companies also need flexibility to efficiently raise money. As a result, it has adopted certain exemptions to the Prospectus Requirement that can be used by private Ontario companies to issue securities to certain kinds of investors without prospectus disclosure. The following are the most commonly used exemptions:

- Private issuer;
- Employee, executive officer, director and consultant;
- Accredited investor;
- Minimum amount of \$150,000;
- Family, friends and business associates;
- Offering memorandum; and

- Crowdfunding.

Other than the private issuer exemption and the employee, executive officer, director and consultant exemption, a company relying on these exemptions must prepare and file a report of the exempt distribution with the applicable securities commissions and pay related fees. This report must generally be filed within 10 days of the exempt distribution.

There is a second default rule, that every person or company that sells securities must be registered (or licensed) to do so under Ontario securities law. This requirement is meant to ensure that those who are in the business of selling securities (i.e. brokers or dealers) are knowledgeable enough to suitably advise their investor clients. However, issuers who sell their own securities on an infrequent basis and whose officers, directors and employees only solicit investors incidentally to their primary role are typically not "in the business" of selling securities and therefore do not need to be registered.

Summary of Common Prospectus Exemptions

Private issuer

The private issuer exemption is the most common and useful exemption for small companies. Indeed, many small companies benefit from reliance on this exemption from inception without knowing it to, for example, issue securities to founding shareholders. Its main advantage is that it does not require the company to deliver an exempt distribution report and related fees to the applicable securities commissions.

As its name suggests, this exemption can only be used by a "private issuer", which is defined as an issuer that is not a reporting issuer or investment fund and the securities of which: (i) are beneficially owned by not more than 50 persons (not including employees and former employees); (ii) are subject to restrictions on transfer in the issuer's constating documents or shareholders' agreement; and (iii) have only been distributed to certain kinds of investors, as set out in the bulleted list below.

The private issuer exemption is only available to distribute securities without disclosure to certain categories of persons, including:

- directors, officers, employees, founders or control persons (typically, a holder of 20% of the voting securities) of the issuer;
- certain immediate family members of a director, executive officer, founder or control person (or of a spouse of these persons);
- close personal friends or close business associates of a director, executive officer, founder or control person;
- current securityholders of the issuer; and

- accredited investors.

See below under the *family, friends and business associates* exemption for a discussion of who qualifies as a "close personal friend" or "close business associate".

Once a company loses its private issuer status, it cannot be regained. Therefore, as a private company, it is important to keep track of how each investor fits into the enumerated categories and of the number of your securityholders, and to ensure that you only sell securities to investors in the enumerated categories. However, if a private issuer can no longer rely on this exemption, there are still other exemptions available, as discussed below.

Employee, executive officer, director and consultant

This exemption relates to distributions by an issuer to an employee, executive officer, director or consultant of the issuer.^[2] In order for this exemption to apply, participation in the distribution must be voluntary – this means that the investor is not induced to participate in the distribution by expectation of continued employment, appointment or engagement by the issuer.

As with the private issuer exemption, this exemption does not require the company to deliver an exempt distribution report and related fees to the applicable securities commissions.

Accredited investor

This exemption relates to distributions of an issuer's securities to "accredited investors", which are considered by the OSC to be sophisticated investors who do not require prospectus disclosure to make an investment decision. Accredited investors include, among others^[3]:

- individuals who, alone or together with a spouse, own financial assets^[4] worth more than \$1,000,000 (before taxes but net of related liabilities);
- individuals who, alone or together with a spouse, have net assets^[5] of at least \$5,000,000;
- individuals whose net income before taxes exceeded \$200,000, or \$300,000 combined with a spouse, in both of the last two years and who expect to maintain at least the same level of income in the current year; and
- companies with net assets of at least \$5,000,000.

Minimum amount of \$150,000

This exemption allows distributions of an issuer's securities to an investor who is purchasing an amount of at least \$150,000 as principal. It is important to note that, as a result of recent regulatory changes, the investor may not be an individual.

Family, friends and business associates

This is a relatively new exemption in Ontario, although it has long been available in other provinces. In addition to allowing distribution of securities to an issuer's directors, executive officers, control persons and founders, it also allows distributions to certain family members, close personal friends and close business associates of such persons.

In determining whether a person qualifies as either a close personal friend or a close business associate, the OSC will consider the length of the time the two individuals have known each other, the nature of the relationship (including frequency of contact), and the total number of close personal friends or close business associates being claimed. For close personal friends, the OSC will also consider the level of trust/reliance between the two individuals in other circumstances. For close business associates, the OSC will also consider the nature and number of business dealings, the length of the period during which they occurred, and the nature/date of the most recent business dealing.

An individual is not a close personal friend or a close business associate solely because he or she is a member of the same club, organization or religious group, a co-worker or colleague, a client or former client, or connected through social media such as Facebook or LinkedIn.

Offering memorandum

This exemption came into existence quite recently in Ontario, taking effect on January 13, 2016. It allows issuers to distribute securities on an exempt basis as long as an offering memorandum is provided to investors. An offering memorandum is a disclosure document that can be thought of as a simplified version of a prospectus. It is important to note that, to use this exemption, the issuer's offering memorandum must strictly comply with certain disclosure and form requirements. It must also be filed with the applicable securities commissions on or before 10 days following the distribution.

There are limits on how much an investor can invest under this exemption, which vary depending on what category the investor falls into:

- Common retail investors can invest \$10,000 per year.
- Eligible investors^[6] can invest \$30,000 per year (or \$100,000 per year if they have received suitability advice from a portfolio manager, investment dealer or exempt market dealer).
- Non-individuals and accredited investors have no investment limits.

In addition, the creation of an offering memorandum can still be quite time-consuming and costly and can expose the issuer to liability for any misrepresentations in the document. It would be prudent for issuers who are considering reliance on this exemption to seek legal assistance.

Crowdfunding

This exemption also came into existence quite recently in Ontario, taking effect on January 25, 2016. It allows companies to distribute simple securities (such as common shares and non-convertible debt) through online registered crowdfunding portals. It is only available to entities incorporated/organized or having a head office in Canada or with a majority of directors resident in Canada.^[7]

As noted, this exemption may only be used if the distribution takes place through a portal registered in a specified dealer category. Investment advice cannot be made available through the portal and the portal must perform background checks on the issuers wishing to offer securities on its portal.

This exemption has prescribed limits for both the issuer and the investor depending on what category the investor falls into. Issuers can only raise up to \$1,500,000 in any rolling 12-month period under this exemption, while investors are subject to the following limits:

- Common retail investors can invest \$2,500 per investment and \$10,000 per year.
- Accredited investors can invest \$25,000 per investment and \$50,000 per year.
- Permitted clients^[8] can invest \$50,000/year.

Resale Restrictions

Investors that purchase securities from a private company under an exemption are subject to restrictions on reselling those securities. To resell their securities, generally purchasers must rely on one of the exemptions mentioned above other than the offering memorandum exemption and the crowdfunding exemption. In addition, the securities purchased from a private company may become freely tradable without reliance on an exemption once the company becomes a reporting issuer (ie. goes public).

Conclusion

Securities laws in Canada apply to all companies issuing securities, not just those that are publicly listed on a stock exchange. Private Ontario companies should be cautious to ensure that, whenever they issue securities, they are properly relying on an exemption from the Prospectus Requirement under securities laws.

by David Andrews and Vlad Duta

¹ We use the word "company" throughout, but our discussion applies to other entities such as limited partnerships as well.[ps2id id='1' target='']

² Or an employee, executive officer, director or consultant of a related entity of the issuer such as a subsidiary, parent, or sister company.[ps2id id='2' target='']

3 Some other entities that qualify as "accredited investors" include: registered securities dealers; financial institutions; governments and governmental agencies; insurance companies; pension funds; registered charities; certain investment funds, pooled funds and managed accounts; and persons or companies recognized by the OSC as an accredited investor. See National Instrument 45-106 *Prospectus Exemptions* and subsection 73.3(1) of the *Securities Act* (Ontario) for a complete definition.[ps2id id='3' target='']

4 Cash, securities, contracts of insurance, or deposits, but not including the value of the purchaser's residence.[ps2id id='4' target='']

5 Total assets minus total liabilities.[ps2id id='5' target='']

6 Investors who meet certain income or asset thresholds below the "accredited investor" thresholds (ie. for individuals, a net income before taxes over \$75,000 or net assets, alone or with a spouse, of over \$400,000). See National Instrument 45-106 *Prospectus Exemptions* for a complete definition.[ps2id id='6' target='']

7 However, the operating subsidiary can be either U.S. or Canadian.[ps2id id='7' target='']

8 "Permitted clients" include: registered securities dealers; financial institutions; governments and governmental agencies; pension funds; certain investment funds; individuals beneficially owning *financial assets* with an aggregate realizable value, before taxes but net of any related liabilities, of over \$5 million; and persons or companies, other than individuals or investment funds, that have net assets of at least \$25 million as shown on their most recently prepared financial statements. See National Instrument 31-103 *Registration Requirements and Exemptions* for a complete definition.[ps2id id='8' target='']

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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