

# CAPITAL MARKETS PODCAST: HOW DO SECURITIES LAWS IMPACT PRIVATE COMPANIES?

Posted on October 10, 2023

**Categories:** [Insights](#), [Podcasts](#)

In this podcast episode, [Ouvedi Rama Naiken](#) and [Ishita Kashyap](#) discuss how securities laws apply to private companies in Canada.

Please note that the following provides only an overview and does not constitute legal advice. Listeners are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

## Transcript

**Ouvedi Rama Naiken:** Hello and welcome to our Capital Markets podcast, a series of episodes where we discuss current issues and topics in capital markets and securities law. My name is Ouvedi Rama Naiken.

**Ishita Kashyap:** And I am Ishita Kashyap. We are both associates in the Capital Markets and Securities Group at McMillan.

**Ouvedi Rama Naiken:** In today's episode, Ishita and I will be discussing at a very high level how securities law apply to private companies in Canada. In our practice, we see many private companies operating under the false assumption that securities laws only apply to public companies listed on stock exchanges, when in reality, securities laws apply to any issuer of securities. An issuer is simply a company, whether it's a public or private company, that issues securities and so, as soon as they do, securities laws apply.

As such, many private companies would be considered as an issuer and thus be subject to certain securities regulations. Whether your company is a startup raising money through seed rounds, or you're a sophisticated company, understanding how securities law affects your company is critical to ensure that you're being compliant with securities regulations.

**Ishita Kashyap:** The good news, however, is that in many cases, private companies can take advantage of the several available exemptions that relieve them from complying with prospectus requirements when issuing securities. Now, before we discuss the exemptions, I think it might be helpful to understand the default rule of

securities law, which is that every person or company that distributes a previously unissued security to investors must file a prospectus with the relevant securities commission and obtain a receipt for it.

The purpose of this rule is investor protection. It is to ensure that investors have sufficient information to make an informed investment decision. Prospectuses, as many may be aware, are very detailed disclosure documents and require business, financial and other material information. So unless there is an intention to become a public reporting issuer, private companies would not want to be caught by the prospectus requirement.

Now, while prospectus requirements serve to protect investors, the securities regulator recognizes that companies also need flexibility to efficiently raise money. As a result, it has adopted certain exemptions that can be used by private companies to issue securities without making these prospectus disclosures. Additionally, in an M&A context, it is important to note that an existing security holder that acquired securities of a private company must comply with Canadian secondary trading rules, also known as resale rules.

What this means is that in many cases, a security sold under a prospectus exemption can only be resold if certain conditions are met. These conditions are basically designed to ensure that there is sufficient disclosure available in the marketplace to allow a subsequent purchaser to make an informed investment decision. To resell the securities, the sellers may once again rely on the available exemptions, some of which we will be discussing today.

**Ouvedi Rama Naiken:** To add to your point, Ishita, the private issuer exemption is probably one of the most common and useful prospectus exemptions that we see small companies use in our practice. And actually, many small companies benefit from reliance on this exemption from inception without even knowing it. For instance, when issuing securities to founding shareholders. So from a very high level, I would say the main advantage of this exemption is that companies are not required to deliver an exempt distribution report and related fees to the applicable securities commissions.

As the 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 where the securities of which are beneficially owned by not more than 50 persons, and this doesn't include employees or former employees. Also, the securities must be subject to restrictions on transfer in the issuer's constituting documents, such as the company's bylaws or articles, or even the shareholders' agreement.

And lastly, the securities must have only been distributed to certain categories of investors. There is a list outlining the categories in the national instrument, but for the purposes of this episode, I'll give some examples, which includes the directors, officers, employees, founders and control persons, current security holders, accredited investors and family members, close personal friends, or close business associates of such

directors, officers, employees, founders, and control persons.

**Ishita Kashyap:** You mentioned close personal friends and close business associates. I want to emphasize here, that it is important to keep in mind what those terms actually constitute. While the regulators have not really provided a bright line test for these relationships, they have provided guidance on the key elements of these relationships, which includes the length of the relationship or the nature of the relationship.

The nature of relationship is tested on matters such as the frequency of contact between the two individuals and the level of trust and reliance. So, for example, you're not really considered a close personal friend by simply being a member of the same club or organization, or even by being a client, a former client, or a customer. Similarly, by merely being connected on LinkedIn or being an associate or colleague at the same workplace does not make you a close business associate.

The securities commissions are very clear that they will not consider a relationship that is primarily founded on participation on an internet forum to be that of a close personal friend or a close business associate. Ouvedi, you also discussed the definition of a private issuer, as well as a list of persons to whom a private issuer can distribute securities.

I want to spend a couple of minutes here on what happens if a private issuer ends up losing its private issuer status. This can happen, for example, if a private company fails to include appropriate transfer restrictions in its constituting documents or ends up distributing securities to more than 50 holders. In such cases, the company will no longer be considered a private issuer and will not be able to continue using the private issuer exemption.

Now, once you lose your private issuer status, you cannot really get it back except in certain very limited circumstances. I do want to clarify here, however, that it does not mean that a company that ceases to be a private issuer automatically becomes a reporting issuer. They simply are no longer able to use the private issuer exemption. Fortunately, such companies may still qualify to use other exemptions. However, it's important to remember that these other exemptions generally require companies to file a report for exempt distribution with the securities regulators in each jurisdiction in which the distribution takes place. That is just something to consider.

**Ouvedi Rama Naiken:** I agree with you, Ishita. It's definitely something companies should be aware of, not only to ensure that they're being compliant with the rules, but also when anticipating the cost of a financing. Fortunately, like you mentioned, if an issuer loses its status and can no longer rely on the private issuer exemption, there are other prospectus exemptions that they can rely on. A commonly used exemption that we see in our practice is the accredited investor exemption, which relates to the distribution of an issuer securities to persons that are considered as accredited investors.

Essentially, these are sophisticated investors who do not necessarily require prospectus-level disclosure to make an investment decision. There is a list of different criteria for being considered as an accredited investor, but for the purposes of this podcast, I will cover only a couple of examples. For individuals who either alone or with their spouse have assets of at least \$5 million, individuals whose income before taxes exceed \$200,000 or \$300,000 if combined with a spouse in the last two years, and companies with net assets of at least \$5 million – would all be considered as accredited investors.

Of course, there is a list that has multiple criteria that people can review to see if they would be considered as an accredited investor. There's also the family friends and business associate exemption, which we sort of touched on earlier. So in addition to allowing distribution of securities to an issuer's director, executive officer, or control persons and founders, this particular exemption also allows distributions to certain family members, close personal friends and business associates of such persons. So like you mentioned earlier, the regulators have provided specific guidance on who can be considered as a family member, a friend and a business associate.

**Ishita Kashyap:** And as you previously mentioned, these are just some of the most commonly used exemptions we see in our practice. As a private company, you may be able to use the other available exemptions, such as the minimum amount exemption, the crowd funding exemption, or the employee executive officer, director and consultant exemption. As a closing thought to today's episode. I want to talk a bit about where the onus lies or whose responsibility it is to determine whether an exemption is available.

So under the Canadian securities laws, it is the expectation of the regulator that a person relying on the exemption is responsible for determining whether the terms and conditions of the exemption are met, including in case of exemptions based on relationships, whether the purchaser actually meets the characteristics required under the exemption. So, for instance, if a company is undertaking a financing and issuing securities to accredited investors, it is the responsibility of the company to take reasonable steps to confirm that the purchasers actually meet the criteria of an accredited investor under the exemption.

On the other hand, for the friends, family and close business associate exemption, if the purchaser claims to be a close personal friend of a director of the issuer, the issuer can fulfill its responsibility by asking the purchaser for relevant information, such as the name of the director and a description of the nature and length of purchaser's relationship with the director. They could also verify the information with the director and, whether that information is accurate. In both cases, based on that factual information, the issuer or the seller can determine whether the purchaser fulfills the criteria.

**Ouvedi Rama Naiken:** Thanks, Ishita. Our podcast episode today aimed to offer a very broad overview of some of the implications of securities laws for private companies. Should you have any inquiries regarding the



issuance of securities and compliance with corporate and securities laws, please feel free to reach out to McMillan's Capital Markets and Securities Group for assistance. This is Ouvedi and Ishita of McMillan, thanks for listening.