KEEP THE STATUS

SECURITIES LAW CONSIDERATIONS FOR PRIVATE CORPORATIONS

Incorporating a new company can seem like a trivial matter for some, and yet a tremendous feat for others. But regardless of experience, the steps are usually quite straightforward: choose a name, choose the management, choose the classes of shares that can be issued – but when it comes to issuing or even transferring those shares, many incorporators and managers will often forget that securities laws apply to even the most privately held companies.

In Canada, companies are required to provide a comprehensive disclosure document thoroughly describing the security and the issuing company in the form of a prospectus before issuing shares to investors. These requirements act as a sort of investor protection – and many exemptions from the prospectus requirement exist where such protections are believed to be unnecessary.

The Private Issuer Exemption

One of the most frequently used exemptions is the private issuer exemption, which permits privately held companies to issue shares without providing a prospectus to:

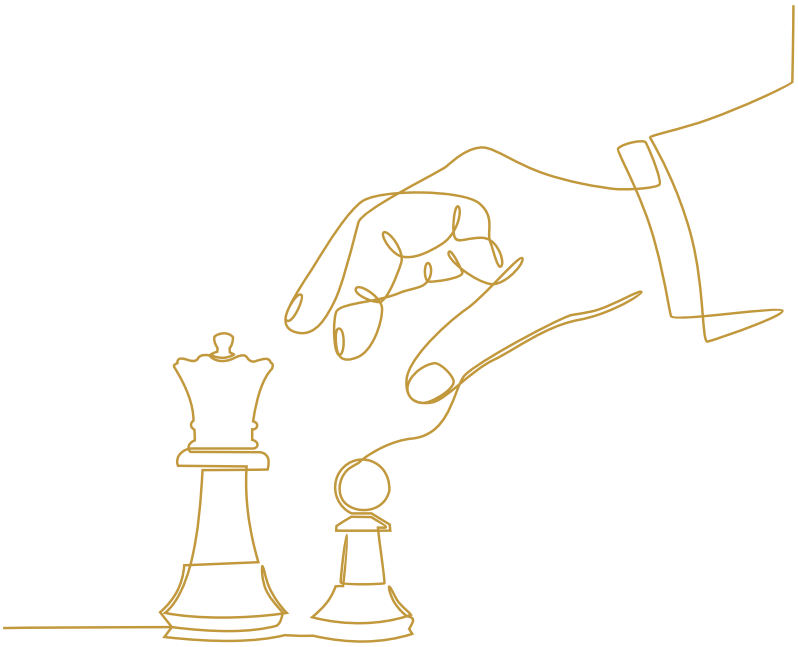
- Close family and friends of the principals and founders of the company;
- Employees and managers of the company;
- Accredited investors (e.g. individuals with net financial assets over $5 million or a net income in each of the two preceding years over $200,000); and
- Existing shareholders.

In addition, any private company wishing to rely on the private issuer exemption must also:

- Not have preexisting reporting obligations (i.e. must not be a reporting issuer);
- Not be an investment fund;
- Not be beneficially owned by more than 50 persons, excluding employees and former employees; and
- Have restrictions on the transfer of securities (either in the company's articles or a shareholders' agreement). [1]

[1] Securities Act, RSO 1990, c S5, s 73.4.

Whether intentional or not, most new companies will use the private issuer exemption when issuing shares: this is not usually a problem, as the first shareholders of a company will often fall easily within the above categories. However, to properly record the company's compliance with securities laws, it is good practice to document the relationships within each subscription document in reference to the appropriate prospectus exemption. Special attention should always be paid when issuing shares to outside investors with little relationship to the company or its existing stakeholders, or limit involvement with the Company and shares in general as this is where a higher risk of unaccredited or otherwise underhanded individuals may appear.



Additional Exemptions

Several additional prospectus exemptions exist in addition to the private issuer exemption, including exemptions for issuing shares to:

- Friends, family and business associates of a principal;
- Employees, managers, and consultants of the company;
- -Accredited investors (e.g. individuals with net financial assets over $5 million or a net income in each of the two preceding years over $200,000); and
- -Entities who are investing at least $150,000 at once. [2]

While these provide an additional workaround to the prospectus requirements, attention must be paid by private companies to avoid accidentally relying on them instead of simply using the private issuer exemption.

Most strikingly, if, as a result of using another exemption, shares are issued to persons who are not permitted under the private issuer exemption, the company would immediately lose their private issuer status. [3]

While this doesn't necessarily impose any reporting obligations onto the company, it will require a notice of exempt distribution to be submitted to the relevant regulators every time shares are issued, adding further complexity and costs to what could have been a routine matter.

Subsequent Transfers

Even once shares are properly issued by a private company, securities laws continue to apply on subsequent transfers. More specifically, any transfer of shares obtained pursuant to the exemptions above – whether or not it was the private issuer exemption – will still be subject to prospectus requirements.[4] The consequence of this is that any subsequent transfer by a shareholder, whether it be to another shareholder or a purchaser as part of an acquisition, will need to again use the appropriate prospectus exemptions to stay in compliance with securities laws.

[2] See NI 45-102, ss 2.3-2.6.1.
[3] NI 45-102, s 2.4(1)(c).
[4] National Instrument 45-102: Resale of Securities, ss 2.5-2.6.

Though it may be simple where the transferee is again a close family member, friend, or business associate, extra care must be taken when making transfers to outside individuals. In many cases, purchasers of shares will be sophisticated themselves – such as a consolidator or private equity firm – yet it is still best practice to confirm their eligibility to receive shares under an exemption in writing, such as with a regulator-approved accredited investor form, attesting to their qualifications. When in doubt, the best course of action for any company is to thoroughly investigate any proposed recipient of shares, to not only comply with the necessary laws, but to protect the best interests of the company as well.

RJS LAW has a uniquely diverse experience in dealing with an extensive range of share matters, from the creation of complex corporate and share structures, to the advisement on the acquisition and divestitures of multimillion-dollar corporations. We highly recommend any corporation to consult with legal professionals prior to the issuance or transfer of any shares, and would be happy to provide tailor-made advice to help you smoothly navigate this area of securities law. The information and views expressed herein are intended to be for informational purposes only and are not to be considered legal advice – for more specific legal advice, please do not hesitate to contact us.

Author: Minsor Huang

June 5. 2024