First-time Funds Series – Video #10: Securities Law Considerations

SPEAKERS

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14:02

In the 10th video of our first-time funds series, Michele Clarkin and Liam Pedersen of our Private Equity practice provide a summary of the key securities issues pertaining to exempt market fund offerings in Canada and the United States, including:

- offerings and prospectus exemptions;
- registration rules; and
- key considerations when offering securities into Canada as a foreign issuer.

Stay tuned for the next episode of our first-time funds series on high-net-worth/retail funds.

Click here to visit the main First-time Funds Series page.

Video Transcript

Michele Clarkin (00:05): Hi, everyone. Thanks for joining us today. I'm Michele Clarkin, a Senior Corporate Associate at Torys' New York office. And this is my colleague, Liam Pedersen, a Corporate Associate, also in our New York office. I am called to the bar in New York and Ontario, and Liam is called to the bar in Ontario as well. Our presentation today will provide you with a summary of the key securities issues pertaining to exempt market fund offerings in Canada and the US, which are commonly known as private placements. Generally, despite having technical differences, the two legal systems have similar legal concepts with respect to exempt market offerings, which we will discuss.

Liam Pedersen (00:42): In Canada, there are two ways to offer securities. First, as a public offering by way of a prospectus, or second, by way of private placement and reliance on a prospectus exemption pursuant to National Instrument 45-106 or in accordance with other applicable Canadian securities laws such as the Ontario Securities Act. Our focus in this presentation is on private placements. In a private placement, capital is not solicited from the general public, but rather from the exempt market, which is generally more illiquid, simply because you can not readily have access to public markets on which to buy or sell securities. It also has less mandated investor disclosures under Canadian securities laws. Although there are numerous prospectus exemptions available to issuers, the three most common prospectus exemptions relied on by issuers in Canada are: (1) the accredited investor exemption; (2) the minimum amount exemption; and (3) the private issuer exemption. First, the accredited investor exemption. Generally, the accredited investor exemption allows issuers to sell their securities to qualified individuals and persons, which includes companies who qualify under the accredited investor definition and meet the criteria in section 2.3 of National Instrument 45-106, and in section 73.3 of the Ontario Securities Act as applicable. The definition of an accredited investor includes, but is not limited to, Canadian financial institutions, pension plans, governments, and individuals who meet the following bright-line tests. The first test the Financial Asset Test. Individuals must, either alone or with the spouse, beneficially own financial assets of over $1M, or a sole individual who beneficially owns financial assets of over $5M, in both cases before taxes and net of any related liabilities. Note that the definition of "financial assets" includes: (a) cash; (b) securities; or (c) a contract of insurance. The value of an investors personal residence is not included in the calculation of financial assets. The second test is the Net Asset Test. An individual must, either alone or with a spouse, have net assets of at least $5M. If the combined net income of both spouses does not exceed $300,000, but the net income of one of the spouses exceeds $200,000, only the spouse whose net income that exceeds $200,000 qualifies as an accredited investor. For purposes of this test, "net assets" is calculated as an investor's total assets, minus all of their total liabilities. Therefore, when ascertaining total net assets, the calculation of total assets would include the value of an investors personal residence, and the calculation of total liabilities would include the amount of any liability such as a mortgage in respect of the investors personal residence. The third test is the Net Income Test. An individual's net income before taxes must exceed $200,000 in each of the two most recent calendar years, or must have a net income before taxes combined with that of a spouse of $300,000 in each of the two most recent calendar years, and who, in either case, reasonably expects to exceed that net income level in the current calendar year. In reliance on this exemption, all individuals must complete a signed risk acknowledgment form also known as Form 45-106F9. The only exception to this risk acknowledgment form requirement is where the individual meets the financial assets test and beneficially owns financial assets of over $5M. This would also allow them to qualify as a permitted client, which is a subset of accredited investor that qualifies under more stringent criteria. The next prospectus exemption that is relatively common is the private issuer exemption under section 2.4 of National Instrument 45-106. This prospectus exemption is not available to reporting issuer or an investment fund. Generally, the private issuer exemption is available to issuer whose securities are beneficially owned by not more than 50 persons, not including employees and former employees of the issuer or its affiliates, where each person is counted as one beneficial owner unless that person was created or used solely to purchase or hold securities of the issuer. If that is the case, each beneficial owner or each beneficiary of the person, as the case may be, must be counted as a separate beneficial owner. Under this exemption, the issuer may only sell the persons who purchased the securities as principal and are included in the list of permitted purchasers in subsection 2.4(2) of National Instrument 45-106, which includes directors, officers, employees, founders and control persons of an issuer as well as accredited investors and any person who is not "the public". Whether or not a person is a member of the public must be determined on the facts of each case. The last prospectus exemption that we will mention today is the "Minimum Amount Exemption" under section 2.10 of National Instrument 45-106. This exemption is not available to individuals. To rely on this exemption, the issuer must only distribute securities to an investor who purchases of securities as principal in the amount of no less than $150,000 in cash at the time of distribution, and the distribution is of a security of a single issuer. Note that following a distribution to investors in Canada and issuer is generally required to file a report of exempt distribution, also known as a Form 45-106F1, with the applicable securities regulators in Canada no later than 10 days after distribution occurs. If the issuer is an investment fund, it can file the report of an exempt distribution not later than 30 days after the end of the calendar

year instead of after the 10 days following distribution. A report of exempt distribution is required when relying on the accreditor investor exemption and the minimum amount exemption, in addition to when relying on other exemptions. However, note that a report is not required when relying on the private issuer exemption.

Michele Clarkin (06:32): In the US under the US Securities Act of 1933, any offer to sell securities must either be registered with the Securities and Exchange Commission or the SEC or meet exemption from registration, typically referred to as a "private placement". Private funds typically rely on Rule 506 of Regulation D, which exempts a fund from registration with the SEC if it only sells securities to an unlimited number of Accredited Investors. Accredited Investors include among others, individuals that alone or with their spouse have a net worth of $1M, excluding the value of the individual's primary residence and entities with assets in excess of $5M. The fund sponsor will also need to get representations from the investors that they have not been subject to any "disqualifying events". If one funds sponsor engages in a general solicitation, (i.e., discussing its fundraise publicly), it must take reasonable steps to verify the accredited investor status of its investors, which requires more than getting simple representations from investors. Funds that rely on Regulation D must file a form called "Form D" with the SEC after the first sale of securities to US investors. And there are also blue sky filings required in the relevant states.

Liam Pedersen (07:46): When a Canadian issuer decides to offer its securities to investors resident in Canada by way of private placement, one of the first questions we often ask is: Does the issuer qualify as an investment fund under Canadian securities laws, or is it a private equity fund, venture capital fund, or other type of vehicle that would not qualify as an investment fund? The distinction between investment funds and non-investment funds is important because investment funds trigger additional registration requirements that non-investment funds, for the most part, do not. Under the Ontario Securities Act, an "investment fund" is defined as a mutual fund or a non-redeemable investment fund. A mutual fund invests money provided by its security holders and offers securities that entitle security holders to receive their investment on demand, or within a specified period after demand. What we typically see are redemption terms of more than twice a year. A "non-redeemable investment fund" is an issuer, whose primary purpose is to invest money provided by its security holders that does not invest for the purpose of exercising or seeking to exercise control of an issuer, other than an insurer that is a mutual fund or a non-redeemable investment fund, or for the purpose of being actively involved in the management of any issue in which it invests other than issuer that is a mutual fund or a non-redeemable investment fund, and that is not a mutual fund. For an investment fund, the entity that undertakes the relevant registrable activities will generally need to be registered in the categories of portfolio manager, investment fund manager, and exempt market dealer or another category of dealer as applicable. A firm can also outsource or employ one or more third parties to undertake each of these roles. Non-investment funds like private equity funds will often also employ an exempt market dealer, especially when they actively solicit investors or hold frequent closings. What I just summarized was a very high-level summary, and I want to emphasize that the facts of each scenario will impact the registration analysis for each firm. Note that there are also additional considerations relevant to non-resident issuers distributing their securities in Canada, which we have not addressed in this presentation.

Michele Clarkin (09:46): In the US, generally, funds that are considered "investment companies" are subject to US federal securities laws. An "investment company" is defined to mean a company that owns or proposes to acquire "investment securities" having a value exceeding 40% of the value of its total assets. Investment securities generally include all securities except for: (i) government securities; (ii) securities issued by employees' securities companies; and (iii) securities issued by a majority-owned subsidiaries of the owner who are not investment companies and are not relying on certain exceptions in the definition of investment company. The Investment Company Act regulates mutual funds and other companies that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public by requiring them to either register with the SEC as an investment company or qualify for an exemption from registration. Registration would subject a fund to numerous regulations would that make it difficult for a sponsor to properly administer a fund. If 40% or more of the fund's assets will be in "investment securities", it will need to rely on one of the two key exceptions from the definition of "investment company", which will be based on the reps given by investors. The first, Section 3(c)(1), if there are less than 100 investors and the other, Section 3(c)(7), all investors are "qualified purchasers". Qualified purchasers include, among others, individuals with USD $5M in investments and entities with $25M in investments. The Section 3(c)(1) and 3(c)(7) exemptions are complex, including a number of rules requiring the fund to look through certain investors to determine their ultimate beneficial owners. Generally, fund advisers that sells securities to US investors are required to register with the SEC as "investment advisers" pursuant to the Investment Advisers Act, unless an exemption applies. If an adviser registers with the SEC, will, among other things: (1) need to put in place a compliance manual that complies with the Act; (2) be subject to routine SEC audits; and (3) will need to follow a form called "Form

ADV" with the SEC. If an adviser has no place of business in the US and has less than USD $25M from US investors, it will be able to rely on the "Foreign Private Adviser Exemption" and will be fully exempt from registration. If the adviser has more than USD $25M from US investors, it will need to look to the "Private Fund Adviser Exemption". This exemption exempts from registration advisers that: (i) have no US clients that are not private funds; and (ii) all assets managed by the adviser from a US place of business are solely attributable to private funds and have a value of less than USD $150M. In other words, if you don't provide asset management advice from a US office, you can rely on this exemption. If certain investment team members are located in the US, the relevant question becomes where the investment decisions are being made. Advisers that rely on the Private Fund Adviser Exemption will not be required to register with the SEC as investment advisers, but they will be considered "Exempt Reporting Advisers" and must file certain information with the SEC on Form ADV. In addition to the federal regulation under the Advisers Act, investment advisers can be subject to US state registration and conduct regulation requirements as well.

Liam Pedersen (12:56): In both Canada and the US, issues will often provide a private placement memorandum, although it is not required unless you're relying on a Canadian offering memorandum prospectus exemption, or they will provide a term sheet subscription agreement and the issue is constating documents upon request, which may include a limited partnership, for example. Note that jurisdiction-specific disclosure, such as investor representations, certifications, questionnaires, and notices are usually included in marketing materials and offering documentation, such as the private placement memorandum and subscription agreements. We encourage you to reach out to your counsel to review such disclosures since there may be securities law related consequences for not including. That concludes our presentation for today. Thank you for taking the time to tune in to our video. We really hope you enjoyed it. If you have any questions on securities law considerations pertaining to exempt market fund offerings in Canada and the US, please don't hesitate to reach out. We would be delighted to speak with you. Next up on the roster will be our colleagues, Guillaume and Ana, who will discuss high-net-worth retail funds. Goodbye.

To discuss these issues, please contact the author(s).