Private Issuer – Clarification from the *Autorité des marchés financiers* regarding *Regulation 45-106 respecting Prospectus and Registration Exemptions* and Private Issuers

Since *Regulation 45-106 respecting Prospectus and Registration Exemptions* ("Regulation 45-106") came into force on September 14, 2005, staff at the *Autorité des marchés financiers* (the "AMF") have been asked numerous questions by industry stakeholders regarding the concept of "**private issuer**." Many of these questions stem from a misinterpretation of the requirements under the Regulation. AMF staff are concerned about the information being conveyed by industry professionals about conditions related to the private issuer exemption. Regulation 45-106 has extended financing options available to small and medium-size businesses in Québec and across Canada and has not added to any burden imposed on them.

Many professionals have suggested that Regulation 45-106 has significantly altered the rules and that small businesses are now at a disadvantage when seeking financing. We do not believe this is so.

Closed company v. private issuer

Before the adoption of Regulation 45-106, small businesses seeking financing without the requirement to prepare a prospectus and draw on the services of a dealer could rely in particular on the exemption in respect of a "closed company." This exemption was set out in the Québec *Securities Act* (the "Act"). Under section 5 of the Act, a closed company was defined as "a company … whose constituting documents provide for restrictions on the free transfer of **shares**, prohibit any distribution of securities to the public and limit the number of its shareholders to 50, exclusive of present or former employees of the company or of a subsidiary." This pertained solely to the definition of a closed company. The provision whereby a business was not required to prepare a prospectus and draw on the services of a dealer was contained in section 3 of the Act.

Under paragraph 2 of section 3, a security issued by a closed company was exempt from the application of Titles II to VIII of the Act "provided the issue is not contrary to the constituting documents, and provided it is not distributed by way of a public distribution." A company was therefore required to meet these two conditions for the purpose of qualifying for the closed company exemption when issuing securities. In the event of failure to meet either of these conditions, a closed company was governed by the Act in its entirety, including any provisions related to penal measures. It should be noted that the AMF also had the right to withdraw the benefit of such an exemption, particularly in cases where its use was being abused. A closed company could not benefit from this former exemption without meeting these conditions. The Act therefore clearly applied to these former closed companies; nothing has changed in this regard under Regulation 45-106.

Retroactive application?

Some professionals have suggested that section 2.4 of Regulation 45-106 is retroactive. Its application is instead a matter of ensuring that a company that benefits from an exemption from requirements under the Act has not failed to meet other requirements imposed on it. Under section 2.4, the private issuer exemption may be used where securities have been distributed only to persons described in this section. A company that has met the applicable conditions under the Act when it was a closed company (whose issue of securities was not contrary to its constituting documents and whose securities were not distributed by way of a public distribution) should be able to meet the conditions that now apply to a private issuer given that this provision broadens the category of persons to whom securities may be distributed. For all practical purposes, the shareholders of a former closed company should generally be included in the list of persons referred to under section 2.4, and the condition should not be difficult to meet. In fact, the list of persons referred to under section 2.4 was prepared based on case law related to the notion of a public distribution applicable in connection with the former system governing closed companies.

However, in the few instances where a former closed company is unable to meet the condition under section 2.4, it would be able to consider the application of a number of other prospectus exemptions available in Québec since the coming into force of Regulation 45-106. Moreover, the AMF would consider granting a discretionary exemption on a case-by-case basis in exceptional circumstances where a company is unable to confirm with certainty that it has met the conditions for the former closed company exemption.

Amended articles of incorporation

Some professionals have suggested that a former closed company must amend its constituting documents or articles of incorporation before October 12, 2007 in order to qualify as a private issuer. It is the opinion of AMF staff that few companies will need to amend their articles of incorporation for the purpose of qualifying for the private issuer exemption, and this position was in fact indicated in a notice published in the AMF Bulletin dated March 31, 2006; the October 12, 2007

deadline therefore applies solely to the last case discussed below. Under section 2.4 of Regulation 45-106, the **securities** of a private issuer, other than non-convertible debt securities, are subject to restrictions on transfer that are contained in the issuer's constating documents or security holders' agreements. Previously, with respect to a closed company, reference was made to restrictions on the free transfer of **shares** and not securities.

The issue therefore is whether, as a result of this distinction, a former closed company must amend its articles of incorporation to qualify as a private issuer and continue to rely on an exemption equivalent to what it benefited from previously. The answer may vary depending on the following cases:

- A "closed company" that only had shares outstanding (common, preferred or any other class of shares) before September 14, 2005 does not need to amend its constituting documents to qualify as a "private issuer." For instance, a company that has not issued stock options, warrants or convertible debentures does not need to amend its articles of incorporation; its securities are the shares, and the term "shares" in its articles is appropriate.

If a company one day decides to issue stock options to its officers, it may then amend its articles of incorporation or provide for restrictions on the transfer of securities in security holders' agreements.

- A company that does not plan to rely on the exemption set out under section 2.4 of Regulation 45-106, and therefore does not plan to issue securities (regardless of the nature of the securities), would also not need to amend its articles.

- As well, a company that has issued shares and other classes of securities but whose security holders' agreements contain restrictions on the transfer of these other classes of securities would not need to amend its articles.

- Before September 14, 2005, a closed company with various classes of securities outstanding (not only shares) that planned to issue **securities** (regardless of their nature) based on the exemption set out under section 2.4 of Regulation 45-106 and whose constituting documents or security holders' agreements did not contain restrictions on the free transfer of securities needed to amend its constituting documents or add restrictions in a security holders' agreement. However, such a company has until October 12, 2007 to amend its articles, as provided for in Decision no. 2005-PDG-0329 dated October 14, 2005. This transitional measure applies only to the clause pertaining to restrictions on the free transfer of securities.

Generally speaking, numerous closed companies issued shares to officers at the time of their incorporation; they subsequently did not issue any securities other than non-convertible debt securities. These companies will therefore not incur any of the expenses required for the purpose of amending their articles of incorporation since their contents meet the conditions for the new private issuer exemption.

Are you a legal person governed by the *Act respecting insurance*?

With respect to legal persons governed by the *Act respecting insurance* (the "Insurance Act") that conclude, following an analysis of the scenarios outlined above, that they need to amend their articles for the purpose of qualifying for the private issuer exemption under Regulation 45-106, the AMF wishes to remind you that specific requirements in this regard are set out in the Insurance Act, including the filing of an application with the AMF, the adoption of a by-law by your company and approval by the Québec Minister of Finance. Because of the time that may be required to obtain amendments to your articles and approvals as necessary, we encourage you to contact us as soon as possible.

More information is available from the AMF at:

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