

# Guiding Small Businesses to Public Financing

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## INTRODUCTION

Emerging small capitalization companies are always seeking fast and low-cost methods of financing. In Quebec, until recently, these companies were too small to be listed on an exchange. This is about to change: a new investment vehicle now available in Quebec could give small capitalization companies access to the public venture capital market. This new Program, called *Capital Pool Companies Program* ("Program" or "CPC Program"), is a creation of the TSX Venture Exchange ("Exchange"). The CPC Program was authorized by the Quebec Securities Commission on November 12, 2002 and will offer new avenues to small companies in Quebec.

The TSX Venture Exchange has improved the CPC Program so as to make it fast and low-cost. On January 15, 2003, an important change was announced by the Exchange, increasing the maximum amount which can be raised through the CPC Program from \$700,000 to \$2,000,000.

## ASSISTANCE TO ENTREPRENEURS

First, it should be mentioned that the name of the Program may be misleading. Indeed, the CPC Program does not necessarily apply only to emerging companies. The name of the Program could have been *Assisted Public Capital Pool Companies* since its objective is to promote start-up financing by assisting companies through the different steps of the Program.

The objective of the CPC Program is to allow companies to be assisted by well-informed administrators through the various stages of this complex financing process.

Since the CPC Program relies mainly on the competence of its management team, it will be required that they collectively possess a positive track record with public corporate governance and the ability to raise funds.

## NEW SOURCE OF FINANCING

There exist three ways to be listed on the Exchange:

- Initial Public Offer ("IPO");
- Capital Pool Companies Program;
- Reverse takeover.

A company may obtain financing by issuing shares, debt securities and rights.

The principal characteristic of the Program, compared to a traditional IPO, is that the CPC, at the time of its first listing on the Exchange, has no commercial activity. It is but a shell which relies solely on the reputation and experience of its directors to attract investors. However, within 18 months of its initial listing on the Exchange, the CPC must complete a transaction that will result in its satisfying the regular listing conditions.

Access to a new source of financing is thus given in the early stages of development of the emerging companies by introducing them to the public capital market.

## TSX VENTURE EXCHANGE

The Exchange, previously called CDNX, was created in November 1999, following the merger of the small capitalization market and the Vancouver, Winnipeg, Alberta and CDN Stock Exchanges. It is now owned by the TSX Group. Its role is to provide a market place for public financing of emerging small companies, over 2,500 of which are listed on its board.

As part of the TSX Group, the TSX Venture Exchange is the subsidiary in charge of supervising the CPC Program and the financing of the small capitalization companies.

The CPC Program has existed for some time, under its current or previous forms. The CPC Program was established 15 years ago under the Alberta Stock Exchange's authority.

Statistics in support thereof are hereafter described:

- 1,392 CPCs have been listed since 1987;
- Since 1987, 1,133 CPCs have completed qualifying transactions;
- 150 companies that began as CPCs are now listed on senior exchanges.

In 2003:

- As at February 28, 418 financing transactions had been completed on the Exchange for a total of \$319.7 million in new issues.

In 2002:

- 1,911 financing transactions were completed on the Exchange for a total of \$1.44 billion;
- The average value per financing transaction was \$0.75 million;
- 88 companies were listed on the Exchange and the Program generated 45 of the new registrations;
- As at December 31, 70 CPCs had not yet completed their qualifying transaction and were in the process of identification or evaluation of potential qualifying transactions.

In 2001:

- 1,540 financing transactions were completed on the Exchange for a total of \$1.08 billion;
- The average value for each financing transaction was \$0.70 million;
- 277 companies were listed on the Exchange (108 were junior companies listed on the Montreal Exchange) and the Program generated 101 of the new listings;
- 64 qualifying transactions were completed, eight of which were with Quebec companies (those figures were 79 and seven respectively for the previous year);

The Exchange is open to Canadian and foreign companies and thus provides an organized market for investors and their advisers looking for opportunities with small capitalization companies. It is a speculative market, with high risks — and potentially high pay-offs. However, with competent advice, as well as through careful risk management, experienced investors can find interesting opportunities since potential returns run high.

The Exchange's performance is reflected in the number of corporations that, after an active period on its trading floor, have graduated to a "senior" exchange — such as the Toronto or New York Stock Exchanges or NASDAQ.

27 companies have graduated to the Toronto Stock Exchange in 2002, representing 22% of the new listings on the Toronto Stock Exchange, compared to 28% in 2001.

#### MANAGEMENT BY THE EXCHANGE

The CPC Program has the advantage of being managed by a recognized Exchange, as more fully described below:

- The CPC Program is a creation of a well-organized Exchange based on its long experience.
- Its disclosure requirements provide extra confidence to investors by ensuring their protection.
- Directors and officers of the CPC must have demonstrated their integrity, especially with regard to securities trading, and have shown relevant experience in the management of a public company and an ability to carry out a qualifying transaction.
- Directors and officers of the CPC must invest their own funds in the company at the onset of the whole process; they may lose their investment if a qualifying transaction is not completed within 18 months of the listing of the CPC, or in case of non-respect of the Program rules.
- After the IPO, the CPC's only activities must be the identification and evaluation of business opportunities in order to complete a qualifying transaction. Moreover, the

CPC may only use its funds for the specific purposes identified by the Program.

- The qualifying transaction is subject to approval by the minority shareholders and by the Exchange if the transaction involves persons not dealing at arm's length with the CPC.
- If a qualifying transaction is not completed within 18 months of its initial listing, it will be delisted and the shares issued to persons not dealing at arm's length with the CPC and at a price lower than the IPO share price will be cancelled.
- Shares issued within the qualifying transaction to persons not dealing at arm's length with the CPC will be held in escrow.
- The CPC is subject to the same continuous disclosure obligations as other reporting issuers.
- All the important documents must be filed with SEDAR and made available to the public through Internet.

#### **THE PROGRAM**

The CPC Program is essentially a two-stage process. The first stage consists of listing the common shares on the Exchange and raising the funds needed to identify and evaluate a qualifying transaction.

The second stage consists of completing the qualifying transaction. Once the qualifying transaction has been completed, the company ceases to be a CPC, becomes listed as a regular company, and is subject to the usual rules of the Exchange.

The expression "qualifying transaction" means a transaction where a CPC acquires significant assets, other than cash, by way of purchase, amalgamation, merger or arrangement with another company or by other means.

#### **ADVANTAGES OF THE PROGRAM**

The CPC Program offers significant strategic advantages by matching an expanding business with a management team experienced with the public capital market, and by providing a low-

cost access to a stock exchange. The Program may be considered when the company needs access to the public capital market, but has not yet reached the size to proceed with a traditional IPO.

The degree of certainty of the expected result — listing a small company on a recognized exchange — is the main difference between the CPC Program and a traditional IPO. A traditional IPO requires the participation of an underwriter, as well as favourable market conditions. Such an operation is costly and will only be undertaken as a best-effort underwriting. The brokerage firm does not promise to reach a given result: all it agrees to is to do its best efforts to achieve the intended result: the IPO. The underwriter will not guarantee that the financing will be completed. Furthermore, firms handling traditional IPOs are generally only interested in financings involving tens of millions of dollars.

When a broker agrees to handle a traditional IPO, a long and expensive process is launched: a prospectus must be drafted; public relations and presentations must be arranged, etc. If market conditions are such that the IPO is postponed or cancelled, the issuer could be faced with a costly and largely uncontrollable situation. Moreover, such a postponement or cancellation could hurt the issuer's image, thus thwarting its capacity to complete the IPO once previous obstacles have disappeared. Often, IPOs are neither appropriate nor affordable for many small capitalization companies.

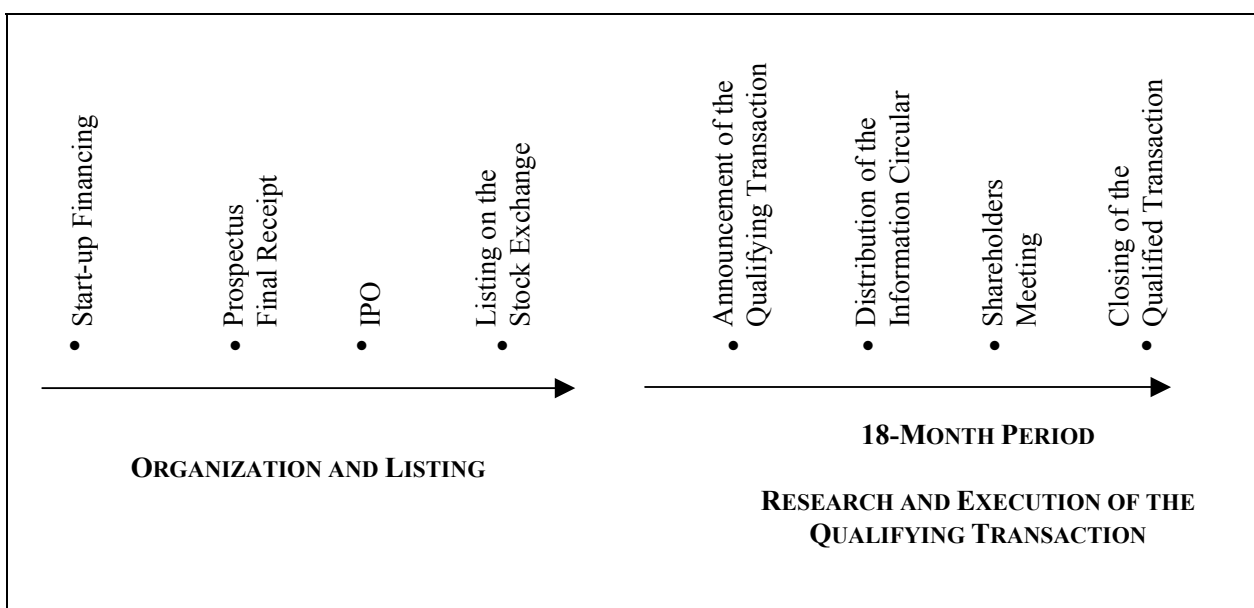
Thus, the CPC Program is very advantageous for small capitalization companies. With the CPC Program, entering the public capital market through a qualifying transaction with a CPC involves one of two scenarios.

1. In the first case, a company is launched by financial promoters. It completes its IPO and its stock is listed on the Exchange as a CPC. At that point, it has not yet identified significant assets or a target company to acquire. Its only appeal lies in the reputation of its promoters and of the underwriter of the initial IPO. It must convince potential investors that its promoters will identify a profitable business. As at February 28, 2003, some

60 CPCs have yet to complete their qualifying transaction and are either trying to identify or are evaluating potential qualifying transactions.

2. The second scenario revolves around a non-arm's length qualifying transaction. In such a case, the company is incorporated and then listed as a CPC by the directors or shareholders of an active company, or persons close to them. At that point, the qualifying transaction is foreseeable.

However, it cannot be finalized at the time of the IPO, as such a plan would disqualify the CPC. Clearly, this is a scenario through which founders use the CPC for the legitimate purpose of listing an operating company on the Exchange. In this case, the process is launched and controlled by the operating company, as opposed to financial promoters.



### TERMS AND CONDITIONS

In summary, the CPC Program consists of the following steps:

*Starting Phase* — An initial investment of \$100,000 to \$500,000 made by the directors and officers of the CPC, who are issued seed shares in return. These seed shares are issued at a discount over the IPO share price. Their price must be the greater of 7.5¢ or 50% of the IPO share price.

Each director and officer, directly or through a trust company or a holding company under his/her control, must subscribe to shares for a minimum of \$5,000.

These shares will eventually be put in escrow in order to guarantee that the Program's terms and conditions will be respected. A key

requirement is that the qualifying transaction takes place within 18 months of the date of listing of the CPC's shares on the Exchange.

Before the listing of a CPC, a written undertaking by the CPC and by each of its directors and officers must be addressed to the Exchange and to the relevant securities commissions confirming:

- That they will comply in all respects with the restrictions in connection with the expenditure of funds raised prior to completion of the qualifying transaction;
- That, if the CPC's shares are delisted from the Exchange, the winding-up of the CPC will take place in the following 90 days of such delisting and distribution of the CPC's property will be made to its shareholders,

on a prorated basis, unless before expiration of this delay and by majority approval, exclusive of the votes of non arm's length parties to the CPC, the remaining property is disposed of otherwise.

The above commitments must be respected by any new director or officer of the CPC.

*Initial Public Offering by way of a Prospectus* — The CPC makes an IPO issuing common shares for a price set between 15¢ and 30¢ (at twice the price of the seed shares). Upon completion of the IPO, the CPC must have at least 200 "public" shareholders.

The funds raised through seed shares and IPO shares must total at least \$200,000, without exceeding \$1,900,000. Funds raised through seed shares, IPO shares and private placement may not exceed \$2,000,000 before the qualifying transaction is completed. However, private placements will be allowed concurrently with the qualifying transaction.

*Listing on the Exchange* — The CPC is listed on the Exchange as a CPC for a maximum period of 18 months, or 24 months, as may exceptionally be authorized by the Exchange, at its discretion. If the CPC fails to proceed with a qualifying transaction within this period, its shares will be delisted and the shares issued to persons not dealing at arm's length with the CPC and issued at a price lower than the IPO share price will be cancelled.

Once the listing has been approved by the Exchange, the CPC's shares become tradable. It is to be noted that the CPC's symbol includes the identifier ".P".

*Identification of a Qualifying Transaction* — After the IPO, the CPC's only expenditures must be the identification and evaluation of opportunities to complete a qualifying transaction. No matter how much was raised by the CPC, the maximum available amount for a CPC's administrative and issuing expenses will be the lesser of 30% of the gross proceeds or \$210,000.

If the CPC experiences difficulty identifying or completing a qualifying transaction within the 18-month limit, it may undertake a combination with one or more CPCs or a public company.

*Qualifying Transaction* — The qualifying transaction must allow the CPC to meet the regular listing requirements on the Exchange.

This second step of the Program begins with the conclusion of an agreement in principle relating to a qualifying transaction and the preparation of detailed CPC information circular or a CPC filing statement.

The agreement in principle between the parties should clarify the terms and conditions of the qualifying transaction, more particularly, by describing the company, the assets or shares to be acquired, the parties to the qualifying transaction, the amount to be paid for acquiring the shares or the assets and the conditions for closing the qualifying transaction itself.

*Shareholders' Vote* — Prior to the last amendments, the qualifying transaction always required the approval of the majority of the votes cast by shareholders other than non arm's length parties to the CPC and other parties related to the qualifying transaction.

This approval is no longer required when the qualifying transaction is not a non-arm's length qualifying transaction. A qualifying transaction is deemed to be a non arm's length transaction where the same party or parties or their respective associates or affiliates control the CPC and the significant assets which are to be the subject of the proposed qualifying transaction. When the transaction is not a non-arm's length qualifying transaction, only the approval of CPC's directors and of the Exchange is required for completing the qualifying transaction. In some cases, however, approval of the shareholders may be required by corporate law, for instance, for a change of name or a merger.

Thus, a shares swap with the shareholders of a target company is possible without the approval of the CPC's shareholders. A merger with this company may then be approved at an annual meeting of shareholders.

In cases where approval of the shareholders is not required, a *Filing statement* must be prepared by the CPC and approved by the Exchange. The level of disclosure used for such

filing statement would be the same as for a prospectus.

*Private Placement* — Before the qualifying transaction has been completed, the CPC may only issue common shares and no units or warrants may be issued before the closing of the qualifying transaction.

Moreover, before the qualifying transaction has been completed, it will not be possible for the CPC to proceed with a private placement if the gross proceeds from the issuance of seed shares and IPO shares and from any other distribution exceed \$2,000,000 at the closing of the private placement.

*Concurrent Private Placement or Public Distribution* — Immediately after the qualifying transaction has been completed, the resulting company may raise additional funding through private placement or public distribution. This supplementary funding may be required to meet the Exchange's listing requirements.

*Listing as a Standard Company* — Once the qualifying transaction has been completed, the resulting company may be listed as a standard company on the Exchange. From that moment onward, the company is no longer considered a CPC, and becomes subject to the standard rules governing companies listed on the Exchange.

#### **ADVANTAGES FOR THE COMPANY**

Listing a company through a qualifying transaction with a CPC Program may be considered under the following circumstances, or for the following reasons:

*Control of the Process* — The CPC Program offers a process under the control of the company and not under the control of the brokers;

*Speed and Low-cost* — It is an efficient and low-cost program for being listed on the Exchange;

*Due Diligence* — The IPO is an opportunity to raise funds for doing a due diligence examination of the prospective operating business or drafting the information circular and various agreements required for the completion of the qualifying transaction as well as organizing meetings;

*Appropriate Moment for an IPO* — The company that is not as yet large enough for interesting a broker in leading an underwriting group in an IPO may be given access to the traditional public capital market through the CPC Program;

*Listing Requirements* — The company does not meet all the listing and maintenance requirements of senior exchanges such as the TSE, the NYSE or NASDAQ.

*Minimum Number of Investors* — The promoters are not certain to attract at least 200 shareholders through an IPO, which is a listing requirement on the TSX Venture (300 shareholders for the TSE).

*Market Conditions* — Market conditions are not always favourable for a traditional IPO. For instance, a company could decide to go public when the market is down, in order to be listed when the market picks up, and thereby benefit from the recovery. It would therefore seek to become listed on a recognized market as soon as possible in order to have better control over the timing and conditions of subsequent share issues. Also, in such a context, a company may wish to use a CPC to seize opportunities.

*Marketability* — Some investors willing to invest in a company insist on unrestricted securities. This is a common requirement of angel investors, institutional and private investors as well as certain investment funds. For example, a company could take advantage of a profitable private placement on the condition that the securities are listed as unrestricted.

*Exit Strategy for First-Round Investors* — An exit strategy, immediate or gradual, may be developed for angel investors, institutional investors or venture capitalists.

Of course, in addition to the above-mentioned considerations for going public specific to smaller companies, the usual considerations are also applicable, such as:

*Deferred Income Plan* — Investors may require securities eligible for deferred income tax plans.

*Consolidation Strategy* — Unrestricted securities may be required in order to achieve a

series of mergers and acquisitions, and stock listed on an exchange is unrestricted. In other words, it may be necessary to have a company that can provide an acceptable consideration, namely from its capital stock, to eventual sellers and partners;

*Estate Planning* — An estate planning strategy may require a larger market and increased liquidity for the securities in order, for instance, to diversify the founder's portfolio.

*Human Resources* — Attracting qualified executives may be easier with an inducement such as stock acquisition and stock options plans in a public company.

*Exposure* — The company may benefit from increased visibility on the capital markets to facilitate the selling of its goods and services.

*Disclosure* — A public company, because of the disclosure requirements, provides extra confidence to investors and creditors.

#### **IPO PROSPECTUS**

The company's IPO is made through a prospectus. At the time of the IPO, since it has never had any activities and is reputed never having had a qualifying transaction, the CPC's only activity consists of raising funds and identifying and evaluating possible qualifying transactions. Its IPO prospectus will be relatively simple, and CPC prospectuses will be quite uniform. The main differences from one IPO to another will be the amount of the IPO, the identification of the directors and officers, the type of qualifying transaction likely to be considered, and in certain instances, the target company. As a result, the legal and accounting costs for drafting and filing the prospectus will be reasonable. However, the costs associated with the qualifying transaction will be higher since it will require, *among* other things, a due diligence, the preparation of a thorough information document, a qualifying transaction and the tax planning for such transaction.

#### **THE IPO BROKER**

In each of the territories in which the IPO is offered, the CPC must have an agent, acting alone or with others, to distribute common shares of the future CPC through a prospectus.

The agent's commission may not exceed 10% of the gross proceeds raised through the IPO. No other security, except options, may be issued to the agent, its affiliates or associates. The number of common shares to be issued upon exercise of the option cannot exceed 10% of the total number of IPO shares, at the IPO issue price. These options must be exercised within 18 months after the CPC has been listed on the Exchange.

#### **SUBSEQUENT FINANCINGS**

A significant part of the financing made after the IPO for companies listed on the Exchange stems from private placements made by individual or institutional investors. This interesting fact is clearly illustrated in the following table:

<b>TYPES OF FINANCING</b>	<b>2001</b>	<b>2002</b>
Initial Public Offering	\$101 millions	\$72 millions
Private Placements	\$900 millions	\$1,251 millions
Additional Public Offerings	\$80 millions	\$115 millions
<b>TOTAL</b>	<b>\$1.1 BILLION</b>	<b>\$1.44 BILLION</b>

#### **USE OF THE FUNDS BY THE CPC**

The use of the CPC's funds during the period preceding the qualifying transaction is regulated and those funds may only be used to achieve the company's purpose, i.e. identifying and evaluating assets and businesses with a view to completing a qualifying transaction. The CPC may, until the qualifying transaction has been completed, only use the lesser of 30% of the gross proceeds raised or \$210,000 to pay for its general and administrative expenses. The funds generated from the sale of securities may be used for identification and evaluation purposes for completing the qualifying transaction.

Certain payments to non-arm's length parties to the CPC or to the company resulting from the qualifying transaction are prohibited prior to the completion of the qualifying transaction. This imposes a restriction on salaries, consulting fees, professional fees, directors' fees,

and on loans and advances. During the period prior to the qualifying transaction, expenditures for investor relation activities are also prohibited, as are expenses to acquire or lease a vehicle.

#### **MANAGERS**

The CPC's only assets prior to the qualifying transaction are its directors and management team and the funds that it has raised. The CPC Program depends largely on the directors' qualifications and great importance is attached to their selection. Generally, the directors must be residents of Canada or the United States and possess publicly listed company experience. Directors must collectively prove that they are capable of identifying, evaluating and completing a qualifying transaction. Evaluation factors and information used by the Exchange to determine whether these conditions are met are the following:

- A positive track record with junior companies, as evidenced by the growth of such companies.
- The ability to raise funds.
- A favourable track record of corporate governance and respect of securities legislation.
- Technical experience in the appropriate industry sector, where applicable.
- The ability to identify and exploit appropriate acquisition opportunities for companies.
- Positive experience as directors or senior officers with public companies in Canada or the United States, as evidenced by the growth of such companies and/or the listing of such companies on a senior exchange such as the TSE, NASDAQ or NYSE.

#### **INCENTIVE STOCK OPTIONS**

CPC incentive stock options may only be granted to its directors, officers and, in certain circumstances, the CPC's technical consultants.

Furthermore, stock options may be granted to the IPO agent, as previously described.

The number of shares that may be issued upon exercise of the options cannot exceed 10% of the common shares outstanding after closing of the IPO. The number of common shares reserved under option for issuance to any individual director or officer may not exceed 5% of the common shares outstanding after the closing of the IPO. This percentage is 2% for a technical consultant. The exercise price per common share cannot be less than the higher of the IPO share price or the prescribed discount at the time of issuance.

Except for those held by the Agent, no options may be exercised before the qualifying transaction has been completed, unless the optionee accepts, in writing, that such shares be held in escrow until the qualifying transaction has been completed.

#### **ESCROWED SHARES**

In order to ensure the reliability of the Program, and in order to prevent the practice commonly known as "flips", some of the CPC's securities must be held in escrow or be subject to a holding period. Escrow means that trade on some shares issued by the CPC is restricted, and that those securities have to be deposited with a third party who will hold them until a specific event takes place. In some cases, the shares may even be confiscated.

Securities subject to escrow include, among other things, discount seed shares and securities held by persons controlling the CPC or not dealing at arm's length with the CPC.

If the value of the securities issued upon the completion of the qualifying transaction is acceptable to the Exchange, 10% of the escrowed securities are released immediately on completion of the qualifying transaction, and the balance is released by blocks of 15% every six months for 36 months.

If the value of such securities is not acceptable to the Exchange, the escrow period will be doubled spreading over 72 months.

If the company meets the Exchange's qualifications requirements for a first tier issuer, the escrowed securities may be released faster.

Summarily, insiders are promoters, directors and officers or holders of a given percentage of shares.

**TYPICAL CASE**

- Five promoters specialized in steel manufacturing wish to make an investment in that field. At this stage, they have not yet identified a target company. They will attempt to identify a company that, once listed on an exchange, will have strong growth potential.
- Their initial investment of \$100,000 in a newly incorporated company representing an individual investment of \$20,000 or 266,666 shares at 7.5¢ per share.
- The company issues common shares at a price of 15¢ per share for its IPO, and 200 shareholders from the public acquire these shares for a total consideration of \$1,200,000.
- It then lists on the Exchange as a CPC.
- During the identification period, the maximum amount to cover the CPC's general and administrative costs will be the lesser of 30% of \$1,300,000 or \$210,000. In reality, only \$190,000 shall be used.

	<b>Shares</b>	<b>Price</b>	<b>Total</b>
<b>Shareholders of the former CPC</b>	1,333,333	\$0.075	\$100,000
<b>IPO</b>	8,000,000	\$0.15	\$1,200,000
<b>Total</b>	<b><u>9,333,333</u></b>		<b><u>\$1,300,000</u></b>

- The CPC enters into an agreement in principle with a steel company, identified as a qualifying transaction, whereby the parties tentatively agree to merge the two companies into one (STEEL INC.). Since shareholders' approval is not required, a *Listing statement* is drafted.
- The parties agree to proceed with the transaction based on the CPC's fair market

value of \$1,500,000 for the shares issued and outstanding before completion of the qualifying transaction.

- Once the qualifying transaction has been completed, the shares of STEEL INC. are held as follows:

	<b>\$ Million</b>	<b>%</b>
<b>Shareholders of the former CPC</b>	1.5	25
<b>Shareholders of STEEL INC. before the qualifying transaction</b>	4.5	75
<b>Total</b>	6	100

- Once the qualifying transaction has been completed, the resulting company shall be listed as a standard company on the Exchange. From that moment onward, the company is no longer considered a CPC and becomes subject to the usual rules governing listed companies.