CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

Canadian Securities Administrators Staff Notice 41-305
Share Structure Issues – Initial Public Offerings

September 24, 2010

Purpose
Before issuing a receipt for a prospectus, staff of the Canadian Securities Administrators generally consider factors to assess whether a prospectus offering is contrary to the public interest.

We have encountered a number of initial public offerings (IPOs) by issuers with share structures that lead us to question whether those share structures are contrary to the public interest. In those cases, we generally recommend that the decision-maker refuse to issue a receipt for the prospectus.

This notice explains the factors we consider when assessing a proposed share structure in an IPO.

Background information
An IPO by a company that has already issued an unusually large number of shares for nominal cash consideration (or for assets or business development where the value is not readily supportable) may raise public interest concerns related to the company's capital structure. These concerns are heightened when:

- the business has a limited history of operations or development for which there are no other clear proxies for valuation,
- the IPO financing is relatively small.

We are concerned with these structures because:

- the large number of nominally priced shares can create a platform for future market manipulation, and
- the dilution of invested capital caused by existing shares issued for nominal amounts means that IPO investors receive an unconscionably low percentage of ownership compared to the amount of capital they are investing.

The TSX Venture Exchange and the CNSX have both published notices setting out guidelines that aimed to address these issues. We think the notices have addressed some of the issues. However, because we still encounter these issues, it is still appropriate for us to tell the market that we may also object to an issuer's share structure.

When we first issued National Policy 46-201 *Escrow for Initial Public Offerings* (NP 46-201) in 2002, we mentioned in our publication notices that issues associated with nominally-priced stock were better addressed by underwriters appropriately exercising their responsibilities related to

IPO pricing and timing.

In addition, section 2.4 of NP 46-201 indicates that securities regulators will generally consider imposing additional escrow if:

- an underwriter has not signed the IPO prospectus;
- the issuer has not applied to have its securities listed on a Canadian exchange, or a Canadian exchange has not agreed to list the securities distributed under the IPO prospectus; or
- there are other exceptional circumstances.

The Notice we issued with NP 46-201 indicated that securities regulators would rely on management of the issuer, underwriters and stock exchanges to assess the appropriateness of share capital structures. That is still the case with the majority of issuers. However, our recent experience is that issuers still file prospectuses with capital structures that raise public interest concerns.

General

As structuring issues are complex, we consider many qualitative and quantitative factors when evaluating the acceptability of IPO share structures.

We consider how the IPO price compares to the average share price paid by the Founders[1]. We may object when the IPO price significantly exceeds the average price paid by the Founders. We are concerned with structures in which the Founders have paid a nominal amount for a large block of shares compared to the IPO price.

We assess the proportion of capital proposed to be contributed by the IPO purchasers in comparison to the percentage of ownership the IPO purchasers will receive in return. We may object when the IPO purchasers are being invited to contribute an amount of capital that will be significantly disproportionate to their equity interest on completion of the offering.

We consider the average capital contributed per share for all issued and outstanding shares on completion of the offering and compare it to the purchase price per share of the IPO. We may be concerned if a large block of Founders' shares issued for nominal amounts reduces the average capital contributed per share significantly in comparison to the IPO price.

Other factors considered in evaluating acceptable share structures include:

- *Prior development of business or concept*: If the Founders have spent time, effort or resources developing a business, then a structure containing significant Founders' shares may be appropriate. We would not normally object to these structures when they represent a realization of business development efforts or otherwise demonstrate value. We may request that the issuer explain and justify the size of the Founder's position and the discount it represents relative to the IPO price. We will consider relevant facts and

[1] Generally, the term "Founders" means anyone who is a director, officer, promoter or insider of the issuer. In some instances, Founders may be a subset of this group.

circumstances, traditional valuation techniques that support the position, and other forms of third party corroboration of the value of the position such as significant pre-IPO arm's length financing activities.

- *Distribution of Founders' shares*: In some cases, some of the Founders may have received their shares at a significantly lower average price than other Founders. In these cases, we may be concerned with some of the Founders' shares but not others.
- *Cash invested by Founders and length of time invested*: Generally the greater the amount of cash the Founders have invested and the longer it has been actively used as part of the issuer's capital structure and development of its business, the more likely a given structure will be acceptable.
- *Warrants and options*: If there are significant convertible securities outstanding at exercise prices lower than the IPO price, we may include these securities in our analysis. If the number is large enough or the exercise price is low enough, the presence of these convertible securities may lead us to object to an otherwise acceptable share structure.

This CSA Staff Notice is not meant to provide certainty for every possible scenario and allow the reader to definitively determine if a given structure is acceptable or not. Rather it is intended to provide some insight regarding factors we consider when evaluating proposed share structures.

We will continue to monitor this issue and consider what further guidance or policy changes may be appropriate.

Questions
Please refer your questions to any of the following people:

Andrew Richardson
Deputy Director
British Columbia Securities Commission
(604) 899-6730
Toll-free (800) 373-6393
arichardson@bcsc.bc.ca

Allan Lim
Manager
British Columbia Securities Commission
(604) 899-6780
Toll-free (800) 373-6393
alim@bcsc.bc.ca

Patricia van de Sande
Senior Securities Analyst
Alberta Securities Commission
(403) 355-4474
patricia.vandesande@asc.ca

Tony Herdzik
Senior Securities Analyst
Saskatchewan Financial Services Commission
(306) 787-5849
tony.herdzik@gov.sk.ca

Wayne Bridgeman
Senior Analyst
The Manitoba Securities Commission
(204) 945-4905
Toll-free (800) 655-5244 (within Manitoba only)
wayne.bridgeman@gov.mb.ca

Michael Bennett
Senior Legal Counsel, Corporate Finance
Ontario Securities Commission
(416) 593-8079
mbennett@osc.gov.on.ca

Rick Whiler
Senior Accountant, Corporate Finance
Ontario Securities Commission
(416) 593-8127
rwhiler@osc.gov.on.ca

Benoit Dionne
Manager, Corporate Finance
Autorité des marchés financiers
(514) 395-0337 ext. 4411
Toll-free (877) 525-0337
benoit.dionne@lautorite.qc.ca

Isabelle Petit
Analyst, Senior Legal Counsel, Corporate Finance
Autorité des marchés financiers
(514) 395-0337 ext. 4427
Toll-free (877) 525-0337
isabelle.petit@lautorite.qc.ca

Jeff Harriman
Securities Analyst
New Brunswick Securities Commission
(506) 643-7856
jeff.harriman@nbsc-cvmnb.ca

Kevin Redden
Securities Analyst
Nova Scotia Securities Commission
(902) 424-5343
reddenkg@gov.ns.ca