Securities Law Newsletter
March 2016
Westlaw Canada

Distributions Outside the Jurisdiction – Flow-Back and Related Issues

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Background

Canadian securities regulators have long been concerned about the possibility that securities distributed to purchasers outside of the local jurisdiction without a local prospectus or exemption could prematurely find their way into the local securities market. This has been the case regardless of whether, or how long, the issuer has been a reporting issuer in the local jurisdiction.

The apprehension around "flow-back" has its roots partly in the establishment of the closed system governing prospectus-exempt distributions. One obvious loophole in the prospectus regime, if unaddressed, would allow an issuer to privately place securities to a person who could immediately resell to the public at large. To counter this possibility, securities legislation first prescribed that the availability of certain prospectus exemptions was confined to distributions to persons who purchased the securities "as principal for investment only and not with a view to resale or distribution". It was subsequently determined that greater certainty should be provided through the establishment of precise hold periods.

For an issuance of securities, the potential existence of a hold period in a particular Canadian jurisdiction depends on whether the issuance is a prospectus-exempt distribution in that jurisdiction. The regulators in some jurisdictions, such as British Columbia, take the position that a distribution "from" the local jurisdiction requires a prospectus in the local jurisdiction, or a prospectus exemption, regardless of the location of the purchasers. The determination of whether a distribution is from the jurisdiction is based on factors such as where the issuer's "mind and management" are primarily located.

The situation is not as clear in Ontario, where the Ontario Securities Commission (OSC) sets out its position in "Interpretation Note 1" (which replaced former OSC Policy 1.5 – *Distributions of Securities Outside Ontario*). Interpretation Note 1 provides for the possibility that even a distribution by an Ontario-based issuer may be considered not to be a distribution in Ontario if adequate steps are taken to ensure that the distributed securities "come to rest" outside of Ontario.

Interpretation Note 1 is in contrast to section 1.2 of the Companion Policy to National Instrument 45-106 – *Prospectus Exemptions* and subsection 3.1(2) of the Companion Policy to the OSC's Rule 45-501 – *Ontario Prospectus and Registration Exemptions*, which remind readers that the definition of "trade" in securities legislation includes any act “in furtherance of a trade”. It may be difficult to conclude that an Ontario-based issuer performs no act in Ontario in furtherance of a distribution of its own securities. The uncertainty in Ontario is reinforced by the fact that OSC Interpretation Note 1 does not have the force of law. Additionally, OSC decisions such as *Re XI Biofuels Inc.* (2010) and the Ontario Divisional Court’s dismissal of the appeal of that decision (*Crowe v. Ontario Securities Commission* (2011)) illustrate that there is no assurance that a regulator or court will consider a distribution by an Ontario-based issuer to non-Ontario purchasers to have taken place entirely outside of Ontario, regardless of the “coming to rest” factor.

If both the issuer and the purchaser are located outside of the jurisdiction, the matter does not necessarily end there. The definitions of “distribution” in most of the Canadian jurisdictions include a series of transactions involving purchases and sales or repurchases and resales “in the course of or incidental to a distribution”. The securities regulators bring this “indirect distribution” branch of the definition into play in addressing the possibility that securities distributed to purchasers outside of the local jurisdiction may be resold quickly into the local market (i.e. the securities may not “come to rest” outside of the local market).

This concern is linked to the question of whether the issuer has a “significant connection” with the local jurisdiction, based on a number of possible “connecting factors”. If a significant connection exists, the regulators have indicated (e.g. in BC Interpretation Note 72-702 and OSC Interpretation Note 1) that the issuer should take steps to prevent flow-back, and that in the case of a private placement, resales into the local jurisdiction should be prevented from occurring before the expiry of the hold period that would be applicable if the initial distribution had taken place in the local jurisdiction.

Approach under the Cooperative Capital Markets Regulatory System

Under the proposed Cooperative Capital Markets Regulatory System, BC Interpretation Note 72-702 would be substantially carried forward in CMRA Policy 71-601 – *Distribution of Securities to Persons Outside CMR Jurisdictions*. Accordingly, a distribution by an issuer located in any one of the participating provincial or territorial jurisdictions would need a prospectus or exemption that met the requirements of the new regulator regardless of the location of the purchasers. Ontario’s Interpretation Note 1 would not be carried forward. The concepts of “significant connection” to the jurisdiction and “coming to rest” would continue to apply, with the participating provincial and territorial jurisdictions (currently British Columbia, New Brunswick, Ontario, Prince Edward Island, Saskatchewan and Yukon) to be treated as a single unit for these purposes.

Comment

Resale restrictions, whether imposed by way of prescribed hold periods or a “coming to rest” requirement, serve as an impediment to efficient capital raising in that potential investors, if they do not shun the resale-restricted securities altogether, will generally demand compensation for the restriction through a reduced purchase price. The Canadian Securities Administrators regularly remind us that their mission incorporates support of efficient capital markets. The current draft of the *Capital Markets Act* under the proposed Cooperative Capital Markets Regulatory System includes fostering efficient capital markets as one of the Act's purposes.

One of the OSC's presently mandated principles to consider, as set out in section 2.1 of the *Securities Act*, is:

> Business and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought to be realized.

Given that resale restrictions impose costs and interfere with the business and investment activities of market participants, what are the regulatory objectives that justify the these obstructions? Certainly issuers should not be able carry out what would otherwise be an illegal distribution simply by using a private placee or foreign investor as a conduit, and a resale restriction serves a purpose in that respect. However, it is difficult to identify who the victims would be if the restriction did not apply to resales that were trades in the normal course (i.e. not pre-arranged between the buyer and seller) on a published market. The general public can buy other securities of the same class at any time, so why does a potential open market purchaser of securities that happened to be recently owned by a private placee or foreign investor need more protection than a purchaser of identical securities that have been outstanding for a longer period of time?

Similar questions might be asked regarding the circumstance where Canadian employees of a foreign public issuer that is not a reporting issuer in a Canadian jurisdiction receive securities of the employer as part of their employment compensation. In the absence of a discretionary exemption, those employees are prohibited indefinitely from selling those securities on a foreign stock exchange unless the conditions in section 2.14 of National Instrument 45-102 – *Resale of Securities* are met. One of the conditions is that residents of Canada must not own more than 10% of the outstanding securities of the class. Presumably, the concern is that a higher percentage of Canadian ownership translates into a more significant connection of the issuer to Canada and a corresponding increase in the probability that an open market sale of the securities on the foreign stock exchange would be to a Canadian buyer. However, in the absence of the Canadian employee's sell order, a Canadian's buy order is probably just as likely to be filled by someone else.

If it presents a challenge to identify a class of victims that would be created by the removal of an existing regulatory burden, this may be an indication that the restriction giving rise to the burden should be revisited.