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The *Investment Company Act of 1940*

Sharon A. Bennett and Alan James

Canadian technology companies often seek funding from U.S. venture capital funds (VCs). Counsel for U.S. VCs often prefer an exchangeable share structure for these investments to accommodate the tax requirements of existing investors and to establish an attractive exit vehicle. In recent years, this structure has been modified in an effort to preserve the favourable tax treatment that Canadian-controlled private corporations (CCPCs) receive. The exchangeable share structure typically involves U.S. VCs that invest in a U.S. holding company (U.S. Holdco), which in turn invests in the Canadian company.

However, when this structure is used, particularly in combination with the desire to maintain CCPC status, a number of unintended consequences may result, including the potentially devastating application of the *Investment Company Act of 1940* (the '40s Act).

What is the '40s Act?

The U.S. '40s Act is a statute that imposes strict disclosure requirements on companies primarily engaged in investing and trading in securities and whose own securities are offered to the public. The Act requires investment companies to make periodic filings with the Securities Exchange Commission that are similar to a prospectus. In practice, it is virtually impossible for a company engaged in active business to run smoothly while complying with these ongoing disclosure requirements.

What is an Investment Company?

Section 3(a)(1) of the '40s Act states that for purposes of the Act, an "investment company" includes any company that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per cent of the value of such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis.

Section 3(a)(2) of the '40s Act states that "investment securities" include "all securities" with certain exceptions, such as government securities and securities issued by majority-owned subsidiaries that are not themselves investment companies.

Sections 3(b) and 3(c) of the '40s Act provide that, notwithstanding Section 3(a), certain types of companies are excepted from the definition of "investment company." Some of the most common exceptions include:

1. Companies that, through a wholly-owned subsidiary, are primarily engaged in a business other than that of investing, owning or trading in securities;
2. Companies that do not offer their securities to the public and whose securities are beneficially owned by no more than 100 persons; and
3. Companies that do not offer their securities to the public and whose securities are owned exclusively by qualified purchasers.

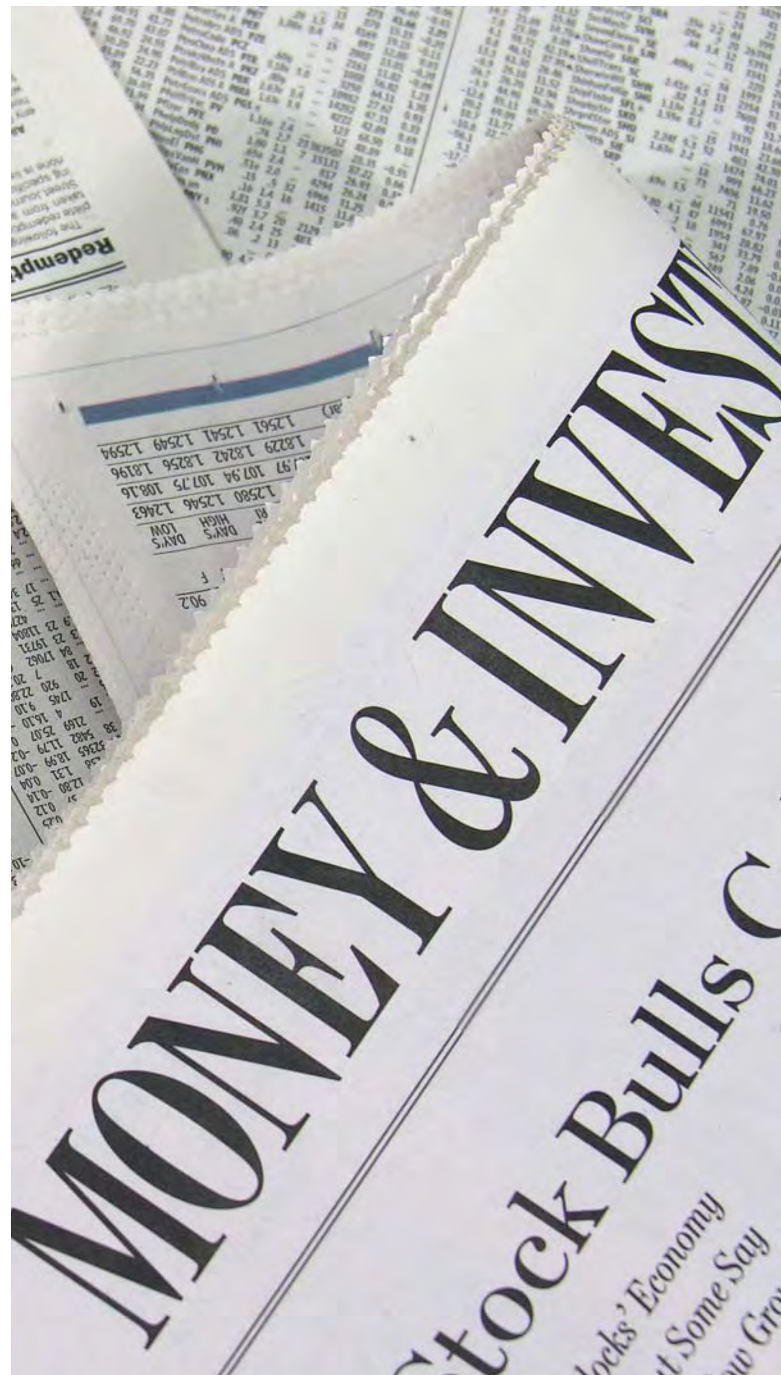
The Consequences of Being an Investment Company

If a U.S. Holdco is deemed to be an investment company for purposes of the '40s Act and fails to comply with its filing requirements, a number of issues will arise. Perhaps the most problematic relates to the enforceability of the U.S. Holdco's contracts. Section 47 of the '40s Act states that contracts made in violation of the '40s Act may be unenforceable by either party, and contracts that have been performed may be rescinded by either party.

Application of this section may result in the unwinding of an investment by a U.S. VC in a U.S. Holdco, since the subscription agreement through which the U.S. VC makes the investment violates the '40s Act. Even if this is not the direct result, uncertainty about the issue may deter subsequent investors from investing in the U.S. Holdco. In fact, Section 47 of the '40s Act will not permit a U.S. VC to waive its rights under the Act: such contracts are specifically characterized as invalid.

How Typical Exchangeable Share Structures Can Create '40s Act Problems

U.S. VCs often prefer to invest in U.S. companies rather than Canadian corporations, usually because U.S. companies are thought to make better exit vehicles than Canadian corporations: in theory at least, they are easier to sell and easier to take public. Also, the constating documents of a U.S. VC may prohibit it from investing directly outside of the U.S.



To solve these problems, a U.S. VC investing in a Canadian corporation, may choose to incorporate a U.S. Holdco. The VC subscribes for shares in the U.S. Holdco, which in turn subscribes for shares in the Canadian operating company (Can Opco). To ensure that the U.S. Holdco is an attractive exit vehicle, the VC's investment is often conditional upon the shareholders of the Can Opco exchanging their shares for shares in the U.S. Holdco.

For Canadian tax reasons, however, it may be disadvantageous for the Canadian founding shareholders of the Can Opco to exchange their shares in the Can Opco for shares of the U.S. Holdco. To alleviate this concern, the founders often exchange their Can Opco shares for non-voting Can Opco exchangeable shares, which derive their economic value entirely from the fact that they may be exchanged for shares in the U.S. Holdco, and are entitled to dividends if, as and when dividends are paid on the U.S. Holdco shares.

When the intention is to preserve CCPC status, and the exchangeable shareholders are given voting rights in relation to Can Opco, the implications of the '40s Act must be considered. The analysis generally proceeds as follows:

1. If the Can Opco will not be "majority-owned" by the U.S. Holdco after the investment transaction, the Can Opco shares held by the U.S. Holdco will be "investment securities." Should the exchangeable shareholders of the Can Opco be in *de facto* control of Can Opco, whether through the terms of a shareholders' agreement or otherwise, the U.S. Holdco may not be the majority owner of the Can Opco for purposes of the '40s Act, even if the U.S. Holdco owns all of the common shares of the Can Opco.
2. If U.S. Holdco owns "investment securities," and such securities account for more than 40 per cent of U.S. Holdco's assets, U.S. Holdco will be an "investment company," unless it falls within an exception set out in the '40s Act.
3. If the U.S. Holdco is an "investment company," and the Can Opco is not a financial or other special entity, the U.S. Holdco can still avoid "investment company" status if its securities are beneficially owned by less than 100 persons or if all of the investors are qualified purchasers. In many circumstances, this is not the case, or is impossible to easily ascertain. For instance, if the Can Opco has adopted a stock option plan, the optionees are typically not all qualified purchasers, and their existence may lead to there being more than 100 security holders. Or if the U.S. VC is a limited partnership, it may itself consist of still more limited partnerships. The number of beneficial security holders could exceed 100, and it may not be possible to determine their qualified status.

If it is concluded that a U.S. Holdco is an investment company under the '40s Act, a new structure should be considered to avoid unfortunate consequences. Failing to pay attention to the '40s Act could turn a U.S. Holdco, which was initially intended as a desirable exit vehicle, into a remarkably unmarketable entity.

Note: The authors would like to thank Stephen L. Pike of Edwards Angell Palmer &Dodge LLP for his assistance with this article.