BANKING ON CORPORATE

BY NEILL MAY

The closed system

There are many reasons to keep old rules around after they have outlived their apparent purpose and utility. For example, securities rules tend to result in systems and processes in which there is significant investment; those practices acquire inertia, and the prospect of reversing course can seem as daunting as a large oil tanker performing a quick U-turn at sea. There is also the benefit of stability in its own right, a factor that I am embarrassed to admit is of increasing appeal to me as the charts for my age and laziness are approaching the right side of the page (I am intentionally ignoring the possibility of emotional attachment to old securities laws — I will have to deal with that in a more general, therapeutic column). But one of the most vexing reasons to keep older rules alive is where those rules have come to serve an objective entirely different from their original purpose(s).

One set of older rules that fits into this paradigm is the framework known in the world of securities law as the "closed system" (this doesn't actually refer to lawyers' social lives, such as they exist, though non-lawyers might wonder). The closed system refers to the limited universe in which securities can be traded if they haven't been qualified by a prospectus.

There are basically two legal ways for an issuer, public or private, to issue securities: under a prospectus, which provides detailed disclosure about the issuer; or through a private placement. Private placements are sales to parties (such as the founders of the company, close friends or family of the founders, certain employees, and other categories of sophisticated investors) that are deemed by securities laws to be knowledgeable or sophisticated enough to not require the disclosure and protection provided by a prospectus. These individuals and organizations comprise the population of the closed system.

For a private company, the closed system is perpetual. The company's securities cannot be freely traded outside of the system, because the market does not have access to full, true, and plain disclosure about the company. Conversely, for public companies the closed system has an escape hatch of sorts. Because public companies make continuous public disclosures about their business and affairs, securities of a public company purchased in a private placement can generally exit the closed system after a "hold period." In Canada, the closed system's airlock swings open after four months.

The policy behind hold periods appears on its face to be the protection of investors from private placees flipping securities bought at some kind of information advantage. Private placement investors may have obtained, due to their proximity to the issuer and/or negotiating skill, access to information not publicly disclosed. In a four-month hold period, during which a quarter end will trigger fresh public disclosure, any informational advantage that may have operated in favour of the private placement investor might be thought to disappear.

But there may be a collateral policy objective as well, whether intentional or not: encouraging participation of retail investors in the capital markets. If the policy behind hold periods is to protect the market from investors re-selling securities to those with an information disadvantage, the logic is unclear. If no additional disclosure is made to private placement investors there is no need for a hold period; and if additional disclosure is made there is no guarantee that it will ever be made publicly — though requiring public disclosure of any additional disclosures made to a private placee would be an interesting option. More generally, why is the four-month hold period not tied to the timing of any public disclosures to cleanse the possible informational imbalance? I could go on, but my real point is that I think that the closed system is serving the secondary objective of encouraging prospectus offerings in which broader segments of the market (particularly "retail investors") can participate.

The problem is that a regulatory system that encourages retail participation indirectly leads, predictably, to distortions. For example, the fact of a four-month hold period often means that companies doing private placements take a discount to the value of the securities to deal with the short-term illiquidity. There are also administrative costs in dealing with a parallel system for securities that are not freely trading, and more confusingly a cottage industry in swapping restricted securities for those that trade freely, which seems to undermine the entire edifice.

It brings to mind the efforts by legislators after the Exxon Valdez oil spill to make shipping safer by imposing unlimited liability on shippers. The net result was a movement by oil companies to subcontract out their shipping to independent shippers that tended to be more judgment proof and also, ironically, tended to have much less rigorous safety standards.

The point is that if something is to be regulated or encouraged perhaps that is best done directly. If a retail market exists, and issuers have advisers who can tell them if it does, then an issuer will be motivated to do a public offering and the integrity of the markets will be protected by the prospectus rules. If it doesn't, it bears asking if a restricted period serves the public, or if it's another oil tanker to be turned around. CL

Neill May is a partner at Goodmans LLP in Toronto. His practice focuses on all aspects of securities law, with an emphasis on M&A and corporate finance. E-mail him at nmay@goodmans.ca. *The opinions expressed are those of the author alone.*