Securities Law Concepts & Overview for Startups

Please note that this memorandum is for informational purposes only and does not constitute legal advice. This memorandum does not create or intend to create a solicitor-client relationship between the reader and the initio Technology & Innovation Law Clinic. Please contact a professional to explore the securities laws applicable to your business.

What are securities?

A security is a financial instrument, representing an interest in a company. A security holds some type of inherent value -- meaning that it is worth something -- based on its underlying asset: the company.

Companies sell securities to investors (called an "issue") as a method of raising money for their business, whether that money be used for natural growth, paying off debts or making an acquisition. The purchasers of securities are investors, who provide money in exchange for the securities. Investors provide their money with the hopes of making a profit on their investment: they are hoping that the value of the security increases as the company grows. This increase is not guaranteed, as not all companies take off. Therefore, investors take a risk when investing in companies with the hope of making a profit, and companies in return receive the money they need to grow.

Securities are sold in both *public* and *private* markets. Public markets are where companies sell shares to the general public, who can then buy and sell securities on a stock exchange. Private markets, however, are private companies that are not publicly traded on a stock exchange. In the private market, securities transactions are out of the public eye. Companies do not usually become listed on a stock exchange until they have reached a certain level of maturity (see memorandum on Raising Startup Capital). Therefore, most technology and startup companies are within the private markets, with private investors providing money (their investment) for a given number of securities in the company.

There are three main types of securities:

1. **Equities**: Otherwise known as a share (or stock), equity securities represent an interest in a company, usually entitling the shareholder to the excess profits of the company. Many believe that shares or equity are "ownership" in the company -- while this is *legally* not the case, it gives you an idea as to the rights shareholders are entitled to, such as voting and rights to excess profits. The value of a share may go up or down over time, depending on the fortunes of the company. For example, Lin buys 1,000 shares in BigCorp worth $100 each, for a total of $100,000. Two years later, those shares increase in value to $125 each. That year, the company divides its leftover profits and pays them out to its shareholders proportionately based on their share ownership (called a "dividend").

2. **Debt**: There are different types of debt securities, but the most common type is bonds. A bond represents a loan made to the issuer by the investor and can be viewed as an IOU between the two. Companies and governments issue bonds to investors to raise money for expensive initiatives that they don't have cash on-hand for, and the company promises to pay the invested amount back at a fixed interest rate over a fixed period of time (because of this, bonds and other debt securities are commonly referred to as **fixed-income instruments**). For example, SkyX needs $100 million to buy a new manufacturing facility, so

it issues 100,000 bonds worth $1,000 each. The bond is issued as a 10-year bond at a 5% interest rate (known as a **coupon**), meaning that in 10 years, they will pay back the original bond price of $1,000 plus an additional 5%.

3. **Hybrids**: Hybrid securities are complex securities that have components of both equity and debt securities.

What is securities law?

Securities in both the public and private markets are regulated at the provincial level, so every province has their own securities laws and regulations, as well as their own securities commission that oversees compliance (e.g. Nova Scotia Securities Commission [NSSC], Ontario Securities Commission, etc.). However, there is an extremely high degree of integration between the securities commissions, so the vast majority of regulations are the same across most, if not all, of the country.

Securities are regulated primarily to (1) protect investors and (2) maintain fair, orderly, and efficient markets. As a society, we want to make sure that people cannot easily dupe others into investing in what amounts to a scam. We also want to ensure that people aren't using insider information to profit off the backs of others, and that investors and the public have the same information in front of them when making an investment decision. Public markets are more heavily regulated and monitored, because of the massive amounts of money at risk and the risk to investors that come with this.

There are two basic requirements at the heart of securities law: **(1)** registration and **(2)** prospectuses.

1. **Registration requirements**: any person or company that is in the business of selling or advising in securities must be registered (i.e. licensed). The registration requirement is to ensure those involved with the sale of securities meet proficiency, integrity and suitability to advise clients standards. Usually, individuals and companies that trade or advise in securities or are financing underwriters or investment fund managers must register.

If your startup's mission or activities include trading securities or advising on investing, you will likely be subject to registration requirements. Companies may also have to comply with registration requirements, among other securities laws, if they deal with any of the following:

- Platforms that connect investors networks and groups;
- Lending platforms;
- Trading platforms;
- Initial token or initial coin offerings;
- Online venture capital raising platforms;
- Crypto-asset trading platforms, exchanges or funds; and
- Technology, data or AI-driven investment advising or facilitating.

Please consult a securities law expert to determine whether registration requirements apply to your company.

2. **Prospectus requirements**: any person or company that issues securities must file and obtain a receipt for a prospectus. Prospectuses are lengthy documents that disclose all of

the details of your company, and it includes all of the information an investor would need to know to make an informed investment decision. Prospectuses, however, are very time-consuming and expensive to make, and often involve lawyers and bankers to ensure they are compliant with securities laws.

The NSSC offers a number of exemptions so that small and medium sized companies in certain circumstances can avoid the long and drawn out process of seeking securities commission approval to get much-needed capital. Before you consider finding investors for your business for a given seed or funding round, it is important that you consider who may and may not be able to invest in your company, depending on the exemption you will be relying upon. The most commonly relied-upon exemptions are listed below. In brackets is the relied-upon regulation. In many cases, a security that is issued in reliance of a prospectus exemption can only be re-sold under certain conditions. Make sure to speak to a legal professional before evaluating your securities law options, and make sure to speak to a qualified professional before exploring any capital raising activities.

Accredited Investor exemption (NI 45-106): Allows companies to raise funds from investors who meet certain requirements and who have the assets to withstand a potential loss on their investment. No prospectus is required, but all accredited investors must file Risk Acknowledgement Forms and the company must file a Report of Exempt Distribution within 10 days *after* the issue. Growth-stage or high-growth companies commonly use this exemption.

Crowdfunding portals exemption (MI 45-108): Allows startups to crowdfund money from the public via an online crowdfunding portal. Issuers can raise a maximum of $1.5 million in a 12-month period through this exemption, and there are some forms and filings that must be submitted to securities regulators. The Nova Scotia Securities Commission (NSSC) only allows registered crowdfunding platforms to operate in Nova Scotia, listed here.

Family, Friends and Business Associates exemption (NI 45-106): Allows companies to issue shares where the purchasers of the shares are either a director, officer, affiliate or major shareholder of the company, or a close family member, personal friend or business associate of any director, officer, affiliate or major shareholder. The company must file a report to the NSSC within 10 days of the issue. Under this exemption, there are restrictions on transferring shares after the issue. Startups commonly use this exemption.

Offering Memorandum exemption (NI 45-106): Allows companies to raise money from a wide range of investors based on an offering memorandum being made for investors rather than a prospectus. An offering memorandum is a shorter version of a prospectus that does not require as much time and money to produce. In addition to the offering memorandum, there are some other filings that must be made to securities regulators. There are some limits on the amount an investor can invest under this exemption, depending on their situation.

Private Issuer exemption (NI 45-106): Allows companies to raise capital without a prospectus where the company has no more than 50 shareholders who are either family, close friends, existing shareholders, close business associates or accredited investors. Under this exemption, there are restrictions on transferring shares after the issue, and you cannot publicise the sale of the securities or the issue. You cannot rely on this exemption in addition to any others, though there are no filings required under this exemption. Startups commonly use this exemption.

Start-Up Crowdfunding exemption (BO 45-524): Allows startups and small/medium-sized businesses to raise up to $250 thousand, twice per year, through an internet portal. There is an investment limit of $1,500 per person, and there are some minor filings that must be submitted to securities regulators.

What are “accredited investors”?

Investors in startup companies, such as venture capitalists (VCs), private equity investors and other private individual investors typically make their investments in companies as “accredited investors”. Accredited investors must be either high-net worth or high-income individuals (with more than $1 million in assets or $200 thousand in annual pre-tax income) or major investment companies or financial institutions. The rationale behind allowing accredited investors certain investment opportunities is because they already have sizable assets and/or expertise in investment, and they therefore are not in need of the same level of investor protection as the general public. Because of the higher degree of risk that accredited investors are allowed to take on, they are permitted to invest in companies that use *most* of the different prospectus exemptions.

Regulatory Sandbox Initiative

The NSSC participates in a national regulatory sandbox, which is an initiative that allows startups with innovative products to work directly with securities regulators to obtain exemptive relief from securities laws. The goal of the Sandbox is to create a regulatory environment that does not stifle innovation, and to make regulators aware of the issues facing startups. Companies that deal with the following are well positioned to benefit from the Sandbox:

- Platforms that connect investors networks and groups;
- Lending platforms;
- Trading platforms;
- Initial token or initial coin offerings;
- Online venture capital raising platforms;
- Crypto-asset trading platforms, exchanges or funds; and
- Technology, data or AI-driven investment advising or facilitating.

Visit the Sandbox website here for more information.

Please contact a professional to explore the securities laws applicable to your business.