The 51st State? Canada Offers a Home-Away-From-Home for US IPOs

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As commerce between Canada and the US has become increasingly integrated, so too has the flow of capital. Cross-border investments by institutional and retail investors have long been the norm, but when it came to public financings, the direction of cross-border capital formation occurred primarily in one direction — south. Canadian companies traditionally have looked to the US public markets as an important option in obtaining necessary growth capital. In contrast, US companies typically did not consider Canadian capital markets as a viable alternative. That has changed. In the past five years it appears US businesses and their advisors have discovered the value proposition presented by Canada's public markets.

Finding capital to grow a business is always challenging. The global credit crisis exacerbated this challenge. Both the flow of private equity money and the robust IPO market of the mid-2000s have substantially eroded over the past two years. M&A exits have also constricted as buyout premiums dropped and venture capital funding diminished. A January 2010 report released by PricewaterhouseCoopers and the National Venture Capital Association stated, "Venture capitalists invested $17.7 billion in 2,795 deals in 2009, marking the lowest level of dollar investment since 1997. ... a 37 per cent decrease in dollars and a 30 per cent decrease in deal volume from 2008."

Where does this leave the scores of good quality US companies looking for capital or an exit strategy for their backers and founders? Listing on the New York Stock Exchange (NYSE) or NASDAQ is the goal for many, but a sense that only the largest or fastest growing companies will be noticed over the "noise" of US public markets and the high cost of going public in the US often dissuades issuers. Is there money for the small or mid-cap sized company? Even more fundamentally, is there US investor interest in these companies?

These questions have served as a catalyst for US mid-market and growth companies to look farther afield for their capital needs. In the mid-2000s, a number of US companies looked to the AIM market in London as a potentially better fit. Many of these companies were excited initially by the valuations they received on listing but ultimately disappointed by the lack of depth and liquidity AIM's secondary market provided. Looking to other European or Asian markets has not drawn meaningful interest from mid-market US companies. So what is left?

Against this backdrop, there is growing interest in the Toronto Stock Exchange (TSX) and the more junior TSX Venture Exchange among US companies, their advisors and investors. The TSX is increasingly viewed in the US as a market with the attributes that are important to mid-market US companies, namely close-to-home with a history of supporting mid-market and growth businesses, and supported by English-speaking professionals, regulators and bankers who understand the market segment. A large part of this awareness emanates from the diligent efforts of the TSX, who have undertaken numerous initiatives in the US to educate US companies, their advisors and financial backers.

Investors and market participants have come to appreciate the relative stability of the Canadian financial system, political culture and economy. Canada's banks have remained remarkably stable and financially resilient during the financial crisis and, perhaps most importantly, Canada's banks have continued to make loans.

Why the TSX?

The TSX and TSX Venture Exchange represent the world's eighth largest stock exchange by issuer market capitalization. In 2009, the TSX posted a record year, raising C$60 billion in total financings with record trading volume of 118.5 billion shares. Currently, 148 US companies are listed on the TSX and the TSX Venture Exchange, of which many are "interlisted" on the NYSE, NASDAQ, AMEX or OTC BB. While these companies were historically based in the resource sector, US listed companies now represent a wide array of industries, including a strong showing in the areas of medical devices and clean tech.

Canadian disclosure principles and styles are similar to those in the US, making for a comfortable transition across the border. The regulatory regime in Canada takes a rigorous but more tempered approach to issuers than does the US. Canadian regulators also tend to be more accessible than their US counterparts. Perhaps most significantly, Canadian regulators have chosen not to adopt an analogue to the SEC's Section 404 of the *Sarbanes-Oxley Act*, which requires auditor review and attestation on the quality of internal controls. Section 404 has been the source of significant costs and the focus of much of the concern related to *Sarbanes-Oxley* compliance. *Sarbanes-Oxley* has been a material deterrent to mid-cap and growth companies choosing to go public in the US.

These facts, coupled with the challenges mid-cap and growth issuers in the US are facing, have meant US companies are taking notice of their neighbor to the north. Efforts by the TSX and Canadian professionals to explain the opportunities, issues and process related to a Canadian initial public offering (IPO) are aiding US interest.

Benefits & Considerations of a TSX Listing

Completing an IPO on the NYSE or NASDAQ can cost well in excess of $1 million including audit, legal fees and compliance measures. Ongoing public company costs, including *Sarbanes-Oxley* compliance, can represent several hundred thousand dollars per year.

Fees tend to be materially less on the TSX and TSX-V, presenting a good value proposition when considering costs versus amounts raised. Moreover, the process in the United States is generally more protracted. The number of initial comments received from the SEC on an S-1 registration statement can run beyond 150, with the process taking up to six months. The Canadian experience is normally much shorter.

On the TSX, it is not uncommon to receive the receipt for a final prospectus within 30 to 60 days of filing the preliminary prospectus. The TSX's flexible approach to currency and management further simplifies listings. US issuers may price their offerings in US dollars and are not required to have any Canadian nexus in their business or management, other than having a board with North American public company experience.

Listing on the TSX or TSX-V is very similar to the process of listing on a US exchange, but US companies must consider certain US securities and tax law issues to determine the structure of a Canadian IPO.

US Securities Laws

US securities laws govern the manner of offer and sale of securities by US companies, both inside and outside the US. The importance of this to Canadian public offerings is that a US company cannot freely issue securities outside the United States. To prevent shares issued outside the US from flowing back into the US, restrictions must be placed on the securities issued by US companies and must remain in place for at least 12 months.

These restrictions interfere with the normal functioning of a public market in the stock. As a result, a US company going public in Canada must take steps to ensure that once issued, its shares can trade freely in the Canadian public markets. For the purposes of US securities law, a company is a US domestic issuer if it is incorporated in the United States, regardless of its shareholdings or where management resides, and regardless of where the assets or operating businesses are located.

Registration

The most direct route for addressing the issue of SEC resale restrictions is for the issuer to simultaneously file an S-1 registration statement with the SEC and file a concurrent (referred to as a "wrap") prospectus with the provincial regulators in Canada. By doing this, the issuer clears the securities with the regulators in each country and can issue free-trading securities in each country. Indeed, a number of large US issuers have historically followed this route. Many of these companies were already reporting with the SEC and trading on a US exchange at the time of listing in Canada. As a result, filing a registration statement in the US covering sales into Canada was a straightforward extension of their existing US public reporting program.

More recently, a number of companies have pursued the route of dual registration without pursuing or having a pre-existing listing on a US exchange. In these cases, the issuer has submitted to SEC requirements alongside Canadian securities requirements for the purpose of accessing *only* the Canadian market. While many of these issuers intend to pursue a listing on a US exchange in the future, they view the Canadian capital markets as "right-sized" for the current stage of their business.

Dual registration offers the most flexibility because it removes all resale restrictions and concern about US flowback under Regulation S. But there are certain drawbacks:

- Timing – The SEC's timeline in reviewing the US registration statement will often govern the timing of the Canadian IPO. Canadian regulators' timelines tend to be significantly shorter and more streamlined than the SEC's. As a result, SEC review may force Canadian underwriters to alter the typical Canadian offering process and timing. In addition, many issuers in Canada have access to "bought-deal" financings (which permits a limited opportunity to pre-market) and the "prompt offering system." For a dual registered issuer, the timing and availability of bought deal financings are more difficult although "work arounds," such as a US "shelf" prospectus, do exist.
- Ongoing flowback issues – Each future issuance of securities will raise the same flowback issues and related restrictions. To avoid the flowback restriction, US issuers who register with the SEC on the IPO must again file a registration statement with the SEC and wait for it to be declared effective each time securities are offered in Canada.
- Costs – Publicly reporting in both Canada and the United States, including *Sarbanes-Oxley* compliance, adds substantial costs.

While reporting compliance in multiple jurisdictions can be burdensome, Canadian securities regulators provide for accommodations to allow the use of SEC filed disclosure in lieu of certain mandated continuous disclosure filings. The Multi-Jurisdictional Reporting System uniquely permits qualifying issuers in one country to file their home country disclosure filings and registration statements or prospectuses with the regulators in the other country. The regulators in the other country generally do not review such filings. As a result, the cost and complexity of complying with the reporting obligations of both jurisdictions is greatly reduced.

Restructuring

A second option exists for companies that decide an SEC registration is either too costly or cumbersome at the time of a Canadian listing. They may choose to restructure their business such that it qualifies as a non-US issuer for SEC purposes (*i.e.*, a "foreign private issuer" in the language of the SEC). By reorganizing as a foreign private issuer, a US business will fall within different SEC regulations, which greatly simplify offerings of securities outside the US.

The main principle behind such reorganizations is to have the US operating company enter into a business combination whereby it becomes the wholly-owned subsidiary of a Canadian or some other offshore entity. The parent entity is the entity that lists on the TSX or TSX-V and is the issuer for US securities law purposes. This approach establishes a foreign incorporation for the issuer. However, the SEC's definition of foreign private issuer requires a second level of inquiry to determine whether a foreign incorporated issuer should nonetheless be treated as a domestic US issuer. Specifically, the SEC excludes from its definition of foreign private issuer not only those issuers that are incorporated in the US but also an entity incorporated outside the US if such issuer has more than 50 per cent of its voting securities held, directly or indirectly, by US residents *plus* any one of three following criteria:

- the majority of the executive officers or directors are United States citizens or residents;
- more than 50 per cent of the assets of the issuer are located in the United States; and
- the business of the issuer is administered principally in the United States.

Most businesses operating in the US satisfy at least one of the three criteria. In those cases, it is important to determine what percentage of the issuer's voting securities will be held in the US after the IPO.

For purposes of the SEC domestic issuer test, "voting securities" means securities the holders of which are currently entitled to vote for the election of directors. In certain cases, US residents hold less than 50 per cent of the common shares post-closing and so the issuer will be treated as a foreign issuer. In other cases, founders of the operating company along with other US shareholders, or US purchasers in the IPO, may collectively represent more than 50 per cent of the ownership in the issuer. In response to that situation, certain transactions have been structured so US shareholders do not hold more than 50 per cent of the voting securities issued. In other words, US holders may receive greater than 50 per cent of the economic interest in the public entity but receive less than 50 per cent of the common stock. In such cases, the US holders or certain groups of US holders, such as the founders, agree to receive some amount of a second security, typically designated as a restricted voting security, which confers economic rights on par with common stock but removes the holders' ability to vote for the election and generally for the removal of directors. The transaction may also be structured so that the US shareholders receive a form of exchangeable stock in the subsidiary of the issuer, with limitations on how and at what value those shares may be exchanged. Once structured the public company will be required to test its status under the "foreign private issuer" test once a year. As shares move in the market, thresholds of US ownership can be crossed causing "foreign private issuer" status to be lost, and so companies need to monitor this issue regularly.

.S Structures

A third option is for the issuer to remain a US domestic issuer but not register its securities with the SEC. In that case, the issuer may use what is known informally as a .S structure. In that case, the ticker symbol of the issuer has a .S suffix attached to it, which notifies the market that the issuer is a US domestic issuer. That notification prompts sellers of the stock to confirm that the buyer is not a US resident. In addition, a document evidencing the residence of the buyer is executed and the transfer agent for the issuer implements other resale mechanics intended to prevent any shares from flowing back into the US. While the .S approach can, to an extent, unfreeze the Canadian public markets for the stock of a US domestic issuer, the additional diligence steps to ensure no shares flow into the US often results in substantially lower trading volumes. Moreover, the .S mechanism is a "man made" device rather than a statutory regime and has not officially been blessed with an SEC "no action" letter. As a result, the .S approach has been used sparingly in northbound IPOs and often only as a bridge until SEC registration occurs.

US Tax Law

An additional structuring issue to consider is US tax treatment. In instances where a US company remains a domestic issuer and either registers with the SEC or uses a .S structure, US tax issues are typically not as material to the structure of the offering. In the scenario where a US company enters into a business combination resulting in foreign issuer status, or the rare instance where a US entity re-domesticates to a foreign jurisdiction, there are serious US corporate and shareholder tax issues to consider.

While the US tax system allows US shareholders participating in many domestic "reorganizations" to defer paying US tax on the appreciation in their shares until those shares are actually sold, US shareholders of a US corporation that exchange their shares for a Canadian corporation or other foreign corporation's shares are only allowed to defer the US tax on gains in limited circumstances. As a result, cross-border reorganizations often raise the specter of crystallizing a large tax gain for US shareholders in a circumstance where they receive no cash.

Fortunately, tax practitioners in the cross-border space have adapted a set of US tax rules drafted to prevent the outflow of US assets to tax havens as a useful tool in achieving tax deferral for US shareholders in cross-border transactions. The rules are referred to generally as the "inversion rules." Through a reverse merger or similar type of transaction, a Canadian or other foreign corporation can qualify as a US corporation for US tax purposes. This type of "corporate inversion" then allows the shareholders of the US company to benefit from potential tax-free treatment on the exchange.

US Congress designed the corporate inversion rules to deter movement of capital into tax havens by treating the offshore entities receiving such capital as US taxpayers. However, the inversion rules have been used effectively to US taxpayers' advantage in cross-border or foreign jurisdiction transactions by structuring IPO transactions in a way that causes the public parent company to be a US taxpayer. This allows the transaction to be viewed as an exchange between two US entities for IRS purposes. Corporate inversions do raise certain serious tax issues related to double taxation of distributions or dispositions post-closing. While the inverted company will be treated as a US company for tax purposes, it will also be subject to the tax regime of the jurisdiction where it is formed. The right team of professionals can plan for this effectively, including re-domiciling the restructured entity into a tax beneficial jurisdiction, such as Cayman Islands, to avoid the specter of double taxation.

To this last point, it is important that any US company seeking a Canadian listing reach out to professionals with experience listing US companies in Canada. Because of the complexity involved in addressing securities and tax laws in both jurisdictions, it is often cost-effective to retain both experienced Canadian counsel and special US counsel. An issuer's historical US counsel may be high-quality and trusted but many of the issues presented are novel and often unclear. These can cause delays and cost overruns as advisors attempt to get up to speed. In such a scenario, the company's historical counsel retains its role advising on all aspects of the company's business but is supplemented by the appropriate US and Canadian counsel to structure the Canadian listing. Canadian counsel will ensure that the listing with the TSX or TSX-V and the filings with the relevant securities commissions are compliant and timely, and continue assisting with compliance and disclosure issues in Canada post-closing. Some US advisors may see the choice by their client to list on the TSX or TSX-V as a diminution in their role. In fact, experience has shown that listed companies tend to become more active on many fronts in the US as a result of fresh capital and often cross-list on a US exchange in future.

Success Breeds Success

Word spreads where there is an ability to monetize and get funding. So it is no surprise that the TSX is gaining profile with

US mid-market players hard hit by the recession. Any lingering disappointment about not being "big enough" yet to list on the Big Board is forgotten quickly when US companies take note of the volume and size of deals listed on the TSX in the natural resource sector. BHP Billiton's current $38.6 billion hostile bid for Potash Corp., the $8.3 billion acquisition of Addax by China's Sinopec Group in 2009, and others are big deals by any standard. They prove the potential offered by the TSX.

As new industry sectors rise to fore – clean tech being a current favorite of investors – money is pouring into the TSX to fuel the latest wave of innovation. Canada already is home to many clean tech companies including run-of-river hydro operations. There is huge competition now between countries to find new solutions and the TSX is actively appealing to clean tech companies to list in Canada regardless of where they operate their business.

The TSX does not have a "one size fits all" approach for companies wanting to go public. US mid-market players should consult with business advisors, as well as both US and Canadian legal counsel, to assess the potential to monetize their business and inject fresh capital. For the right companies, the TSX is proving to be the right option. ■

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