

Settlement Mechanics in a Financing Transaction: The Basics

In a closing for a financing transaction, settlement refers to the delivery of securities to the purchaser or underwriters/agents in exchange for payment to the issuer. The mechanics for settlement can often be complicated. This bulletin serves as a “cheat sheet” on technical considerations for lawyers working on a financing closing.

Options for Settlement

Securities can be issued (1) by way of physical certificates, (2) by way of direct registration system (“**DRS**”) statements, or (3) through CDS Clearing and Depository Services Inc. (“**CDS**”).

- Securities issued through the facilities of CDS or by way of DRS statements are referred to as “book entry” or “paperless” securities, meaning ownership of such securities is recorded electronically.
- In some financings, securities are “book entry only” (“**BEO**”). A BEO issue is registered exclusively in CDS’ nominee name (CDS & Co.) and is deposited with CDS for the life of the issue. Physical certificates are not available to beneficial holders for BEO issues.
- The underwriters or agents typically determine the preferred methods for settlement which may include one, two or all three options.

What are the differences between the settlement methods?

- **CDS** typically involves holding securities through a broker who acts as an intermediary. Securities are held electronically in the central depository, often under the broker’s name or in a nominee account. For CDS settlements, the delivery of securities is done entirely electronically.
- **DRS** is a method of recording securities in book-entry form. Instead of being represented by physical certificates, securities are held in the securityholder’s name and recorded electronically on the issuer’s books and records, which are maintained by the issuer’s transfer agent. For DRS settlements, the delivery of DRS statements is facilitated through the issuer’s transfer agent. On closing, issuer’s counsel will instruct the issuer’s transfer agent to issue, register and deliver the DRS statements.
- For **physical certificate** settlements, physical certificates are typically couriered or hand-delivered promptly following closing. Often, parties will close on scans of the certificates with a commitment to mail certificates to the underwriters promptly after closing. However, if a broker requests delivery-against-payment (DAP) settlement, the physical certificate must be received by the broker prior to funds being released to the issuer.

What is a CUSIP?

A CUSIP number is a unique identifier for each new security that is issued (i.e., common shares, units, warrants, options, bonds, etc.).

When working on a financing transaction where a new security is being issued, one of the initial tasks for issuer’s counsel is to obtain a CUSIP number.

- **It is important to remember that each new security requires a separate CUSIP number.** For example, if an issuer is proposing to issue units composed of common shares and warrants, a CUSIP number will be required for each of the units, the common shares (which may already exist) and the warrants.
- Existing CUSIP numbers can be used if the financing involves freely tradeable securities. For example, if the issuer has common shares listed on a stock exchange and is issuing freely tradeable common shares under a prospectus, the common shares being issued in the prospectus offering will use the existing freely trading common share CUSIP number. By contrast, if common shares are being issued in a private placement and are subject to a hold period, a new CUSIP number would be required.
- **CUSIP Eligibility:** Eligibility requests must be submitted **two full business days** before closing (e.g. if closing on Wednesday, the eligibility request must be submitted prior to noon ET on Monday to avoid late fees).
- **Restricted versus Unrestricted CUSIPs:** If a security is a restricted security (i.e., the security is subject to restrictions on resale), the CUSIP number must be stamped with a legend. *However*, in the context of a private placement of securities where securities are being issued by way of DRS statement or a physical certificate, an issuer’s existing freely tradeable CUSIP number (i.e., for its common shares) may be used as long as the hold period is specified in the treasury direction.

Legends

Resale restrictions are commonly legended to Canadian securities. Resale restrictions on securities refer to limitations on a holders' ability to sell or transfer securities after they have been issued, including restrictions imposed under (i) applicable securities laws such as statutory hold periods and notice requirements, (ii) the four-month hold period imposed by the TSX Venture Exchange, and (iii) any restrictions under applicable escrow or pooling agreements. We also often see a specific US legend for securities being sold in the United States.

Key Considerations for a Financing involving Units

If the financing involves units composed of common shares and warrants, and the broker wishes to **settle in units** such that the units will be deposited with CDS on closing:

- The broker is responsible for requesting the Deposit ID for the units and the issuer's transfer agent is responsible for requesting the Deposit ID for the common shares and warrants.
- On closing, issuer's counsel will instruct the issuer's transfer agent to initiate the CDS deposit of the common shares and warrants. Upon confirmation of the component deposits by the issuer's transfer agent, CDS will confirm the deposit of the units in the broker's account. CDS will then be responsible for separating the units following closing in accordance with unit separation instructions provided by the broker.
- Note that if brokers exercise an over-allotment option *following closing*, the over-allotment option cannot settle in units and must be settled in components. In this case, the broker is responsible for requesting the Deposit ID for the common shares and warrants. CDS will not be included in the closing email chain.

By contrast, if the broker wishes to **settle in its component** parts such that the units will be separated prior to closing and common shares and warrants will be deposited with CDS, the broker is responsible for requesting the Deposit ID for the common shares and warrants. On closing, issuer's counsel will instruct the issuer's transfer agent to initiate the CDS deposit of the common shares and warrants.

US Buyers

- A Qualified Institutional Buyer or QIB is a class of sophisticated US investor that does not require the regulatory protection that the US Securities Act's registration provisions otherwise affords to investors.
- Similarly, a US accredited investor is a class of US investor who meets certain criteria regarding income, net worth and qualifications.
- When it comes to settlement of Canadian securities, QIBs can settle through CDS but US accredited investors that are not QIBs can only settle via DRS or physical certificates.
- The US-equivalent of CDS is The Depository Trust & Clearing Corporation or DTC.

What's in a Treasury Direction?

For CDS settlements, a treasury direction will include the following:

- A "Deposit ID".
 - The request for a Deposit ID number can be future-dated by **no more than one business day**.
 - A restricted CUSIP number must be made "eligible" by issuer's counsel before the broker can obtain a Deposit ID for the restricted CUSIP. *See section above on "CUSIP Eligibility"*.
- The following broker information:
 - Broker name (institution)
 - Broker CUID – this is the "customer unit identifier", the four letter identifying code for members of the financial community
 - Broker contact (individual), email and phone number

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