

# SECURITIES

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## and CORPORATE REGULATION

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## Corporate Residence At Common Law, Part III

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Depending on how the slight deviation from the model case (*i.e.*, the full board not travelling to and acting in Trinidad as a body) is viewed, these facts represent either peripatetic or divided control. If the deviation is insignificant in that it can be said that the directors acting in Trinidad in fact constituted or represented (or exercised the authority of) the full board, control was peripatetic. If, instead, the acts of the full board are to be distinguished from those of the directors acting in Trinidad, control was divided with part being exercised in England and part being exercised by a *de facto*, albeit ostensibly subordinate, source authority in Trinidad. The case is interesting in this respect for it illustrates how difficult it may be to describe the operation of central management and control in circumstances where, as Lord Radcliffe described it, the facts "have not always so arranged themselves as to make it possible to identify any one country as the seat of central management and control".<sup>135</sup>

Divided control, in contradistinction to pure peripatetic control, contemplates multiple source authorities. An obvious example of divided control would be where a corporation carries on two distinct and independent busi-

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# Rule 144A: Enhancing The U.S. Market For Institutional Resales Of Restricted Securities

by  
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The U.S. Securities and Exchange Commission (the "SEC") has adopted new Rule 144A under the U.S. *Securities Act* of 1933 (the "*Securities Act*") which is intended to facilitate a more active and efficient U.S. institutional resale market for unregistered securities. The Rule, adopted by the SEC in a release dated April 19, 1990 (SEC Release No. 33-6862; 34-27928; IC-17452), establishes a "safe harbour" from U.S. registration requirements for resales to qualified institutional buyers of restricted securities which are not of the same class as securities listed on a U.S. exchange or quoted on NASDAQ.

The new provisions are expected to increase the attractiveness of the U.S. institutional resale market to Canadian and other foreign issuers who have previously avoided the market due to the prior lack of certainty as to when resale exemptions were available or due to the costs of complying with stringent U.S. registration and disclosure rules.

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## RULE 144A

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Generally speaking, a security may not be offered to the public in the U.S. unless a "registration statement" as to the security is in effect. The registration statement includes the form of

prospectus pursuant to which the distribution is made, so that the requirement equates in general terms to the requirement under Canadian securities laws that securities be qualified by a prospectus in order to be offered in a primary distribution or from a control block.

The main effect of the Rule is to provide a non-exclusive safe harbour exemption from *this* registration requirement for resales by persons, other than the issuer, of eligible securities to qualified institutional buyers and registered broker-dealers meeting specified ownership of securities tests as well as to financial institutions meeting an ownership of securities and a net worth test.

The Rule is not available for resales of privately-placed securities that, at the time of their issuance, were of the same class as securities listed on a national securities exchange such as the NYSE or quoted on an automated inter-dealer quotation system in the U.S. such as NASDAQ.

The Rule does not impose further conditions on subsequent resales but, in the case of issuers not currently subject to U.S. reporting obligations, is conditioned on the issuer making available certain basic financial information to holders of securities acquired under the Rule and prospective purchasers from them.

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## QUALIFIED INSTITUTIONAL BUYERS

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Qualified institutional buyers are purchasers which, in the aggregate, own (or invest on a discretionary basis) at least \$100 million (U.S.) in securities of issuers not affiliated with the purchaser. Securities issued or guaranteed by the United States, bank deposit notes and certificates of deposit, loan participations, repurchase agreements, securities owned but subject to a repurchase agreement, and interest rate,

currency and commodity swaps may not be included in calculating whether the eligibility test is met. Securities are valued at cost, except where a buyer reports its securities holdings on the basis of their market value, and the relevant cost figures are not publicly available.

The eligibility threshold for registered broker-dealers is \$10 million (U.S.) of securities of issuers not affiliated with the broker-dealer, including securities held in either investment or trading accounts; *i.e.* securities held in market-making inventories may be counted toward satisfying the \$10 million (U.S.) eligibility threshold, but securities which are part of a broker's unsold allotment in a public offering are specifically excluded. Registered broker-dealers acting as "riskless principals" for identified qualified institutional buyers are also qualified purchasers.

The Rule permits the ultimate parent in a corporate structure to aggregate holdings of its wholly-owned and majority-owned subsidiaries if the investments of such affiliated companies are managed under the direction of the ultimate parent. Aggregation is also permitted for investment companies such as mutual funds managed by the same or affiliated investment advisors.

In addition to meeting the U.S. \$100 million of securities requirement, banks and savings and loan associations, whether foreign or domestic, must have a net worth of at least U.S. \$25 million as demonstrated in their latest published annual financial statements. The theory behind this requirement is that financial institutions with deposits insured by the Federal Deposit Insurance Corporation are not subject to the same market discipline as other institutions and that a combined test based on securities ownership and net worth is a better measure of their investment sophistication. Foreign

banks and their U.S. branches are treated similarly to avoid putting U.S. financial institutions at a competitive disadvantage. Registered broker-dealer affiliates of financial institutions are not subject to the additional net worth test.

Sellers must reasonably believe that a purchaser is a qualified institutional buyer and may rely either on information in the purchaser's most recent publicly available annual financial statement as to the amount of securities owned or invested by it on a discretionary basis or on similar information in a recognized securities manual such as those published by Moody's or Standard & Poors. Alternatively, sellers may rely on a certificate of the purchaser's chief financial officer specifying the purchaser's holdings.

#### ELIGIBLE SECURITIES

Rule 144A is not available in respect of resales of securities that, when issued, were of the same class as securities listed on a national securities exchange or quoted on NASDAQ. Shares of the same class as securities underlying listed American Depositary Shares are also ineligible. The intent is to prevent the development of side-by-side public and private markets.

For purposes of applying the Rule, common shares are deemed to be of the same class as listed securities if they are substantially similar in character and the holders enjoy substantially similar rights and privileges. Preferred shares are deemed to be of the same class as listed securities if their material terms relating to dividend rate, cumulation, participation, liquidation, preference, voting rights, convertibility, call, and redemption are substantially identical. Debt securities are deemed to be of the same class as listed securities if their material terms relating to interest rate, maturity, subordination, security, convertibility, call,

redemption and similar matters are substantially equal.

The Rule incorporates safeguards to protect against convertible securities and warrants being used to evade the Rule's prohibitions. For example, the Rule is unavailable for sales of securities convertible to ineligible securities unless, at issuance, the convertible security is subject to an effective conversion premium of at least 10%. Warrants convertible into a listed security are eligible only if the warrant has a life of at least three years and an effective exercise premium of at least 10%. Pursuant to a general anti-avoidance rule, transactions technically in compliance with the Rule but intended to evade the registration requirements of the Securities Act will be excluded from eligibility for the Rule.

#### INFORMATION REQUIREMENTS

In cases where the issuer (other than a foreign government) does not file periodic reports under the U.S. *Securities Exchange Act* of 1934 (the "*Exchange Act*") or furnish home country information to the SEC pursuant to Rule 12g3-2(b) under the *Exchange Act*, the availability of the Rule is conditional upon the holder of securities, or a prospective purchaser designated by it, having the right to obtain from the issuer, on request, certain basic financial information, and upon such prospective purchaser receiving the information prior to the time of sale. The information requirement is limited to a brief statement of the issuer's business, products and services and its most recent balance sheet and profit and loss and retained earnings statements, audited if audited statements are reasonably available, together with comparable statements for the two preceding fiscal years.

It is anticipated that many Canadian and other foreign private issuers cur-

rently not reporting in the United States and who wish to make their securities Rule 144A eligible will obtain Rule 12g3-2(b) exemptions on a voluntary basis. Rule 12g3-2(b) provides an exemption from *Exchange Act* reporting requirements for foreign private issuers who file with the SEC on a current basis material which the issuer: (i) has made or is required to make public in its home jurisdiction; (ii) has filed or is required to file with the exchange on which its securities are listed; and (iii) has distributed or is required to distribute to its security holders.

Canadian institutional investors who purchase securities through private placements should consider requiring that the issuer have an obligation either to provide the information required by Rule 144A to any holder of the securities and to prospective purchasers, or to file the applicable disclosure documents under Rule 12g3-2(b). This obligation should either be attached to the securities in some manner or otherwise be transferable to subsequent purchasers.

#### RESTRICTIONS ON SUBSEQUENT RESALES

The Rule does not impose resale restrictions but a seller must take reasonable steps to ensure that any buyer is aware that the seller is relying on Rule 144A.

Concurrently with the implementation of Rule 144A, Rule 144 (which generally governs the resale of restricted securities acquired in a private placement) has been amended to allow the two-year hold period required prior to the public resale of restricted securities to run continuously from the initial acquisition of restricted securities from an issuer. As a result, eligible institutional buyers purchasing securities pursuant to Rule 144A and subsequently reselling these securities pub-

licly under the safe harbour for public resales of restricted securities provided by Rule 144 will be entitled to tack to their own holding period the holding period of prior holders unaffiliated with the issuer.

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## ASSESSMENT

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Rule 144A should facilitate a more efficient and liquid U.S. inter-institutional resale market for privately placed securities by creating an exempt market in which large qualified institutions may trade eligible restricted securities among themselves without being subject to SEC registration and disclosure requirements.

Notwithstanding the new Rule, however, access to the U.S. institutional resale market will continue to be restricted by specific prudent investor rules limiting the ability of institutions such as mutual funds and insurance companies to invest in privately placed or foreign securities. Also, state securities laws will continue to be applicable.

Further, the information requirements of the Rule will limit its availability with respect to currently outstanding securities of issuers that do not file disclosure documents with the SEC, because these issuers will have no obligation to provide the required information.

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## CONCURRENT DEVELOPMENTS

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Concurrently with the adoption of Rule 144A, the SEC has approved a new NASD automated trading system for the trading of Rule 144A restricted securities in the institutional resale market. The new system will be known as PORTAL, an acronym for Private Offerings, Resales and Trading Through Automated Linkages.

The SEC has also recently released new Regulation S (SEC Release No.

33-6863; 34-27942; IC-17458) which clarifies the scope of extraterritorial application of the *Securities Act* registration requirements to offers and sales of securities made outside the United States. The SEC has not yet, however, re-released or finalized its proposal being made by it, in conjunction with the Ontario and Quebec Securities Commissions, for a multi-jurisdictional disclosure system to facilitate cross-border public offerings by eligible Canadian and U.S. issuers.

In the next issue we will summarize Regulation S and discuss the combined effect of Regulation S and Rule 144A on access by Canadian issuers to the U.S. institutional markets.

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## Corporations Controlled By Shareholders: Principals, Agents Or Servants?†

by Robert Flannigan\*

One of the most intractable questions of corporate law, "the question which has been fought backwards and forwards in various shapes"<sup>1</sup> to the present day, is: What are the circumstances in which it may be found that a shareholder, rather than the corporation in which the shares are held, carries on the business ostensibly carried on by that corporation? Specifically, apart altogether from a traditional express or implied agency relationship,<sup>2</sup> when can it be found that the corporation carries on business for or on behalf of the shareholder notwithstanding that the corporation owns or appears to own that business? To this date there has been no satisfactory general answer to this question.<sup>3</sup> Here it is argued that the circumstances in

which a shareholder may be found to be carrying on the business are in fact quite limited (although probably not uncommon) but that, if those circumstances do exist there is every reason for, and no legal impediment to, treating that shareholder as a principal in relation to the business.

The approach taken in examining this question begins with a consideration of the concept of "piercing the corporate veil". That concept, or more accurately, that terminology, is seen as having been extended beyond its descriptive utility and that, whatever its proper usage, it is not descriptive of the solution to the problem dealt with here. The distinction between the structural and asset control of a corporation is then described. This distinction and the further distinction between authorized and unauthorized asset control allow for the precise identification of the circumstances where, apart from percing the veil, a shareholder may be treated as a principal. Those circumstances are where there is unauthorized asset control manifested in a lack of corporate independence. The jurisprudence is reviewed and it is found that the courts do accept that a shareholder can be treated as a principal in such circumstances. Given that, the argument is then developed that the proper characterization of the relationship between the shareholder and the corporation he controls is one of employment rather than agency. The legal consequences of this characterization, including its impact on non-controlling shareholders, are examined. Policy considerations are shown to support this treatment and to require it whenever there is a non-nominal degree of *de facto* unauthorized asset control. Finally, the emerging concept of enterprise entity is reviewed. It is pointed out that the corporate employment approach discussed herein is itself a technique for legally combining what is in fact a single enterprise. Through-