Capital Pool Companies

A Primer on the TSX Venture Program

Entrepreneurs dazed by the mind-numbing securities regulations that confront early-stage companies in the U.S. might be stunned to discover how different things can be just north of the border in Canada. The Canadian Capital Pool Company (CPC) program gets a new venture off the ground with access to public capital markets and a stock exchange listing, starting with as little as C$100,000 ($88,000) of seed capital.

Canada's junior stock market, the TSX Venture Exchange, supervises the formation of CPCs and guides them each step of the way. The exchange takes the position that the knowledge and experience of the founders is at least as important as the money they invest. There is no rigid formula but the three to six founders are expected to have "an appropriate combination of business and public company experience."

"Becoming a founder of a CPC is a unique way for experienced investors to participate in what we call 'Formalized Angel Investing' to help grow Canadian emerging companies," said Linda Hohol, president of the TSX Venture Exchange. "They also invest their own personal capital in the CPC. That means the interests of the financing group are directly aligned with the interests of the company. It serves both groups well and we believe it leads to the success of more companies."

As a practical matter, CPCs can launch a new venture or bring growth capital into an early-stage company at considerably less expense than would normally be the case using a specified purpose acquisition company or by taking a cash shell company public on London's Alternative Investment Market. There are some serious new legal problems with U.S. SEC Rule 419 blank check companies that make them a risky option at any price.

These are the nuts and bolts of what must happen after CPC founders put their money in the kitty:

1. Create the entity. The CPC—a shell company—is incorporated. The founders get initial shares for their seed money. The share price is no less than half the share price at which the subsequent shares will be offered by prospectus to the investing public. However, regardless of the later offering price, the founders must pay at least five cents (four cents U.S.) per share. The CPC and its advisers prepare a prospectus explaining management's plan to raise between C$200,000 ($176,407.57) and C$1.9 million ($1.68 million) by selling shares. The prospectus will also discuss how it intends to identify and evaluate potential acquisitions.

2. Get acquisition money. The CPC files the prospectus with the appropriate Canadian securities commission or commissions (there are several). Simultaneously it applies for a listing on the TSX Venture Exchange. The broker sells the shares to at least 200 arms-length shareholders, each of whom buys at least 1,000 shares. No single investor is allowed to buy more than 2% of the offering. There are some other restrictions intended to prevent concentrations of ownership this early in the company's life. The ".P" designator is added to the CPC's ticker symbol to clearly identify it as a CPC.

3. Get to work. Within 24 months, the CPC identifies an appropriate business as its "qualifying transaction." The exchange's rules require that the CPC distribute a news release announcing the deal. The CPC prepares a disclosure document which is reviewed by TSX Venture to ensure the resulting business will meet minimum listing requirements.

4. Close the deal. The disclosure document is posted for a minimum of seven days on Canada's public securities database SEDAR. (SEDAR is Canada's EDGAR.) Only after the disclosure period has passed can the deal close. Typically, shareholder approval is not required to complete the acquisition. The ".P" is dropped from the ticker symbol and the resulting company trades as a regular TSX Venture listed company.

As the junior equities exchange in Canada, TSX Venture sees the nurturing of entrepreneurship and innovation as a core responsibility. The process begins even before a budding entrepreneur starts looking for seed money. To get these potential start-up founders headed in the right direction the TSX Venture exchange conducts "entrepreneurial boot camps" to bring the recruits eyeball-to-eyeball with the realities of going public.

The CFC is one of several mechanisms TSX Venture uses to lure potential growth companies onto its exchange. After the company is signed up, the junior exchange works to help the company grow to the point at which it can graduate to the senior equity exchange, the Toronto Stock Exchange (TSX). (TSX owns the TSX Venture Exchange.)

So, how are they doing? In 2005, some 165 new companies listed on TSX Venture while 46 graduated to the TSX. During the first six months of this year, 32 TSX Venture companies have graduated to the senior exchange. Of the more than 2,000 companies listed on TSX Venture in the first week of July, 125 were CPCs. Of those, 80 were trading and 45 were on the sidelines because the exchange had halted or suspended trading.

Apparently, TSX Venture doesn't just have rules. It enforces them.

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"The beauty of it is that you can raise venture capital in a regulated environment," said Marc Lavine, CEO of the Chrysalis Capital Group, which packages CPCs, as well as investing in them for its own account. "The investors are protected from 'pump and dump' and all the other common abuses. You get a clean company with a listing."

While the regulation of Canadian CPCs is reasonably inexpensive, he said, it provides considerably more protection for the investing public than the Over-the-Counter market in the U.S. "There is a lot of activity over the counter in the States," Lavine said. "People go to their brokers and they sell over the counter. And they go to their brokers and they buy over the counter. And they think somebody is watching. They are wrong. Nobody is watching."

Lavine brings an interesting perspective to the discussion of capital formation in Canada. He has been working with what are in essence capital pool companies for longer than the TSX Venture Exchange has existed.

How is that possible? The original version of the capital pool company was born on the old Alberta Stock Exchange. As Canadian capital markets consolidated, the exchange was, through a series of transactions, absorbed into what is now the TSX Venture Exchange.

Lavine has seen the CPC process from both sides—from the perspective of the company raising capital and from the viewpoint of the company providing capital. He took Points International (PTS.TO) and Cyberplex (CX.TO) public through CPCs. Both are now traded on the senior Canadian market, the TSX.

Through the Chrysalis Capital Group he has formed three more CPCs:

- **Chrysalis Capital I Corp.,** which went public in March 2004. It completed its "qualifying transaction" in April 2005. The company resulting from the transaction is PharmEng International (PII.VN), a consulting and manufacturing company serving the pharmaceutical industry.
- **Chrysalis Capital II Corp.,** which went public in March 2005. This past December it announced a "proposed qualifying transaction" with Tangarine Concepts Corp., a St. Catharines, Ont., company which markets electronic point of sale payment systems for retailers.
- **Chrysalis Capital III Corp.,** completed its offering on June 27, raising C$1.2 million ($1.06 million). That brings its total cash position to C$1.6 million ($1.4 million). Chrysalis III is looking for an acquisition.

Chrysalis Capital Group is unusual among Canadian venture capital companies in that it maintains offices in Toronto and Paris. The reason for the Paris office is that the company wants to start taking European companies public through Canadian CPCs. This is something that has never been done. In time, Lavine hopes to persuade one of the European exchanges, possibly the small and mid cap specialist Alternext, to establish a program of its own modeled after TSX Venture's CPCs.

"It used to be you could only use a CPC to buy a Canadian or U.S. company," Lavine said. "A little bit at our suggestion, that restriction has been taken off. Now you can use a CPC to buy a company anywhere. I have been building—well, I have built—a bridge between Canada and Europe."

He said Chrysalis Capital has beefed up its staff in Toronto. Lavine said that has freed him up to work almost exclusively on the complexities of moving into the European market. "I spend almost all of my time in Paris," he said. "There are a lot of regulatory hoops to get through. There are a lot of tax hoops. But there's no reason we can't get through all of them."

Any attempt to compare CPCs with SPACs, AIM cash shells and Rule 419 blank check companies to raise capital in the C$200,000 ($176,000) to C$1.9 million ($1.7 million) neighborhood rather quickly becomes laughable.

Based upon data provided by Goldman Advisors, an affiliate of Sunrise Securities Corp., the average deal size for SPACs in 2005 was $96 million. Through May 15, 2006, the figure was $94 million. Meanwhile, London's AIM has tightened up its rules governing cash shells. As a practical matter a cash shell must now raise at least £3 million ($5.5 million) at admission to get on AIM. After that, the cost of retaining the AIM listing runs in the vicinity of £100,000 ($184,937) to £150,000 ($277,349) a year.

That leaves the U.S. Securities and Exchange Commission's Rule 419—"Offerings by Blank Check Companies." It is not a terribly difficult rule to understand, even for the layman. The problem arises after a business is up and running, when the founders and promoters who have brought the company into this world and nurtured it through its infancy wish to enjoy the fruits of their labors by selling their unregistered shares.

When that day comes, the original shareholders turn to SEC Rule 144(k) to learn what they are required to do. And if they have the sense to consult a lawyer who understands shell companies and reverse mergers, that is the day they learn that an SEC rule doesn't always mean what it says. When Rule 144(k) is applied to the promoters of blank check companies, the SEC would have done just as well to adopt the words that the Italian poet Dante wrote were inscribed on the gates of Hell: "Abandon hope all ye who enter here."

Louis Bevilacqua, a partner in the law firm of Thelen Reid & Priest, explains the reasons for hopelessness among shareholders of Rule 419 blank checks in the article, "The Worm/Wulff Letters and Their Implications for Blank Check Mergers," (*The Reverse Merger Report*, Aug. 2, 2005; p.13.)

Bevilacqua refers in the article to an SEC staff letter taking the position that the promoters or affiliates of blank check companies are really "statutory underwriters" and their shares can only be sold through registration under the Securities Act of 1933. "Based on this view, Rule 144 will never be available to promoters and affiliates to create a public float in blank check company securities without an effective registration statement, notwithstanding the fact that technical compliance with Rule 144 is possible," Bevilacqua wrote.

In his article, Bevilacqua also identified circumstances under which an innocent investor from the general public who buys shares in a blank check company or a company with only minimal operations could have his investment rendered worthless by the registration requirement. Reached by telephone at his law office in Washington, DC, Bevilacqua said nothing has changed since he wrote about the subject. Rule 144 still says a registration exemption is available and the SEC staff still says it's not. *–RC*

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