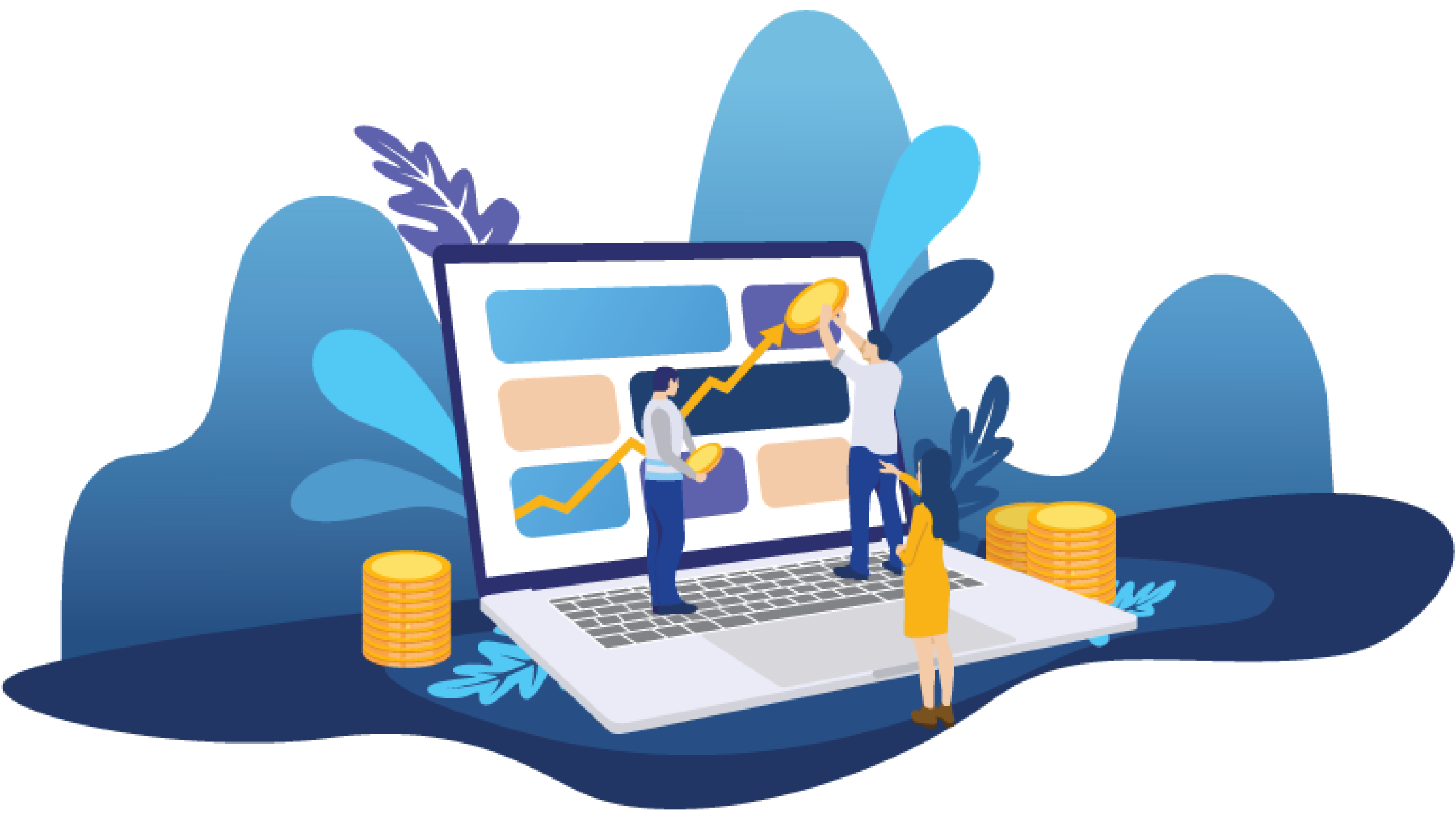
World Law Group

2021

Global Venture Capital Guide



INTRODUCTION

We are pleased to announce the release of the World Law Group 2021 Venture Capital Guide.

The turmoil of an ongoing pandemic notwithstanding, through 2020, WLG member firms continue to act on a number of investment and exit transactions for global venture capital investors and high-growth, innovative companies operating across a range of industry verticals.

The objective of this publication is to serve as a Q&A-style multi-jurisdictional guide to venture capital law in 33 countries where WLG member firms have offices. The guide intends to provide a high level overview of the venture capital market, including key sectors, preferred investment structures, regulatory approval requirements, limitations on acquisition of control in portfolio companies, restrictions on investment, investor protection, and exits; and hopes to provide readers the benefit of the shared global knowledge and local insights among the WLG member firms.

All information provided in this guide is up to date as of November 1, 2020 unless stated otherwise. This guide provides general information in relation to the venture capital market, and is not intended to be comprehensive. It does not replace professional and detailed legal advice, as facts and circumstances vary on a case-by-case basis and country-specific regulations may change.

We hope to update this guide annually, both to expand our current coverage of jurisdictions as well as to apprise the reader of changes to the venture capital regulatory framework in the relevant jurisdictions.

The WLG Venture Capital Group Co-Chairs wish to express their deep appreciation for the efforts of each of the contributing member firms of the WLG Venture Capital Group, as well as all others who contributed to the preparation of this guide.

WLG Venture Capital Group Co-Chairs

Srinath Dasari, AZB & Partners
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CANADA

Goodmans LLP and Davies Ward Phillips & Vineberg LLP

1) <u>In your jurisdiction, which sectors do venture capital funds typically invest in?</u>

Key sectors attracting venture capital investments in Canada include information and communications technology, software, cleantech, life sciences, healthcare, commercial services, pharmaceuticals and biotechnology, and consumer products.

In Q2 2020, CDN 1.7 billion in venture capital was invested across a variety of Canadian companies. This was 23% higher than Q2 2019 and more than double the amount invested in Q1 2020. This was the highest investment in a second quarter since 2013. The average deal size in this period was CDN 11.45 million, 56% higher than the average deal size during the five-year period between 2015-2019.

2) <u>Do venture capital funds require any approvals before investing in your jurisdiction?</u>

With respect to issuing securities and raising funds in Canada, venture capital funds must comply with applicable securities laws. Depending on the facts underlying the investment, a person or firm issuing securities and raising funds may be required to register under more than one category unless an exemption is available. However, in some circumstances, venture capital and private equity funds may fall outside the definition of "investment fund" if the fund takes active involvement in managing the business and affairs of the investee business.

Furthermore, certain investments may require prior governmental approval depending on the industry of the investee company and the control and/or majority economic interest of the venture capital or private equity fund.

3) <u>Are there any legal limitations to an offshore venture capital fund acquiring control or influencing the business, operations, or governance of an investee entity?</u>

The *Investment Canada Act* (R.S.C. 1985) applies to foreign investments in Canadian businesses. A key issue is whether the transaction is subject to notification, which is straightforward, or review, which is more onerous.

Where a transaction is notifiable, the only applicable requirement is for the foreign investor to submit a notification containing basic information with respect to the transaction within 30 days of closing. Where a transaction is reviewable, however, the foreign investor must prove that the investment is of net benefit to Canada. Special rules apply to foreign investments involving cultural businesses, investments that may raise national security concerns, and investments by state-owned enterprises.

Investments are reviewable under the *Investment Canada A*ct when they involve an acquisition of control in a Canadian business by a non-Canadian and they meet the prescribed financial thresholds. The applicable thresholds depend on the type of investor (i.e., trade agreement, WTO, or state-owned enterprise), the type of investment (i.e., direct vs. indirect) and whether the investee entity is engaged in a “cultural business”, generally relating to books, newspapers, audio or video recordings, or magazines. Generally, the financial threshold attracting *Investment Canada Act* review is far higher than that of typical venture capital investments, and so these legal limitations are generally not an issue for venture capital investors (subject to the special rules relating to foreign investments involving cultural business, investments that may raise national security concerns, and investments by state-owned enterprises).

4) Would an investor be required to undertake an antitrust analysis prior to investment? When would such a requirement be triggered?

The Competition Act (R.S.C. 1985, c. C-34) requires that parties to a proposed transaction exceeding certain thresholds must make pre-merger notification filings, unless a regulatory exemption applies. If such filings are required, the transaction is "notifiable." In practice, most pre-merger filings involve applications for an advance ruling certificate or no-action letter from the Competition Bureau, with or without formal notification filings.

As a general rule, a transaction is notifiable if (a) an operating business is the subject of the transaction; (b) the parties to the transaction, together with their affiliates, have either assets or annual gross revenues in Canada that exceed CDN 400 million in aggregate value; (c) the transaction exceeds a "size of transaction" threshold (CDN 96 million for share purchases, asset purchases and amalgamations); and (d) in certain circumstances, a minimum ownership threshold is exceeded. Generally, venture capital transactions (even so-called "mega-deals") are too small to exceed any of the relevant thresholds and are therefore not notifiable.

5) What are the preferred structures for investment in venture capital deals? What are the primary drivers for each of these structures?

Most VC funds established in Canada are structured as limited partnerships, with investors becoming limited partners and a newly created corporation being the general partner. This structure is primarily driven by the following factors:

- Gains and losses flow through to the partners; and
- The liability of the limited partners is generally limited to their initial investment, provided that the limited partners are not involved in the business of the partnership (though participation on advisory committees is permitted).

6) Is there any restriction on rights available to venture capital investors in public companies?

No. The rights available to venture capital investors are the same as those available to any shareholder of a company.

7) What protections are generally available to venture capital investors in your jurisdiction?

When making an equity investment in Canada, typical contractual protections requested by the venture capital fund may include:

- Representations and warranties of the investee company regarding its capital structure, financial condition, operations, intellectual property, assets, rights and obligations (note that depending on the round of the capital raise, the scope of the representations and warranties will vary greatly);
- Indemnities in respect of the foregoing representations and warranties, given by either the investee company or by the founders personally;
- A preference with respect to dividends or the proceeds of any liquidation;
- Redemption rights;
- Anti-dilution rights;
- Conversion rights;
- Rights to information;
- Rights of first refusal;
- Tag-along rights;
- Drag-along rights;

- Board nomination rights and quorums requiring the presence of a board member nominated by the VC;
- Veto rights with respect to certain fundamental matters; and
- Registration rights with respect to a qualified initial public offering.

8) Is warranty and indemnity insurance common in your jurisdiction? Are there any legal or practical challenges associated with obtaining such insurance?

Warranty and indemnity insurance is becoming increasingly common in Canadian M&A and capital markets transactions. Purchasing an insurance policy can give a buyer increased comfort where they would otherwise be relying on contractual indemnities given by the company or by the founders personally, especially in a high-value transaction.

The following are the legal and practical challenges associated with obtaining such insurance:

- Some warranty and indemnity insurance policies exclude certain known risks from coverage, which detracts from the benefits provided by the insurance;
- Some strategic buyers and foreign buyers (who are less familiar with warranty and indemnity insurance) may be unwilling to rely on such policies;
- A buyer may seek special line-item indemnity for items that the insurer excludes from the warranty and indemnity policy, which mitigates the benefits of having such a policy in place; and
- Most insurance providers will not begin the underwriting process until the buyer has signed a binding letter of intent and has obtained exclusivity concerning the transaction.
- The cost associated with this type of insurance often makes it too expensive on venture capital transactions.

9) What are common exit mechanisms adopted in venture capital transactions, and what, if any, are the risks or challenges associated with such exits?

The common exit mechanisms in Canadian venture capital transactions include:

- A third-party sale of the investee company;
- An initial public offering (“IPO”); and
- A recapitalization of the investee company through private equity or institutional funding.

The most common exit option is a third-party sale of the company. Such an arrangement provides a complete exit for venture capital investors and generally is less expensive and time-consuming than an IPO. Some of the risks or challenges associated with such an approach include:

- Post-closing indemnification obligations of the seller may hinder the company’s ability to return funds to investors (though this issue is often addressed through the purchase of representation and warranty insurance); and
- The transaction may be subject to regulatory review if it is “notifiable” from the perspective of the Competition Bureau, or if the company is being sold to a foreign investor.

Recently there have been a number of high-profile exits via IPO in the Canadian market. While an IPO can offer a substantially higher return on investment for the VC, such transactions come along with the following disadvantages:

- An IPO is a much more expensive undertaking than a third-party sale;

- An IPO is not an immediate 100% exit for a significant investor who will have to commit not to sell significant portions of its shareholdings for a prolonged period of time;
- Regulators, underwriters and prospective investors will have requirements with respect to how much of the IPO can be made up of existing stock to pay out departing shareholders versus new stock to raise money for the company itself; and
- Going public attracts ongoing securities law and regulatory requirements for the investee company and its significant investors. Complying with such requirements can be an expensive and time-consuming process.

10) <u>Do investors typically opt for a public market exit via an IPO? Are there any specific public market challenges that need to be addressed?</u>

There are a variety of public market challenges that need to be addressed in the event of an IPO in Canada, primarily that going public subjects the company to significant regulatory requirements and attendant costs. Further, it can take a significant amount of time to bring an IPO to market. In light of those challenges, a number of Canadian VCs have opted for faster exits through third-party sales.

Notwithstanding the foregoing, there have been some prominent recent VC-backed IPOs in Canada. In Q3 2019, Lightspeed POS Inc. completed its IPO, listing on the TSX with a market capitalization of CDN 1.1 billion. Additionally, Milestone Pharmaceuticals Inc. recently closed its IPO on the Nasdaq with a market capitalization of CDN 468 million. In 2018, Ceridian HCM Holding Inc. began trading on the TSX after its IPO, with a market capitalization of almost CDN 3 billion.

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CANADA