

## PRIVATE EQUITY AND VENTURE CAPITAL UPDATE

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### OSC Decision in Momentas Case Raises Registration Concerns for Private Equity and Venture Capital Funds

By Samantha Horn

The recent August, 2005 decision of the Ontario Securities Commission in the Momentas case raises concerns as to whether a private equity or venture capital fund and/or its employees involved in their own “private placement” fundraising activities where the services of registered dealers are not used may be considered “market intermediaries,” requiring registration under and compliance with the *Securities Act* (Ontario) (the *Act*).

A “market intermediary” is generally defined under the *Act* as a person or company that engages or holds itself out as engaging in Ontario in the business of trading in securities as principal or agent, other than for its own account for investment only and not with a view to resale or distribution. There has been very little interpretation of the term “market intermediary.” Section 3.2 of the Companion Policy to National Instrument 45-106 states in part that “the Ontario Securities Commission takes the position that if an issuer retains an employee whose primary job function is to actively solicit members of the public for the purposes of selling the issuer’s securities, the issuer and its employees are in the business of selling securities. Further, if an issuer and its employees are deemed to be in the business of selling securities, the Ontario Securities Commission considers both the issuer and its employees to be market intermediaries.”

Momentas was a private corporation that offered its securities by offering memorandum. It described its principal business activities as being the use of an automated equities trading system for equities trading and the trading of foreign currencies through foreign exchange traders. Momentas was issuing and selling its own convertible debentures to residents of Ontario and elsewhere to fund those business activities. Momentas employed approximately twenty-seven individuals (nineteen of them for the primary purpose of selling its convertible debentures), who are described in the decision as either “lead generators” or “sales representatives.” In selling the convertible debentures in Ontario, Momentas relied upon the “accredited investor” exemption, and it was noted that virtually all of Momentas’ capital came from the proceeds of the sale of its convertible debentures.

The OSC found that Momentas was a market intermediary, and in making such finding, the OSC commented that “[Momentas] has hired and remunerated a significant number of

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employees (approximately 70% of its workforce) for the sole purpose of raising capital. It is carrying on, internally, the business of raising funds, rather than relying on the efforts of others in the business of raising funds. This alone is sufficient to constitute Momentas a market intermediary.”

The OSC identified a number of factors that led it to the conclusion that Momentas was in essence, if not in form, soliciting investors through the sale of its convertible debentures for funds to be invested “for their benefit” through its trading program:

- the convertible debentures were the only significant source of funds for Momentas and the returns promised were extremely rich and obviously depended on the execution of its professional trading activities. The OSC considered this to be similar to the function of a manager of a pooled investment fund for fully managed accounts;
- the fact that returns on the convertible debentures were not explicitly tied to the performance of Momentas in its professional trading activities was not a significant factor; and
- the fixed rate of returns was in effect seen as analogous to a guaranteed performance promise with respect to the professional trading program and trading activities.

The OSC imposed a temporary cease trading order effective until the date Momentas became registered as a limited market dealer.

It is not clear how the OSC decision in Momentas will apply to private equity or venture capital funds involved in their own fundraising activities. It would seem prudent, however, for private equity or venture capital funds to adopt the following safeguards in fundraising activities to assist in making the argument that such funds and their employees were not market intermediaries, while recognizing that such an argument may not be persuasive to the OSC:

- none of the employees of a fund, its general partner or manager should be primarily employed in actively soliciting the purchase of units of the fund; rather, their primary functions should be related to the investment of the funds raised;
- it would be prudent not to refer to employees as “sales” personnel or any similar term, or to remunerate them on the basis of the capital raised for the fund;
- fundraising should be limited to sophisticated investors, such as institutional investors, and accredited investors familiar with the principals of the fund; and
- advertising should not be used and none of the fund, the general partner or the manager, or any of their employees, should hold themselves out as engaging in the business of trading in securities.

For funds governed by the *Securities Act* (Ontario), consideration should also be given to the necessity for advisor registration, which is not discussed here.

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