SASKATCHEWAN POLICY STATEMENT 43-601

UNCONSCIONABLE CONSIDERATION - PROMOTERS

PART 1 INTRODUCTION

Clause 70(2)(b) of *The Securities Act, 1988* states that:

> "The Director shall not issue a receipt for a prospectus where, in his opinion:
>
> (b) an unconscionable consideration has been paid or given or is intended to be paid or given for promotional purposes or for the acquisition of property;"

A very strict interpretation would limit the prohibition in clause 70(2)(b) to unconscionable promotional fees and unconscionable fees for the acquisition of property. However the staff of the Saskatchewan Securities Commission have generally taken a wider interpretation of this section of the Act and include unconscionable returns to the promoter vis a vis the investors in their review of offering documents. In any case, the absolute discretion granted by Subsection 70(1) would bring these matters under the purview of the Director.

The dictionary defines unconscionable as "not guided or controlled by conscience, shockingly unfair or unjust". Thus, while it seems fair that promoters should not make shockingly unfair or unjust returns at the expense of investors, the difficulty arises in attempting to define what is shockingly unfair or unjust. The general practice in Canada appears to be to rely on "judgment" to determine unconscionability. In addition, there is little by way of policy statements of Securities Commissions to offer guidance either to promoters or to staffs of the Commissions as to how this judgment is to be applied.

The purpose of this policy statement is to offer very general guidance as to how Paragraph 70(2)(b) will be interpreted. It recognizes, however, that in any particular case, discretion will rest with the Director.

PART 2 RATIONALE BEHIND THE POLICY

2.1 Objectives of a Policy on Unconscionable Consideration

In general, there are four objectives for attempting to ensure that returns to promoters are not unconscionable:

(1) To ensure that sufficient funds remain in the company to accomplish its purposes. Clearly, it would not be in the best interests of the investors if the return to the promoters were so great as to jeopardize the future viability of the company;

(2) To act as an inducement for the original promoters to manage the company at least until it becomes successful. This objective presumes that the original promoters have some

unique expertise which will increase the likelihood of success of the company. Achieving this objective is dependent upon the timing of the consideration to the promoters. If the inducements are structured to allow an excessive early return to the promoters, the effect will be to encourage them to withdraw from the company. On the other hand, if the inducements to the original promoters are too severely structured (the converse of unconscionable), the effect will also be to encourage the original promoters to withdraw;

(3) To act as an inducement for promoters to promote only companies which have a chance of success. This objective assumes the promoter's reward will be linked to the success of the company and not solely to the sale of securities in the company;

(4) To encourage public confidence. If there are a large number of instances where promoters are perceived to obtain unconscionable returns, the public's worst fears about the unfairness of the securities marketplace will be realized and public confidence will decline. A decline in public confidence is in no one's best interests since it inevitably results in difficulty in raising capital and a decline in economic growth.

Interestingly, the first objective is shared with Paragraph 70(2)(c) of the Act which states that the Director may not issue a receipt where:

> "the proceeds from the sale of the securities to which the prospectus relates that are to be paid into the treasury of the issuer, together with other resources of the issuer, are insufficient to accomplish the purpose of the issue stated in the prospectus."

To meet this requirement of the Act, Commission staff determine whether or not cost estimates are unreasonable and working capital is sufficient to accomplish the purpose of the issue.

Escrow or pooling arrangements are the most common method used to achieve the second objective (Paragraph 70(2)(f)). However, it is of particular importance to investors to ensure that the promoters remain with the company if it begins to run into difficulty. Escrow arrangements which provide a benefit to the promoters, years into the future, are not likely a strong enough inducement, by themselves, to encourage the original promoters to remain with the company under such circumstances.

The third objective is the one most acutely addressed by Paragraph 70(2)(b).

The fourth objective, can in part, be achieved by ensuring that the first three objectives are met.

Although our society generally recognizes that it is fair that there are greater rewards for entrepreneurship than for ordinary investments, this societal value is derived from the notion that

entrepreneurs take greater risks and hence should receive greater rewards if their efforts are successful. This points out the difficulty with simply using escrow arrangements. In such circumstances, the risk to entrepreneurs is simply lost income in the future. In addition, unconscionability very much depends upon the return investors receive. Where investors make an average or above average return, large returns to the promoters are less likely to be considered unconscionable than if investors earn low returns or lose money.

2.2 Forms of Consideration for Promoters

A promoter's return from a project can take several forms including revenue from sale of shares, property acquisition fees, management fees, consultancy fees and an ownership percentage of the completed project. The determination of unconscionability in any particular case generally turns on the combined level of the various returns to the promoter in relation to the returns to investors.

PART 3 GENERAL PRINCIPLES

Staff will review offerings for unconscionability. In doing so, they will consider the following general principles:

(1) In general, promoters must contribute something of value to the company.

(2) Promoters should not receive an overall return from a company or from a sale of shares in the company that is greater than a prudent person would consider reasonable.

(3) Promoters who buy or sell property or services from or to a company should charge fair market value.

(4) Promoters should disclose all conflicts of interest and potential conflicts of interest.

(5) A promoter should not do business in competition with a company he or she promoted.

(6) Pricing with suppliers and others which are related, associated or affiliated with the company or the promoter should be at fair market value. The parties or the proposed parties should be identified in the offering document if the amount paid or payable within a year is material.

(7) Investors purchasing voting or equity securities of an issuer should not be forced at a future time to redeem their securities without their consent.

PART 4 APPLICATION AND EFFECTIVE DATE

This policy applies to all persons and companies who apply to the Commission for a receipt or an order

permitting the sale of securities. It does not apply to offerings exempt under *The Securities Act*. It is effective for offerings initially filed after March 1, 1988.

Adopted by the Commission on February 22, 1988
Amended on November 7, 1988

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