TSX VENTURE EXCHANGE

CAPITAL POOL COMPANIES

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CAPITAL POOL PROGRAM

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CAPITAL POOL PROGRAM

Background

The capital pool company program was introduced into Ontario on June 15, 2002. It is administered by the TSX Venture Exchange Inc. and is subject to the *Securities Act* (Ontario) and its rules and regulations.

The CPC Program enables businesses a unique means of sourcing capital and management. It is available to emerging businesses that want to become public at a time when a traditional IPO would not be suitable. The objective of the CPC Program is to facilitate a company becoming public and using the Venture Exchange as a springboard to a more senior listing.

The CPC Program consists of two stages. The first stage is the formation of a capital pool company and the completion of its IPO. The second stage involves the CPC completing an acquisition of a business that meets the minimum listing requirements of the Venture Exchange.

As part of the first stage the CPC will raise a minimum of $300,000 and a maximum of $2,000,000 of capital. The minimum listing requirements for a Tier 2 issuer require adequate working capital for 12 months, $50,000 of pre-tax earnings in the last year (or two of the last three years) and $500,000 tangible net assets. Failure to complete a Qualifying Transaction within 24 months of the date of listing on the Venture Exchange could result in the delisting of the CPC.

Public Company Considerations

As a result of the Qualifying Transaction, the target company becomes or is acquired by a public company. There are numerous benefits to public company status. It offers capital, visibility, an exit strategy for investors and a means of management and employee participation in future growth. A public company is also well suited for follow on investments and using its shares as a "currency" for subsequent acquisitions.

However, there are also drawbacks to being a public company. These include the cost of maintaining the public company status (such as holding annual meetings and increased financial reporting), the distraction of short term share price movement rather than long term financial performance, and increased financial and business disclosure which is available to competitors as well as investors.

In addition to the benefits of public company status, a CPC will benefit from a board of directors experience in earning capital and with an understanding of public markets, a formal market and increased exposure for its shares, a broader investor base including venture capital companies and angel investors and public company status at a lower cost and shorter time frame.

The CPC Program permits a "blind pool" company to conduct a public offering without an identified business. As a result there is a heavy reliance on management. The directors and officers of the CPC must have public company experience and be capable of identifying, analysing and completing a Qualified Transaction.

Experience

One goal of the Venture Exchange is to provide junior companies with access to capital. Its policies are tailored for companies in their formative stages as opposed to larger companies that could conduct an IPO. A further objective of the Venture Exchange is to assist businesses to grow and transition to a senior exchange. It is a training ground - an opportunity for the business and management to season. The statistics are impressive. During the last two years, 146 CPC's were listed on the Venture Exchange and 147 CPC's completed a Qualifying Transaction. Of the 53 companies that graduated from the TSX - Venture Exchange to the TSX - Senior Exchange in 2002, 22 of these were initially CPC's. Graduates from the CPC Program include Boardwalk Equities Inc., Yogen Fruz World-Wide Inc., BPI Financial Corp. and RTO Enterprises Inc.

CPC PROGRAM POLICIES

Overview

The CPC Program consists of two stages. The first stage is the initial public offering and subsequent listing on the Venture Exchange. The second stage is completion of a Qualifying Transaction which involves the identification and acquisition of a suitable business or assets.

Agreement in Principle

The CPC Program is not available where the CPC has reached an "agreement in principle" with the target company before completing its IPO. For these purposes an "agreement in principle" means an enforceable agreement or commitment which identifies the fundamental terms of a Qualifying Transaction including identification of the business, the parties and the consideration or means by which the consideration will be determined.

In short, an agreement in principle exists if there are no material conditions to closing the Qualifying Transaction which are beyond the control of the parties. It is not necessary to have the agreement reduced to a formal written document as long as it exists.

Examples of conditions which the Venture Exchange recognizes to be beyond the control of the parties include:

(a) a best efforts financing that has not been completed;
(b) the parties have not agreed on the price or the means by which the price will be determined; or
(c) valuations, financial statements or due diligence which have not been completed.

Particular concerns arise for non-arm's length transactions because it is much more likely that an agreement exists. These concerns can generally be satisfied if a majority of the directors of the CPC are independent and their approval is required prior to completing the transaction. If there is doubt as to whether or not an agreement in principle exists, the principals of the CPC should review the issue in advance with the Venture Exchange.

CPC Capital Structures

The shares of the CPC are divided into two categories. "Seed Shares" which are shares which are issued before the IPO such as to the promoters or as part of a private placement and "IPO Shares" which are shares that are issued as part of the IPO. Only a single class of common shares may be issued as Seed Shares and IPO Shares.

The minimum amount of capital raised through the issuance of the Seed Shares is $100,000. The directors and officers of the CPC (or trusts or holding companies controlled by them) must subscribe for at least $100,000 of Seed Shares. Each director and officer of the CPC must subscribe for Seed Shares having an aggregate consideration of at least $5,000. Seed Share subscriptions by others will only be permitted after the initial $100,000 has been contributed.

The maximum amount of capital which could be raised by the CPC through the issuance of Seed Shares was $500,000. This limit was recently changed and now only applies to shares issued at a discount to the IPO price. As a result it is possible to raise more than $500,000 of capital prior to the IPO as long as the excess is raised at the IPO price. These changes are intended to allow grater participation by venture capital companies and angel investors. They can now subscribe for more than 2% the shares offered in the IPO and will receive shares free of escrow restrictions as long as they are dealing at arm's length and subscribe at the IPO price.

A CPC must raise at least $200,000 and no more than $1,900,000 of capital from its IPO. The maximum aggregate capital that a CPC may raise is $2,000,000.

The minimum price at which the IPO Shares may be issued is $0.10 per share. The minimum price at which the Seed Shares can be issued is the greater of $0.05 and 50% of the IPO price.

Two business models have emerged for CPC's. The first involves a small initial capitalization in the range of $300,000 to $500,000. A private placement is then completed simultaneously with the Qualifying Transaction increasing the total invested capital. The second involves a larger initial capitalization of $1,500,000 to $2,000,000 without the need for a companion private placement.

The smaller CPC has the advantage that it is less costly, potentially less dilutive for the target company, and the private placement investors will know and be able to assess the merits of the Qualifying Transaction. The larger CPC has the advantage that all of the capital is in place so that larger Qualifying Transactions can be pursued.

A sample capital structure for a CPC is set out in Appendix A.

Use of Proceeds

Permitted Uses

Until completion of the Qualifying Transaction, the gross proceeds realized by the CPC from the sale of securities are to be used to identify and evaluate businesses or assets and obtain shareholder approval for a proposed Qualifying Transaction.

The proceeds may be used for expenses incurred for the preparation of:

(a) valuations or appraisals;

(b) business plans;

(c) feasibility studies and technical assessments;

(d) sponsorship reports;

(e) engineering or geological reports;

(f) financial statements, including audited financial statements;

(g) fees for legal and accounting services; and

(h) agent's fees, costs and commissions

relating to the identification and evaluation of businesses or assets and obtaining approval for the Qualifying Transaction.

In addition, with the prior approval of the Venture Exchange, up to an aggregate of $225,000 may be advanced as a refundable deposit or secured loan by the CPC to a vendor or target company. A maximum amount of $25,000 may be advanced as a non-refundable deposit or advance to a vendor or target company to preserve assets without prior approval of the Venture Exchange.

Restricted Uses

Until completion of a Qualifying Transaction, no more than 30% of the gross proceeds realized by the CPC from the sale of securities or $210,000 may be used for purposes other than those described above. For greater certainty, expenditures which are not permitted, include:

(a) listing and filing fees (including SEDAR fees);

(b) other costs for the issuance of securities, (including legal, accounting and audit fees) relating to the preparation and filing of a prospectus; and

(c) administrative and general expenses of the CPC, including office supplies, rent, utilities, printing costs and equipment leases.

No amount of the proceeds may be used to obtain or lease a vehicle. Furthermore, no payment may be made to a related party of the CPC or the vendor or target company except for the reimbursement for expenses that are otherwise permitted.

Options

A CPC may adopt an incentive stock option plan that provides for the grant of stock options to directors, officers, employees and technical consultants for up to 10% of the issued and outstanding shares. The number of stock options that can be granted to any individual director or officer may not exceed 5% of the issued and outstanding shares, and the number of stock options that may be granted to a consultant may not exceed 2% of the issued and outstanding shares.

The stock option plan must be in accordance with the requirements of the Venture Exchange. The stock options must be non-transferrable and may not have an exercise period longer than five years. Any shares acquired pursuant to the exercise of options prior to the completion of the Qualifying Transaction must be deposited into escrow which is discussed below.

The exercise price of the stock options must be at least equal to the greater of:

(a) the IPO offering price; and

(b) the last closing price of the CPC's shares before issuance of the press release disclosing the options (less a permitted discount) subject to a minimum of $0.10 per share.

It is standard for the agent conducting the IPO to receive an option to acquire 10% of the IPO shares. The agent may exercise its option at any time, but may only sell 50% of the shares reserved under the option prior to completion of the Qualifying Transaction. The agent has 24 months from the date the CPC is listed on the Venture Exchange to exercise its options.

Escrow Requirements

General

The Venture Exchange imposes escrow restrictions on the shares of certain shareholders. These requirements are intended to align the interests of the public shareholders with the interests of related parties and those persons who acquire shares of the CPC at a price less than the IPO price. The escrow requirements vary depending upon the time and price at which the shares were issued and whether the resulting issuer would qualify as a Tier 1 or Tier 2 issuer.

Shares Issued Before a Qualifying Transaction

Certain shares issued prior to the completion of the Qualifying Transaction will be subject to escrow. These shares include shares that are issued at a discount to the IPO price and shares acquired by non-arm's length parties. Under the escrow, generally 10% of the escrowed shares will be released from escrow on approval of the Qualifying Transaction and an additional 15% will be released on the dates 6 months, 12 months, 18 months, 24 months, 30 months and 36 months following the initial release.

Escrowed Securities on the Qualifying Transaction

Shares issued pursuant to the Qualifying Transaction are characterized as either "Value Securities" or "Surplus Securities". Generally, the securities issued pursuant to the Qualifying Transaction are considered to be "Value Securities" if 75% of the securities are issued at a value equal to the value of the assets which are the subject of the transaction. Otherwise the securities are considered to be "Surplus Securities".

The principal distinction between Value Securities and Surplus Securities is the time period for release of the securities from escrow. The release period further depends upon whether or not the resulting issuer is a Tier 1 or Tier 2 issuer. The release period for a Tier 1 issuer ranges from a minimum of 18 months for Value Securities to a maximum of three years for Surplus Securities. The release period for a Tier 2 issuer ranges from three years for Value Securities and six years for Surplus Securities.

THE PROSPECTUS PROCESS

General

The *Securities Act* (Ontario) prohibits a corporation from "distributing" its shares to the public unless it has filed a prospectus and a receipt has been issued by the Commission unless the shares are issued pursuant to an exemption. Once the seed capital has been raised, the CPC will have to file a prospectus in order to "distribute" its shares.

Under the terms of the arrangements between the Venture Exchange and the Commission, the Venture Exchange reviews the CPC's prospectus and provides comments on their joint behalf. The Commission, however, retains ultimate authority to refuse to issue a receipt for the CPC's prospectus.

The principal documents involved in a CPC prospectus include the following:

(a) the preliminary prospectus;

(b) audited, and possibly unaudited interim financial statements;

(c) an agency agreement between the CPC and the brokerage firm that will conduct the distribution; and

(d) an escrow agreement between non-arm's length parties and an escrow agent.

The CPC must comply with the provisions of the *Securities Act* (Ontario) and in particular the prospectus must meet the requirements of OSC Policy 41-501. The Venture Exchange has prescribed standard terms for a CPC prospectus which simplifies the process. In addition, the prospectus for a CPC is simplified because it has no assets other than cash and has not conducted business.

As with all prospectus offerings, the CPC prospectus is based on the principle of "full, true and plain disclosure". This has particular implications for disclosure regarding any Qualifying Transaction contemplated at the time of the public offering. These transactions should be disclosed in the prospectus depending on the stage of the transaction.

A CPC by definition has no established business for investors to evaluate. Any investment is based primarily on the experience and ability of management to identify and evaluate businesses and assets for acquisition. Accordingly, disclosure concerning the background and qualifications of the management is paramount.

The prospectus will contain audited financial statements of the CPC dated within 120 days from the date of the preliminary prospectus. If the audited financial statements are dated outside of 120 days, then interim financial statements within 90 days, reviewed by the CPC's auditors, must also be included. Typically, the CPC will only have been recently formed and the financial statements are limited to an opening balance sheet together with notes and an auditor's report.

Filing Procedure

The CPC prepares a preliminary prospectus and all supporting documents which are filed with the Venture Exchange and the securities commissions of the jurisdictions in which the shares are to be offered for sale. The responsibility for vetting the prospectus generally lies with the Venture Exchange. However, the commissions may refuse a receipt for prospectus if they believe the offering is not in the best interests of the public.

The CPC will file a preliminary listing application concurrently with the preliminary prospectus. Once all of the deficiencies in the preliminary prospectus have been resolved and the Venture Exchange has conditionally approved the CPC for listing, the CPC will be invited to file a final prospectus. Once a receipt is issued for the final prospectus, the agent is allowed to conduct the offering. If all post offering documentation is satisfactorily filed, then the Venture Exchange will issue a notice permitting the shares of the CPC to commence trading. At this time the IPO will be complete and the CPC may commence looking for a business or assets that would constitute a Qualifying Transaction.

THE AGENT

The shares of the CPC are sold to the public by an agent who must be a member of the Venture Exchange. The underwriting of the shares will be conducted pursuant to the terms of an agency agreement between the CPC and the agent at a fixed price. The agent will undertake to use its best efforts to sell the shares of the CPC without any guarantee that a minimum number of share will be sold.

In consideration for its services, the agency agreement will provide for a commission which may not exceed 10% of the gross proceeds raised pursuant to the IPO. The agent may provide other services to the CPC, such as in connection with the Qualifying Transaction, for which it will be compensated. These arrangements must be disclosed in the prospectus if known at the time that it is filed.

In addition to the sales commission the agent may be granted an option to acquire shares of the CPC. The option must:

(a) be non-transferrable;
(b) not exceed 10% of the total number of IPO shares;

(c) have an exercise price that is not less than the IPO price; and
(d) be exercisable only for 24 months after the shares are listed on the Venture Exchange

A maximum of 50% of the optioned shares may be sold by the agent prior to completion of the Qualifying Transaction.

THE LISTING PROCESS

The listing process is conducted concurrently with the public offering. The CPC must make an application for listing on the Venture Exchange at the same time that it files its preliminary prospectus. The application for listing must be in accordance with Policy 2.3 of the Venture Exchange and will be submitted to the listing committee once all of the issues relating to the preliminary prospectus have been resolved. Once the offering is completed and all post-offering documentation is filed, then the shares of the CPC will commence trading on Tier 2 of the Venture Exchange with the designation that it is a CPC.

Each director and officer of the CPC must meet the minimum suitability requirements under Policy 3.1 of the Venture Exchange and the board of directors of the CPC must as a whole have the requisite public company experience. The Venture Exchange requires the directors and senior officers of the CPC to possess the ability to identify, investigate and acquire a business or assets that would meet the minimum listing requirements.

The parameters for the capital structure of the CPC have been set out earlier. In addition, the CPC must have at least 1,000,000 of its issued and outstanding shares in the public float. After the IPO, the CPC must have a minimum of 200 shareholders each owning at least 1,000 shares free of any resale restrictions excluding any shares held by non-arm's length parties.

THE QUALIFYING TRANSACTION

General

Once the CPC is listed, it has 24 months to complete a Qualifying Transaction. A "Qualifying Transaction" is defined in Policy 2.4 as a transaction whereby a CPC acquires Significant Assets, (other than by way of cash) by purchase, amalgamation, merger or arrangement with another company or by other means. The essence of a Qualifying Transaction is that the resulting issuer meets the minimum listing requirements of the Venture Exchange.

The Venture Exchange has discretion to disallow a Qualifying Transaction. Approval would not be given where other aspects of the policies of the Venture Exchange are not satisfied. For example, the resulting issuer may not be a finance company or mutual fund.

Approval of a Qualifying Transaction

Upon the CPC reaching an agreement in principle to acquire Significant Assets, the CPC must issue a comprehensive news release. At this time the Venture Exchange generally will halt trading in the CPC's shares until the filing requirements of the Venture Exchange have been satisfied. Within 75 days after issuance of the news release, the CPC is required to submit either an information circular or a filing statement that complies with applicable corporate and securities laws and the requirements of the Venture Exchange.

Generally, an information circular must be submitted where the Qualifying Transaction is Non-Arm's Length and a filing statement is submitted where the Qualifying Transaction is Arm's Length. The information circular or filing statement must contain prospectus level disclosure of the target company. Upon acceptance by the Venture Exchange, the CPC must issue a press release and file the filing statement or mail the information circular and related proxy material to its shareholders in order to their obtain majority of the minority approval.

Unless waived by the Venture Exchange, the CPC will also be required to retain a sponsor, who must be a member of the Venture Exchange, and who will be required to submit to the Venture Exchange a sponsor report prepared in accordance with its policies. The CPC will no longer be considered to be a CPC when the Venture Exchange has issued its final approval.

Minimum Listing Requirements

The resulting issuer must satisfy the minimum listing requirements of the Venture Exchange (other than public distribution requirements) for the particular industry sector in either Tier 1 or Tier 2. A summary of these listing requirements is attached as Appendix B.

Delisting

If the CPC does not complete its Qualifying Transaction within the 24 months, shareholders who are dealing at arm's length with the CPC will have the choice of winding up the CPC or authorizing its listing on NEX. Prior to April 13, 2005, if a CPC did not carry out its Qualifying Transaction within the prescribed period, all Seed Shares issued at a discount to the IPO price and held by persons not dealing at arm's length with the CPC had to be cancelled. Now if the CPC is moved to NEX these persons can keep such number of Seed Shares is equal to the number of shares they would have obtained if their subscription price had been equal to the IPO price. In practice this will be 50% of their shares.

Issuers that are delisted and do not move to NEX will be required to cancel all Seed Shares held by non-arm's length parties issued at a discount to the IPO price.

Trading Halts

The Venture Exchange will generally halt trading in the shares of the CPC from the date of the public announcement of an agreement in principle until all filing requirements of the Venture Exchange have been satisfied. This includes submission of a sponsorship acknowledgement form, where the Qualifying Transaction is subject to sponsorship, and personal information forms for all individuals who may be directors, senior officers, promoters, or insiders of the resulting issuer. The Venture Exchange will conduct background searches on these individuals as it considers necessary before the trading halt will be lifted.