APPENDIX "A"

LIST OF COMMENTERS

General

Swinton & Company, Barristers & Solicitors
Vancouver Stock Exchange
Scott & Aylen, Lawyers
Canadian Dealing Network Inc. (CDN)
Catalyst Corporate Finance Lawyers
Ogilvy Renault, Barristers & Solicitors
Union Securities Ltd.
Osler, Hoskin & Harcourt, Barristers & Solicitors
Montpellier & McKeen, Barristers & Solicitors
Prospectors & Developers Association of Canada (PDAC)
Davies, Ward & Beck, Barristers & Solicitors
Armstrong Perkins Hudson, Barristers & Solicitors
Investment Dealers Association of Canada (IDA)

Transfer Agents

Security Transfer Association of Canada (3 comment letters)
Equity Transfer Services Inc.
Pacific Corporate Trust Company
The Trust Company of Bank of Montreal
TD Trust Company

Venture Capitalists

Canadian Venture Capital Association (CVCA) (2 comment letters)
Davis & Company (on behalf of Ventures West Management Inc., Royal Bank Capital Corporation, Business Development Bank and Working Opportunity Fund)
Réseau Capital (2 comment letters)
Société Innovatech Québec et Chaudière-Appalaches
GrowthWorks Capital Ltd.
Bank of Montreal Capital Corporation
Mercator Investments Limited
Elnos Corporation
Royal Bank Capital Corporation
BCE Capital
Clairvest Group Inc.
Investissemenets Novacap Inc.
Saskatchewan Government Growth Fund
Les placements Telsoft Inc.
Hydro-Québec CapiTech
Whitecastle Investments Limited

APPENDIX "B"

SUMMARY OF COMMENTS RECEIVED AND RESPONSES OF THE CSA ON PROPOSAL FOR A NATIONAL ESCROW REGIME APPLICABLE TO INITIAL PUBLIC DISTRIBUTIONS

The CSA received submissions on the *Proposal for a National Escrow Regime Applicable to Initial Public Distributions* (the "initial proposal") from the 34 commenters listed in Appendix "A".

The CSA considered the submissions received in revising the initial proposal and preparing the National Policy. We thank all the commenters for providing their comments.

The following is a summary of comments received on the initial proposal, together with the CSA's responses, organized by topic. This summary is organized into three parts:

A. General Comments (comments on all aspects of the initial proposal, except the "passive investor" provisions and provisions directly affecting escrow agents)
B. Comments on passive investor provisions (including venture capital organizations' comments)
C. Escrow agents' comments

A. General Comments

1. Competition with United States Capital Markets

The paramount concern voiced by the commenters was that the proposed Canadian escrow regime continues to put the Canadian exchanges at a significant competitive disadvantage to United States exchanges and electronic trading systems. Many of the commenters raised this issue when commenting on specific aspects of the initial proposal. A few commenters raised the issue generally in support of suggestions that the Canadian escrow regime be abolished entirely or replaced with another regime that would be no more restrictive than United States resale restrictions. (See *Abolish/Replace the Escrow Regime* below.)

The CSA take this issue very seriously. We consulted with US securities lawyers, US state securities regulators, the North American Securities Administrators Association (NASAA) and the Pacific Exchange to get a clearer understanding of the resale restrictions and lock-up (or escrow) restrictions imposed on securityholders of issuers that do initial public offerings (IPOs) in the US.

Comparison of National Policy with US Regime

Offering size

US market participants and regulators advised that the regulatory and due diligence costs of a public offering in the US are quite high. Consequently, IPOs for less than US $20 million are not common. Very few US underwriters are interested in raising financing below this level. Most issuers that seek a listing on the Canadian Venture Exchange Inc. (CDNX) and many that seek a listing on The Toronto Stock Exchange Inc. (TSE) raise less than this amount and, therefore, do not realistically have the option to conduct an IPO in the US. Smallcap and microcap companies in the US often obtain financing through private placements and semi-public offerings, delaying an IPO until later in their development cycles. By a "semi-public offering", we mean a public offering that is conducted under US state securities legislation that is basically equivalent to a private placement under US federal securities law.

Senior Issuers

While it is difficult to compare listing criteria, we found that the minimum original listing requirements of the TSE are lower than those of the Nasdaq National Market or the New York Stock Exchange (NYSE) and in the range of those of the American Stock Exchange (AMEX) and the Nasdaq Smallcap Market. Even the TSE's highest original listing criteria, those for its "exempt" issuer category, are, with one exception, generally lower than those of the Nasdaq National Market or the NYSE, although they are somewhat higher than those of AMEX.

Because exemption from escrow under the National Policy is tied to exempt listing status on the TSE, most issuers that would be exempt from escrow in the US because they qualify for listing on the NYSE or Nasdaq National Market would also be exempt from escrow in Canada under the National Policy. Indeed, some Canadian issuers that might be subject to escrow or lock-up arrangements if they conducted their IPO in the US could be exempt from escrow under the National Policy.

The one exception mentioned above is that an issuer can list on the Nasdaq National Market if it has a market capitalization of at least US $75 million after its IPO. This would not necessarily qualify it for listing in the TSE's exempt category. However, issuers with that market capitalization would also, at current currency exchange rates, be exempt from escrow under the National Policy because we have changed the category of "exempt issuer" under the National Policy to include issuers with a market capitalization of at least $100 million after their IPO.

Junior Issuers

It appears that Canadian issuers conduct IPOS earlier in their growth cycles than those in the US. The feedback we have received suggests that issuers of the type listed on CDNX and certain of the junior issuers on the TSE would not be able to conduct an IPO in the US at all because of the significant costs. In the US markets, those types of issuers would often be restricted to private financing until they grow enough to list on a national securities exchange. If these junior issuers conducted a semi-public offering in the US, the majority of the state securities commissions

would require the imposition of a lock-up either on the basis of NASAA policies or under their own state laws. Under the policies, a broader category of persons would be subject to escrow and the terms of release would generally be more onerous than would be the case under the National Policy. Issuers that are doing a registered offering with the US Securities and Exchange Commission and using Coordinated Review at the US state level are subject to escrow or lock-up under the NASAA policy regarding promotional shares.

Other

In addition to regulator-imposed lock-ups, US underwriters and market makers typically impose lock-up arrangements. Hold periods are also imposed under US federal securities law (Rule 144 under the Securities Act of 1933).

Conclusions

Many Canadian issuers are choosing to list in the US. Some are trading over-the-counter in the US without ever having conducted an IPO in either country. We acknowledge that this emigration of secondary market trading to the US may have important effects on the Canadian capital markets, but our research and analysis indicate that the National Policy should not be a factor in issuers' decisions on where to have their securities traded.

Changes to initial proposal to address competition concerns

We made significant changes to the initial proposal to ensure that an issuer that elects to list on a Canadian exchange is not subject to greater restrictions than are reasonable to accomplish the purpose of escrow. We narrowed the scope of the National Policy, applying it only to issuers that are not TSE exempt issuers or issuers with a market capitalization of less than $100 million after their IPO, cutting the escrow periods in half, and offering added flexibility to principals in dealing with their securities at the time of the IPO.

The following changes have been made to the initial proposal to address the competition concerns raised by some of the commenters:

- The class of exempt issuers has been broadened.

- The escrow period has been shortened:
  for established issuers from 3 years to 18 months with 4 equal releases, starting on the listing date and then every 6 months from listing, and
  for emerging issuers from 6 years to 3 years with 7 releases, 10% on listing and then 15% every 6 months from listing.

- The definition of principal has been narrowed:
  The percentage equity interest that, alone, will subject a securityholder to escrow requirements has been increased from 10% to more than 20% of the voting rights attached to the issuer's outstanding securities.

A securityholder holding more than 10% but 20% or less of the voting rights attached to the issuer's outstanding securities will only be subject to escrow requirements if the securityholder selects, or has the right to select, one or more directors or senior officers of the issuer or a material operating subsidiary.
Percentage equity interest will be calculated after the issuer's IPO, instead of before.

- A *de minimis* exception has been added.
  A principal will not be subject to escrow requirements if the principal holds less than 1% of the voting rights attached to the issuer's outstanding securities, calculated after the issuer's IPO.

- Principals have been provided with an early liquidity opportunity. At the time of the issuer's IPO, principals may sell their escrow securities free of escrow restrictions in a secondary offering disclosed in the issuer's IPO prospectus.
  If the secondary offering is firmly underwritten, any principal may sell escrow securities.
  If the secondary offering is on a best efforts basis, only principals other than promoters, directors and senior officers of the issuer or any of its material operating subsidiaries, may sell their escrow securities, provided all or the specified minimum number of the securities offered by the issuer in the IPO are sold prior to the secondary offering.

2. Abolish/Replace the Escrow Regime

One commenter suggested that the escrow regime could be abolished altogether. In the commenter's view, the escrow regime is not needed to accomplish the stated purpose of escrow, i.e. to tie management and other key principals to the issuer, as current rules and market forces already accomplish this objective.

The CSA remain convinced that escrow continues to serve an important function in the Canadian marketplace. The CSA do not agree that current rules and market forces, without escrow, alone will be sufficient encouragement for management and other key principals to devote their time and attention to carrying out the issuer's IPO business plan.

A few commenters suggested that the Canadian escrow regime be replaced with resale restrictions closely replicating US Rule 144 limitations, or other rules that would be no more stringent than the escrow regime in place in the US. For the reasons discussed above, our research and analysis indicate that the National Policy should not be a factor in issuers' decisions where to have their securities traded.

Another commenter suggested an alternative approach. Principals would be prevented from selling into the open market for an 18-month period. After that, they would be required to provide 7 days prior notice before selling into the open market. We believe that the regime in the National Policy is preferable because shares are released on a staged basis, beginning on listing, and then every 6 months thereafter, and the length of escrow is related to the classification of the issuer. This approach provides greater predictability for market participants while offering principals earlier and increasing liquidity.

One commenter emphasized that Canadian escrow requirements should be easily understood and flexible so that Canadian issuers do not choose to go public in the US to avoid an onerous, complex regime.

One of the CSA's objectives in reviewing the initial proposal for revision was to ensure that the proposal would be easy to understand and apply so that compliance would be straightforward and administration would be efficient. We have made several changes to the initial proposal, including:

- adoption of exchange classifications for use in the National Policy,

- revisions to the definition of principal for persons and companies that are "principals" as a consequence of equity interest, basing the test for such principals on objective factors that are easily determined, eliminating the need for a definition of "passive investor" and a determination as to whether a particular securityholder is a “passive investor”,

- basing escrow requirements upon completion of a take-over or other business combination on objective factors that are easily determined, and

- presenting the National Policy in plain language, addressing clearly and logically the questions most likely to arise.

3. Purpose of the Escrow Regime

While commenters generally concurred with the stated purpose of escrow, some of the commenters noted that there were other rationales for escrow that were not reflected in the initial proposal. One of these, "controlling cheap stock", prevents principals from selling securities that they acquired at a price that is significantly less than the IPO price into the market shortly after the issuer's IPO which depresses the trading price of the securities. Another rationale is to provide founders with a degree of control during the formative stages of an issuer.

The CSA considered and reconfirmed the stated purpose of escrow: to encourage the issuer’s principals to remain with and devote their time and attention to the issuer for an appropriate period after the issuer's IPO to best enable the issuer to carry out the IPO business plan. In our view, the role of the issuer's underwriter includes dealing with valuation issues in the course of pricing the IPO.

4. Failure to Recognize Value

Several commenters expressed concern that value contributed to the issuer by principals was not recognized in the initial proposal. Commenters suggested that principals would be discouraged from providing value for their securities as a consequence of the initial proposal not making any distinction between securities issued for value, and securities issued for nominal or little consideration. A commenter suggested that principals are more committed if they have contributed value. Another commenter suggested that seed capital investors would be unwilling to become principals because they will not want their shares subjected to escrow requirements.

Commenters raised US competition concerns, stating that principals that have paid fair value for their securities will choose to list where their contribution is recognized.

Commenters suggested several alternative models. Some suggested a formula tied to price paid, others also took dilution of the issuer's assets into account in the formula. Most of these commenters agreed with the elimination of property valuations to support the issuance of free-trading shares to founders, although there was a commenter that disagreed.

The CSA are of the view that issues of value are better dealt with by underwriters in pricing the issuer's IPO, than by standard, mandatory escrow requirements imposed by the CSA. The CSA do not disagree with commenters that expressed the concern that principals should not be discouraged from contributing value to the issuer, but do not believe that the National Policy would have this result. However, the CSA do not agree that a seed capital investor's decision as to whether or how to participate in the management of an issuer will be governed by whether escrow requirements will apply to the investor, especially with the reduction in escrow periods and the opportunity for principals to participate in a permitted secondary offering at the time of the issuer's IPO.

5. Time-based Model vs. Performance-based Model

A commenter suggested that a performance factor should remain in the escrow release formula because this would align the interests of the public shareholders with the issuer's principals. The commenter's view was that in a purely time-based release formula, there is an incentive for the principals to take the issuer public prematurely, because the sooner the issuer goes public, the sooner their shares will be released from escrow.

The CSA do not agree that failure to include a performance factor in the release formula will have the result of an issuer going public prematurely. The timing of a particular issuer's IPO depends on many factors, especially the issuer's need for capital, and the comparative cost to the issuer of capital from available sources. Furthermore, the farther along the issuer's stage of development, the shorter the period of escrow, and for securities of issuers that are sufficiently developed to qualify as exempt issuers based on the TSE's criteria or significant market capitalization, no escrow will be required.

We believe that there are other mechanisms in place to align the interests of principals and shareholders, including fiduciary and statutory duties of principals, prospect of growth in personal holdings of the issuer's securities, stock options and conventional employment arrangements.

We do agree with this commenter that, in most cases, if principals have attracted a take-over bid for the issuer, the securities of the principals should be released from escrow, but not for the same reason as stated by this commenter. (See *Release from Escrow – Release upon Take-over Bid* below.)

6. Persons whose Securities are subject to Escrow Requirements (Definition of Principal)

A few commenters thought that the definition of principal was too broad and should be restricted to persons who are key to the issuer's success. A commenter suggested that it would be more appropriate to calculate percentage equity interest for the purpose of the definition after the issuer's IPO, rather than before. A few commenters suggested that directors and officers with nominal shareholdings be excluded from escrow requirements.

The CSA generally agree with these comments and have narrowed the definition of principal. We believe that whether a securityholder is subject to escrow requirements should be based on whether the securityholder has effective control over the issuer or a significant influence on management. Those that do should be subject to escrow requirements.

Therefore, we have made the following changes to the definition of principal that was contained in the initial proposal:

- The percentage equity interest that, alone, will subject a securityholder to escrow requirements has been increased from 10% to more than 20% of the voting rights attached to the issuer's outstanding securities, calculated after the issuer's IPO, rather than before.

- A securityholder holding more than 10% but 20% or less of the voting rights attached to the issuer's outstanding securities will only be subject to escrow requirements if the securityholder selects, or has the right to select, one or more directors or senior officers of the issuer or a material operating subsidiary. The percentage equity interest will be calculated after the issuer's IPO, rather than before.

We also agree that a *de minimis* exception is appropriate. Therefore we have added a provision to the National Policy that excludes from escrow securities held by principals that hold less than 1% of the voting rights attached to the issuer's outstanding securities. The percentage equity interest will be calculated after the issuer's IPO.

A commenter suggested that associates should be excluded from the definition of "principal". We agree that including all associates of the principal is too broad, and therefore have limited the associates that will be treated as principals to the principal’s spouse and relatives who share the same home.

A commenter stated that a person who has acted as a promoter a long time prior to the issuer’s IPO should not be subject to escrow. The CSA agree with this comment and have restricted the definition of principal to apply to persons that have acted as promoters of the issuer within two years of the issuer's IPO.

7. Escrow Periods

Several commenters stated that the length of the escrow period in the initial proposal was unnecessarily long. Some commenters made this comment in the context of competition concerns. One commenter pointed out that the proposed period was far longer than an issuer

would generally need to carry out its IPO business plan. Another commenter noted that principals that cause their issuers to carry out IPOs for the purpose of creating greater investment liquidity would not do so if the escrow requirements are too onerous. A commenter noted that unreasonable escrow requirements could lead to management appointing nominee boards in order to attempt to evade the escrow requirements.

We agree that the escrow periods in the initial proposal were longer than necessary. We have made the following changes:

- The escrow period for emerging issuers has been shortened from 6 years to 3 years with 10% of a principal's securities released on listing and the balance released in 6 equal instalments in 6 month intervals after listing.

- The escrow period for established issuers has been shortened from 3 years to 18 months with 25% of a principal's securities released on listing and the balance released in 3 equal instalments at 6 month intervals after listing.

- The class of exempt issuers has been expanded. An exempt issuer is now defined as an issuer that, upon completion of its IPO, is classified as an exempt issuer on the TSE or has a market capitalization of at least $100 million after its IPO. As a consequence of this change, approximately 20% of issuers that were subject to escrow in 1997 and 1998 would be exempt issuers under the National Policy.

The concept of an issuer changing its classification from emerging issuer to established issuer status has been retained. If an emerging issuer becomes an established issuer, there will be an automatic release of escrow securities equal to the amount of securities that would have been released to date as if it were an established issuer on its IPO, and any securities remaining in escrow will be released in accordance with the established issuer schedule.

8. Issuer Classification Thresholds

The CSA received several comments on thresholds. A few commenters stated that the threshold for exempt issuer status was too high. As noted above, we agree and have lowered the threshold for exempt issuer status by adopting the TSE category for exempt issuers.

A few commenters stated that the categories resulted in inappropriate treatment for technology issuers that often have limited cash flow and profit. Other commenters pointed out inconsistencies in the treatment of research issuers once such issuers begin commercialization of product.

A commenter stated that the emerging issuer definition was confusing, and should be stated in positive terms. Another commenter made detailed suggestions as to certain elements of the natural resource category, in line with industry criteria and practice.

The CSA agree that the classifications set out in the initial proposal were not entirely appropriate, nor were they easily applied. In consultation with the Canadian exchanges, we adopted exchange categories for use under the National Policy.

In particular:

- TSE listed exempt issuers are be classified as "exempt issuers".

- Other TSE listed issuers and CDNX listed Tier 1 issuers are classified as "established issuers".

- CDNX listed Tier 2 issuers are classified as "emerging issuers".

- Issuers listed only on the Bourse de Montréal Inc. (Bourse) are classified based on the same criteria. If a Bourse-listed issuer meets the CDNX Tier 1 minimum listing criteria, the issuer is classified as an "established issuer". Otherwise the issuer is classified as an "emerging issuer".

In addition, to address competition concerns, issuers whose market capitalization after their IPO is at least $100 million are also exempt from escrow.

A few commenters suggested that more categories be created to allow for differences in treatment among issuers that are not exempt. We believe that these concerns are addressed by the significant reduction in escrow periods.

9. Treatment of Options

One commenter suggested that we broaden the definition of "option" to exclude from escrow options exercisable for cash, shares or a combination of both to allow issuers flexibility in designing compensation programs. We believe that broadening the exclusion may invite abuse.

A commenter stated that all options be excluded from application of the escrow regime. We disagree because options are no different from other securities. There is an exception for non-transferable incentive stock options issued to directors, officers or employees because these are governed by other policies.

Another commenter stated that issuers would avoid granting options to insiders until after the IPO is receipted in order to avoid the application of escrow. We do not see this as a problem because the exercise price of options must be at least equal to the market price of the securities on the day they are granted.

10. Change in the Issuer's Status after the IPO

A few commenters commented that established issuers should be allowed to become exempt issuers after their IPO, which would result in the immediate release of all escrow securities. There is no compelling need for this change since we reduced the length of the escrow period for established issuers. An18-month escrow period is too short a period to warrant a review. Therefore we have not included a provision for change in status from an established issuer to an exempt issuer.

11. Release from Escrow – Departure of Principals

A commenter stated that the securities of an officer who is terminated without cause should be automatically released from escrow, as the rationale for escrow no longer exists, although the commenter was of the view that voluntary resignation should not result in a release.

Another commenter stated that there should be an automatic release from escrow of the securities of any director or officer who leaves the position, whether voluntarily or involuntarily.

We disagree with the automatic release from escrow of the shares of departing principals, because this may encourage principals to depart prematurely. However, we agree that it would be beneficial to allow a departing principal to transfer shares to a new principal, and to allow principals to transfer shares among themselves, to reflect re-arrangements of responsibilities. Therefore the National Policy allows transfers among principals at any time.

12. Release from Escrow - Release upon Take-over Bid

Several commenters questioned the rationale for requiring exchanged securities to be substituted for previously escrowed securities on completion of a take-over bid. The reasons stated included:

- Minority securityholders of the acquiror do not need or expect escrow protection.
- In an exchange bid, the participation of the initial principals will be diluted.
- Control of the issuer will in most cases shift away from the initial principals.
- Escrow continuation may artificially affect the consideration paid in the transaction and may reduce the value obtained by the shareholders of the target company.
- Some of the commenters suggested that:
- Securities should be released if the principal will not be a principal of the successor issuer after completion of the take-over bid.
- Securities should be released if the successor issuer is an exempt issuer after completion of the take-over bid.

- The opportunity for change of status should be available to the successor issuer after completion of the take-over bid.

- Securities should be released from escrow if the principal's holding in the successor issuer is *de minimis* after completion of the take-over bid.

We agree. These changes have been made.

13. Release from Escrow – Release upon Death

A few commenters questioned the news release requirement upon the death of a principal, especially where the death does not constitute a material change. The CSA agree. The National Policy does not require a news release. In the event the death constitutes a material change in the affairs of the issuer, general disclosure requirements will apply.

14. Release from Escrow – Release upon Emerging Issuer Becoming Established Issuer

A commenter questioned the provision requiring released securities to be returned to escrow if the issuer did not meet the criteria for becoming an established issuer. We agree that this would have been a problem; however with the change to exchange classifications, there will be no doubt whether an issuer's classification has changed, and therefore this situation should not arise.

15. Transfers within Escrow – Transfers to Directors and Senior Officers

A few commenters questioned the propriety of requiring the issuer's board of directors to approve a transfer between directors and senior officers. While directors are required to act in the issuer's best interest, they note that these may not be the same as the shareholders or otherwise consistent with the purposes of escrow.

We disagree. At the time of the transfer, a decision made in the best interests of the issuer furthers the purpose of escrow. The transfer to a new director or senior officer or an existing director or senior officer will further the successful completion of the issuer's business plan.

A commenter notes that it is inconsistent to require all principals to escrow their securities and then restrict transfers to directors and senior officers. We agree. The National Policy permits the transfer of escrow securities to a 20% holder and to a person or company that will be a 10% holder with the right to appoint a director or senior officer after the transfer.

16. Transfers within Escrow – Transfers upon Bankruptcy or to Certain Plans

A commenter stated that the provision allowing transfers to RRSPs and RRIFs should be expanded to allow transfers to spousal RRSPs, to allow holders of escrow securities more latitude in tax planning, provided the securities remain in escrow on the same terms.

We agree. The National Policy allows transfers within escrow to any similar registered plan with a trustee, provided the beneficiaries of the plan are limited to the original principal, and his or her spouse, children and parents.

A commenter stated that RRSP trustees might be unwilling to sign the escrow agreements. We are not aware of this having been a problem in the past.

A commenter noted that if the principal goes bankrupt the trustee would need to sell the escrow securities. We have not made this change. The trustee will be subject to the same restrictions upon transfer of the escrow securities as applied to the principal. This result is consistent with the purpose of escrow and accurately reflects the value of the escrow securities.

17. Dealing with Escrow Securities – Prohibitions on Pledging Escrow Securities

Several commenters stated that the outright prohibition on pledging escrow securities was unduly restrictive, and that principals should be permitted to pledge their escrow securities as security for a loan. A commenter pointed out that the prohibition is particularly problematic for active business corporations that often charge assets in standard banking arrangements.

The CSA also took note of the fact that in certain Canadian jurisdictions, the pledge of escrow securities is common business practice. We balanced these comments against the anti-avoidance purpose of the prohibition and the concern that a principal may be less committed to the issuer if the securities have been pledged, and would certainly be less committed if the securities have been realized upon by the pledgee.

The National Policy permits a principal to pledge, mortgage or charge escrow securities as collateral for a loan from a financial institution. If the financial institution realizes upon the securities, the securities will be subject to the same escrow conditions as they were in the hands of the principal. In addition, anti-avoidance provisions have been added to the National Policy and standard escrow agreement.

18. Secondary Offerings

A few commenters urged the CSA to consider the introduction of an automatic release mechanism for secondary offerings by way of prospectus. In support they pointed out that:

- Prospectus level disclosure exists.
- The sale demonstrates the favourable attitude of the market to the secondary offering.
- If a situation arises that securities regulators perceive as abusive, the securities regulators may refuse to give a receipt for the prospectus.
- Securities regulators have allowed releases in these circumstances in the past.

- It would weaken the US competitive advantage, as it would parallel the US policy allowing affiliates to sell their shares free of Rule 144 limitations by preparing a registration statement.

The CSA agree that it would be beneficial to permit principals to sell their escrow securities at the time of the issuer's IPO in a secondary offering that is disclosed in the IPO prospectus. Under the National Policy, if the secondary offering is underwritten, any principal may sell their escrow securities. If the secondary offering is on a best efforts basis, only principals that are not promoters, directors or senior officers may sell their escrow securities, provided all or the specified minimum number of securities offered by the issuer in the IPO are sold.

The National Policy restricts secondary offerings by principals to the time of the issuer's IPO. The IPO purchasers will have notice of the securities to be sold or proposed to be sold by principals, and will be able to form their decisions to purchase securities in the IPO based on full information.

19. Non-Compliant Arrangements

Two commenters stated that it was unduly burdensome not to assign responsibility for accepting non-compliant arrangements to only one jurisdiction. Securities regulators in each jurisdiction where the issuer's IPO prospectus is filed have jurisdiction over the escrow agreement and the escrow securities.
The securities regulators will apply mutual reliance principles in administering the National Policy.

20. Transitional

A commenter suggested that the initial proposal be amended to include a mechanism for opting into the new regime. Another commenter requested clarification of the escrow requirements that will apply once the rule is adopted.

Section 8.1 of the National Policy permits, on the conditions set out in that section, amendments to escrow agreements made prior to the date of the National Policy to reflect the release terms in the National Policy.

21. Application to Reverse Take-Overs, Junior Capital Pool Companies and Similar Transactions

A commenter requested guidance on the terms of escrow that will apply to reverse take-overs, junior capital pool companies and similar transactions.

Another commenter suggested that the CSA should decline to make escrow requirements based on the initial proposal for reverse take-overs, junior capital pool companies and similar transactions. In the commenter's opinion, the terms of the initial proposal were not appropriate for these transactions and would be detrimental to the policy objectives of these initiatives.

We have worked in consultation with representatives of the Canadian exchanges in revising the initial proposal. We have deferred to the Canadian exchanges for escrow policies applicable to reverse take-overs, reorganizations, reactivations, junior capital pool companies, major acquisitions and similar transactions, and to direct listings. The policies of the Canadian exchanges are consistent and harmonious with the National Policy.

22. Additional Requirements if there is no Underwriter or Listing

Two commenters questioned the rationale for imposing additional escrow requirements if there is no underwriter involved in an IPO, or if an issuer's equity securities will not be listed on a Canadian exchange on completion of its IPO. They pointed out that underwriters do not generally require a lock-up for more than 180 days, and the securities held by pre-IPO shareholders would generally be subject to a one year hold period from listing under applicable legislation.

The National Policy continues to make it clear that securities regulators may impose additional or different escrow terms in these circumstances. This is because the function served by the underwriters when they price an IPO, effectively valuing the issuer, and the function served by a Canadian exchange in regulating the issuer are not present.

23. Application on a National Basis

Most commenters supported a national regime, although one commenter was of the view that different escrow arrangements are appropriate to allow for innovation and market segmentation. The commenter pointed out that each Canadian exchange has developed a different market segment and needs a framework that allows the specialization to continue.

The CSA believe that this commenter's concern has been addressed by the reorganization of the Canadian exchanges and the revisions to the initial proposal made in consultation with the Canadian exchanges.

24. Mergers and Amalgamations

A commenter suggested that an exemption from the initial proposal be available for an IPO of an amalgamated company. The CSA agree and made this change.

The CSA also noted that the initial proposal did not adequately deal with the escrow of securities of issuers resulting from business combinations (successor issuers). Section 5.3 of the National Policy addresses the escrow of securities of successor issuers.

B. Comments on Passive Investor Provisions and the Treatment of Venture Capital Organizations

Under the initial proposal:

- An investor holding more than 10% of the outstanding voting securities of an issuer (other than an exempt issuer) prior to the issuer's IPO was subject to escrow requirements, unless the investor was a "passive investor".

- An "institutional investor" was deemed to be a "passive investor" unless the institutional investor selected a director or senior officer or effectively controlled the issuer.

- Venture capital organizations were not included in the list of investors that were considered "institutional investors".

- An investor could apply to a securities regulator to be considered a passive investor. The initial proposal included a list of relevant factors.

The CSA received many comments from venture capital organizations and other commenters with respect to this aspect of the initial proposal.

Venture capital organizations stated that their securities should be exempt from escrow, citing the following reasons:

- There is no rationale that justifies imposing escrow on venture capital organizations because IPO investors do not look to them as principals responsible for carrying out the IPO business plan.

- Venture capital investments are generally designed for the medium term. The venture capital organization will have typically held the investment for 3 to 8 years prior to the issuer's IPO, and should not be denied an exit opportunity at the IPO stage.

- If venture capital organizations are forced to hold their investments in issuers for the additional length of time required by the initial proposal, they will decrease their investment in start-ups.

- IPOs by Canadian issuers in Canada will be less frequent because issuers will choose to conduct their IPOs in the US or will sell equity to strategic buyers.

- The delay of sales by venture capital organizations of their escrow securities will delay the recycling of venture capital funds into other pre-public issuers.

- Sources of capital for venture capital organizations will shrink, because investors in venture capital organizations will not want to receive escrow securities or a delayed return.

They claimed that the initial proposal contrasted sharply with the local policies under which venture capital organizations were operating.

Venture capital organizations and others had the following comments on the initial proposal:

- Venture capital organizations should be included in the list of institutional investors. One commenter questioned the distinction between the Business Development Bank of Canada and financial institutions that make investments directly (which were included in the list of institutional investors) and financial institutions that make investments through venture capital subsidiaries (which were not considered institutional investors).

- Venture capital organizations should not be precluded from being considered institutional investors as a consequence of having selected a director or senior officer of the issuer. Venture capital organizations often put a nominee on the issuer's board of directors as a means of obtaining information about the issuer. This is beneficial to the issuer as it provides the issuer with access to the venture capital organization's experience. Board representation is not synonymous with control or direction over the issuer and a test for *de facto* control would be more appropriate.

- Effective control should be determined at the conclusion of the issuer's IPO, not prior to the IPO.

- A discretionary relief provision should be added allowing a venture capital organization that is not otherwise exempt as an institutional investor to apply for a designation as an institutional investor, to avoid the necessity of applying on an investment-by-investment basis.

- Greater clarification should be made to the factors listed for consideration as a passive investor. Examples of factors requiring greater clarification include that the investor not be "involved in the management of the issuer", and not have a prior or existing "significant relationship" with a principal of the issuer.

- If the securities held by a venture capital organization are escrowed, a provision should be added permitting the distribution of the escrow securities to the beneficial owners of the venture capital organization.

In response, the National Policy:

- rationalizes the treatment of venture capital organizations with other significant investors and dispenses with the problematic concepts of "passive investor" and "institutional investor",

- ensures that the imposition of escrow on securities of significant investors is consistent with the purpose of escrow,

- ensures that the escrow regime is reasonable and will not unduly interfere with venture capital investment,

- makes the test for determining whether an investor's securities will be subject to escrow objective and straightforward, and

- eliminates the need for costly and time-consuming applications which can result in inconsistent treatment of investors.

- We have redesigned the definition of principal as it relates to significant investors, so that:

- an investor will be considered a principal if the investor holds more than 20% of the voting rights attached to the issuer's outstanding securities after completion of the issuer's IPO, and

- an investor that holds more than 10% but 20% or less of the voting rights attached to the issuer's outstanding securities after the issuer's IPO will only be considered a principal if the investor selects or has the right to select a director or senior officer of the issuer or a material operating subsidiary.

The CSA are of the view that an investor holding more than 20% of the voting securities of a public issuer is likely to have effective control of or significant influence over the issuer.

The CSA are also of the view that if an investor holding more than 10%, but 20% or less of the voting rights attached to the issuer's outstanding securities has selected or has the right to select a director or senior officer of the issuer or of a material operating subsidiary upon the completion of the issuer's IPO, then it is likely that the investor is participating in the management of the issuer through the selection of a "corporate director". Accordingly, the investor's securities should be subject to escrow.

This approach is consistent with the purpose of escrow. The test is objective, straightforward and applies to all investors equally. We believe that it is fair and appropriate to subject the securities of a venture capital organization to escrow if it is participating in management of the issuer.

The CSA believe that changes made to other aspects of the initial proposal address the liquidity concerns expressed by the venture capital organizations. These include the following:

- We have expanded the class of exempt issuers.

- We have significantly reduced the escrow period from 3 years to 18 months for an established issuer, and from 6 years to 3 years for an emerging issuer.

- 75% of the venture capital organization's securities in an established issuer, and 40% of its securities in an emerging issuer, will be released within one year from listing.

- An emerging issuer may become an established issuer, resulting in an automatic release of securities no longer subject to escrow under the established issuer release schedule, and an accelerated release of any remaining securities.

- All of the venture capital organization's securities in an issuer may be sold at the time of the issuer's IPO in a secondary offering on a firmly underwritten basis or, subject to certain

conditions, on a best efforts basis, so long as the secondary offering is disclosed in the IPO prospectus.

C. ESCROW AGENTS' COMMENTS

1. Trust Company as Escrow Agent

Several commenters disagreed with the initial proposal that only trust companies be permitted to act as escrow agents, and commented that transfer agents should be permitted to act as escrow agents. The following reasons were given in support:

- Transfer agents have control over registration of securities, and associated rights of ownership are in the transfer agent's hands.

- The initial proposal will not result in equality in treatment of companies that provide escrow agent services from province to province, as requirements for a trust company under trust legislation differ from province to province.

- The initial proposal is anti-competitive and will result in higher costs being paid by issuers.

- The requirement does not add to the protection of the investing public, as the escrow agency relationship is a contractual relationship, the escrow agent is not asked to exercise any discretionary trust powers, the escrow securities are in registered form, not readily fungible and are not covered by CDIC insurance.

We agree that the class of persons who could act as escrow agent under the initial proposal was too limited. The National Policy permits any person or company that a Canadian exchange has approved to act as a transfer agent to be an escrow agent.

Another commenter stated that the underwriter for the issuer's IPO and legal counsel should also be entitled to act as escrow agent. The CSA are of the view that trust companies and other persons and companies that act as transfer agents have the appropriate relationship with the issuer and infrastructure in place to carry out escrow agent duties.

2. Indemnification of Escrow Agent

A few commenters stated that the indemnity of the escrow agent should be from the issuer and the securityholders, jointly and severally. This change was made.

A few commenters requested that language be added providing that the indemnity survives the release of all escrow securities and the termination of the escrow agreement. This change was made.

3. Drafting Comments

CSA received several technical drafting comments for the escrow agreement that we adopted.

4. Additional Provisions

A commenter suggested that a provision for the appointment of the escrow agent should be added to the escrow agreement. This change was made.

A commenter suggested that a provision be added to the escrow agreement directing the escrow agent to release escrow securities upon evidence of a decision of the appropriate securities regulators. To address this and other comments, we have added to the escrow agreement provisions noting the securities regulators with jurisdiction and requiring the consent of securities regulators to any amendments.

Commenters requested that the following provisions be added to the escrow agreement:

- The Escrow Agent shall not be responsible for the sufficiency, correctness, genuineness or validity of any securities deposited with it.

- The Escrow Agent shall be protected in acting upon any written document it receives, as to the document's due execution, validity and effectiveness, and the truth of its contents.

- The Escrow Agent may employ independent counsel and other advisors for the purpose of discharging its duties under the escrow agreement at the cost of the Issuer.

- The Escrow Agent shall have no duties or liabilities except those expressly set forth in the escrow agreement.

- The Escrow Agent shall not be bound by any notice of a claim or demand with respect thereto, or any waiver, modification, amendment, termination or rescission of the escrow agreement unless received by it in writing, and signed by the other parties, and, if the duties or indemnification of the Escrow Agent herein are affected, unless it shall have given its prior written consent.

- This is the entire agreement among the parties concerning the subject matter set out herein and supersedes any and all prior understandings and agreements.

We agree and added similar provisions to the escrow agreement.

We did not agree with the suggestion to add a provision stating that the Escrow Agent shall not be liable for any action taken or omitted by it, or any action suffered by it to be taken or omitted excepting only its own gross negligence or wilful misconduct. We do not agree that this is an appropriate standard of care. The appropriate standard of care is negligence.