Securities Law Bulletin

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Securities Alert!
Major Changes to Canadian Capital Raising Exemptions

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The Canadian Securities Administrators ("**CSA**") have reacted to the fundamental changes in the Canadian capital markets, which are similar to the changes that have been occurring within many developed capital markets internationally. The key change is a shift in capital formation from initial public offerings and additional issues to the remarkably large increase in funds raised through the prospectus exempt market.

This shift in activity has led the CSA and securities regulators globally to place their focus and resources on the regulation of prospectus exempt market participants, especially broker dealers, as well as on enforcement in order to be assured that the prospectus exempt market is open only to those who do not require the protections offered in the public market. Clearly, the CSA had concerns that the participants in the prospectus exempt market included far too many people for whom such a market was not designed.

Accordingly, the CSA reviewed certain Canadian securities laws and instruments relating to capital raising. The review came about as a result of investor protection concerns triggered by the recent financial crisis. Specifically, concerns were raised around whether investors properly understood the applicable exemptions from the prospectus requirement and, in particular, the specific category of the applicable prospectus exemption. Such knowledge is necessary to understand both the nature and risk inherent in an investment.

In connection with this review, effective as of May 5, 2015, the CSA adopted amendments to National Instrument 45-106 *Prospectus and Registration Exemptions* ("**NI 45-106**"). The amendments relate to, among other things, the "accredited investor" ("**AI**") exemption, the minimum amount ("**MA**") exemption, and the adoption of a new "family, friends and business associates" ("**FFBA**") exemption for Ontario (collectively, the "**Amendments**").

The Amendments include the following:

1. Two new categories of AI have been made available: (a) the "permitted client" and (b) the "family trust". The "permitted client" category applies to an individual who beneficially owns financial assets with realizable value before taxes in excess of $5 million. The "family trust" category applies to a person for whom a trust has been set up (not the settlor) who is an AI, where the majority of the trustees of the trust are AIs, or where all beneficiaries are family of an AI, an AI's spouse or former spouse.

2. Individual accredited investors other than "permitted clients" must now complete a Risk Acknowledgement Form ("**RAF**"), which must be signed at the time they purchase securities in reliance on the AI exemption. The forms must disclose the specific category of AI under which the purchaser qualifies for the exemption. The RAF describes in plain language the categories of AI, identifies key risks associated with purchasing exempt market securities, and identifies the "salesperson" in relation to the subscription (including representatives of the issuer who meets with or provides information to the subscriber with respect to his or her investment). Signed RAFs must be kept by the issuer or dealer of the securities purchased in reliance on the AI exemption for eight years after the trade.

3. The MA exemption may no longer be used to distribute exempt market securities to individuals. The MA exemption allows purchases of securities with an acquisition cost of not less than $150,000 cash to be made without a prospectus. The MA exemption is still available to holding companies, trusts and partnerships.

4. Ontario has adopted the FFBA exemption, similar to existing exemptions in other jurisdictions, whereby investors (other than investment funds) may purchase securities as principal if they are:

a. a director, executive officer or control person of the issuer, or of an affiliate of the issuer;

b. family of a director, executive officer or control person of the issuer, or of an affiliate of the issuer, or of their spouse;

c. a close personal friend of a director, executive officer or control person of the issuer, or of an affiliate of the issuer;

d. a close business associate of a director, executive officer or control person of the issuer, or of an affiliate of the issuer;

e. a founder of the issuer or family, close personal friend or close business associate of a founder of the issuer, or family of the spouse of a founder;

f. a person of which a majority of the voting securities are beneficially owned by, or a majority of the directors are, persons described above; and

g. a trust or estate of which all of the beneficiaries or a majority of the trustees or executors are persons described above.

To qualify, an investor must obtain a RAF signed by the issuer, the investor and the person with whom the investor has the relationship, and the form must disclose the specific relationship that qualifies the purchaser for the exemption. Generally, the FFBA exemption replaces the previous "founder, control person and family" exemption in Ontario.

5. The companion policy to NI 45-106 now includes language pursuant to which an issuer and a seller are required to take "reasonable steps" to verify the status of purchasers under the capital raising exemptions in NI 45-106 (including the AI exemption and the FFBA exemption). For instance, when distributing securities under the AI exemption, a dealer or adviser may not simply rely on a purchaser's representation in its subscription documents or a "check the box" system of representations. Rather, the dealer or adviser must take "reasonable steps" to verify the information represented by an investor. The meaning of "reasonable steps" will depend in large part on the context of the transaction and includes considerations such as how potential purchasers are located, which category of the AI exemption an investor claims to meet, what type of background information is known and whether the person who meets with the investor is registered.

While the meaning of "reasonable steps" has not been prescribed, such steps might include providing detailed information to an investor regarding the different categories of the AI exemption such as, for example, explaining how the income and asset tests are applied, requesting details regarding a purchaser's financial circumstances and, if concerns about exemption eligibility remain, requesting independent documentation to corroborate the purchaser's representations. As a result, issuers and sellers should prepare their own checklist of questions for investors to complete in order to obtain as much information from the investor as possible, such as:

a. How did the investor come to know the issuer/seller?

b. How long have they known each other?

c. Who is the contact person?

d. Is there a reasonable basis to believe that the investor has met the correct AI exemption category indicated?

e. Does the investor understand the definitions of the terms used in the particular AI category such that the investor knows which category it falls under?[1]

In large part, the Amendments represent an attempt to reduce investor confusion and highlight risks inherent in the prospectus exempt market by requiring market participants to attend to the information being represented by investors. How the prospectus exempt market will react, however, remains to be seen.

[1]Additionally, issuers must also pay particular attention to the privacy concerns raised by obtaining such level of disclosure from investors or third parties and should consider adopting information and privacy policies in order to properly document findings and safeguard the investor information obtained.

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