

INNOVATIVE FINANCE NEWS



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in Ontario

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PROSPECTUS EXEMPTIONS IN ONTARIO



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INTRODUCTION

A starting point for securities regulation in Canada requires entities that propose to distribute securities to file with securities regulators and obtain approval of a "prospectus" and to provide a copy of the prospectus to any proposed purchaser of such securities.

The prospectus requirement is intended to ensure that prospective investors receive "full, true and plain" disclosure about the securities offered for sale, as well as a meaningful remedy if there are any misrepresentations in that disclosure. However, the prospectus requirement can be an expensive and time-consuming process. It imposes a particularly onerous burden on small businesses and start-up companies in search of capital, but which have limited resources at the outset.

Fortunately, certain exemptions from the prospectus requirement are available.

WHAT IS THE EXEMPT MARKET?

The options available to issuers distributing securities in Canada are to: (i) provide a prospectus; (ii) qualify for an enumerated exemption from the prospectus requirement; or (iii) apply to securities regulators for a discretionary exemption from the prospectus requirement.

Those transactions that qualify for an exemption are referred to as "exempt market transactions," as they allow securities to be issued without the prospectus requirement and thereby enable capital to be raised on more flexible and cost-effective terms.

POLICY CONSIDERATIONS BEHIND PROSPECTUS EXEMPTIONS

There are four primary policy considerations that underlie most prospectus exemptions. These are:

A. SMALL TO MEDIUM SIZED ISSUERS

The specific circumstances of start-up, small to medium-sized issuers requires greater flexibility and cost efficiency than the prospectus process allows. Doing away with the regulatory burden of the prospectus process may allow for an increase in initial amounts of working capital.

A typical IPO (initial public offering) prospectus in Ontario can cost in the range of \$250,000 to prepare and carry through to approval and the overall process can take months to complete. By contrast, a securities offering by way of prospectus exemption can cost \$5,000 to \$75,000 (depending on complexity, or more in extremely complex cases) and be complete and "on the street" in as little as two or three weeks.

B. SOPHISTICATED INVESTORS

A second policy consideration acknowledges that some wealthy and/or sophisticated investors are capable of making investment decisions without the information that a prospectus provides. The assumption is that such investors are capable of acting rationally in their own economic self-interests and will seek out, directly from the issuer or its representatives, any information they consider relevant to their investment decisions.

These investors primarily fall into the "accredited investor" exemption. The spirit of this exemption is the recognition that some investors have the intellectual and/or financial means to bear the increased risk that is inherent in an investment that is highly speculative but potentially profitable.

C. CLOSE PRE-EXISTING RELATIONSHIPS

When entities issue securities to persons with whom they have a pre-existing relationship, the requirements of the prospectus process may be relaxed. In such instances, it is assumed that the investor has already had access to relevant information about the issuer and its financial prospects. This satisfies a primary purpose of a prospectus, which is to distribute material information to prospective investors. The investor, therefore, is already in a position to gain access to information akin to that which would be contained in a prospectus.

D. SAFE SECURITIES

Some types of securities are deemed to be so safe that filing a prospectus for them is considered redundant. The policy rationale for exempting these market transactions, therefore, lies in the simple fact that investors do not need protection.

Examples of such exempt securities in the Ontario Securities Act (Section 35(2)) include government bonds, municipal debentures and indebtedness issued by Canadian banks, insurance companies and credit unions.

COMMON ISSUER EXEMPTIONS

The prospectus exemptions which are most commonly used by small to medium sized enterprises ("SMEs") are discussed below.

A. ACCREDITED INVESTOR

Any distribution to an investor who qualifies as an "accredited" investor is exempt from the prospectus requirement. Section 1.1 of National Instrument 45-106 – Prospectus and Registration Exemptions ("NI 45-106") contains a lengthy description of investors who qualify. Virtually all institutional investors (including banks, trust, loan and insurance companies, credit unions and governments) are "accredited."

Section 1.1(j) of NI 45-106 deems an individual investor to be "accredited" if that individual, either alone or with a spouse, beneficially owns financial assets "having an aggregate realizable value that, before taxes but net of any related liabilities, exceeds \$1,000,000." The Companion Policy to NI 45-106 defines "financial assets" to mean cash, securities, or a contract of insurance. These are generally liquid or relatively easy to liquidate.

This contrasts unfavourably with the U.S. rule (found in Regulation D to the U.S. Securities Act), which provides that an "accredited investor" (for U.S. purposes) includes a person "whose individual net worth with that person's spouse, at the time of the purchase exceeds \$1,000,000". This includes the investor's principal residence, as well as other real estate assets and other assets generally, which conceivably could include collectibles, furnishings and the contents of a wine cellar. The more restrictive Canadian rule (which was apparently brought about at the behest of the Ontario Securities Commission) dramatically scales back the number of persons who could qualify for this exemption and, therefore, restricts available capital to SMEs.

Further categories of "accredited investor" include: (Section 1.1(k)) an individual whose net income before taxes exceeded \$200,000 (\$300,000 if together with a spouse) in each of the two most recent years and who, in either case, reasonably expects to exceed that net income level in the current year; and (Section 1.1(l)) an individual who, either alone or with a spouse, has net assets of at least \$5,000,000. (This includes real estate and other assets, which are included in the U.S. \$1,000,000 threshold.)

B. "PRIVATE ISSUER" EXEMPTION

The "private issuer" exemption is found in Section 2.4 of NI 45-106. This provision provides a prospectus exemption to issuers who distribute their securities to a limit of fifty investors who are close colleagues, directors, officers, employees or a founder or control person of the issuer, friends, family, accredited investors and persons or companies that are "not the public."

C. "FAMILY, FRIENDS AND BUSINESS ASSOCIATES" EXEMPTION

This exemption is set out in Section 2.5 of NI 45-106, but does not apply in Ontario. The more restrictive "founder, control person and family" exemption (Section 2.7) applies in Ontario. "Family" (in Ontario) refers to "a spouse, parent, brother, sister, grandparent or child of an executive officer, director or founder of the issuer". The Ontario rule excludes "close personal friends" and "close business associates", which are available pursuant to the broader rule in the entire balance of the country. Again, this restricts available capital to SMEs in Ontario.

D. MINIMUM AMOUNT INVESTMENT

Section 2.10 of NI 45-106 provides for a prospectus exemption for distributions of securities to a person who invests a minimum of \$150,000. The investor must purchase as principal and pay the entire purchase price in cash at the time of the distribution. As in the case of the accredited investor exemption, the minimum investment exemption assumes that an investor with the means to invest at least \$150,000 has the financial wherewithal to absorb potential losses and the sophistication to assess the merits and advisability of the prospective investment.

E. OFFERING MEMORANDUM

An “offering memorandum” means a document, together with any amendments, purporting to describe the business and affairs of an issuer, that has been prepared primarily for delivery to and review by a prospective purchaser so as to assist the prospective purchaser to make an investment decision in respect of securities being sold pursuant to a prospectus exemption.

The offering memorandum exemption (Section 2.9 of NI 45-106) applies in nine provinces and two territories, but, unfortunately, not in Ontario. This exemption is available where the issuer delivers an offering memorandum, in the prescribed form. In five provinces and the two territories, this exemption is only available if the purchaser is an “eligible investor” or invests no more than \$10,000. An “eligible investor” is someone considerably less affluent than an “accredited investor” – “net assets” with spouse exceed \$400,000 or net income alone of \$75,000 per annum or net income with spouse of \$125,000 per annum. The prescribed form of offering memorandum is onerous and detailed, but can be prepared at far lower cost and far more quickly than a prospectus. The offering memorandum exemption, therefore, is very accommodative to SMEs seeking to raise capital, particularly in later (but pre-IPO) stages. Again, Ontario is the odd man out, leaving Ontario SMEs with more restricted access to capital. This will undoubtedly adversely impact on the number of, capitalization of, and employment by, SMEs in Ontario.

EXEMPT MARKET DEALER REQUIREMENT


Unfortunately, utilization of the exempt securities market has been made more difficult with the CSA's implementation of National Instrument 31-103 - Registration Requirements and Exemptions (“NI 31-103”), which came into effect on September 28, 2009. In Ontario, registration as a Limited Market Dealer

(“LMD”) has long been required for anyone who was considered a market intermediary – that is, a person or company that was in the business of buying and selling prospectus exempt securities. The new category of Exempt Market Dealer (“EMD”) imposes a more restrictive approach to securities distributions.

NI 31-103, which applies throughout all of the Canadian provinces and territories, provides that dealer registration is mandatory when an individual or firm conducts trading activity as a business or holds itself out as being in the business of trading. (The Companion Policy 31-103CP provides additional guidance, whereby a person who trades securities for his own account will not generally be required to register.)

The impact of this new category is significant. Similar to the former LMD category, EMDs will be restricted to dealing in prospectus-exempt securities or with persons to whom prospectus-exempt securities can be distributed (i.e., accredited investors), but unlike LMDs (who were expressly excluded from these requirements), the new category provides that EMDs are subject to all the capital, insurance, record-keeping, reporting, disclosure and other conduct requirements outlined in the Instrument. Therefore, much more onerous conditions are imposed on EMDs. As a result, the overall accessibility to the exempt market will be reduced, as far fewer entities will be able to maintain qualification as EMDs than was the case when the LMD category applied. Whereas the prospectus exemptions were intended to provide greater flexibility and ease of access for exempt market participants, it appears that NI 31-103 may have the opposite effect.

CONCLUSION

Given the high cost of prospectus offerings, the availability of prospectus exemptions is of vital importance to SMEs seeking capital. Fairly generous exemptions are available in almost the entire country (with the exception of Ontario), creating an accommodative environment for SME capital formation. 

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