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# SECURITIES

M A T T E R S

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## New Private Placement Rules

### HARMONIZATION AT LONG LAST

by John A. Peters, *q.c.*

#### INTRODUCTION

The Canadian Securities Administrators, the inter-provincial association of securities regulators (the “CSA”), recently established a comprehensive set of rules to deal with private placements under National Instrument 45-106 (“NI 45-106”). The rules contained within NI 45-106 incorporate exemptions contained in earlier legislation or other policies. In this article we will very briefly examine the exempt market rules as they existed under legislation originally and the rules during a period of transition when various jurisdictions had their own sets of requirements. We will also consider a number of the exemptions contained within the new NI 45-106.



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## REGISTRATION AND PROSPECTUS REQUIREMENTS

Securities legislation in Canada generally imposes two requirements on companies wishing to issue shares or other securities. The first is known as the “*registration requirement*”, the second as the “*prospectus requirement*”.

Section 74 of the *Securities Act* of Alberta, (the “*Alberta Act*”) sets out the *registration requirement* and states that no person or company shall trade in a security or act as an underwriter unless the person or company is registered with the Alberta Securities Commission as a dealer, sales person or a director or officer of a registered dealer. This requirement also extends to those who act


as advisors. The purpose of the registration requirement is to ensure that only qualified individuals advise investors on securities. Canadian security regulators impose stringent requirements on investment dealers, which includes training programs, bonding, background checks and so on.

The *prospectus requirement* is found in Section 110 of the *Alberta Act*, which states that no person or company shall trade in a security unless a preliminary and final prospectus have been filed and approved by the Securities Commission. The *Alberta Act* also prescribes the forms to be used when a prospectus is filed. Anyone who has completed the process of filing and having a prospectus vetted by securities regulators will be aware of the costs and time involved in this process.

Notwithstanding these two requirements, securities legislation has also long recognized that not every sale of securities should be subject to these burdens. As a result, there have always been a number of exemptions to these general requirements known as the “*exempt market*” or “*private placement*” rules.

## PRIVATE PLACEMENT RULES

The private placement rules have undergone significant reform over the past number of years. There has been an ongoing effort by the CSA to standardize and harmonize Canadian securities legislation. On September 14, 2005 all jurisdictions of Canada adopted NI 45-106, which established one set of standard and comprehensive rules for trades and transactions in securities, which are



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exempt from the prospectus and registration requirements. While there unfortunately remain some variations in this new policy to take into account certain provincial concerns, companies and their legal advisors wishing to issue securities can now turn to a single document to determine the rules for exempt market dealings and transactions.

Regulatory legislation does not exist in a vacuum. Public policy underlies the legislation and public pressures alter the legislation over time. The laws governing securities are no exception. There are a number of broad public policy considerations behind the exempt market rules. Generally speaking, the prospectus exemptions provide for the following situations:

- ▶ the purchaser is sophisticated or well capitalized,
- ▶ the seller and the buyer of securities stand in a certain relationship to each other,
- ▶ the security is of such a high quality that no regulatory protection is required,
- ▶ the value of the trade is sufficiently large,
- ▶ the transaction is made within a small circle and there is no public aspect to it,
- ▶ the transaction may proceed on something less than a prospectus (i.e. an offering memorandum),
- ▶ a creditor is enforcing a debt against a security, and
- ▶ the transaction is already subject to securities or other regulation.

## THE ORIGINAL SYSTEM

Under the original system of securities regulation, the exemptions to the prospectus and registration requirement were generally contained within legislation passed by the provincial legislatures. Over time, certain powers were devolved to the Securities Commissions in order that they could act outside of the strict confines of the legislation. For example, the Securities Commissions were empowered to give discretionary orders exempting trades and the minimum amount of the sophisticated investor exemption, originally fixed in the Alberta Act at \$97,000., was to be established by the securities regulators rather than the legislature.

The original capital raising exemptions inhibited the growth of private companies, unless the investors were prepared to put up large amounts of capital. Once an issuer reached a 50-investor limit, future capital from new private investors could only be raised in two ways. The first was under the sophisticated investor exemption, which had a minimum investment requirement of \$97,000., or \$150,000., depending upon the jurisdiction. The other method was the offering memorandum exemption, which required the preparation of an offering memorandum and had its own limits in terms of frequency and number of investors one could attract.

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## INTERIM RULES IN VIEW OF THE CHANGING ENVIRONMENT

Over time, the provincial legislatures of the major jurisdictions devolved more power to the Securities Commissions to make rules that did not require any further legislative action.

Given these powers, the Ontario Securities Commission was the first to move and change the exempt market rules. In late 2001, Ontario brought in Rule 45-501 to govern exempt distributions. This rule introduced the “accredited investor” concept, significant components of which come directly out of United States securities legislation.

The Western provinces, principally British Columbia and Alberta, developed their own exempt market rules and in June of 2003, Multilateral Instrument 45-103 came into effect. This new rule was implemented in all of the Western provinces, three of the four Atlantic provinces and the Northwest Territories. New Brunswick and the Yukon Territory, which did not have the same rule making authority, also agreed generally to apply this multilateral rule to applications

made on a case-by-case basis. Neither Ontario nor Quebec implemented this new policy, with the result that issuers had to comply with different policies in major jurisdictions.

Importantly, MI 45-103 adopted the “accredited investor” concept. However, it retained the familiar notion of the private issuer and provided more certainty as to the individuals who could invest in a private issuer. It left the limit of shareholders for a private issuer at 50. The rules regarding private placements by offering memorandums were also changed and a new form was prescribed for this document.

In connection with the offering memorandum exemption, a new concept of the “eligible investor” was adopted.

The capital raising exemptions were broken down into four major categories consisting of the following:

- ▶ the private issuer exemption,
- ▶ family, friends and business associates exemption,
- ▶ offering memorandum exemption, and
- ▶ accredited investor exemption.

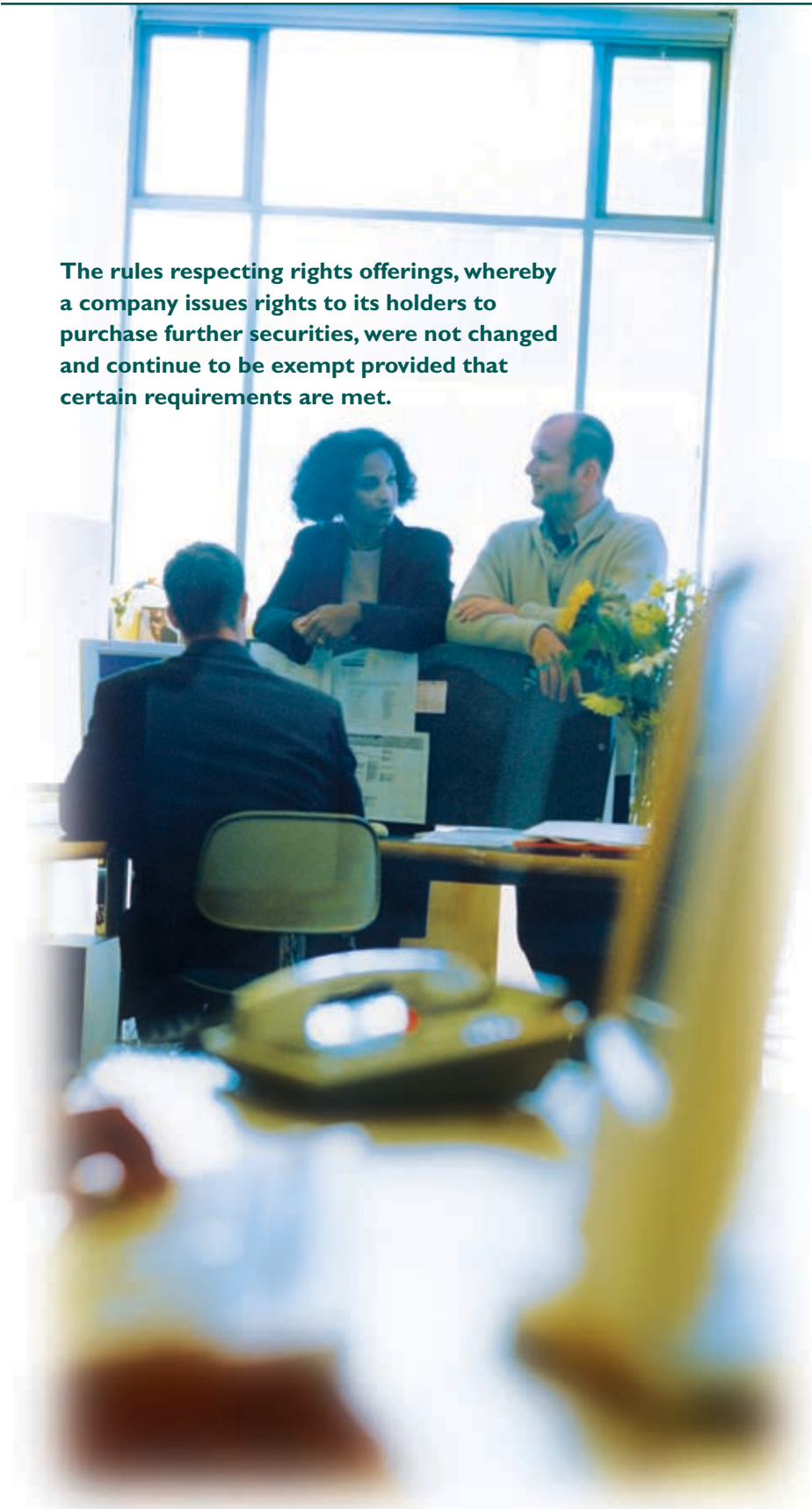
More than any other change to securities law, the adoption of the accredited investor exemption in Ontario and the other provinces and territories under MI 45-103 gave life to the widely-held and well capitalized private company in Alberta, especially in the oil and gas sector.

## THE NEW RULES

On September 14, 2005 NI 45-106 came into effect. These new rules apply to every jurisdiction in Canada, although Ontario did not adopt all of the exemptions.

The new rules are much more comprehensive than the two predecessor policies with the result that virtually all prospectus and registration exemptions are governed by the new rules. NI 45-106 breaks down the exemptions into the following groups:

- ▶ capital raising exemptions,
- ▶ transaction exemptions,
- ▶ investment fund exemptions,
- ▶ employee, director and officer exemptions,
- ▶ miscellaneous exemptions,



**The rules respecting rights offerings, whereby a company issues rights to its holders to purchase further securities, were not changed and continue to be exempt provided that certain requirements are met.**

- ▶ registration exemptions,
- ▶ control block distribution exemptions, and
- ▶ venture exchange offering exemptions

Some of the exemptions are highlighted below.

#### **Rights Offerings**

The rules respecting rights offerings, whereby a company issues rights to its holders to purchase further securities, were not changed and continue to be exempt provided that certain requirements are met. There is also a national instrument of the CSA that specifically deals with rights offerings.

#### **Reinvestment Plan**

Unlike its predecessors, NI 45-106 specifically sets out the requirements for dividend reinvestment plans.

#### **Accredited Investor**

Not surprisingly, the “accredited investor” concept introduced in 2001 has survived, although there are some technical changes to take into account the fact that additional provinces have signed on to the new policy. These technical changes do not affect the important exemptions related to qualifying individuals.

Apart from the usual typical exempt purchasers, such as banks, trust companies, pension funds and so on, this rule recognizes certain individuals and companies who can purchase securities without the need for the protections afforded by the registration and prospectus requirements. Specifically, these categories are as follows:

- ▶ an individual who owns or together with a spouse owns financial assets, i.e. cash and securities, having a value, net of related liabilities, of over \$1,000,000.,
- ▶ an individual whose net income before taxes exceeds \$200,000. in each of the two most recent years or whose net income before taxes combined with that of a spouse exceeds \$300,000. in each of those years and who had a reasonable expectation of exceeding that same income level in the current year,
- ▶ a company or other entity that has net assets of at least \$5,000,000. as reflected in its most recently prepared financial statements, and

- ▶ a person or company, the owners of which are all accredited investors, i.e. fall within the above and other categories recognized by the rule.

#### **Private Issuer**

Fortunately, Ontario has again accepted the older definition of the private issuer, i.e. an entity that has no more than 50 owners. As a result, private issuers can now issue securities across the country to their directors, officers, employees and close personal friends or associates or certain family members of directors, executive officers, founders or control persons. It should also be noted that accredited investors may also invest in private issuers without having that type of relationship with the company or its executives.

#### **Family, Friends and Business Associates**

Even companies that are not private will be able to use this exemption, which allows sales of securities to directors, officers and control persons, their family members and close personal friends or associates. For trades in Saskatchewan, one must obtain a prescribed risk acknowledgement form. Unfortunately, Ontario did not agree to adopt this exemption in precisely the same form. Ontario's requirements with respect to the family and friend's exemption are somewhat different than those in the rest of Canada.

#### **Offering Memorandum**

The offering memorandum exemption allows for sales of securities using an offering memorandum in prescribed and fairly simple form. There are certain regional variations. For example, in Alberta, Manitoba, Quebec and Saskatchewan there is a requirement that the purchaser must be an eligible investor or the acquisition cost to the purchaser does not exceed \$10,000.00. British Columbia and the three Atlantic provinces other than P.E.I. do not impose this requirement. In addition, Ontario has not accepted the offering memorandum exemption at all. The offering memorandum must be in a prescribed form. It should be noted that there is no longer any requirement regarding a maximum number of purchasers.

An eligible investor is defined as a person or company who

- ▶ has net assets of over \$400,000. either alone or with a spouse,
- ▶ has net income before taxes of over \$75,000. in each of the two most recent years and who expects to exceed that level of income in the current year, or
- ▶ has net income before taxes combined with the income of a spouse of over \$125,000. in each of the two most recent years and who reasonably expects to exceed that level in the current year.

#### **Minimum Investment Amount**

We now have a standard \$150,000. minimum investment amount across the country. This applies so long as the investor purchases as a principal from a single issuer. The \$97,000. exemption in Alberta has now been revoked. There is also a similar exemption governing trades of securities or assets if the assets have a fair value of not less than \$150,000.

#### **Business Reorganizations and Takeover Bids**


The exemptions that relate to business reorganizations, amalgamations and takeover bids have now been moved from securities legislation generally and brought under the national instrument and remain the same.

#### **Private Investment Clubs and Private Investment Funds**

Both of these exemptions, previously covered by securities legislation or rules generally, have now been brought under the new policy.

#### **Employees, Executive Officers and Directors**

The regulations surrounding these trading activities are complex. However, generally a company may issue a security of its own issue to an employee, executive officer, director or consultant of the issuer if participation in the trade is voluntary. This exemption allows the trading that takes place in stock option plans, for example.



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### **Dividends or Distributions**

Dividends or distributions made in kind by an issuer to its security holders are also exempt, as before.

### **High Grade Debt**

Certain high quality debt securities continue to be exempt from the prospectus and registration requirements. Government of Canada or provincial debt securities, municipal debt, Canadian financial institution or Schedule 3 bank debt and certain international bank debt remain exempt.

### **Short Term Debt**

Negotiable promissory notes or commercial paper maturing not more than one year from the date of issue are exempted from the generally requirements, provided they are not convertible into another security and have been approved to a certain standard from an approved credit rating agency.

### **Syndicated Mortgages**

Generally, deals in syndicated mortgages must be registered under mortgage brokerage or mortgage dealer legislation and thus come within a different regulatory scheme. As a result, trading in mortgages is generally exempt from the prospectus and registration requirements. It should be noted, however, that British Columbia, Manitoba, Quebec and Saskatchewan do not extend the exemption to a syndicated mortgage, i.e. a mortgage to which two or more people participate as lenders.

### **Not for Profit Organizations**

Securities legislation in Canada has generally exempted trades in securities by organizations that have been established exclusively for educational, benevolent, fraternal, charitable or religious or recreational purposes and not for profits under certain circumstances. One of the qualifications to this exemption is that no part of the net earnings benefits any security holder of the organization. It is by virtue of this exemption that golf courses, for example, can issue shares to their members without having to comply with the securities legislation generally.

### **RRSP Trades**

For some time, trades between an individual and his or her RRSP or RRIF have been exempt. NI 45-106 continues to recognize this exemption.

### **Certificates of Deposit**

Certificates of Deposit issued by a Schedule 3 bank continue to remain exempt.

### **Conversions**

Canadian securities legislation has generally acknowledged that converting one form of security to another of the same issuer should not be subject to the prospectus and exemption requirements. This particular exemption is recognized in the new national instrument.

**NI 45-106 represents an important step forward in the harmonization and rationalization of the private placement rules. Virtually all of the prospectus and registration exemptions can now be found in one source.**

### **TSX Venture Exchange – Exchange Offering Properties**

For some time, the TSX Venture Exchange and its predecessors allowed its listed companies, which meet certain requirements, to offer their securities under a short form disclosure document known as the exchange offering prospectus. There are a number of significant limitations on the use of this exchange offering document including restrictions on the number of securities that may be offered, the proceeds to be raised (limited to \$2,000,000.) and the parties who may purchase the securities. NI 45106 continues to allow this exemption, except in the province of Ontario.

### **REPORTING REQUIREMENTS**

It has long been the practice that an issuer must file a report of the exempt trade and pay certain fees based upon the capital raised. Part 6 of NI 45-106 continues this practice and requires that a report of a trade by the issuer be filed within 10 days of the date of distribution under certain exemptions, including the accredited investor, family, friends and business associates, offering memorandum and minimum amount investment (\$150,000.) exemptions.

### **HOLD PERIODS**

In Canada, we generally have what is known as a “closed system”. This means that the exempt trade in a security does not entitle the holder to further trade the security without meeting certain requirements. If the security that the holder has acquired is of an entity that is not a “reporting issuer”, which is typically a publicly traded company, then there is an indefinite hold period on the securities. In other words, the purchaser may not further sell the security unless he can avail himself of a further prospectus exemption.

In order to get out of the closed system, the issuer must become a reporting issuer and subject itself to the continuous disclosure requirements, including financial statement and material change disclosure.

National Instrument 45-102, which was also amended in light of NI 45-106, sets out the rules regarding resales of securities. Essentially, under Part 2.5 of NI 45-102 a purchaser must hold a security issued by a reporting issuer for 4 months before the security is freely tradable. In addition, if the security originally acquired was of a private company, then the company must become a reporting issuer before the security can be traded without reliance on a further prospectus exemption.

### **CONCLUSION**

NI 45-106 represents an important step forward in the harmonization and rationalization of the private placement rules. Virtually all of the prospectus and registration exemptions can now be found in one source. This should be of great assistance both to companies wishing to issue their securities and to their professional advisors.

It is indeed unfortunate that there continue to be some fairly important provincial exceptions to the general rules. Notably, Ontario has opted out of a number of the significant exemptions or chosen to adopt its own policy in certain circumstances. In due course, one would hope that these provincial exceptions will fall by the wayside and we will be left with one comprehensive set of rules for the entire country.

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