

OSC Introduces Four Proposed Prospectus Exemptions in Ontario

In connection with its **Exempt Market Review**, the Ontario Securities Commission (**OSC**) is publishing for a 90-day comment period proposals for four new prospectus exemptions in Ontario (the **Proposed Prospectus Exemptions**):

- an offering memorandum (**OM**) prospectus exemption (the **OM Exemption**),
- a family, friends and business associates prospectus exemption (the **FFBA Exemption**),
- a prospectus exemption for distributions by a reporting issuer to its existing security holders (the **Existing Security Holder Exemption**), and
- a crowdfunding prospectus exemption (the **CF Exemption**).

Expanded OSC Exempt Market Review

The Exempt Market Review was originally focused on the accredited investor prospectus exemption in section 2.3 of NI 45-106 – *Prospectus and Registration Exemptions* (the **AI Exemption**) and the minimum amount investment prospectus exemption in section 2.10 of NI 45-106 (the **MA Exemption**).

As a result of the feedback received during the original Exempt Market Review, the OSC decided to expand its review to consider ways to facilitate greater access to capital through the exempt market, particularly for start-ups and small and

medium-size enterprises (**SMEs**), while maintaining appropriate investor protection.

Substance And Purpose Of The Proposed Prospectus Exemptions

OM exemption

The OM Exemption was proposed to support the capital raising needs of issuers that are moving beyond the early stages of development. In order to facilitate harmonization, this exemption is based on the existing OM exemption in section 2.9(2) of NI 45-106, which is currently unavailable in Ontario. It is expected that the OM Exemption will provide enhanced opportunities for exempt market dealers to be involved in start-up and SME financings.

FFBA exemption

The OSC believes that start-ups and other early-stage issuers could benefit from greater access to capital from their network of family, close personal friends and close business associates than is currently permitted under Ontario securities law. This exemption is based on the existing FFBA Exemption in subsection 2.5(1) of NI 45-106, which is currently unavailable in Ontario.

Existing Security Holder exemption

Many SMEs continue to face capital raising challenges after they have become reporting issuers and are listed on a stock exchange. Furthermore, retail security holders generally have less opportunity to invest in primary offerings by listed issuers, even if they have already made an investment decision to acquire the issuer's securities in the secondary market. It is anticipated that the Existing Security Holder Exemption will help to address these issues.

For a more detailed discussion on the corresponding exemption adopted by other CSA jurisdictions (other than Newfoundland), please refer to our bulletin [here](#).

CF exemption

Crowdfunding has quickly become an important new method of raising capital through the internet. To date, it has generally been used to raise money for specific projects and does not generally involve the issuance of securities. It is believed that crowdfunding through an appropriately regulated internet portal can be a viable method for start-ups and SMEs to raise capital.

The proposed crowdfunding securities regulatory framework has two main components:

- the CF Exemption; and
- a set of crowdfunding internet portal requirements.

Recognizing that the crowdfunding model has found significant followings, particularly in areas of perceived market inefficiencies, other CSA jurisdictions are proposing corresponding exemptions. For a discussion of the exemption being proposed by Quebec, Saskatchewan, New Brunswick, Manitoba and Nova Scotia, please refer to our bulletin [here](#).

Analysis Of Costs And Benefits

The Proposed Prospectus Exemptions would increase investment opportunities for non-accredited investors who currently have very limited access to the exempt market.

Issuers that want to raise money across Canada currently face higher funding costs because capital raising rules in the exempt market are not harmonized across the provinces. Many issuers in Ontario are limited to raising capital under the AI Exemption or MA Exemption.

The most significant of the Proposed Prospectus Exemptions are likely to be the OM Exemption and CF Exemption in terms of impact on capital raising.

The OM Exemption has been long anticipated and brings Ontario, where more than 96% of the investors do not meet the test of the current AI Exemption¹, in line with the rest of Canada. In our experience, some companies have been reluctant to avail themselves to the OM exemptions in other provinces in part because of its unavailability in Ontario. This proposed exemption, if implemented, will likely change the cost/benefit analysis of the OM exemptions across Canada, and open up a large pool of potential financing for cash strapped issuers. Despite there being a lack of the OM Exemption, 60% of the Canadian exempt market funding comes from Ontario², where more than 90% of such funding is currently done by way of the AI Exemption, with the MA Exemption making up the bulk of the remaining amounts³.

For the CF Exemption, reporting issuers that rely on this exemption are not expected to incur any additional compliance costs. However, non-reporting issuers relying on the CF Exemption will be subject to certain ongoing disclosure requirements. Although the anticipated costs of these requirements should be significantly less than disclosure obligations for a reporting issuer, they may be higher than the cost of raising funds through other prospectus exemptions such as the AI Exemption, the MA Exemption or the FFBA Exemption, which are also available for non-reporting issuers.

The most significant ongoing expenditure for non-reporting issuers would involve its preparation of annual financial

¹ "Welcome to Canada's exempt market: Exclusive, anything goes investments – but play at your own risk", The Financial Post (June 15, 2013).

² "Equity Crowdfunding: A Brave New Market?", The Calgary Herald (March 18, 2014).

³ OSC Exempt Market Review, [OSC Notice 45-712 Appendix C](#), at page 12.

statements. Issuers would need to provide annual financials at point of sale if they have had incurred any expenditures and would have to provide them on an annual basis to investors. The annual financial statements would need to be reviewed by an independent public accounting firm. However, if the aggregate amount raised under the CF Exemption and any other prospectus exemption is over \$500,000 since the issuer's formation and the issuer has expended at least \$150,000 since that time, then the annual financial statements would need to be audited.

In introducing the CF Exemption, the OSC is responding to a worldwide trend in equity crowdfunding. Given Canada's depressed venture capital market, this is potentially a significant change and puts them ahead of the SEC which, despite the JOBS Act passing in 2012, still has not adopted rules to implement an equity crowdfunding exemption in the United States.

The FFBA Exemption is an attempt to harmonize Ontario with other CSA jurisdictions and should be helpful for start-ups. While the proposed changes do not expand the categories of qualified investors from the existing founder, control person and family exemption in section 2.7 of NI 45-106, it does, among other things, provide helpful guidance on investor qualifications.

The Existing Security Prospectus Holder Exemption may provide a cost-effective method for reporting issuers listed on the TSX, and more importantly for junior issuers listed TSXV and the CSE, to do offerings to existing security holders which will be quicker and cheaper than rights offerings under the current regulatory regime. There are no additional disclosures or filing requirements (other than an offering news release) than those already required for reporting issuers.

One investor protection concern is that existing security holders who do not participate in a distribution under the Existing Security Prospectus Holder Exemption may experience significant dilution. The OSC is attempting to mitigate this

concern by limiting the maximum dilution of the outstanding securities in the same class as those subject to the offering to 100%, and requiring issuers to give existing security holders the right to subscribe on a *pro rata* basis.

Comments must be submitted in writing by June 18, 2014.

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[a cautionary note](#)

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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Comparison of Proposed Prospectus Exemptions

Exemptions	OM	FFBA	CF	Existing Security Holder
Issuer restrictions				
Qualification criteria	<ul style="list-style-type: none"> ▪ Available to both reporting issuers and non-reporting issuers ▪ Not available to investment funds 		<ul style="list-style-type: none"> ▪ Issuer must be incorporated or organized with head office in Canada ▪ Not available to issuers not in compliance with the ongoing requirements of the crowdfunding prospectus exemption 	Reporting issuers for not less than 12 months with a class of equity securities listed on the Toronto Stock Exchange (TSX), TSX Venture Exchange (TSXV) and Canadian Securities Exchange (CSE)
Distribution details				
Types of securities	Not available for distributions of the complex or novel securities defined in NI 44-102 <i>Shelf Distributions</i> and NI 25-101 <i>Designated Rating Organizations</i>	<ul style="list-style-type: none"> ▪ Exemption applies to a distribution of a security by an issuer as well as a selling security holder ▪ Only some types of securities can be distributed, such as common shares, flow-through shares under the <i>Income Tax Act</i> (Canada), not available for complex or novel products 	<ul style="list-style-type: none"> ▪ Limited to distributions by an issuer of securities of its own issue ▪ Limited types of securities can be offered, such as common shares and flow-through shares under the <i>Income Tax Act</i> (Canada) 	<ul style="list-style-type: none"> ▪ Exemption applies to a distribution by an issuer of securities of its own issue ▪ Offering can consist only of the class of equity securities listed on the TSX, TSXV or CSE, or units consisting of listed security and a warrant to acquire listed security
Offering parameters	<ul style="list-style-type: none"> ▪ No limit on the size of offerings, or the number of offerings an issuer may make ▪ No requirements with respect to the length of time an OM offering can remain open 	<ul style="list-style-type: none"> ▪ No limit on the size of offering made under the exemption 	<ul style="list-style-type: none"> ▪ Cannot raise more than \$1.5 million under the crowdfunding exemption during the period commencing 12 months prior to the current offering ▪ Offering cannot remain open for more than 90 days ▪ Offering document must disclose minimum offering size ▪ Offering cannot be 	<ul style="list-style-type: none"> ▪ An offering cannot result in an increase of more than 100% of the outstanding securities of the same class ▪ Issuer must permit each person who held a listed security of the issuer of the same class and series as the listed security to be distributed under the exemption, to

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			<p>completed unless: (i) minimum offering fully subscribed; and (ii) at time of completion of offering, issuer has financial resources sufficient to achieve the next milestone in its written business plan</p>	<p>subscribe for securities distributed under the exemption on pro rata basis</p>
<p>Registrants</p>	<ul style="list-style-type: none"> ▪ No restrictions on the category of registrant that can be involved in an OM offering ▪ Registrants that are related (i.e., affiliates in the same corporate structure) to an issuer will be prohibited from participating in an OM distribution 			<ul style="list-style-type: none"> ▪ There are no restrictions on the type of registrant that may participate
<p>Restriction on solicitation and advertising</p>		<ul style="list-style-type: none"> ▪ Advertising to solicit investors is prohibited ▪ Payment of any commission, finder's fee, referral fee or similar payment to any person in connection with a distribution is prohibited 	<ul style="list-style-type: none"> ▪ Issuer, portal or any other person involved with an offering cannot advertise the offering or solicit potential investors, except as specifically permitted ▪ Offering materials must be made available to potential investors on portal's website but not on any other website and delivered to the regulator simultaneously ▪ Marketing materials limited to offering document 	

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Investor protection measures				
Investor qualification	3 types of "eligible investors" <ul style="list-style-type: none"> ▪ Net income test ▪ Net asset tests ▪ Role of "eligibility adviser" 	Exemption for distributions to family members, close personal friends and close business associates with enhanced guidance on investor qualifications		Each investor must represent in writing to the issuer that the type of listed security the investor is acquiring under the exemption
Investment limits	A cap of \$10,000 - \$30,000 depending on if individuals are eligible or non-eligible investors	No investment limits	<ul style="list-style-type: none"> ▪ Less than \$2,500 in a single investment ▪ Less than \$10,000 in total in a calendar year 	Less than \$15,000 for investors residing in Canada
Risk acknowledgement form	Form 45-106F13 must be signed by investor before signing agreement to purchase the security	Form 45-106F12 must be signed by investor and whom that investor with asserted relationship and issuer, and to disclose the relationship they have with each other	Proposed Form 45-108F2 must be signed by investor	
Point of sale disclosure	<ul style="list-style-type: none"> ▪ Existing OM forms must be used ▪ OM must be delivered to the OSC on or before the 10th day after the distribution 	No requirement for issuer or selling security holder to provide investor with any disclosure at time of distribution	<ul style="list-style-type: none"> ▪ Streamlined disclosure document must be provided that includes basic information about the offering, the issuer and the portal with required financial information ▪ Offering document must be delivered to the regulator at the time that it is posted on the portal's website 	<ul style="list-style-type: none"> ▪ Issuer is not required to provide an offering document ▪ Issuer must issue an offering news release disclosing the proposed offering and file any offering materials on the same day it provides the materials to purchasers
Advertising and marketing materials	<ul style="list-style-type: none"> ▪ No new restrictions on advertising ▪ Issuers are required to incorporate by reference into the OM any marketing materials used 			

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	<ul style="list-style-type: none"> Additional guidance on marketing practices in 45-106CP Any marketing materials used in an OM offering must be filed with the OSC 			
Statutory or contractual rights in the event of a misrepresentation	Investors have certain rights of action for damages or rescission in the event of misrepresentation	If an issuer or selling security holder voluntarily provides a potential investor with an OM in connection with a distribution, investors have certain rights of action for damages or rescission in the event of a misrepresentation	If comparable right not provided by securities legislation of jurisdiction in which purchaser resides, issuer must provide contractual right of action for rescission or damages in the event of a misrepresentation if any materials made available to purchaser	Subscription agreement between the issuer and purchaser must contain a contractual right of action against the issuer for any misrepresentation in a "document" or "core document", each as defined in section 138.1 of the <i>Securities Act</i> (Ontario).
Right of withdrawal	Investors have two business days to withdraw	No right of withdrawal available to investors	Investors have 48 hours prior to the disclosed offering deadline to withdraw	No right of withdrawal available to investors
Resale restrictions	<ul style="list-style-type: none"> Securities of a reporting issuer are subject to a four month hold period (subject to certain other conditions being met) Securities of a non-reporting issuer are subject to an indefinite hold period and can only be resold under another prospectus exemption or under a prospectus 			Securities of a reporting issuer are subject to a four month hold period (subject to certain other conditions being met)
Ongoing disclosure	<ul style="list-style-type: none"> Limited continuous disclosure is required for non-reporting issuers that distribute securities under the exemption Non-reporting issuers are required to make requested annual financial statements available to investors and deliver to the securities 	<ul style="list-style-type: none"> No requirement for non-reporting issuers to provide any ongoing disclosure Reporting issuers subject to ongoing continuous disclosure obligations under applicable securities law 	<u>Ongoing disclosure</u> <ul style="list-style-type: none"> A reporting issuer must provide ongoing continuous disclosure in accordance with securities law requirements A non-reporting issuer must provide requested ongoing disclosure on an annual basis 	Reporting issuers must comply with continuous disclosure obligations under applicable securities law

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	regulatory authority ▪ Audited annual financial statements must comply with the requirements of section 4.1 of NI 51-102 <i>Continuous Disclosure Obligations</i> and NI 52-107 <i>Acceptable Accounting Principles and Auditing Standards</i>		<u>Books and records</u> A non-reporting issuer must keep books and records which contain requested information at a minimum	
Reporting				
Reporting of distribution	Report of exempt distribution on Form 45-106F11 must be filed within 10 days of the distribution			