

CSA Adopts Amendments to Accredited Investor and Minimum Amount Investment Prospectus Exemptions

Managed Accounts are now Accredited Investors for Investment Funds in Ontario

On February 19, 2015, the Canadian Securities Administrators (“**CSA**”) announced the adoption of amendments (“**the Amendments**”) to National Instrument 45-106 – *Prospectus and Registration Exemptions* (“**NI 45-106**”). There were significant changes in respect of the accredited investor prospectus exemption (“**AI exemption**”) and the minimum amount investment prospectus exemption (“**MA exemption**”). The changes were initially published for comment in February 2014. The Amendments also introduced to Ontario a family, friends and business associates exemption (“**FFBA exemption**”), published initially for comment in March 2014. There were also changes to the short-term debt prospectus exemption and the introduction of a short-term securitized products prospectus exemption, first published for comment in January 2014.

1. Background to the review

The AI and MA exemption review was triggered by investor protection concerns raised during the financial crisis of 2007-2008. The Amendments address several concerns over the AI and MA exemptions. Reliance on these exemptions is based on the assumptions that the investor is sophisticated, is able to withstand financial loss, has expert advice and the opportunity to evaluate the

investment. The CSA expressed concern that some individual investors may not understand the risks of investing using the AI exemption or may not qualify as accredited investors.

The Amendments are also intended to address concern that the threshold of \$150,000 as the amount for the MA exemption may not represent the ability of an individual investor to withstand financial loss. The CSA was also concerned that the current MA exemption encouraged investors to unduly concentrate their investments and increase their risk.

The introduction of the FFBA exemption to Ontario was intended to achieve harmonization with other CSA jurisdictions.

The short-term debt prospectus exemption amendments and short-term securitized products prospectus exemption result from analysis of systemic concerns in the short-term credit market.

2. The AI and MA exemptions and amendments

Currently, the definition of an “accredited investor” contained in NI 45-106 includes individuals that meet one of the following tests (s. 2.3 of NI 45-106):

- where an individual beneficially owns \$1,000,000 of assets according to s. 1.1 (j);
- where an individual has \$200,000 of net income or an individual and his/her spouse have jointly \$300,000 of net income according to s. 1.1 (k);
- where an individual has \$500,000 of net assets according to s. 1.1 (l).

The MA exemption may be used where equity and debt securities are purchased with an aggregate acquisition cost of not less than \$150,000 paid in cash at the distribution of the security (s. 2.10 of NI 45-106).

Thresholds for individuals to qualify as accredited investors and the threshold of the amount for the MA exemption have not changed with the Amendments.

a) AI and MA Final Amendments - Generally

The Amendments require that individual accredited investors complete a new Form 45-106F9 – *Form for Individual Accredited Investors* (“**Form 45-106F9**”). This form requires that individuals acknowledge the risks of purchasing securities in the exempt market. There is no requirement to complete Form 45-106F9 for portfolio managers acting on behalf of their clients, but it is required in the case of exempt market dealers.

The Amendments also provide additional guidance on what an issuer or other seller of securities should do to ensure that prospective purchasers meet the requirements for a prospectus exemption, including the following:

- the seller should understand the terms and conditions of the exemption enough to explain them to a purchaser and any party to the transaction;
- a seller is expected to have policies and procedures in place to confirm that all parties to the transaction understand the exemption being relied on;
- a seller cannot rely solely on standard representations in a subscription agreement or an initial beside a category on Form 45-106F9 unless the seller has taken reasonable steps to verify the representations made by the purchaser. For exemptions based on income or asset tests, the seller should verify the purchaser meets the criteria for the exemption by asking questions about the purchaser’s net income, financial assets or net assets, or elicit details about the purchaser’s financial circumstances. For exemptions based on relationships, sellers should ask about the nature and length of the relationship with the director, executive officer, founder or control person identified by the purchaser;

- a seller should keep relevant and detailed documentation to evidence the steps they used to determine the purchaser met the conditions of the exemption. For example, this could include having the purchaser sign written statements that give the name of a director, and the nature and length of the relationship, and having the director also sign to confirm this information.

Form 45-106F9 obtained from individual "accredited investors" should be retained by the issuer or other seller for eight years.

One other change of note is that trusts established by accredited investors for family members are now also included in the definition of "accredited investor" for the purposes of the AI exemption.

The Amendments also restrict the MA exemption to only be available for distributions to non-individuals. Accordingly, natural persons are excluded from being able to rely on this exemption.

b) Managed Accounts are now Accredited Investors for Investment Funds in Ontario

With the Amendments, Ontario's fully managed accounts that purchase investment fund securities are now included under the AI exemption's managed account category (s. 1.1(q) of NI 45-106). The Amendments remove the previous carve-out in s. 1.1(q)(ii) that required that a security purchased in Ontario to not be a security of an investment fund. This change aligns Ontario with other CSA jurisdictions.

c) Changes from the proposed 2014 amendments for the AI and MA exemptions

The final Amendments included some changes from the February 2014 proposed amendments with respect to the AI and MA exemptions. The CSA removed the requirement for salespersons and finders to sign Form 45-106F9. The categories of those who must sign the form were clarified and the form was revised to try to make it easier for investors to understand. The Companion Policy to NI 45-106 was modified to provide more detail on practices used to verify when purchasers satisfy the conditions for the exemptions. For

instance, the CSA added an example of the key elements that should be confirmed to establish the “close personal friend” and “close business associate” relationships in order to use them as a basis for an exemption. The CSA cautions that these relationships are often difficult to define.

The CSA proposed major amendments in 2014 to the Form 45-106F1 – *Form of Report of Exempt Distribution*. It would have involved that each category of purchaser be identified under a prospectus exemption such as the AI exemption. In the Amendments released on February 19, 2015, the CSA announced it is deferring the review of those proposed amendments.

3. Ontario’s Family, Friends and Business Associates Exemption

The Amendments also introduced to Ontario the FFBA exemption. The exemption is available for distributions to directors, executive officers, control persons and founders of the issuer as well as family members, close personal friends and close business associates of the directors, executive officers, control persons or founders of the issuer (s. 2.5(1) of NI 45-106). The Amendments also repeal the current founder, control person and family exemption in section 2.7 of NI 45-106.

The exemption allows early-stage issuers to benefit more from cost-effective capital from family, friends and business associates. This also provides investment opportunities for investors who may not otherwise qualify as “accredited investors” or meet the requirements for another exemption.

This exemption applies to both reporting and non-reporting issuers. The Amendments harmonize Ontario law with other CSA jurisdictions by removing the Ontario-specific carve out currently in the FFBA exemption in s. 2.5(1) of NI 45-106. However, unlike other CSA jurisdictions, the exemption is not available for investment funds. There is no limit on the amount of securities sold, but short-term securitized products may not be distributed under this exemption.

Similar to Form 45-106F9 for the AI exemption discussed above, the FFBA exemption in Ontario requires a separate risk acknowledgment form, Form 45-106F12 – *Risk Acknowledgment Form for Family, Friend and Business Associate Investors*. A similar form is currently used for exempt distributions in Saskatchewan.

4. Short-term Debt Prospectus Exemption and Short-Term Securitized Products Prospectus Exemption

The Amendments also include several changes to the short-term debt prospectus exemption. The Amendments modify the credit ratings that are needed to distribute short-term debt (primarily commercial paper) and also make the short-term debt prospectus exemption unavailable for securitized products like asset-backed commercial paper. The purpose of these Amendments is to remove the regulatory disincentive of some commercial paper issuers to obtain an additional credit rating, to allow for consistent treatment between commercial paper issuers with similar risk, and to maintain the credit quality of commercial paper currently distributed under the exemption.

The Amendments also create a new short-term securitized products prospectus exemption under s. 2.35.1 of NI 45-106. The main conditions of this exemption are that the conduit has a global-style liquidity agreement with an appropriate financial institution, there are no synthetic assets in the conduit's asset pools, and there is disclosure through an information memorandum. The exemption's purpose is to improve practice and market stability in the asset-backed commercial paper market. The short-term debt, private issuer, FFBA exemption and the offering memorandum exemptions cannot be used for the distribution of short-term securitized products.

5. Next steps

The Amendments will come into force May 5, 2015 upon ministerial approval. While the FFBA amendments in Ontario also come into force on May 5, 2015, Ontario's AI and MA exemption will come into force on either May 5, 2015 or when s. 12(2) of Schedule 26 of the *Budget Measures Act*, 2009 is proclaimed in force, whichever is later.

by Jason A. Chertin, Money Khoromi and Ke-Jia Chong,
Student-at-law

For more information please contact:

Toronto	Jason A. Chertin	416.865.7854	jason.chertin@mcmillan.ca
Toronto	Money Khoromi	416.865.7137	money.khoromi@mcmillan.ca

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.

© McMillan LLP 2015