Note: [28 Sep 2005] *– Changes to 45-509CP arising from the implementation of NI 45-106.*

COMPANION POLICY 45-509

OFFERING MEMORANDUM FOR REAL ESTATE SECURITIES

1. Background to the Offering Memorandum Exemption

Securities legislation applies to all trades of a security. In brief, the legislation prohibits a person or company from trading in a security unless the person or company is registered in the appropriate category (the dealer registration requirement) and requires the use of a prospectus for any distribution of securities (the prospectus requirement). The legislation provides exemptions from both of these requirements in certain circumstances.

One of the exemptions from the dealer registration requirement and prospectus requirement is the offering memorandum exemption (OM Exemption), which is set out in section 4.1 of ~~Multilateral~~**National** Instrument 45-~~103 *Capital Raising*~~**106 *Prospectus and Registration Exemptions*** (~~MI~~**NI** 45-~~103~~**106**). To rely on the OM Exemption, an issuer must deliver to the purchaser an offering memorandum prepared in accordance with one of the two forms listed in section ~~8.1~~**6.4** of ~~MI~~**NI** 45-~~103.~~**106.**

For distributions of real estate securities by offering memorandum, however, the Alberta Securities Commission (ASC) has adopted a third form of offering memorandum, which is tailored more specifically to real estate securities. ASC local rule 45-509 *Offering Memorandum for Real Estate Securities* (Rule 45-509) defines "real estate security" and requires an issuer to prepare an offering memorandum in accordance with Form 45-509F *Offering Memorandum for Real Estate Securities* (Form 45-509) if the issuer is going to distribute real estate securities by offering memorandum.

2. Interaction of Rule 45-509 with ~~MI~~NI 45-~~103~~106

As stated above, Rule 45-509 requires an issuer, who is relying on the OM Exemption to distribute real estate securities, to prepare an offering memorandum in accordance with Form 45-509. Rule 45-509 would not be triggered if an issuer were relying on the OM Exemption to distribute equity or debt securities of itself, even if that issuer's business relates to real estate. In that situation, the issuer would have to prepare an offering memorandum in accordance with one of the two forms listed in section ~~8.1~~**6.4** of ~~MI~~**NI** 45-~~103.~~**106.**

Notwithstanding Rule 45-509's requirement that an offering memorandum be prepared in accordance with Form 45-509 rather than one of the forms listed in section ~~8.1~~**6.4** of ~~MI~~**NI** 45-~~103,~~**106,** other requirements pertaining to the OM Exemption set out in ~~MI~~**NI** 45-~~103~~**106** still apply. For example, under ~~Part 4~~**section 2.9** of ~~MI~~**NI** 45-~~103~~**106**

- purchasers must complete Form 45-~~103~~**106**F~~3~~**4** *Risk Acknowledgment* and issuers must hold the consideration in trust for two business days,

- issuers must file their offering memorandum and a report in the form of Form 45-~~103~~**106**F~~4~~**1** *Report of Exempt Distribution* with the ASC within time periods set out in ~~MI~~**NI** 45-~~103,~~**106,** and
- certain requirements apply to updates of the offering memorandum.

Further, the *Securities Act* (Alberta) (the Act) gives purchasers who buy a security under the OM Exemption certain statutory rights. They have the right to cancel the agreement to purchase the real estate securities within 2 business days (section 209.1) and they have certain rights of action if the offering memorandum contains a misrepresentation (section 204).

This Companion Policy provides guidance regarding the application of Rule 45-509 and the use of Form 45-509. For guidance regarding the OM Exemption generally, as well as other exemptions available under ~~MI~~**NI** 45-~~103,~~**106,** issuers should refer to Companion Policy 45-~~103CP *Capital Raising Exemptions*~~**106CP *Prospectus and Registration Exemptions***.

3. What is a Real Estate Security?

Rule 45-509 defines a real estate security to be

> an investment contract under which
> (a) the purchaser's economic entitlement is to a material extent attributable to a real estate project, and
> (b) the occupation or use by the purchaser of the real property that is the subject of the real estate project is prohibited or materially restricted.

Although the Act defines a "security" to include "any investment contract", it does not, in turn, define "investment contract". Nevertheless, there is a considerable body of case law[1] on the question of what constitutes an investment contract. As a result, issuers and their legal counsel must determine on a case-by-case basis whether the issuer is offering an investment that would be an interest in real estate only, or would constitute an investment contract.

At a minimum, the issuer should ask itself:

> Is this a contract, transaction or scheme whereby a person invests his money in a "common enterprise" and is led to expect profits (i) solely from the efforts of the promoter or a third party, or (ii) if not solely from the efforts of a promoter or third party, then the efforts of the promoter or third party are the undeniably significant ones, those essential managerial efforts that affect the failure or success of the enterprise?

[1] For example, see *Re: Land Development Company Inc. (The)*, 26 March 2002 (ASC) and the cases cited in that decision.

The key components of the question are:

1. Will the purchaser be making an investment of money with the intention to earn a profit?
2. Will there be a "common enterprise" – an enterprise in which the fortunes of the purchaser are interwoven with and dependent upon the efforts and success of those promoting the investment or of third parties?
3. Do the purchasers expect to make a profit
   (a) based solely on the efforts of others, or
   (b) based on the efforts of others where the efforts of those others are expected to be undeniably significant and will be the managerial efforts essential to the success or failure of the enterprise?

In considering the matter, the issuer must look to the substance of the transaction, not the form. The fact that an enterprise is referred to as a "joint venture" or "partnership" does not prevent a conclusion that a purchaser is, in fact, dependent upon the efforts of the issuer or a third party. Factors that suggest that the purchaser is dependent include the following:

- the purchaser has limited legal rights;
- the purchaser's practical ability to exercise its legal rights is limited;
- the purchaser lacks the capability to intelligently exercise its powers,
- the purchaser's role is intended to be passive;
- the purchaser is lacking experience or knowledge in business affairs generally;
- the purchaser is reliant on the promoter's efforts because of lack of business knowledge, finances or control over the operation;
- the promoter or manager has unique entrepreneurial or management abilities on which the purchaser is dependent; and
- the purchaser cannot, looking at practical realities, remove the manager.

4. Who is the "Issuer"?

The issuer in respect of a real estate security is determined by considering the substance and economics of the investment contract. Depending on the terms and circumstances of the investment contract, the issuer may include any person or company, acting alone or in concert with others, who was instrumental in the founding, development, management or operation of the real estate project. Depending on the real estate security, the issuer could be or include any one or more of the following: the promoter, developer, manager, seller or other similar party.

5. Non-Corporate Issuers

Form 45-509 requires an issuer to include a certificate in the prescribed form signed by the chief executive officer and the chief financial officer or, if no such officers have been appointed, by a person acting in that capacity on behalf of the issuer. For a non-corporate issuer, this certificate should be signed by those who perform functions on behalf of the issuer similar to those of a chief executive officer and a chief financial officer.

The certificate must also be signed on behalf of the board of directors by two directors of the issuer other than the persons referred to above. Non-corporate issuers are directed to the definition of "director" in the Act to determine the appropriate signatories to the certificate.

Section 5 of the "General Instructions and Interpretation" of Form 45-509 provides requirements for non-corporate issuers that are limited partnerships or trusts. Issuers that are not companies, as defined in the Act, are directed to the definition of "person" in the Act.

6. What is included in the Real Estate Project?

The definition of "real estate project" includes a range of real estate projects, from the development of bare land to the operation of a business such as a hotel or resort.

The first prong of the definition refers to "a business or undertaking that is proposed primarily to generate for purchasers of real estate securities income, gain or other return, or funds distributable on dissolution or sale..." (emphasis added). The definition is not intended to include condominium units that are sold to the general public for residential purposes.

The second prong of the definition refers to projects to develop or redevelop real property for use in a business or undertaking described in the first prong, or for resale. In brief, this prong includes real estate projects to develop undeveloped land.

7. Appraisals and Disclosure about Values

For the second type of real estate project – development of undeveloped land – issuers are required to disclose a value of the real property determined by a qualified appraiser who is independent of the issuer, the real property and the real estate project.

Issuers are not required to disclose a value for other types of real estate projects – for example, an operating business. However, if they do disclose a value, that value must be determined by an independent qualified appraiser.

Subsection 3(3) of Rule 45-509 requires the appraiser to be an accredited member of the Appraisal Institute of Canada in good standing. It also sets out when an appraiser would not be considered independent.

Section 3.4 of Form 45-509 requires disclosure about the history of the real property ownership within the 2 years before the date of the offering memorandum. An issuer must state, in the second column of the table, whether the transfer was to a related party or was non-arm's length. The reference to "related party" in paragraph 3.4(b) does not refer to the nature of the relationship between the transferor and the transferee, who may or may not have been at arm's length with each other. The term "related party" is defined in section 3 of the General Instructions and Interpretation of the Form. If either the transferor or the transferee were a related party, as defined in that section, then state "related party" in column 2 and state the name and relationship in column 3. Conversely, if neither the transferor nor the transferee were a

related party, state "arm's length" in column 2 and "n/a" in column 3. In either case, the consideration exchanged in the transaction must be disclosed in column 4.

8. Interaction with other Legislation

Depending on the nature of the transaction, an offering of real estate securities may not only have to comply with the Act, but may also have to comply with other legislation, for example, the *Real Estate Act* (Alberta), the *Condominium Property Act* (Alberta) or securities or other legislation of another jurisdiction.

Although Form 45-509 sets out its requirements using headings and a particular order, issuers are not required to use those headings or that order. There are only two exceptions to this. The information prescribed by Item 1 must be set out on the cover page of the offering memorandum, and the certificate required by Item 15 must be set out as the last page of the offering memorandum. Issuers may therefore present the information required by Form 45-509 using different headings or a different order. This flexibility in the presentation of information should make it easier for issuers of real estate securities to prepare an offering document that meets the requirements of Form 45-509 even if the document must also meet disclosure requirements of other legislation.

If the issuer is required to prepare an offering document to comply with other legislative requirements, the issuer may use that offering document to construct the offering memorandum. Subsection 2(e) of "General Instructions and Interpretation" of Form 45-509 states that the offering memorandum can be "wrapped" around another offering document so that the complete document contains all of the information and certificates required by Form 45-509. To avoid repetition in the combined offering memorandum, the additional "wrapped" material can contain a cross-reference to information required by Form 45-509 that is set out in the wrapped document.

Form 45-509 prescribes the minimum information that must be in an offering memorandum for offerings of real estate securities. The offering memorandum may therefore contain information required by other legislation but not required by Form 45-509. For example, Item 13 of Form 45-509 requires disclosure about the purchaser's right under the Act, which includes a right to cancel the purchase within 2 business days under section 209.1. The purchaser may also have a right to cancel the agreement under other legislation and they may have that right for a longer period. The issuer should disclose all such purchaser's rights and identify which legislation gives rise to that right.

9. Divisional and Carve-out Financial Statements

Financial statements are required for a real estate project that is an operating business or that has been an operating business within the 12 months preceding the date of the offering memorandum (collectively, for the purposes of this section, a "business"). In some cases, where that business was a division or some lesser component of another person or company (the parent), the financial statements may have to be extracted or "carved-out" of the financial statements of the parent.

The terms "divisional" and "carve-out" financial statements are often used interchangeably although a distinction is possible. Some companies maintain separate financial records and financial statements for a business activity or unit that is operated as a division. Financial statements prepared from these financial records are often referred to as "divisional" financial statements. In other circumstances, no separate financial records for a business activity are maintained; they are simply consolidated with the parent's records. In these cases, if the parent's financial records are sufficiently detailed, it is possible to extract or "carve-out" the information specific to the business activity in order to prepare separate financial statements of that business. Financial statements prepared in this manner are commonly referred to as "carve-out" financial statements. The guidance in this section applies to the preparation of both divisional and carve-out financial statements unless otherwise stated.

Preparation of Divisional and Carve-Out Financial Statements

(a) When complete financial records of the business have been maintained, those records should be used for preparing and auditing the financial statements of the business. For the purposes of this section, it is presumed that the parent maintains separate financial records for its divisions.

(b) When complete financial records of the business do not exist, carve-out financial statements should generally be prepared in accordance with the following guidelines:

  (i) *Allocation of Assets and Liabilities* – A balance sheet should include all assets and liabilities directly attributable to the business.

  (ii) *Allocation of Revenues and Expenses* – Income statements should include all revenues and expenses directly attributable to the business. Some fundamental expenditures may be shared by the business and its parent in which case the parent's management must determine a reasonable basis for allocating a share of these common expenses to the business. Examples of such common expenses include salaries, rent, depreciation, professional fees and general and administrative expenses.

  (iii) *Calculation of Income and Capital Taxes* – Income and capital taxes should be calculated as if the entity had been a separate legal entity and filed a separate tax return for the period presented.

  (iv) *Disclosure of Basis of Preparation* – The financial statements should include a note describing the basis of preparation. If expenses have been allocated as discussed in subparagraph (b)(ii), the financial statements should include a note describing the method of allocation for each significant line item, at a minimum.

Statements of Assets and Liabilities and Statements of Operations

When it is impracticable to prepare carve-out financial statements of a business, include an audited statement of assets and liabilities and a statement of operations of the business. The statement of operations should exclude only those indirect operating costs not directly attributable to the business, such as corporate overhead. If indirect operating costs were previously allocated to the business and there is a reasonable basis of allocation, they should not be excluded.

10. Future-Oriented Financial Information (FOFI)

For guidance relating to FOFI, refer to National Policy 48 *Future-Oriented Financial Information* or any successor instrument or policy.

Rule 45-509 requires that the offering memorandum be updated if, before the issuer accepts an agreement by a purchaser to purchase the offered real estate security, a change occurs in the events or assumptions used to prepare FOFI included in the offering memorandum, if the change has a material effect on the FOFI. For requirements relating to updating an offering memorandum refer to ~~Part 4~~**section 2.9** of ~~MI~~**NI** 45-~~103~~**106,** particularly ~~sections 4.4(4~~**subsections 2.9(13**) and ~~4.7.~~**(16).**