

Alberta Securities Commission Notice - Revised February 13, 2002
Proposed Amendments to Multilateral Instrument 45-103 Capital Raising Exemptions and
Other Proposed Consequential Rules

Publication for Comment

The Alberta Securities Commission ("ASC") has republished for comment proposed:

- Multilateral Instrument 45-103 *Capital Raising Exemptions* ("MI 45-103");
- Companion Policy 45-103CP ("Companion Policy");
- Form 45-103F1 *Offering Memorandum for Non-Qualifying Issuers* ("Form 45-103F1");
- Form 45-103F2 *Offering Memorandum for Qualifying Issuers* ("Form 45-103F2"); and
- Form 45-103F3 *Risk Acknowledgement* ("Form 45-103F3").

In addition, the ASC has published for comment proposed:

- ASC Rule 45-802 *Implementing Multilateral Instrument 45-103 Capital Raising Exemptions and Forms 45-103F1, F2 and F3* ("ASC Rule 45-802"); and
- Amendments to Alberta Securities Commission Form 20 *Report Under Section 132(1) of the Securities Act*.

Summary

Proposed Rule Changes

The ASC is republishing certain documents because there are various proposed changes to them. The most significant proposed changes are:

1. a requirement that a purchaser's investment under the offering memorandum exemption be limited to \$10,000 unless the purchaser meets an "ability to withstand loss test", evidenced by either,
 - (a) the purchaser meeting certain specified financial tests, e.g., \$75,000 pre-tax net income or \$400,000 net assets, or
 - (b) the purchaser obtaining advice regarding the suitability of the investment from an investment dealer or a securities dealer; and
2. the exclusion of certain mutual fund issuers from use of the offering memorandum exemption.

The ASC is also requesting comment on whether a further condition should be added to the offering memorandum exemption which would prohibit the payment of selling or promotional expenses other than for professional services or to registered dealers. A considerable amount of debate occurred in our focus groups regarding the involvement of registrants in the exempt market. We wish to obtain further comment on the issue so that we can more fully consider it.

Proposed Statutory Amendments

The statutory amendments originally contemplated to occur in connection with implementation of MI 45-103 will be delayed in Alberta until at least Fall, 2002. On implementation of MI 45-103, and until repeal of the statutory exemptions, issuers will be able to use any of the existing statutory exemptions or any of the new exemptions under MI 45-103.

The ASC previously announced its intent to repeal the exemption at section 131(1)(d) of the *Securities Act* (Alberta) (formerly section 107(1)(d)), the “\$97,000 exemption”; however, in response to comment received, the ASC is reconsidering the repeal of both that exemption and the “top-up” exemption at section 122(d) of the *ASC Rules*. We anticipate retaining those exemptions for a period of time and, during that time, examining who is using them and the extent to which they are used. This may help us in assessing whether the accredited investor exemption requires modification in order to better address the needs of the Alberta capital markets.

Background

On September 27, 2001, the ASC, together with the British Columbia Securities Commission (“BCSC”), published MI 45-103, the Companion Policy and Forms 45-103F1, F2 and F3. MI 45-103 is intended to provide four harmonized new exemptions from the prospectus and registration requirements in Alberta and British Columbia:

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

The goal of MI 45-103 is to make it easier for issuers to access capital, reducing the time and costs usually associated with a financing, while still providing appropriate investor protection.

The public comment period ended November 30, 2001. In total, the ASC and BCSC received 41 public comment letters. Although various comments were made, two themes of particular significance arose:

1. commentators strongly encouraged early implementation of MI 45-103 in order to assist small and medium-sized issuers currently experiencing difficulty in obtaining financing; and
2. they raised concerns that the proposed offering memorandum exemption permitted essentially a prospectus offering without sufficient alternative investor protection safeguards to those associated with a prospectus offering.

Early Implementation Concerns

When MI 45-103 was initially published for comment, we advised that we expected certain statutory amendments to be made concurrently with implementation of MI 45-103. Those statutory amendments were anticipated to repeal certain existing prospectus and registration exemptions and, more importantly, to introduce expanded statutory rights of action for purchasers under the proposed new offering memorandum exemption. The proposed statutory rights of action include a two day right of withdrawal; a right of action for damages or rescission in the event of a misrepresentation (which right is available against not just the issuer but also the directors, CEO, CFO and promoters); and an extended limitation period. Unfortunately, it now appears unlikely that the proposed statutory amendments to the *Securities Act* (Alberta) will be considered by the Alberta Legislature before Fall, 2002.

If the ASC pursues early implementation of MI 45-103:

1. both the current prospectus and registration exemptions and the new exemptions under MI 45-103 will co-exist for a period of time; and
2. more significantly, the new offering memorandum exemption will become available even though the new expanded statutory rights of action for investors purchasing under that exemption, will not exist.

Nevertheless, we are pursuing early implementation of MI 45-103 on the condition that an “ability to withstand loss” test be added to the offering memorandum exemption. This additional condition has been proposed, in part, to address the concerns of early implementation and, in part, to address the investor protection concerns that have been raised with regard to the offering memorandum exemption.

Investor Protection Concerns

Various public commentators raised concerns that the removal of the 50 person limit contained in the existing offering memorandum exemptions in Alberta, coupled with the removal of the prohibition on paying selling or promotional expenses to persons, other than professionals and registered dealers, essentially permits a public offering without the investor protection safeguards that exist in the prospectus regime.

Analysis

To assist in the analysis of the regulatory attributes of sales made under the proposed offering memorandum exemption, we prepared the following table which compares sales made under the proposed offering memorandum exemption with sales made under a prospectus and in the secondary market.

Purchase of Securities

| | Under OM Exemption in MI 45-103 | Under Prospectus | In Secondary Market |
|---------------------------------------|--|--|--|
| Disclosure Required | <ul style="list-style-type: none"> • Offering memorandum • No “misrepresentation”, ie. no untrue statement of a material fact, no omission to state a material fact that is required and no omission to state a material fact that is necessary to be stated in order for a statement not to be misleading | <ul style="list-style-type: none"> • Prospectus • Full, true and plain disclosure of all material facts relating to the securities | <ul style="list-style-type: none"> • Continuous disclosure |
| Registrant Required? | <ul style="list-style-type: none"> • No, although practically a registrant may be required for larger offerings (in which case must assess suitability*) | <ul style="list-style-type: none"> • Yes, registrant required for sale of securities - must assess suitability* | <ul style="list-style-type: none"> • Yes, registrant required for sale of securities - must assess suitability* |
| Due Diligence? | <ul style="list-style-type: none"> • A registrant may or may not be involved in the sale. Even if they are involved, they are not required to sign the offering memorandum nor are they subject to statutory liability. Without statutory liability there may be less incentive to perform due diligence. | <ul style="list-style-type: none"> • An underwriter is almost always involved. If an underwriter is involved, it will be required to sign the prospectus and, in doing so, will attract statutory liability which acts as an incentive to perform due diligence. | <ul style="list-style-type: none"> • n/a |
| Vetted? | <ul style="list-style-type: none"> • No | <ul style="list-style-type: none"> • Yes | <ul style="list-style-type: none"> • n/a |
| Advertising Permitted? | <ul style="list-style-type: none"> • Yes, no restrictions imposed other than general prohibition regarding misrepresentations in connection with a trade. | <ul style="list-style-type: none"> • Yes - but restricted during period between preliminary and final prospectus. Also subject to general prohibition regarding misrepresentations in connection with a trade | <ul style="list-style-type: none"> • n/a |
| Investor Protection Attributes | <ul style="list-style-type: none"> • offering memorandum • blunt risk acknowledgement form • statutory rights of action <ul style="list-style-type: none"> • 2 day withdrawal right exercised by notification to the issuer • action for rescission or damages if OM contains misrepresentation - but only against issuer, directors, CEO, CFO and promoters • Note: if OM introduced before legislative changes are made to create statutory rights, the right of action will only be against issuer | <ul style="list-style-type: none"> • prospectus • 2 day withdrawal right exercised by notification to dealer • action for rescission or damages if prospectus contains a misrepresentation • action against issuer, directors, CEO, CFO, promoters, underwriter, auditors, and other experts that provided consents. • suitability assessment by registrant • usually due diligence regarding the business and management • ability to immediately resell securities in the event of an adverse material change | <ul style="list-style-type: none"> • continuous disclosure if issuer is a reporting issuer • suitability assessment by registrant • ability to immediately resell securities in the event of an adverse material change |

*Must assess suitability unless exempted from doing so as a result of not providing any advice in connection with the trade.

As indicated in the above table, the offering memorandum exemption under MI 45-103, as originally proposed, would permit a very broad public offering without many of the investor protection elements that exist in the prospectus regime. Under the prospectus regime more comprehensive disclosure is provided. Further under both a prospectus and in the secondary market, trades are made through a registrant which will usually require that the registrant assess whether the investment is suitable to the potential purchaser. In addition, in the prospectus context there is typically an underwriter who, because of the potential risk of statutory liability, performs due diligence. In comparison, there is no requirement that a registrant be involved in the sale of securities by offering memorandum and consequently, in many cases, no assessment of suitability is performed. Furthermore, registrants selling under the offering memorandum exemption are not subject to statutory liability and thus may not have the same incentive to perform due diligence. The primary investor protection provision under the proposed offering memorandum exemption which might, in part, counterbalance the absence of the investor protections afforded in the prospectus regime is the blunt risk acknowledgement form.

Further Consultation

After completing the analysis described above, it appeared to us that the proposed offering memorandum exemption may put too much reliance on the risk acknowledgement form. However, to ensure that we obtained a broad base of comment, we invited certain market participants to participate in a focus group to discuss the originally proposed offering memorandum exemption. The focus group concluded that the proposed offering memorandum exemption likely did not provide adequate investor protection. We then took the issue to the ASC's Securities Advisory Committee ("SAC") and asked them to consider whether the proposed offering memorandum exemption in MI 45-103 provided adequate investor protection. We asked SAC to consider possible alternatives and discussed the following options with SAC:

- (i) ***Mandating Involvement of a Registrant According to Offering Size*** - This would require mandating the use of a registrant once the offering size exceeds a specified dollar amount such as \$2.0 million, at least for non-qualifying issuers.
- (ii) ***Reintroduction of the Prohibition Against Paying Remuneration to Non-Registrants*** - This would require adding a clause to the new offering memorandum exemption comparable to the current subsections 131(1)(q)(vi) and 131(1)(r)(vi) (formerly sections 107(1)(p)(vi) and 107(1)(q)(vi)) of the *Securities Act* (Alberta) and subsection 128(a)(v) of the *BCSC Rules*. The provision would prohibit the payment of selling or promotional expenses other than for professional services or for the services of a registered dealer.
- (iii) ***Introduction of an Investment Cap and "Ability to Withstand Loss" Test*** - Under this approach, the offering memorandum could be used to sell securities to any investor up to a maximum cap of \$10,000. For investments over \$10,000, an "ability to withstand

loss” test would be introduced. The “ability to withstand loss test” could be satisfied in one of two ways: a) a suitability assessment by a registrant; or b) the purchaser meeting a minimum prescribed income or net worth test (e.g., minimum net assets of \$400,000 or net income in the last two years of \$75,000 alone or \$125,000 with spouse).

- (iv) ***Maintain Exemption as Published in order to Maintain a Harmonized Rule*** - We also discussed maintaining the offering memorandum exemption as originally published in proposed MI 45-103. We discussed the fact that BC market participants appeared to have less concern regarding the breadth of the proposed offering memorandum exemption. We surmised that the reason for the difference in response between the two markets may be that the proposed offering memorandum exemption is a less significant expansion as compared to the existing offering memorandum exemptions in BC. The existing offering memorandum exemptions in BC already permit an offering to an unlimited number of purchasers and without restrictions on payments of commissions to non-registrants, provided that each investor invests at least \$25,000 and is a “sophisticated investor” (the definition of which includes a bright line financial test similar to our proposed “ability to withstand loss test”).

We advised SAC that the BCSC would likely not be introducing any restriction on the offering memorandum exemption and that if the ASC were to introduce a new condition, we ran a significant risk of creating a lack of uniformity in the offering memorandum exemptions as between Alberta and BC. Finally, we advised our SAC that if we made any significant changes to MI 45-103, such as the introduction of further conditions to the exemption, it would likely mean that the rule would have to be republished in Alberta for a further comment period.

Our SAC concluded that the proposed offering memorandum exemption likely did not provide adequate investor protection and that the blunt risk acknowledgement form was likely not enough to counterbalance the absence of other investor protections that exist in the prospectus context.

Conclusion

As a result of the public comment and because of the concerns regarding early implementation of MI 45-103, we have recommended that a condition be added to the offering memorandum exemption under MI 45-103 to require that either:

- the purchaser be an “eligible investor”; or
- the purchaser’s aggregate acquisition cost not exceed \$10,000.

“Eligible investor” is defined to include:

- persons or companies whose
 - net assets, alone or with a spouse, exceed \$400,000, or

- net income before taxes exceeded \$75,000 in each of the two most recent years and who reasonably expects to exceed that income level in the current year, or
- net income before taxes combined with that of a spouse exceeded \$125,000 in each of the two most recent years and who reasonably expect to exceed that income level in the current year;
- various entities beneficially owned or controlled by eligible investors; and
- a person or company that has obtained advice regarding the suitability of the investment from an investment dealer or securities dealer.

The full text of the proposed condition and definition of “eligible investor” is contained in the revised version of MI 45-103 which has been published today.

Payments of Commissions to Non-Registrants

The offering memorandum exemptions that currently exist under Alberta securities law provide that no selling or promotional expenses may be paid or incurred in connection with the offer or sale of the securities, except for professional services or for services performed by a registered dealer. Although the provision does not mandate that all sales made under an offering memorandum must be made through a registered dealer, by prohibiting the payment of compensation, it has the effect of discouraging non-registered third party selling agents from selling securities under an offering memorandum.

Registered investment dealers and securities dealers, when trading securities on behalf of clients, are usually required to comply with the “know your client” rule and to assess the suitability of the investment for the client. This is intended to ensure that the dealer considers whether the proposed investment is suitable for the client and in keeping with the client’s investment objectives. These registered dealers are also subject to educational and bonding requirements, intended to provide a certain level of investment acumen and financial stability. Unregistered individuals are not subject to any of these requirements. As such, concerns have been raised that many unregistered dealers may be more likely to encourage an imprudent business decision.

Conversely, concerns have been raised that many registered dealers are not interested in financing small to medium-sized issuers, particularly non-reporting issuers, that have no immediate intention of going public. Some commentators have suggested that restricting payment of commissions to registered investment dealers and securities dealers adversely impacts many smaller issuers, preventing them from retaining credible merchant banks or other similar parties as sales agents.

We are therefore requesting comment on whether the offering memorandum exemption should be amended to add to the end of section 4.1(3), the following additional subsection:

- “(e) no selling or promotional expenses have been paid or incurred in connection with the offer or sale of the securities, except for professional services or for services performed by an investment dealer, securities dealer or their equivalent, registered under securities legislation of a Canadian jurisdiction.”

We also seek comment on whether there is a more appropriate method of balancing these competing concerns.

Exclusion of Mutual Funds from Use of Offering Memorandum Exemption

As originally published, MI 45-103 would permit mutual funds to rely on the new offering memorandum exemption. This was not an intended result. As such, the offering memorandum forms are not well suited for use by a mutual fund issuer.

One of the concerns that exists with regard to allowing mutual fund issuers to use the new offering memorandum exemption is that if they are permitted to use the offering memorandum exemption they may then never conduct a prospectus offering and never obtain reporting issuer status. National Instrument 81-102 *Mutual Funds* ("NI 81-102"), which establishes a comprehensive regime governing mutual funds, only applies to mutual funds that are reporting issuers. Accordingly, MI 45-103 may inadvertently undermine the goals of NI 81-102.

Mutual fund issuers are somewhat distinguishable from other issuers. Other issuers, that are not reporting issuers, if they distribute securities to a large number of security holders, will at some point typically be under pressure from those security holders to provide liquidity for the securities. This will involve the issuer obtaining reporting issuer status. However, a mutual fund issuer, particularly an open-end mutual fund, may never be under pressure from its security holders to become a reporting issuer. Mutual fund security holders who wish to sell their securities typically expect to redeem the securities rather than trade them to other investors.

We propose to amend MI 45-103 to exclude certain mutual fund issuers from use of the new offering memorandum exemption until the issue can be more fully considered. The only mutual funds that are to be excluded are those that would be subject to National Instrument 81-101 *Mutual Fund Prospectus Disclosure* if they were conducting a prospectus offering.

Over the next year we will consider whether it is appropriate to permit mutual funds to rely on the new offering memorandum exemption or some other alternative exemption and, if so, will consider developing an offering memorandum form designed specifically for mutual funds. Of course, mutual fund issuers may also be able to sell securities under either the proposed accredited investor exemption or the \$97,000 exemption. In addition, until the statutory amendments are made, mutual fund issuers can continue to use the existing offering memorandum exemptions contained in subsections 131(1)(q) and (r) of the *Securities Act* (Alberta).

Consequences of Imposing Additional Conditions

The BCSC does not propose to introduce any additional conditions to use of the offering memorandum exemption nor does the BCSC propose to exclude mutual fund issuers from use of the offering memorandum exemption. Consequently, if the changes proposed by the ASC are implemented, the offering

memorandum exemptions under Alberta and BC securities law, although very similar, will not be identical.

A significant degree of uniformity will have been achieved given that the offering memorandum forms, the risk acknowledgement form and each of the private issuer, accredited investor and family, friends and business associates exemptions under MI 45-103 will remain identical. However, complete uniformity will not have been achieved.

If the additional conditions proposed by the ASC are implemented, we believe that MI 45-103 will better respond to Alberta market participant comments and more appropriately balance the competing goals of capital formation and investor protection. MI 45-103 will still also represent a significant expansion as compared to the existing capital raising exemptions under Alberta securities law.

During the period between implementation of MI 45-103 and the proclamation of the new statutory rights of action, we intend to monitor use of the offering memorandum exemption in Alberta and are interested in receiving public comment on whether the additional condition is appropriate or whether it imposes an unnecessary barrier to capital formation.

Both the ASC and BCSC intend to monitor use of their respective offering memorandum exemptions and to revisit MI 45-103 in a year's time. We also hope to work with other jurisdictions to extend the application of MI 45-103 to these other jurisdictions.

Other Changes Being Proposed by Both the ASC and BCSC

Other changes that are proposed to be made to MI 45-103 and which will be made by both the ASC and BCSC, include those described below.

1. The definition of "accredited investor" has been amended to remove reference to a "fully managed account if it is acquiring a security that is not a security of a mutual fund or non-redeemable investment fund". This change has been made because we believe that fully managed accounts already have a broader ability to purchase securities under the accredited investor exemption. Section 131(2) (formerly section 107(2)) of the *Securities Act* (Alberta) and section 74(1) of the *Securities Act* (British Columbia) deems certain entities, such as trusts as portfolio managers, to be acting as principal in certain circumstances when trading for accounts that are fully managed by them. As such, these entities could potentially purchase securities under the accredited investor exemption on the basis that they qualify as accredited investors under subsections 1.1(a), (e) or (n) of the definition. The text proposed to be deleted suggests an unintended restriction on the types of securities that a fully managed account may purchase.
2. Grandparents have been added to the list of family members in both the private issuer exemption and the family, friends and business associates exemption.
3. A requirement has been added that provides that if securities legislation where the purchaser is resident does not provide statutory rights of action in the event of a misrepresentation, then the issuer

must provide contractual rights of action.

4. We have removed the requirement that the certificate to the offering memorandum be true at the date the offering memorandum is signed by the purchaser. The provision has been replaced with a requirement that if the certificate ceases to be true after being delivered to the purchaser, the issuer must not accept a subscription from the purchaser until the purchaser has been delivered a newly certified update to the offering memorandum and the purchaser re-signs the agreement.
5. A requirement has been added that if a purchaser exercises the two day right to cancel the agreement, the issuer must promptly return the purchaser's money.
6. The exemption that previously existed in Form 45-103F2 (ie. the qualifying issuer offering memorandum) that exempted qualifying issuers from certain requirements of National Instrument 43-101 *Standards of Disclosure for Mineral Projects* has been moved into the rule.

Proposed changes to Form 45-103F1 include:

1. the addition of required language describing the contractual and/or statutory rights of action;
2. clarification of how the offering memorandum may be used to wrap around a prospectus or similar document; and
3. the addition of a requirement that if the offering memorandum is being used for a distribution and during that distribution, the issuer files a current AIF (as defined in Multilateral Instrument 45-102 *Resale of Securities*) the offering memorandum must be updated to incorporate by reference the current AIF.

Proposed changes to Form 45-103F2 include:

1. an amendment to the requirement to disclose penalties, sanctions and bankruptcies, extending the disclosure requirement from five years to 10;
2. the addition of required language describing the contractual and/or statutory rights of action;
3. clarification of how the offering memorandum may be used to wrap around a prospectus or similar document;
4. clarification of the financial statement requirements for the issuer;
5. clarification of the financial statement requirements for a business acquired or proposed to be acquired that meets the prescribed threshold tests;

6. addition of a financial statement exemption, in certain circumstances, for acquired businesses or businesses to be acquired that will be an investment of the issuer accounted for by the equity method;
7. addition of a financial statement exemption permitting financial statements, in certain circumstances, to be prepared in accordance with certain foreign generally accepted accounting practices and to be audited in accordance with certain foreign generally accepted auditing standards; and
8. expansion of the financial statement exemption which permits an opening inventory qualification.

ASC Rule 45-802 Implementing Multilateral Instrument 45-103 Capital Raising Exemptions and Forms 45-103F1, F2 and F3

Originally, Forms 45-103 F1, F2 and F3 were intended to form part of MI 45-103; however, for logistical reasons, the BCSC requested that they be implemented as separate documents. In Alberta, in order to accomplish this, each of the forms will be implemented as separate ASC Rules. To provide the necessary connection between MI 45-103 and the various forms, ASC Rule 45-802 provides that:

- the offering memorandum permitted to be used by a qualifying issuer (as defined in Multilateral Instrument 45-102 *Resale of Securities*) relying on the offering memorandum exemption in MI 45-103 is Form 45-103F2;
- the offering memorandum required to be used in other cases by issuers relying on the offering memorandum exemption in MI 45-103 is Form 45-103F1;
- the required form of risk acknowledgement under MI 45-103 is Form 45-103F3; and
- the required report of distribution to be filed in connection with a distribution made under certain of the exemptions in MI 45-103 is ASC Form 20.

Proposed Amendment to ASC Form 20 Report Under Section 132(1) of the Securities Act

Consequential amendments to ASC Form 20 have been made to include reference to prospectus exemptions under MI 45-103.

Request for Comment

We invite you to comment on the proposed changes to:

- Multilateral Instrument 45-103 *Capital Raising Exemptions*,
- Companion Policy 45-103CP,
- Form 45-103F1 *Offering Memorandum for Non-Qualifying Issuers*,
- Form 45-103F2 *Offering Memorandum for Qualifying Issuers*, and
- Form 45-103F3 *Risk Acknowledgement*.

We also invite you to comment on proposed:

- ASC Rule 45-802 *Implementing Multilateral Instrument 45-103 Capital Raising Exemptions and Forms 45-103F1, F2 and F3*, and
- Amendment to ASC Form 20 *Report Under Section 132(1) of the Securities Act*,

Each of the documents is published with this Notice.

Comments received before **March 11, 2002** will be considered. Please submit your comments in writing to:

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Comment letters can be delivered in hard copy, by fax or by e-mail.

Comment letters will be placed in a public file and will form part of the public record unless you request confidentiality. Although we will not place comment letters requesting confidentiality in the public file, freedom of information legislation may require us to make comment letters available. If you submit a comment letter you should be aware that the press and members of the public may be able to obtain access to your letter.

If you have any questions, contact either:

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