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Significant Changes To Canada's Exempt Market Effective May 5, 2015:

The increased pace of regulatory change experienced over the last few years appears poised to continue during 2015, along with the Canadian Securities Administrators' (CSA) focus on enhancing protections for retail investors. The CSA recently finalized and released important amendments to National Instrument 45-106 *Prospectus and Registration Exemptions* (to be retitled National Instrument 45-106 *Prospectus Exemptions*) as well as the Companion Policy to NI 45-106 (NI 45-106 and CP45-106) and other related instruments available here.

This latest regulatory development will have a significant impact on issuers, registrants and investors alike. Some of the most popular prospectus exemptions in NI 45-106 are being overhauled and new prospectus exemptions introduced, including a version of the friends, family and business associates exemption in Ontario and a new exemption aimed at asset-backed commercial paper. These changes, which come into force on May 5, 2015 1, will have implications for issuers' subscription agreements, offering memoranda and compliance practices, among other things, while dealers and other registrants will need to understand the implications of the amendments on their ability to make recommendations to clients about exempt market securities.

The amendments are the result of the CSA's on-going review of the exempt market in Canada and, in particular, whether the prospectus exemptions that are currently available in NI 45-106 remain relevant in light of economic developments and the perceived need for more protections for retail investors 2. And while there is more to come – for example, we await the CSA's revised crowdfunding proposals and the revamped reporting requirements for exempt distributions – these amendments will result in a shift in emphasis in the exempt market from "buyer beware" to a more paternalistic approach that limits access to investments.

Changes at a Glance

1. Accredited investor exemption (AI Exemption)

- Ontario joins the rest of the country in permitting fully managed accounts to purchase investment fund securities under the managed account category of the AI Exemption, without regard to the nature of the underlying account holder
- The definition of accredited investor is being expanded to add a new higher-wealth category of individual accredited investor with net financial assets of more than $5 million (this is the same category of individual who qualifies as a "permitted client" for other purposes)
- Certain family trusts will now qualify as accredited investors
- Individual accredited investors with net financial assets of less than $5 million will be required to complete and sign a risk acknowledgement form before or at the same time of a purchase of securities under this exemption

2. Minimum amount investment exemption (MA Exemption)

- The MA exemption is no longer available to individual investors

3. Friends, family and business associates exemption (Ontario) (FFBA Ontario Exemption)

- A version of the friends, family and business associates exemption which is largely harmonized with the exemptions available in other jurisdictions in Canada, will now be available for use in Ontario
- The FFBA Ontario Exemption is not available for use by investment fund issuers and, like the version of this exemption in Saskatchewan, will require the investor, the individual at the issuer with whom the investor has a relationship, and the issuer to complete and sign a risk acknowledgement form
- The founder, control person and family exemption currently in NI 45-106 and available to Ontario market participants, including investment funds and their founders and control persons, as well as their families, will be repealed

4. Short-term debt exemption (Short-term Debt Exemption)

- The credit ratings required to distribute short-term debt, which is primarily commercial paper, under the Short-term Debt Exemption have been modified

5. Short-term securitized products exemption (Securitized Products Exemption)

- A new exemption has been introduced to allow for the prospectus-exempt distribution of short-term securitized products that meet certain conditions

We note that the proposed crowdfunding regime and the proposed Ontario version of the offering memorandum exemption have yet to be finalized 3. The OSC and the CSA continue to work on these proposals, which may be published in final form (or for further comment, if warranted) later this year. The CSA also continue to consider how issuers should report distributions made in the exempt market and may propose further changes.

Getting Ready For May 5, 2015

NI 45-106 has particular impact on issuers – including investment fund issuers and investment fund managers. Not only are the exemptions changing, but the CSA's expectations on issuers' compliance with the prospectus exemptions have significantly increased, as illustrated by the additional detailed commentary provided by the CSA in CP45-106.

Update Subscription Agreements – As subscription agreements generally include references to the AI Exemption or MA Exemption, issuers should review and update these agreements to ensure that the new requirements are met, for example, by including a risk acknowledgement form for individual accredited investors, who don't meet the new net financial assets test noted above and to ensure that compliance with the new requirements is appropriately documented.

Update Offering Memoranda (OM) – If an OM is provided in connection with a prospectus exempt trade, the OM should be reviewed to ensure that the terms of the AI Exemption and MA Exemption, and the subscription instructions, reflect the updated rules. If an OM has been prepared to meet the "OM exemption" requirements set out in section 2.9 of NI 45-106 (the OM exemption is available in certain provinces, most notably British Columbia and is not affected by the amendments) the OM needs to be updated to include updated audited annual financial statements no later than 120 days after the financial year end of the issuer (that is, by April 30 for an issuer with a December 31 year-end). Issuers and fund managers who are in the process of updating their OM to include updated financial statements should also review the OM to ensure that the terms of the prospectus exemptions are correctly described.

Update Compliance Policies and Procedures – Issuers (and their managers in the case of investment fund issuers) should review, update and/or prepare compliance policies and procedures to reflect the amended rules and increased guidance in NI 45-106.

Registrants, particularly exempt market dealers, will need to ensure that dealing representatives, as well as executive and compliance staff understand the nature of the changed prospectus exemptions that issuers can use to issue securities to their clients, as well as the enhanced record-keeping and "know your client" expectations that these amendments will have on their dealings with clients.

Review Agreements with Selling Dealers – If an issuer wishes to rely on a selling dealer to help document the availability of a prospectus exemption (for example, that the investor meets one of the financial tests set out in the definition of "accredited investor"), that may need to be better reflected in the subscription agreement and/or a dealer agreement. This is particularly relevant given the CSA's enhanced guidance on their expectations in this area in CP45-106.

The AI Exemption

In Ontario, fully managed accounts will now be permitted to purchase investment fund securities under the managed account category of the AI Exemption, as they have been able to in all the other provinces and territories of Canada. We have long urged the OSC to permit the purchases, given that a fully managed account, by definition, means that the client has given the registered adviser full discretion to invest the client's assets, including investing in investment funds, where the adviser considers this to be in the client's best interest. This change will eliminate the confusion that currently exists where one of the investment fund manager or the client resides in Ontario and will give Ontario investors, who may not qualify as accredited investors, greater access to professional management of their assets, as well as more cost-efficient investment vehicles.

The definition of accredited investor in NI 45-106 is also being expanded in two ways:

1. New category of individual accredited investor
   Accredited investors will now include individuals who beneficially own financial assets having an aggregate realizable value that before taxes, but net of any related liabilities, exceeds $5 million (Permitted Client AI). If an individual meets this test, they also meet the test to be a "permitted client" under NI 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* and they do not need to complete and sign the new risk acknowledgement Form 45-106F9 *Form for Individual Accredited Investors* (AI Risk Form).
2. New category of family trust accredited investor
   Trusts established by an accredited investor for the benefit of certain family members (including former spouses and their families) will now qualify as accredited investors, provided that a majority of the trustees are accredited investors.

All individual accredited investors, except those that qualify as Permitted Client AIs, will have to complete and sign the AI Risk Form. The AI Risk Form is designed to alert individual accredited investors that they will not receive certain protections under securities laws when they invest. It requires individual accredited investors to specify the category of accredited investor they fall under – the AI Risk Form includes a plain language description of the various categories – and to acknowledge that their investment is risky, which will include the investor specifying the total amount of the investment that could be lost. The AI Risk Form can be signed electronically and requires the applicable salesperson to include his or her name, contact information and firm name (if registered). Issuers must retain the signed AI Risk Form for eight (8) years. We anticipate that the AI Risk Form may necessitate additional disclosure of risks in OMs and may cause dealers to carefully reconsider whether individuals who do not qualify as Permitted Client AIs should be permitted to invest in exempt securities, given the perception of higher risk associated with those investments.

The CSA chose to ignore those commentators who pointed out that the risk of a security distributed under a prospectus exemption lies in the nature of the investment and not in how it is distributed. The CSA have unfairly forced issuers to state that all securities sold by prospectus exemption are "high risk", which we consider inappropriate and potentially misleading. This will almost certainly result in restricted access to securities distributed in the exempt market. It is not clear whether investors are required to initial all the purported risks set out in section 2 of the AI Risk Form, even if they do not apply to a particular offering.

The MA Exemption

The MA exemption will no longer be available to individual investors, no matter the size of their investment. This change is driven by the CSA's concern that individual investors, who may not have the requisite financial sophistication or net worth as those who qualify as accredited investors, are participating in the exempt market. The CSA have preserved the ability of entities such as corporations, partnerships and trusts as well as institutional investors to rely on this exemption, however, it will remain to be seen whether the MA Exemption will remain relevant for institutional investors, given that the majority of institutional investors will almost certainly qualify also as accredited investors.

Expanded Guidance to Verify Qualification of Investors Under Prospectus Exemptions

The CSA have expanded the guidance in CP45-106 on the steps an issuer or selling securityholder (collectively, seller) should take to verify the status of purchasers acquiring securities under prospectus exemptions, including the AI Exemption. This new guidance advises sellers to take an escalating approach to verification and makes clear that the CSA do not consider it sufficient for a seller to simply rely on representations made by an investor or a "check the box" form, unless the seller has taken reasonable steps to verify the representations made by the investor.

What is reasonable, according to the CSA, depends on a variety of circumstances, such as the particular facts and circumstances of the investor, the type of offering and the exemption being relied on. For instance, to verify that an investor is an accredited investor, the CSA expect the seller to ask questions about the investor's net income, financial assets or net assets, or to ask other questions designed to elicit details about the investor's financial circumstances. If the seller has concerns about the investor's responses, the seller should make further inquiries about the investor's financial circumstances. If the seller still questions the investor's eligibility, the seller could ask to see documentation that independently confirms the investor's claim as to his or her status. The seller should also consider what documentation it needs to retain or collect from an investor to evidence the steps the seller followed to establish that the investor met the conditions of the applicable prospectus exemption.

Ontario Friends, Family And Business Associates Exemption

The OSC is introducing its own version of the friends, family and business associates exemption. The FFBA Ontario Exemption will be substantively harmonized with the corresponding version available in the other provinces and territories, with some important differences.

The FFBA Ontario Exemption will permit issuers (other than investment fund issuers) to distribute securities to the issuer's directors, executive officers, control persons and founders as well as certain family members, close personal friends and close business associates of such persons. The FFBA Ontario Exemption will require the issuer to obtain a signed risk acknowledgement form from the investor, Form 45-106F12 *Risk Acknowledgement Form*

for Family, Friend and Business Associate Investors (Form 45-106F12). Form 45-106F12 must also be signed by the issuer and the individual at the issuer with whom the investor has the relationship and be retained by the issuer for eight (8) years after the date of the distribution. Form 45-106F12 is similar to, but different from, the prescribed form that is used for this exemption in Saskatchewan.

The OSC, in explaining why the FFBA Ontario Exemption, unlike similar exemptions in the other jurisdictions, will not be available to investment fund issuers, notes that this exclusion is consistent with the focus of the policy initiative of its exempt market review to facilitate capital raising for start-ups and small and medium-sized enterprises.

Expanded guidance will also be added to CP45-106 on the meanings of close personal friend and close business associate, including the fact that a "close personal friend" or "close business associate" does not include an individual with whom a friendship is primarily founded on participation in an internet forum or on social media.

As part of the coming into force of the FFBA Ontario Exemption, the OSC will repeal the founder, control person and family exemption currently contained in NI 45-106, which will have implications on issuers, in particular on investment fund issuers, as well as their founders, control persons and their families who are relying on this exemption today.

No Changes to Reports of Exempt Distribution ... At Least for Now

The status quo remains for reports of exempt distributions. The CSA had earlier proposed introducing a combination of four reporting forms – one specific form for British Columbia, two forms in Alberta, New Brunswick, Ontario and Saskatchewan (one for investment funds and another for all other issuers) and a fourth form in the remaining provinces and territories. The CSA have decided to defer these changes for further study and consideration in a separate CSA project. Stay tuned.

Additional Requirements Introduced to the Short-Term Debt Exemption

Currently, short-term debt distributed under Short- term Debt Exemption must have at least one credit rating at or above one of four prescribed credit ratings (the Rating Threshold Condition) and no credit rating below the ratings in the Rating Threshold Condition (the Split Rating Condition). The Split Rating Condition will be amended May 5, 2015 to require that the short-term debt has no rating below new specified ratings.

New Exemption Available for Short-Term Securitized Products, Such as Asset-Backed Commercial Paper

The CSA are also introducing a new exemption to specifically address the distribution of short-term securitized products. The Securitized Products Exemption permits issuers of short-term securitized products (defined as conduits in NI 45-106) to distribute short-term securitized products (also a newly defined term in NI 45-106), provided that the short-term securitized product meets prescribed conditions (including certain credit ratings and the existence of a "global-style" liquidity agreement with an appropriate financial institution) and the conduit complies with disclosure requirements. Disclosure must be provided about:

- the conduit, including its structure, business and operations, in Form 45-106F7 *Information Memorandum for Short-term Securitized Products Distributed under Section 2.35.1* (Information Memorandum) on or before the date that a purchaser purchases a short-term securitized product;
- the conduit, including asset transactions, asset pools and their performance, in Form 45-106F8 *Monthly Disclosure Report for Short-term Securitized Products Distributed under Section2.35.1* (Monthly Report) no later than 50 days from the end of the most recent month; and
- certain significant events relating to the conduit's credit rating and the payment of principal or interest no later than the second business day after the conduit becomes aware of the change or event.

Transition periods are provided in NI 45-106 for the provision of the Information Memorandum and Monthly Reports.

Short-term securitized products will not be permitted to be distributed under the private issuer prospectus exemption, the friends, family, and business associates prospectus exemptions, the founder, control person and family prospectus exemption (while it still exists) and the offering memorandum prospectus exemption.

Please Contact Us for More Information

These are the most significant changes to Canada's exempt marketplace in many years. We would be pleased to assist you with determining how these amendments to NI 45-106 will affect your firm, its business, compliance procedures and documentation. We can also assist in determining how the new exemptions in NI 45-106 can be best leveraged by your firm in the context of its business. It will be important to be proactive in making these determinations so that you are not caught off guard on May 5, 2015.

Please contact your usual lawyer in BLG's Securities and Capital Markets group, including BLG's Investment Management group, the authors of this Bulletin or any of the leaders indicated below.

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1 In Ontario, the amendments to the AI Exemption and the MA Exemption come into force on the later of May 5, 2015 and the day on which subsection 12(2) of Schedule 26 of the B*udget Measures Act, 2009* is proclaimed in force. Note that Ontario has maintained much of the prospectus exemptions in the *Securities Act* (Ontario), including the amended definition of "accredited investor", which although the legislation is consistent with NI 45-106, will require Ontario market participants to review the legislation in addition to NI 45-106.

2 For background, see our earlier newsletters: *Significant Amendments Proposed to Prospectus Exemptions in Canada Designed to Achieve Greater Protections for "Retail" Investors* Securities & Capital Markets Alert February 2014 and *Increased Reporting Obligations and New Prospectus Exemptions Proposed* Securities & Capital Markets Bulletin April 2014.

3 Investment funds will be excluded from using the crowdfunding regime and relying on the Ontario version of the offering memorandum exemption, if the final versions of these rules remain consistent with the proposals.

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