Securities Commission Offers Rare Guidance Regarding The Due Diligence Defence And The Family, Friends And Business Associates Prospectus Exemption

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The B.C. Securities Commission's (the "Commission") decision in *Re SunCentro* (2017 BCSECCOM 58) provides insight into the applicability of the Family, Friends and Business Associates prospectus exemption, and also delivers rare guidance regarding the availability of the due diligence defence to allegations of distributing securities without a valid prospectus exemption or under a prospectus.

This case arose following a series of securities distributions made by SunCentro Corporation (the "Company" or "SunCentro"), a private solar company, to twenty-six of its investors. After examining the distributions, the executive director of the Commission issued notices of hearing in respect of the same to the Company, two of its directors and officers, two finders who were involved in the distributions, and two of the directors and officers of the corporate finder (collectively, the "Respondents"). All distributions were allegedly made pursuant to the Family, Friends and Business Associates prospectus exemption. However, the Commission ultimately found that none of the investors qualified for the exemption.

Nineteen of the investors (the "YDS Investors") were referred to the Company by YDS Energy, Resources and Humanitarian Relief Corporation ("YDS"). The YDS Investors claimed to be close personal friends or business associates of the principals of YDS. At the time of the distributions, YDS and SunCentro were under the impression YDS was an "affiliate" of SunCentro and that the YDS Investors therefore qualified for the prospectus exemption. However, YDS was not an "affiliate" of SunCentro; thus the requirements of the Family, Friends and Business Associates exemption were not satisfied.

Six of the investors (the "Weiss Investors") were referred to the Company by Donald Weiss ("Weiss"). The Weiss Investors claimed to be close personal friends or business associates of Weiss's son, who was a director and senior officer of SunCentro. Upon examination by the Commission, the Weiss Investors admitted that while they knew Weiss's son, they were not, in fact, close personal friends or business associates of Weiss's son, but rather they were close personal friends of Weiss. As a result, the

Commission found that the Weiss Investors did not satisfy the Family, Friends and Business Associates exemption.

One investor (the "Carswell Investor") was referred to the Company by John Carswell ("Carswell"), a director and executive officer of SunCentro. The Carswell Investor claimed to be a close personal friend of Carswell, but in actual fact the investor was the sister of Carswell's friend and had only met Carswell on one occasion. The Commission found this to be insufficient for the purpose of satisfying the Family, Friends and Business Associates exemption.

The Commission's decision indicates that the group of people who can qualify under the Family, Friends and Business Associates exemption is relatively narrow and confined, and illustrates that the Commission will not hesitate to examine alleged relationships to ensure they comply with the Family, Friends and Business Associates prospectus exemption.

After finding that the distributions clearly violated Section 61 of the Securities Act (*British Columbia*) (the "Act"), the Commission considered whether a due diligence defence was available. Although the Act does not specifically provide for a due diligence defence, the Commission found that such defence existed under the common law.

The Commission noted that respondents could make out a due diligence defence if they established that all reasonable steps were taken while selling the securities in question. The following guidance was provided regarding what constitutes reasonable steps:

- the steps that are reasonable will vary depending upon the facts and circumstances of the purchaser, the offering, and the exemption being relied upon;
- while sellers should obtain and retain documentation of certain key facts, including obtaining representations and warranties and/or confirmations of a purchaser's financial or other personal status, these steps will not be sufficient in and of themselves;
- sellers should understand the terms and conditions of the exemptions that they intend to rely upon;
- sellers should adopt appropriate policies and procedures to ensure that persons acting on their behalf understand the terms and conditions of the exemptions being relied upon; and
- sellers should take steps to verify the factual basis of the information being relied upon, including asking questions of purchasers.

In light of the above factors the Commission considered whether a due diligence defence was available in respect of the distributions made to the YDS Investors, the Weiss Investors, and the Carswell Investor.

In respect of the YDS Investors, the Commission found that although SunCentro took many reasonable steps, including obtaining subscription agreements from each investor, adopting a board policy to guide their capital raising activities, and seeking legal advice regarding available prospectus exemptions, that the Board's efforts in obtaining a full understanding of the prospectus exemption were incomplete. Specifically, the Board knew there was an open question regarding the meaning of “affiliate” and chose to make its own determination regarding said meaning instead of

seeking further legal advice on the subject. As a result the Commission found the Board did not take reasonable steps to avoid illegally distributing securities, and that a due diligence defence was therefore not available. This finding demonstrates the necessity for issuers and promoters to obtain comprehensive legal advice and a full understanding of the legal framework surrounding the distribution of securities in order to make out a successful due diligence defence.

In respect of the Weiss Investors and the Carswell Investor, the Commission ultimately found that the steps taken by SunCentro established a due diligence defence. Like with the YDS Investors, SunCentro had obtained subscription agreements from each investor, adopted a board policy to guide their capital raising activities, and educated board members on the applicable prospectus exemptions. However, here the differentiating factor was that the Board received and relied upon assurances from certain board members that the information contained in the subscription agreements was accurate and that the investors qualified for the prospectus exemption. Specifically, certain board members confirmed that the investors were their close personal friends or business associates, as applicable. The Commission found that obtaining this confirmation was a reasonable step for the Company to take towards verifying the factual basis for the availability of the prospectus exemption and, that taken together with the other steps taken by the Company, it was enough to establish a due diligence defence.

Interestingly enough, neither YDS, Wiess nor Carswell were able to establish a due diligence defence in respect of the investors they referred as each finder solely relied on the investigations of SunCentro. The Commission found that if a party receives payment for an activity, they must do more than simply rely on the actions of others if they want to avail themselves of a due diligence defence.

Ultimately, the Commission ordered that SunCentro was subject to a permanent cease trade order and was made to pay a US$165,500 penalty, being the amount collected under the illegal distributions. The individual Respondents were prohibited from acting as directors or officers of an issuer for various time periods ranging from 2-4 years, and they were also ordered to pay administrative penalties. YDS was subjected to a no trade order and was ordered to pay an administrative penalty equal to the amounts it obtained as a result of its contravention of the Act.

Going forward issuers and finders will want to take certain steps to ensure they can make out a due diligence defence in case it is later found that they illegally distributed securities. Issuers should:

- have board policies in place for capital raising activities;
- ensure that comprehensive legal advice is obtained regarding the prospectus exemptions being used and ensure board members are educated regarding the same;
- have policies and procedures in place to confirm that the parties acting on the issuer's behalf understand the exemption being relied on; and
- have systems in place to obtain and verify relevant information.

In addition, when the Family, Friends and Business Associates exemption is being used, representations and confirmations should be obtained from the relevant officer or director investors are claiming to have a relationship with.

The Commission's decision, while providing more clarity regarding the availability of a due diligence defence, may be a double-edged sword. On the one hand, companies can protect themselves by taking steps to ensure they qualify for a due diligence defence should such defence be needed. On the other hand, the decision may place more onerous obligations on companies, finders and their directors, and open such persons up to further liability. What we do know is that obtaining sophisticated, comprehensive legal advice regarding distributions and the availability of prospectus exemptions is more important now than ever.

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