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THE PROSPECTUS EXEMPTION FOR DISTRIBUTIONS TO EXISTING SECURITY HOLDERS – ONTARIO MAKES IT (ALMOST) UNANIMOUS

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The Ontario Securities Commission (OSC) has adopted a prospectus exemption for distributions by issuers of securities to their existing security holders, joining the other members of the Canadian Securities Administrators (CSA), all of whom had announced the adoption of the exemption in March of 2014. (Some publications have indicated that Newfoundland had not adopted the exemption. Although not announced simultaneously with the other non-Ontario jurisdictions, the exemption actually was implemented in Newfoundland by way of a blanket order later in the same month.) The exemption will be available in Ontario commencing February 11, 2015 through an amendment to OSC Rule 45-501 – *Ontario Prospectus and Registration Exemptions*, subject to Ministerial approval.

It is apparent from the OSC's responses to the comments it received when its exemption was at the proposal stage that the final version of its exemption might have been different had the OSC not decided to make accommodations for the sake of harmonization with the versions that were already in place in the other CSA jurisdictions. Nevertheless, although the exemption is similarly worded for the most part among the jurisdictions, there are some differences which are noted below along with some observations on some of the conditions and implications of the exemption.

Permitted Size of the Distribution

Ontario is the only CSA jurisdiction that will prohibit a distribution of securities under the exemption from increasing the number of outstanding securities of the same class by more than 100%. This is consistent with the limitation on the use of the revised rights offering prospectus exemption currently being proposed by the CSA, but is in contrast to the accredited investor and other prospectus exemptions that have no similar limit. The logic of this inconsistency is not easily explained given that the dilutive effect on existing security holders from an issuance of securities is the same regardless of the exemption used, and the rules of the stock exchanges on security holder approval and pricing of share issuances are applicable to private placements made in reliance on the new exemption.

Of interest is that the OSC's 100% limit has no timeframe attached to it to address the possibility of multiple uses of the exemption within a short period of time, unlike other limits imposed by securities regulators and stock exchanges. For example, the comparable current and proposed rights offering exemptions prescribe a 12-month period during which the applicable limit applies in the aggregate to all distributions relying on the exemption. It might be expected that the OSC would consider intervening if an issuer attempted to circumvent the new exemption's limit by staggering the multiple use of the exemption in short intervals, which could be regarded as an abuse of the exemption. In this connection, however, it might be noted that the OSC itself, in responding to a commenter who opposed the 100% limit, pointed out that issuers would not be limited in the number of times they could use the exemption in a 12-month period.

The OSC also observed in its defence of the 100% limit that issuers may also use other prospectus exemptions. This would appear to mean that the OSC would not object if an issuer were to use the new exemption simultaneously with the accredited investor exemption for those security holders who qualified, so that the aggregate number of securities distributed through the use of the two exemptions could increase the number outstanding by significantly more than 100% without running afoul of the limit.

Issuer Eligibility

Ontario is the only jurisdiction that is not allowing investment fund issuers to use the exemption. The OSC said in its commentary that to permit investment funds to use the exemption would be inconsistent with the regulatory framework for the sale of investment funds to retail investors and with the policy initiatives in this area that are currently underway. A second stated reason was that the exclusion would be consistent with the objective of the OSC's policy project to introduce new prospectus exemptions, of which the existing security holder exemption is one, that would facilitate capital raising for small and medium-sized enterprises. However, there is no issuer size test for determining eligibility.

When first published for comment by the CSA on behalf of the non-Ontario jurisdictions, the existing security holder exemption was intended to address the financing difficulties encountered by junior issuers and was only to be applicable to issuers with a class of equity securities listed on the TSX Venture Exchange. Based on comments received to the effect that the policy rationale for the exemption applied equally to issuers listed on other Canadian exchanges, the CSA notice expanded the exemption's availability to all issuers with equity securities listed on the TSX Venture Exchange, the Toronto Stock Exchange or the Canadian Securities Exchange. The OSC added to that list the Aequitas NEO Exchange, which was recognized as an exchange by the OSC in November 2014.

Jurisdictional Issues

The lack of uniformity between Ontario and the other jurisdictions could give rise to age-old questions of territorial jurisdiction. For example, if a non-Ontario-based issuer were to use the exemption to increase the number of the outstanding securities of the class by more than 100% but subscriptions that were just from Ontario purchasers did not exceed that 100% threshold, would the OSC consider this to constitute a violation of its limit? Would the OSC exercise its public interest jurisdiction in this circumstance regardless of the issue of technical compliance? Until there are real-life examples or regulatory guidance is provided, there will be no clear answers to these questions.

Allocation of Securities Distributed

The OSC originally intended to part ways with the other CSA jurisdictions in regard to the allocation of the securities distributed under the exemption. The OSC proposed to require the securities to be offered on a pro rata basis to security holders based on their existing holdings, as in a rights offering (subject to a 12-month maximum purchase cost of $15,000 for a security holder that did not receive investment suitability advice). In the interest of harmonization, the OSC ultimately decided to join the other jurisdictions in requiring only that each security holder be permitted to subscribe for securities in the distribution. However, concurrently with the adoption of the exemption, the OSC is adding Part 8 to the Companion Policy to Rule 45-501 to indicate that the OSC may not look kindly on an allocation it considers to be unfair.

The wording of the allocation requirement is not identical among the CSA jurisdictions. Some, including Ontario, require the issuer to permit each security holder to "subscribe" for securities, whereas others

require the issuer to “make the offer available” to all security holders. For practical purposes, this may not amount to a substantive difference, and the OSC uses the “available” language in its Companion Policy. However, the OSC’s Companion Policy also contains the statement that “there is no requirement that an issuer accept all subscriptions from each existing security holder” and contemplates that an issuer might set a minimum subscription amount so as to avoid an administrative burden. If a minimum subscription amount were to be perceived by security holders or regulators as too high, there could be an interpretation issue as to whether there was compliance with the applicable allocation requirement. The OSC’s Companion Policy contemplates this possibility by including a statement that a rejected subscription could call into question whether the offering was made available to all security holders.

Timing of Record Date

All of the jurisdictions require the record date for determining the security holders entitled to participate in the distribution to be at least one day prior to the day the issuer announces in a news release its intention to conduct the distribution. Normally, record dates for security holder entitlements are announced in advance, not retroactively. In fact, stock exchanges generally require seven trading days’ notice in advance of a record date for dividends, rights offerings and other security holder entitlements, so that the market is adequately informed before “ex-trading” in the affected security begins.

Because the normal settlement period for trades on a stock exchange is three trading days, a security holder entitlement generally remains with the seller of the security for stock exchange trades that take place on and after the “ex-date”, which is the second trading day before the record date for the entitlement (unless the stock exchange introduces a system of due bills for the trading of the security, which does not happen routinely in Canada). The stock exchange designates and announces the ex-date to the trading community, since each Canadian exchange has a rule (e.g. Rule 4-407 of the Toronto Stock Exchange Rule Book) that prescribes that in all trades of securities, other than bonds or debentures, any right given to holders of those securities passes with the security and belongs to the purchaser unless otherwise provided by the exchange or the parties to the trade by mutual agreement. The exchanges have not indicated an intention to view that rule as applying to distributions under the existing security holder exemption so as to require the applicable exchange to formally designate an ex-date. It would appear that the normal ex-date, the second trading day before the record date, applies to these distributions despite the absence of the designation.

The market price of a security often drops on an ex-date, all else being equal, because purchasers may discount the value of the security by the perceived value of the entitlement from which, as of that date, they are excluded. In the case of the existing security holder exemption, during the period from the ex-date to the announcement of the distribution, first-time purchasers of the security will be excluded from the entitlement without knowing it, and there is a possibility that in some cases they will pay more for the security than they would have had they known of the distribution and their exclusion from it. This is the scenario that the exchanges’ rules requiring advance notice of the record date for dividends, rights offerings and other entitlements are designed to prevent. For the existing security holder exemption, this may not be a serious issue in most cases if the offering price is not at an inordinately large discount from the market price. The private placement pricing restraints imposed by the rules of the exchanges will help in this regard.

Issuer’s Responsibility for Compliance with Investor Qualification Criteria

The Canadian securities regulators have often expressed concerns about shortcomings in the processes undertaken by issuers to adequately confirm that private placement purchasers qualify as “accredited

investors" when the issuer is relying on that prospectus exemption. This issue has arisen in enforcement hearings and in proposed amendments to the Companion Policy to National Instrument 45-106 – *Prospectus and Registration Exemptions*, published for comment in February 2014, that indicate the regulators' desire for a fairly rigorous confirmation process. The same potential concern is not reflected in the terms of the existing security holder exemption itself or in the amendment to the Companion Policy to OSC Rule 45-501 that addresses the exemption. Some versions of the exemption provide that the issuer or a salesperson acting on the issuer's behalf must not reasonably believe that the mandated representation from the purchaser as to its security holder status is untrue, but that is the extent of the prescribed comfort level explicitly required from the issuer as to the purchaser's qualification for the exemption. There is no prescribed verification process for ensuring compliance with the 12-month $15,000 purchase limit for purchasers not having the requisite investment suitability advice. It is possible that this discrepancy from the accredited investor exemption reflects the recognition on the part of the regulators that the time and expense of an involved verification process would materially detract from the benefits of the existing security holder exemption and discourage its use.

No Minimum Offering Period

A very short offering period for a distribution under the exemption creates the potential for disappointed security holders who learn of the opportunity too late to participate. In response to a commenter who suggested implementing a minimum offering period, the OSC noted that the other CSA members had not imposed a minimum offering period and that a very short offering period may call into question whether the issuer would meet the requirement to make the offer available to all security holders. While this may not generally arise as an issue in practice, it is arguable that a prescribed minimum offering period may have been preferable to leaving the matter as an area of uncertainty.

Remedies for Misrepresentation

Some CSA jurisdictions require the subscription agreement between the issuer and purchaser for a distribution under the exemption to contain a contractual right of action for rescission or damages for a misrepresentation in a "document" or "core document", as those terms are defined in the securities legislation on civil liability for secondary market disclosure. Other jurisdictions instead apply the secondary market liability regime directly to securities issued under the exemption. Issuers located in the jurisdictions that directly prescribe secondary market liability still have to provide the contractual right of action to investors located in the jurisdictions where that right is required.

Resale Restriction

Securities issued under the exemption are subject to a four-month hold period, as is the case for the accredited investor exemption and most of the other capital raising exemptions, rather than the seasoning period that applies to securities issued in a rights offering. For any prospectus exemption, the benefits of a hold period are open to question if the securities involved are of a publicly traded class and of a reporting issuer in full compliance with its continuous disclosure obligations. Hold periods can inhibit capital raising by reducing the number of potential private placement purchasers, particularly in times of volatile markets where the hold period may add a significant degree of perceived risk to an investment under consideration. To compensate purchasers for the hold period, issuers must generally offer securities at a deeper discount from the market price than would otherwise be necessary, thereby raising the cost of capital. It is difficult to identify who the victims would be and how they would be negatively impacted if hold periods were no longer to apply to resales that were normal course, non-prearranged trades in the open market.

The participating jurisdictions in the proposed Cooperative Capital Markets Regulatory System have indicated that, in order to minimize disruption to market participants, the initial uniform provincial legislation under the new system will not introduce significant changes to existing rules. A review of resale restrictions is therefore not a policy project that is likely to be undertaken in the near term, but it would be a worthwhile candidate for consideration once the dust settles on the establishment of the new regulator.