New existing security holder prospectus exemption comes into force in Ontario

February 11, 2015

Jonah Mann

Of the **four new prospectus exemptions** proposed by the Ontario Securities Commission in March 2014, the “existing security holder” exemption, an exemption that permits certain reporting issuers to issue new securities to their existing security holders without having to file a prospectus (the “**Ontario Exemption**”), has been adopted by the OSC and comes into force today. **As announced on November 27, 2014**, the Ontario Exemption is being adopted through amendments to OSC Rule 45-501 and varies somewhat from the exemption as originally proposed and published for comment on March 20, 2014 (the “Proposal”).

Requirements of the Ontario Exemption

Under the Ontario Exemption, existing security holders of an issuer are permitted to purchase equity securities of the issuer on a prospectus exempt or "private placement" basis provided the securities are listed on the TSX, TSXV, CSE or the Aequitas NEO Exchange (each a “listed security”). The Ontario Exemption also extends to units comprised of a listed security and a warrant entitling the holder to acquire a listed security and applies where the person is purchasing as principal only. In order to rely on the Ontario Exemption, the issuer must be a reporting issuer in a Canadian jurisdiction, other than an investment fund, and be current in its continuous disclosure filings. An announcement of the offering must be made in a news release containing a reasonably detailed description of the offering, including the number of securities proposed to be distributed and how they will be distributed, the aggregate proceeds of the distribution and the proposed use of the proceeds.

To participate in the offering, a purchaser must represent to the issuer, in writing, that it held at the “record date” (a date determined by the issuer, which must be at least one day prior to the announcement date) and continues to hold the applicable listed security. A purchaser may only purchase an aggregate of up to $15,000 of listed securities in any 12-month period pursuant to the Ontario Exemption, *unless* it has obtained suitability advice in respect of the investment from a registered investment dealer in Canada. Securities purchased under the Ontario Exemption are subject to a four-month hold period under section 2.5 of **National Instrument 45-102 Resale of Securities**.

The Ontario Exemption imposes an anti-dilution measure that prohibits an issuer from making a distribution that would increase the number of its outstanding listed securities by more than 100% (the “Dilution Limit”). In addition, issuers relying on the exemption are required to make certain representations in the subscription agreement that “core documents” and “documents” (as defined in **s. 138.1 of the Securities Act** (Ontario) under the "secondary market civil liability" provisions) do not contain a misrepresentation and that there are no undisclosed material facts or material changes relating to the issuer. Other than the subscription agreement, offering materials must be filed with the regulator.

Ontario Exemption vs. Proposed Exemption

While the Ontario Exemption is similar to the Proposal, in some instances, the requirements deviate from those initially proposed. For example, the Proposal contained a seasoning period for issuers intending to use the exemption and a requirement that securities be distributed to purchasers under the exemption on a *pro rata* basis. While the seasoning period has been completely removed, the *pro rata* requirement is no longer in the rule itself but rather in **Companion Policy 45-501** ("45-501CP"), which recommends that an issuer treat its security holders in a manner that is perceived to be fair and equal. According to the OSC, fair treatment involves giving each security holder an identical opportunity to invest in the distribution and by implementing specific policies and procedures, an issuer can provide reasonable assurance that the investment opportunities will be allocated fairly among its security holders.

The liability regime included in the Ontario Exemption has also been amended. The Proposal contained a regime of contractual liability, which required that the subscription agreement entered into between a purchaser and issuer provide the purchaser with contractual rights against the issuer in the event that the issuer made a misrepresentation in its disclosure record. In the Ontario Exemption, the OSC eschewed this contractual liability for secondary market civil liability ("SMC Liability"). According to the OSC, SMC Liability is advantageous to contractual liability as it: (i) gives purchasers additional rights of action, (ii) provides additional persons against whom those rights are enforceable, and (iii) ensures greater consistency among issuers because the applicable contractual provisions would very likely differ from issuer to issuer (or be excluded altogether). However, as noted above, the Ontario Exemption still requires that the subscription agreement include an issuer representation that (i) certain disclosure documents do not contain a misrepresentation, and (ii) there is no material fact or change that has not been generally disclosed by the issuer.

On the other hand, despite comments advocating to the contrary, there were many requirements from the Proposal that were retained. For example, while commentators advocated for a longer minimum time period between the record date and the announcement date, the OSC maintained the one-day requirement. Commentators also opposed the requirement that a purchaser obtain suitability advice from a Canadian investment dealer or be limited to a $15,000 investment. One comment proposed that the limit, instead of being capped at $15,000, should be set at an amount equal to a purchaser's *pro rata* ownership in the listed security. In this way, a purchaser would be able to maintain a *pro rata* position in the listed security without having to obtain suitability advice. However, the OSC maintained that the $15,000 limit is an important investor protection mechanism that (i) mitigates the risk of loss to an investor, (ii) encourages asset class diversification, and (iii) maintains flexibility for those investors for whom it may be appropriate to exceed the limit.

Harmonization with the Other Provinces Exemption

The OSC justified many of its decisions to keep or remove criteria by citing its desire to harmonize the Ontario Exemption with the similar exemption that was adopted in March of this year by the securities regulators in the rest of the Canadian provinces and territories (other than Newfoundland and Labrador) (the "**Other Provinces Exemption**").

Given that **Aequitas NEO Exchange obtained recognition as an exchange on November 13, 2014**, only the Ontario Exemption is available to issuers listed on the Aequitas NEO Exchange. In contrast to the Other Provinces Exemption, the Ontario Exemption is not available to investment funds. This exclusion, in the eyes of the OSC, is not only consistent with the objective of the Ontario Exemption, which is to facilitate capital-raising by business enterprises, particularly small- and medium-sized enterprises, but also with the principles underlying the existing regulatory framework that applies to investment funds. Lastly, the Ontario Exemption imposes the Dilution Limit, which is not included in, nor is a similar anti-dilution measure imposed by, the Other Provinces Exemption. It is the OSC's position that the Ontario Exemption should not result in the significant dilution of security holders' holdings and because issuers, subject to individual investors' investment limit, are not prohibited from using the Ontario Exemption multiple times in a year, the OSC does not believe that the Dilution Limit is overly restrictive.

Practical Considerations

The Ontario Exemption will likely appeal to small-cap issuers that wish to avoid the more onerous requirements associated with the rights offering exemption in **NI 45-101** (the "Rights Offering Exemption"). The Rights Offering Exemption currently requires that a circular be prepared and submitted to the applicable securities regulator for review, and only allows an issuer to dilute its outstanding securities by 25%. In contrast, the Ontario Exemption only requires a news release to be issued and permits up to 100% dilution of an issuer's securities. Even after the **proposed amendments to the Rights Offering Exemption recently published by the OSC for comment**, which would increase the dilution limit to 100% and remove the requirement that the circular be reviewed by the OSC, the Ontario Exemption may still be advantageous due to lower transaction costs. Whereas the Rights Offering Exemption requires the preparation of a circular and distribution of notices to shareholders, the Ontario Exemption only requires the preparation of a subscription agreement and a news release. Finally, given the $15,000 investment limit (without suitability advice) imposed by the Ontario Exemption, large-cap issuers may not find the Ontario Exemption particularly useful.