Your investors : Who are they?

October 9, 2015

Author

Josianne Beaudry

Partner, Lawyer

NEW REQUIREMENTS FOR PRIVATE PLACEMENTS
("Regulation 45-106")

OBLIGATION TO KNOW YOUR INVESTOR WELL

Issuer's obligations:

Ask questions
Verify the investor's declared income and assets
Confirm the relationship between the investor and the issuer
Obtain proof of the investor's status
Keep the documents on file

Last May, the Canadian Securities Administrators amended *Regulation 45-106 respecting Prospectus Exemptions* **("Regulation 45-106")** as well as the *Policy Statement to Regulation 45-106* **("Policy Statement")**.

Recap
We will first review the scope of the application of Regulation 45-106. The main purpose of this regulation, which was first adopted in September 2005, was to uniformize the Canadian rules for the distributions of securities under an exemption from the requirement to prepare a prospectus.

An important reform of this regulation dealt with the rules applicable to private issuers (previously known as closed companies).

Since then, the issuance of securities by a private issuer constitutes a public offering, but remains exempt from the requirement to prepare a prospectus provided the issuer's securities are subject to restrictions on transfer and are owned by not more than 50 persons, not including employees and former employees of the issuer or its affiliates.

Copyright (c) Lavery, de Billy, S.E.N.C.R.L. - L.L.P.

Furthermore, private issuers' securities can only be distributed to the persons described in **section 2.4 of Regulation 45-106**.

These persons include officers, directors, employees, founders, family members of the officers and directors, close personal friends, close business associates and accredited investors.

Recent amendments
Recent amendments made to Regulation 45-106 and to the Policy Statement deal in particular with:

the requirements for verifying the investor's status;
the definition of *accredited investor*;
the requirement to obtain a risk acknowledgement form from certain investors; and
the exemption for the minimum amount investment.

Let us consider these amendments in greater detail.

RESPONSIBILITY AND DUE DILIGENCE

The CSA has clarified and set out in detail the requirements for issuers relying on a prospectus exemption in regard to their responsibility to verify that the conditions have been met.

Some of the exemptions are based on income or assets tests. Other exemptions are based on relationships between the purchaser and a director, executive officer, founder or control person of the issuer, such as that of a family member, close personal friend, or close business associate.

Issuers that distribute securities under these exemptions must obtain certain information from the purchaser in order to determine whether the purchaser has the requisite income, assets or relationship to meet the terms of the exemption.

For example, the CSA expects the issuer to ask questions on the purchaser's net income, financial assets or net assets, or to ask other questions about the purchaser's financial circumstances; and to ask questions designed to confirm the nature and length of the relationship.

It should also confirm the nature and length of the relationship with the director, executive officer, founder or control person identified by the purchaser.

Don't get caught

The CSA has clearly indicated that standard representations included in a subscription agreement or initials beside a category of investor are insufficient as a representation unless the issuer has taken reasonable steps to verify the purchaser's representations.

To determine whether the issuer has taken reasonable steps, the authorities will consider the particular facts and circumstances of the purchaser, the offering, and the exemption being relied on. Factors that may be considered include the following:

1. how the issuer identified or located the potential purchaser;
2. what category of accredited investor the purchaser claims to meet;
3. what type of relationship the purchaser claims to have and with which director, executive officer, founder or control person of the issuer; and
4. how much and what type of background information is known about the purchaser.

The issuer should keep on file all the necessary documents showing that it properly relied on the exemption for a period of at least eight years.

AMENDMENT TO THE EXEMPTION FOR DISTRIBUTIONS TO "ACCREDITED INVESTORS"

Copyright (c) Lavery, de Billy, S.E.N.C.R.L. - L.L.P.

Trusts
The CSA has clarified what types of trusts may henceforth qualify as accredited investors by adding a new category of accredited investor.

According to the new definition of accredited investor in Regulation 45-106, trusts established by an accredited investor for the benefit of the accredited investor's family members of which a majority of the trustees are accredited investors and all of the beneficiaries are the accredited investor's spouse, a former spouse of the accredited investor or a parent, grandparent, brother, sister, child or grandchild of that accredited investor, of that accredited investor's spouse or of that accredited investor's former spouse, are accredited investors.

Individuals
The exemption for a distribution to accredited investors does not apply to the distribution of securities to certain individuals referred to in the definition of the expression "accredited investor" in Regulation 45-106 unless the person distributing the securities obtains from the individual a signed risk acknowledgement in the form prescribed by Regulation 45-106 at the same time or before that individual signs the agreement to purchase the securities. The issuer must keep this form on file for a period of eight years following the distribution.

This new requirement does not apply to the distribution of the securities of a private issuer.

MINIMUM AMOUNT INVESTMENT ($150,000)

Since the adoption of the amendments to Regulation 45-106, the prospectus exemption for the minimum amount investment of $150,000 is only available to investors who are not individuals. The other requirements for this prospectus exemption remain unchanged.

CONCLUSION

By way of conclusion, it is clear from the new rules that the issuer must have a thorough understanding of the regulatory requirements and know its investors well, otherwise it would certainly be better advised to retain the services of a duly registered financial intermediary, whether it be an investment dealer or a dealer in the exempt market.

Copyright (c) Lavery, de Billy, S.E.N.C.R.L. - L.L.P.