

# DISCLOSE THIS - THE OFFERING MEMORANDUM EXEMPTION GETS A REVAMP - CSA PROPOSE ADDITIONAL REQUIREMENTS WITH A FOCUS ON REAL ESTATE ISSUERS AND COLLECTIVE INVESTMENT VEHICLES

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The Canadian Securities Administrators (the “**CSA**”) recently proposed amendments (the “**Proposed Amendments**”) to the offering memorandum exemption (the “**OM Exemption**”) in National Instrument 45-106 *Prospectus Exemptions* (the “**NI 45-106**”) and the Companion Policy to NI 45-106 (the “Companion Policy”). The Proposed Amendments require enhanced disclosure for issuers engaged in “real estate activities” and issuers considered “collective investment vehicles,” both new definitions under the Proposed Amendments as well as making several general amendments designed to clarify or streamline particular aspects of NI 45-106. The Proposed Amendments partially result from findings by the CSA that the use of the OM Exemption had evolved from its original design expectations. The comment period for the Proposed Amendments closes on December 16, 2020.

## Background

The OM Exemption was initially intended to be a financing tool for small and early stage businesses to raise capital without having to resort to the more costly and onerous prospectus regime. It permits issuers to distribute securities to investors who may or may not qualify as “eligible investors” and, in most jurisdictions affects the amount an investor may purchase, without having to prepare and file a prospectus provided that they use the form of offering memorandum prescribed in Form 45-106F2 – *Offering Memorandum for Non-Qualifying Issuers* (the “**OM Form**”). An eligible investor is a broader category of investor than the accredited investor category thereby providing issuers with access to a broader pool of capital when they are seeking funding.

As a result of data obtained from the review of reports of exempt distributions filed by issuers using the OM Exemption in 2017, the CSA determined that: (i) issuers with assets of more than \$100 million account for almost 40% of the use of the exemption; (ii) 17% of issuers reported their industry as “real estate”; and (iii)

approximately 43% of issuers relying on the exemption may be considered, depending on their investment objectives and purpose, to be a “collective investment vehicle.” If adopted, the Proposed Amendments would directly impact at least half of issuers currently relying on the OM Exemption. The CSA further observed as a result of regular compliance reviews that issuers may be unclear as to what disclosure is required under the current OM Form with a view to providing investors with sufficient information to make an investment decision. The Proposed Amendments are intended to assist investors and issuers by clarifying and tailoring the OM Form disclosure requirements for specific types of issuers.

The Proposed Amendments will not impact issuers that utilize offering memoranda in connection with the private placement of securities in reliance on other exemptions from the prospectus requirement under applicable securities laws, such as the “accredited investor” exemption, as there is no prescribed form of offering memorandum for these types of offerings.

### **Issuers Engaged in “Real Estate Activities”**

Under the Proposed Amendments, an issuer will generally be considered to be engaging in “real estate activities” where its business purpose is primarily to generate income or gain for security holders from the lease, sale or other disposition of real property, subject to certain exceptions including issuers engaged in mining and oil and gas activities. Corresponding proposed amendments to the Companion Policy to NI 45-106 provide examples of what would be considered “real estate activities” including: (i) developing or redeveloping real property for sale as commercial or industrial space, residential buildings lots or homes or condominiums; (ii) developing or redeveloping real property for lease; (iii) owning and leasing real property; (iv) buying, holding or selling real property with a view to profit; and (v) issuing an interest in real property that is a security.

Where an issuer is engaged in “real estate activities” the issuer is required to provide the additional disclosure in new Schedule 1 - *Additional Requirements for an Issuer Engaged in Real Estate Activities* (the “**Real Estate Schedule**”) to the OM Form. The Real Estate Schedule requires disclosure:

- relevant to issuers developing real property, including a description of approvals or permissions required, estimated costs of completion of projects and project milestones;
- relevant to issuers that own and operate developed real property, such as the age, condition and occupancy level of the real property.
- of penalties, sanctions, bankruptcy, insolvency or quasi-criminal convictions for parties other than the issuer, such as parties acting as a developer; and
- of any purchase and sale history of the issuer’s real property with a related party (as the term is defined in NI 45-106).

Importantly, the required disclosure in the Real Estate Schedule would not apply to real property that when taken together would not be significant to a reasonable investor.

In addition, under the Proposed Amendments, an issuer engaged in real estate activities must provide an independent appraisal of an interest in real property to investors if:

- the issuer acquires, or proposes to acquire an interest in real property from a related party;
- a value for an interest in real property is disclosed in the offering memorandum, except for in the issuer's financial statements; or
- the issuer intends to use a material amount of the proceeds of the offering on an interest in real property (this third factor would likely capture the majority of real estate investment trusts or "REITs" relying on the OM Exemption to distribute securities).

The independent appraisal must include a certificate (an "**Appraisal Certificate**") signed by a qualified appraiser stating the appraisal is prepared in accordance with the standards and the code of ethics established or endorsed by the professional association of which the qualified appraiser is a member. In addition, it must provide the appraised fair market value of the interest in real property without considering any proposed improvements or proposed development and the appraised fair market value of the interest in real property must be as of a date within six months preceding the date the appraisal is delivered to the purchaser.

### **Expected Impact of Proposed Amendments on Real Estate Issuers**

For issuers engaged in "real estate activities," the Proposed Amendments will mean substantial changes to offering memorandum disclosure to potential investors, potential increased costs associated with obtaining independent third party appraisals of real property (to the extent that this is not already done), required updates to subscription agreements, additional time in connection with the preparation of six month interim financial reports and increased ongoing maintenance and operating costs. Although senior issuers utilizing the OM Exemption will likely be able to bear the additional cost and time associated with complying with the Proposed Amendments, it may become prohibitively costly for more junior issuers with fewer resources, forcing them to undertake financing relying on other prospectus exemptions.

### **Issuers Classified as "Collective Investment Vehicles"**

Under the Proposed Amendments, an issuer will be considered to be a "collective investment vehicle" where its primary purpose is to invest money provided by its securityholders in a portfolio of securities. The term would also include investment funds to the limited extent that they are currently permitted to use the OM Exemption in certain jurisdictions of Canada. As such, the Proposed Amendments are expected to have the greatest impact on issuers that invest in mortgage securities, such as mortgage investment entities.

Where an issuer is considered to be a collective investment vehicle, it is required to provide the additional disclosure in new *Schedule 2 Additional Disclosure Requirements for an Issuer that is a Collective Investment Vehicle* (the “**Collective Investment Vehicle Schedule**”) to the OM Form. The Collective Investment Vehicle Schedule requires disclosure of:

- the issuer’s investment objectives, strategy and criteria, any restrictions or limitations on investments and how securities are identified and selected for purchase or sale;
- penalties, sanctions, bankruptcy, insolvency and criminal or quasi-criminal convictions for persons involved in the selection and management of the investments;
- information regarding the portfolio; and
- the performance of the portfolio along with the methodology used for determining the value of the securities in the portfolio and calculating the performance data of the portfolio.

It is anticipated issuers that qualify as collective investment vehicles under the Proposed Amendments could easily comply with these disclosure requirements as much of the additional information required by the Collective Investment Vehicle Schedule is typically already included by convention in offering memoranda of these types of issuers.

### **Expected Impact of Proposed Amendments on Collective Investment Vehicles**

For issuers considered to be “collective investment vehicles,” the Proposed Amendments will mean a significant enhancement to the offering memorandum disclosure to potential investors including a summary of several items on the cover page of the offering memorandum, potential increased costs associated with information and data gathering to satisfy the additional disclosure and additional time and costs associated with the preparation of six month interim financial reports and the related amendment to the offering memorandum for issuers with a continuous offering. New and early stage collective investment vehicles may find the additional time and costs associated with complying with the Proposed Amendments not to be cost effective and may resort to relying on other prospectus exemptions such as the “accredited investor” exemption.

### **General Amendments**

The Proposed Amendments also include a number of general clarifying or streamlining amendments to NI 45-106 relating to the general disclosure standards applicable to an offering memorandum and requiring that an offering memorandum be filed in a form that allows for electronic searching of key words. There are also a number of changes to the disclosure requirements in the OM Form including:

- the addition of several disclosure items to the cover page to summarize same for investors;

- heightened disclosure where a material amount of proceeds of the offering will be transferred to another entity that is not a subsidiary of the issuer;
- disclosure of criminal or quasi-criminal convictions;
- the requirement to disclose the source or funds for dividends or distributions that exceed cash flow from operations;
- the requirement to include an interim financial report for the most recently completed 6 month interim period of an issuer where a distribution of securities under
- the OM Exemption is taking place on an ongoing basis (requiring additional time and resources from issuer management to prepare); and
- changes to Form 45-106F4 *Risk Acknowledgement*, required for investors purchasing securities under the OM Exemption making the form more understandable and useful to investors. In order to comply with these changes, issuers will need to update their form of subscription agreement to include the new risk acknowledgment form.

If you have any questions regarding the Proposed Amendments or require assistance preparing a comment letter to the Proposed Amendments, members of McMillan's Capital Markets Group would be pleased to assist you.

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### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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