

RAISING MONEY WITH THE OFFERING MEMORANDUM PROSPECTUS EXEMPTION: CSA ADOPTS ADDITIONAL REQUIREMENTS WITH A FOCUS ON REAL ESTATE ISSUERS AND COLLECTIVE INVESTMENT VEHICLES

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The Canadian Securities Administrators (the "CSA") recently announced the adoption of amendments (the "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"). As discussed in our prior bulletin here, the Amendments were initially proposed in September 2020. The Amendments require enhanced disclosure for issuers engaged in "real estate activities" and issuers considered "collective investment vehicles," both new definitions under the Amendments, as well as several general amendments designed to clarify or streamline particular aspects of NI 45-106. In Ontario, the Amendments also require (subject to certain exceptions) issuers include interim financial statements in an offering memorandum for on-going distributions. Such interim financial statements must be for the issuer's most recently completed 6-month period. The Amendments partially result from findings by the CSA that use of the OM Exemption had evolved from its original design expectations.

The Amendments are expected to come into force on March 8, 2023 (the "**Effective Date**") however (subject to certain exceptions) issuers may to continue using an offering memorandum prepared in accordance with the version of Form 45-106F2- Offering Memorandum for Non-Qualifying Issuers (the "**OM Form**") in-force immediately prior to the Effective Date, until such offering memorandum is amended. In addition, the CSA will revise CSA Staff Notice 45-309 *Guidance for Preparing and Filing an Offering Memorandum under NI 45-106* to make it consistent with the Amendments.

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 the issuer uses 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 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: (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." 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 CSA provides the Amendments are intended to give investors enhanced disclosure, and in the case of "real estate issuers" or "collective investment vehicles", disclosure that is more tailored to the issuer. The CSA anticipates this will provide investors with better information enabling them to make more informed investment decisions.

The Amendments will not impact issuers utilizing 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 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 amendments to the Companion Policy to NI 45-106 provide examples of what is 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 the new Schedule 1 - Additional Disclosure Requirements for an Issuer Engaged in Real Estate Activities (the "Real Estate Schedule") to the OM Form. The Real Estate Schedule requires disclosure of, amongst other information:



- prescribed information respecting each interest in real property;
- relevant to issuers <u>developing real property</u>, including a description of approvals or permissions required, estimated costs of completion of projects, timing of significant costs, project milestones for next 24 months and after 24 months, consequences if project milestones not met and any future cash calls;
- relevant to issuers that <u>own and operate developed real property</u>, such as the age, condition, occupancy level of the real property and key terms of any rental pool or management agreement, if applicable;
- penalties, sanctions, bankruptcy, insolvency and criminal or quasi-criminal convictions for parties other than the issuer, such as parties acting as a developer or manager under a rental management agreement; and
- any purchase and sale history of the issuer's real property with a related party (as defined in NI 45-106) and reasons for any differences in consideration paid by the issuer and the related party.

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

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

- the issuer proposes to acquire an interest in real property from a related party and a reasonable person would believe that the likelihood of the issuer completing the acquisition is high; or
- a value for an interest in real property is disclosed in the offering memorandum, except in the issuer's financial statements.

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.

The appraisal must be filed concurrently with filing an offering memorandum or any amended offering memorandum or, if the appraisal is produced after the filing of the offering memorandum or any amended offering memorandum, on or before the 10th day after the first distribution for which the appraisal was required to be delivered to a purchaser.

Expected Impact of Amendments on Real Estate Issuers

For issuers engaged in "real estate activities," the Amendments 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 this is not already done), required updates to subscription agreements and increased ongoing maintenance and operating costs. Although senior issuers utilizing the OM Exemption will be able to bear the additional cost and time associated with complying with the Amendments, it may become prohibitively costly for more junior issuers with fewer resources, forcing them to undertake financing relying on other prospectus exemptions. The appraisal requirement may also raise confidentiality issues for potential acquisitions of real property from related parties. This is because if a reasonable person would believe the likelihood of the issuer completing the acquisition is high when purchase agreements for such properties are still in negotiation and would otherwise be confidential, disclosure would nonetheless be required.

Issuers Classified as "Collective Investment Vehicles"

Under the 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, other than securities of subsidiaries of the issuer. The term also includes investment funds to the limited extent they are currently permitted to use the OM Exemption in certain jurisdictions of Canada. Accordingly, the Amendments are expected to have the greatest impact on issuers that invest in mortgage securities, such as mortgage investment entities.

For issuers considered "collective investment vehicles", they are 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:

- except with respect to mortgage lending, 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;
- for mortgage lending issuers, the issuer's investment objectives for types of properties, geographical focus, material mortgage terms (range of interest rate and length of term), priority ranking or mortgages, and policies or practices on any subsequent valuations, loans to relater parties, renewals, concentration of funds and assessment of repayment ability by borrower;
- penalties, sanctions, bankruptcy, insolvency and criminal or quasi-criminal convictions for persons involved in investment objectives and strategy, setting limits or restrictions on investments, and the selection and management of the investments;
- information regarding the portfolio;



- 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; and
- conflicts of interest with respect to related parties so a purchaser is able to make an informed investment decision.

Expected Impact of Amendments on Collective Investment Vehicles

For issuers considered to be "collective investment vehicles," the Amendments require 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 collection to satisfy the additional disclosure and additional time and costs associated with the preparation of six month interim financial reports in Ontario, as well as related amendments to the offering memorandum for issuers conducting a continuous offering. New and early stage collective investment vehicles may find the additional time and costs associated with complying with the Amendments not to be cost effective and may resort to relying on other prospectus exemptions such as the "accredited investor" exemption.

General Amendments

The Amendments also include a number of general clarifying or streamlining changes to NI 45-106 relating to the general disclosure standards applicable to an offering memorandum and requiring an offering memorandum be filed in a form allowing 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;
- in Ontario, 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). However, the interim financial report for the most recently completed 6 month interim period is not required to be included if the issuer appends to the offering memorandum an additional certificate certifying: (i) there is no misrepresentation in the offering memorandum as of the date of the additional certificate, (ii) there has been no material change in relation to the issuer that is not disclosed in the offering memorandum and (iii) the offering memorandum, when read as of the date of the additional



certificate, provides a reasonable purchaser with sufficient information to make an informed investment decision; 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 Amendments, members of McMillan's Capital Markets Group would be pleased to assist you.

Readers of this bulletin may also find these other bulletins informative:

- <u>Structuring Private Equity Real Estate Funds in Canada</u>
- Thinking About Real Estate in Canada? Practical Considerations for Structuring a Private REIT

by Alex Bruvels, Michael Shannon, Bruce Chapple, Michael Burns and Troy Hilson

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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