

ASC NOTICE 45-705
COMPLIANCE WITH INVESTMENT LIMITS
UNDER THE OFFERING MEMORANDUM
PROSPECTUS EXEMPTION

January 16, 2020

Introduction and Purpose

As part of our strategy of proactive and comprehensive compliance, staff of the Alberta Securities Commission (**Staff or we**) analyzed issuers' reliance on section 2.9 *Offering Memorandum* (the **OM Exemption**) of National Instrument 45-106 *Prospectus Exemptions* (**NI 45-106**) and compliance with prescribed investment limits. We are publishing this notice as a summary of the analysis and to provide guidance to issuers that have relied on, or intend to rely on, the OM Exemption. Dealers and purchasers (i.e. investors) may be interested in the results and the guidance to better understand the investment limits that apply under the OM Exemption.

Summary

Staff reviewed 80,158 separate distributions to 6,343 individual purchasers under the OM Exemption. We have concerns with compliance with the investment limits for eligible investors as set out in section 2.9. Although the investment limits have been in place since April 30, 2016, 14% of capital raised from individuals during the review period did not appear to be compliant with the OM Exemption investment limits, and compliance with the limits did not appear to improve over the review period.

In cases of apparent non-compliance, we asked the issuer to explain how the purchaser qualified for the distribution and to send us the Form 45-106F4 that had been completed by the investor.

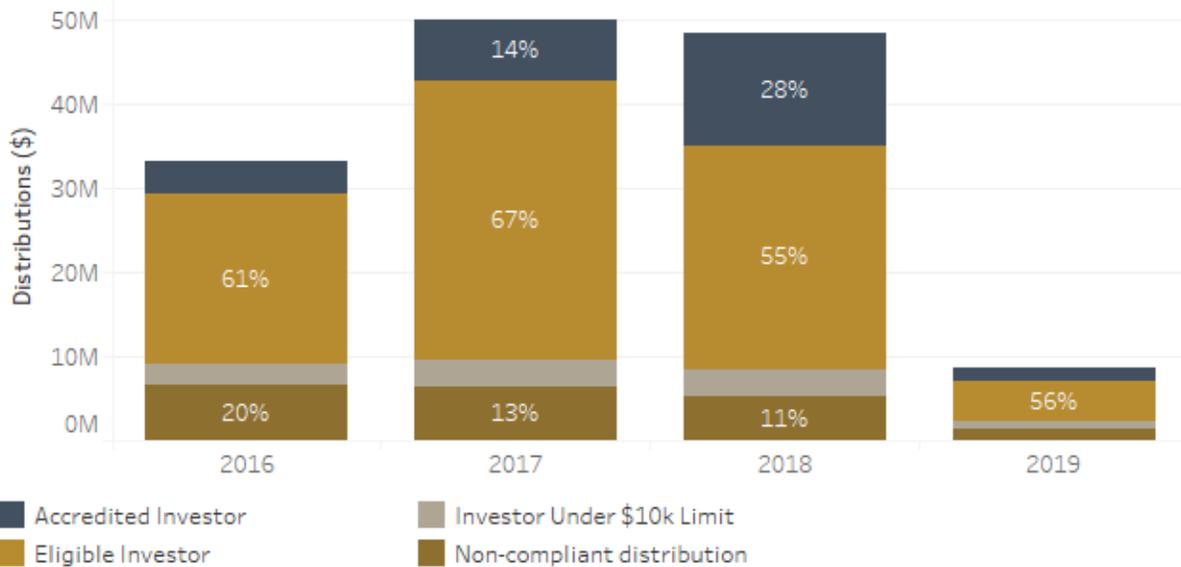
Much of the non-compliance was due to issuer and dealer errors in recordkeeping. Issuers are responsible for reporting in Schedule 1 of Form 45-106F1 how an investor meets the eligibility criteria. Investors, depending on eligibility, are limited to a certain amount of investments under the OM Exemption in a 12-month period, and therefore the issuer or dealer should consult its records to ensure that a given investor has not exceeded the limit.

Background

Project Summary

The primary objective of the analysis was to assess overall compliance with the investment limits. The OM Exemption is used regularly in Alberta. Chart 1 shows total distributions to individual Alberta investors under the OM exemption, by issuers in any jurisdiction, since April 30, 2016. This is when several amendments to the OM Exemption came into force, including the investment limits. The review period for this analysis was April 30, 2016 to March 31, 2019. The classification of investors, as shown in Chart 1, was based on filings of Form 45-106F1 *Report of Exempt Distribution (Form 45-106F1)* and the associated Schedule 1, which contains details of each distribution and certain information about each purchaser, including whether and how a purchaser qualified as an eligible investor or accredited investor.

CHART 1: DISTRIBUTIONS TO INDIVIDUALS UNDER THE OM EXEMPTION BY TYPE OF PURCHASER



Note: This chart does not include distributions to non-individuals under the OM exemption. 2016 shows April 30, 2016 to December 31, 2016 and 2019 shows year-to-date as of March 31, 2019, when the sample was taken for this analysis.

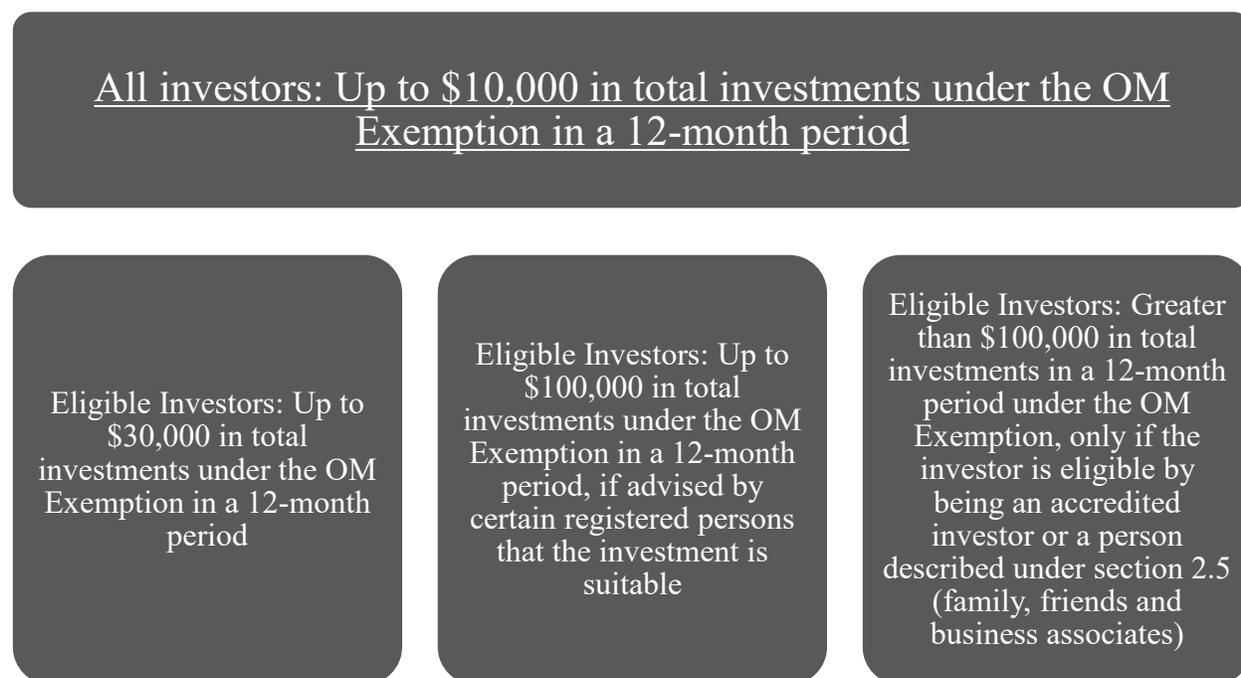
Amendments to the OM Exemption

On October 29, 2015, the ASC published *Multilateral CSA Notice of Amendments to National Instrument 45-106 Prospectus Exemptions Relating to the Offering Memorandum Exemption*, which amendments came into force in Alberta on April 30, 2016. The amendments included the introduction of investment limits.

Investment Limits under the OM Exemption

Chart 2 illustrates to whom an issuer may distribute securities under the OM Exemption, subject to the other conditions of the exemption. Anyone is qualified to purchase up to \$10,000 of securities in a 12-month period, in contrast to other prospectus exemptions that are available to issuers with a more limited group of investors. Issuers relying on the OM Exemption must obtain a Form 45-106F4 – *Risk Acknowledgement (Form 45-106F4)* completed by the purchaser, which includes representations as to how the purchaser qualifies.

CHART 2: PURCHASERS WHO MAY QUALIFY UNDER THE OM EXEMPTION*



*NOTE: The above graphic is for illustrative purposes. Issuers intending to rely on the OM Exemption should review section 2.9 of NI 45-106 to ensure the exemption is available.

Distributions up to \$10,000

Any purchaser is qualified under the OM Exemption to purchase up to \$10,000 of securities in a 12-month period.

Distributions from \$10,000 to \$30,000

Eligible investors are qualified to purchase up to \$30,000 of securities in a 12-month period. An eligible investor is an investor who meets one of the criteria set out in NI 45-106¹, including:

- A person whose net assets, alone or with a spouse, in the case of an individual, exceed \$400,000;

¹ See section 1.1 of NI 45-106 for how a purchaser may qualify as an eligible investor.

- A person whose net income before taxes exceeded \$75,000 in each of the 2 most recent calendar years and who reasonably expects to exceed that income in the current calendar year;
- A person whose net income, before taxes, alone or with a spouse, in the case of an individual, exceeded \$125,000 in each of the 2 most recent calendar years and who reasonably expects to exceed that income in the current calendar year.

Distributions from \$30,000 to \$100,000

Eligible investors are qualified to purchase up to \$100,000 of securities in a 12-month period, if they receive a suitability recommendation from a registered portfolio manager, investment dealer, or exempt market dealer.

Distributions over \$100,000

Subsection 2.9(2.3) of NI 45-106 provides an exemption from the investment limits under the OM Exemption for accredited investors² or investors described under subsection 2.5(1) of NI 45-106, the *family, friends and business associates* prospectus exemption.

Compliance Review

The purpose of this review was to identify issuers that had not complied with the purchaser limits of the OM Exemption by distributing to individual purchasers who acquired:

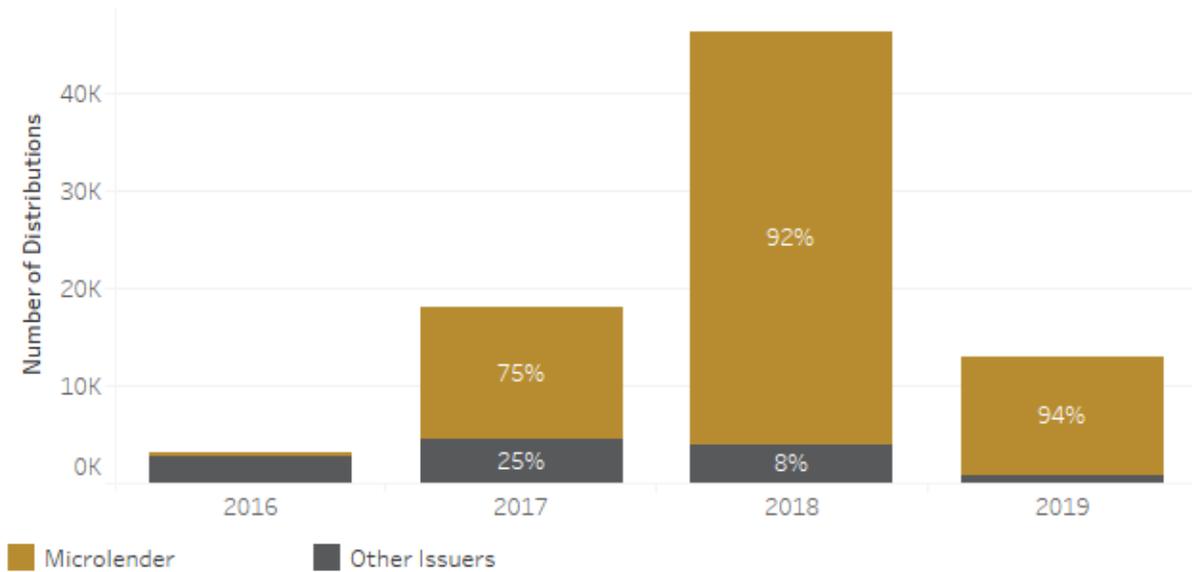
- More than \$10,000 in securities in a 12-month period, if the purchaser was not eligible;
- More than \$30,000 in securities in a 12-month period, if the purchaser was not accredited or a person described under subsection 2.5(1) of NI 45-106 and had not received suitability advice;
- More than \$100,000 in securities in a 12-month period, if the purchaser was not accredited or a person described under subsection 2.5(1) of NI 45-106.

We also wished to identify investors that had exceeded the 12-month limit by purchasing more than the applicable limit of securities in total in a 12-month period from more than one issuer, even though the separate purchases from each issuer may have been under the limit.

For the review, we identified all distributions made to individuals in Alberta using the OM Exemption from April 30, 2016 to March 31, 2019. Our analysis examined 80,158 distributions from 230 issuers to 6,343 individual purchasers. The number of OM distributions to individual Alberta investors increased from 3,324 in 2016 to 47,273 in 2018. As Chart 3 shows, this increase in the number of distributions was largely due to the presence of a single micro-lender. The number of distributions by other issuers remained between 3,000 and 5,000 per year.

² See section 1.1 of NI 45-106 for how a purchaser may qualify as an accredited investor.

CHART 3: COUNT OF DISTRIBUTIONS TO INDIVIDUAL INVESTORS IN ALBERTA



Analysis of total purchases by investors in trailing 12-month period

Of these 80,158 distributions, 61,228, or 76%, were to investors who purchased a total amount of securities less than \$10,000 in the preceding 12 months and therefore the investor did not need to qualify as an eligible investor. These 61,228 distributions accounted for \$23.6 million of the total \$140.7 million raised during the review period, or 17% of the total. The average size of these distributions was \$385, which included a large number of small distributions by a micro-lender.

Another 13,554 distributions were to investors who purchased between \$10,000 and \$30,000 in the preceding 12 months, and therefore needed to qualify as eligible investors. These 13,554 distributions accounted for \$51.5 million raised during the review period, or 37% of the total dollars raised.

An additional 4,573 distributions were to investors who purchased between \$30,000 and \$100,000 in the preceding 12 months, who therefore needed to be eligible investors and have received suitability advice. These 4,573 distributions accounted for \$52.4 million raised during the review period, or 37% of the total dollars raised.

Finally, 803 distributions were made to investors who purchased more than \$100,000 in the preceding 12 months. These investors needed to qualify as accredited investors or investors under subsection 2.5(1) of NI 45-106. These distributions accounted for \$13.2 million raised during the review period, or 9% of the total dollars raised.

Analysis of potential non-compliance

Based on our analysis of filed Forms 45-106F1 and the associated Schedule 1s, 5,262 distributions totalling \$19.4 million appeared to be non-compliant with the investment limits under the OM Exemption. This represented 14% of total capital raised during the review period. Alternately, 86% of the total capital raised appeared compliant with the investment limits.

When we counted non-compliant distributions, these 5,262 that appeared to be non-compliant represented 6.6% of the total 80,158 distributions, meaning that 93% of reported distributions appeared compliant with the investment limits. See table 1 for a breakdown of the non-compliant distributions, which are further discussed below.

	<i>Table 1: Instances of Apparent Non-Compliance</i>				
	<i>Single Issuer</i>			<i>Multiple Issuers</i>	<i>Total Distributions</i>
	<i>Single Distribution</i>	<i>Multiple Distributions</i>	<i>Total</i>		
<i>Total purchases of \$10,000 - \$30,000 in 12 months without reporting the purchaser as an eligible investor</i>	287 (5.5%)	3,536 (67%)	3,883 (73%)	701 (14%)	4,584 (87%)
<i>Total purchases of \$30,000 - \$100,000 without reporting the purchaser as an eligible investor</i>	128 (2.4%)	44 (0.8%)	172 (3.3%)	79 (1.5%)	251 (4.8%)
<i>Exceeded \$100,000 in 12 months without reporting the purchaser as an eligible investor who is accredited or a person qualified under section 2.5</i>	33 (0.6%)	362 (6.9%)	390 (7.5%)	37 (0.6%)	427 (8.1%)
Totals	448 (8.5%)	3,942 (75%)	4,390 (83%)	872 (17%)	5,262 (100%)

Of the non-compliant distributions, \$14.5 million, or 74% of the non-compliant capital, appeared non-compliant with the investment limits due to a single distribution. In each of these cases, a single distribution was made to an investor who appeared to be unqualified for the amount of that distribution. We noted 448 of these single “unqualified” distributions, which accounted for 8.5% of the total non-compliant distributions.

Another \$3.0 million, or 16% of non-compliant capital, appeared non-compliant as the investor had, in the previous 12 months, purchased a total amount of securities from one issuer in excess of the applicable limit. That is, multiple distributions were made by an issuer to an investor that,

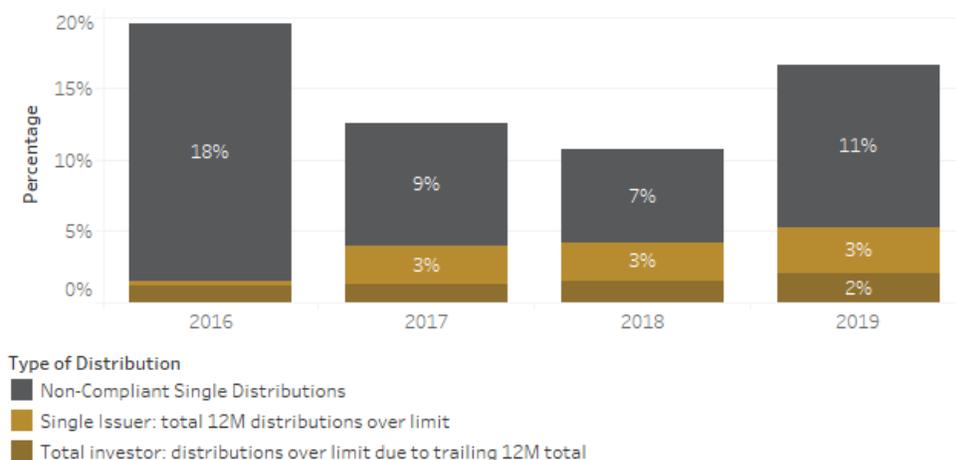
in total, exceeded the investment limit for the preceding 12-month period. We noted 3,942 of these distributions, and these accounted for 75% of all non-compliant distributions.

In total, 90% of the non-compliant capital was issued by single issuers that reported distributing over an applicable limit in a 12-month period. By count, these represented 83% of the total non-compliant distributions.

Finally, the remaining \$2.0 million, or 10% of non-compliant capital, appeared non-compliant as the investor had purchased securities from multiple issuers, the total of which exceeded the applicable investment limit for the preceding 12-month period. These 872 instances represented 17% of non-compliant distributions.

Chart 4 shows that the proportion of distributions, by amount of capital raised from individuals, that appeared non-compliant has remained above 10% since 2016 and has grown in 2019 to date. Issuer compliance with the investment limits did not appear to improve over time.

CHART 4: NON-COMPLIANT DISTRIBUTIONS BY TYPE AS PERCENTAGE OF TOTAL CAPITAL RAISED



Review process and results

As part of our review, we sent letters to the issuers who displayed the most significant non-compliance with the investment limits. We asked issuers to explain how the purchasers qualified and to provide copies of Forms 45-106F4, which must be obtained by the issuer from the purchasers at the time of purchase and retained by the issuer for 8 years.

Based on our correspondence with the issuers, the reasons for apparent non-compliance with the investment limits included the following:

- In Schedule 1 to Form 45-106F1, several issuers did not properly note the paragraph under which the purchaser qualified as an eligible investor. In some cases, the issuer neglected to enter the information; in other cases, the issuer entered the information incorrectly.

- In one case, the issuer instituted a quarterly investment plan for employees of an affiliate of the issuer without the employees completing a new Form 45-106F4 for each new purchase.
- An issuer made distributions of greater than \$100,000 to investors with fully managed accounts, but failed to correctly record the eligibility of these investors. The issuer mistakenly reported that the investors were registrants, and allowed the portfolio manager to complete the Forms 45-106F4 on behalf of the investor. Neither of these were compliant as the investors were not registrants and the F4 must be completed by the purchaser.

The results of our review showed that 93% of the distributions under the OM exemption appeared compliant with the investment limits, representing 86% of the total capital raised during the review period. Apparent non-compliance was almost entirely due to a single issuer-investor relationship: 90% of all apparent non-compliant distributions by dollar volume were made by one issuer to one purchaser. Further, based on our correspondence with issuers, it seems like issuers tended to comply with the underlying investment limits of the OM Exemption, but did not correctly complete Schedule 1, to show how purchasers qualified. There were a few distributions that exceeded the investment limits by multiple distributions from multiple issuers.

In addition, one issuer and exempt market dealer was found to have distributed significantly more than \$100,000 under the OM exemption to an eligible investor who at the time of distribution did not qualify as an accredited investor nor as a person under subsection 2.5(1) of NI 45-106. This distribution was, therefore, not compliant with the investment limits. In this instance, the issuer agreed to a monetary settlement with the ASC.

Guidance

Investment limits

Issuers relying on the OM Exemption are responsible for ensuring that they distribute to qualified purchasers, including observing the applicable investment limits. Registered dealers and representatives also have obligations to establish that a prospectus exemption is available, in addition to complying with their suitability and other registrant obligations in relation to the distribution. Section 1.9 of Companion Policy 45-106CP *Prospectus Exemptions* provides guidance on meeting these obligations, including types of procedures that could be used to reasonably confirm that the purchaser meets the conditions for a particular exemption.

In addition, in cases where an issuer distributes to an investor multiple times, the issuer is in a position to know how much has been distributed to the investor in a 12 month period. We expect issuers to have a record of the distributions it has made, to use its records to identify potential non-compliant distributions before the distributions are made, and to observe the investment limit. Similarly, we would expect a registered dealer to have a record of the investments made by the firm's clients, to use its records to identify potential non-compliant distributions before the distributions is made, and to observe the investment limit.

Form 45-106F1

Issuers relying on the OM Exemption are required to file a completed Form 45-106F1. Issuers must take care to accurately complete the Form 45-106F1 and the associated Schedule 1. We use these filings to monitor compliance with the OM Exemption and other prospectus exemptions. Incomplete fields may appear to us to be non-compliance with the conditions of the exemption.

Risk Acknowledgement Forms

Under the conditions of the OM Exemption, the issuer must obtain a signed Form 45-106F4 from the purchaser for each distribution. A registered dealer or representative cannot complete Form 45-106F4 on behalf of the investor, even in cases of a fully-managed account. All Forms 45-106F4 must be completed by the investor. Only the purchaser may sign the Form 45-106F4 and only the purchaser may initial in the sections applicable to the purchaser.

While an issuer may rely on the OM Exemption to distribute securities to a beneficial holder of a fully-managed account, the manager of which may qualify as an accredited investor under paragraph (p) or (q) of the accredited investor definition, there is no provision in the OM Exemption to deem the manager as purchasing as principal. Therefore, to comply with the investment limits of the OM Exemption, the purchaser must still be qualified as an eligible investor, receive suitability advice, or qualify as an accredited investor or a person described in section 2.5 of NI 45-106, as applicable to the distribution. In addition, the beneficial holder must complete Form 45-106F4.