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May 29, 2001

VIA COURIER

Ontario Securities Commission
20 Queen Street West
Suite 1903
Box 55
Toronto, Ontario M5H 3S8

Attention: John Stevenson, Secretary

Dear Sirs:

Re: Proposed OSC Rule 45-501 - Exempt Distributions – Request for Comments

Further to the request for comments concerning Proposed OSC Rule 45-501 (the "Proposed Rule") that appeared in the April 6, 2001 Ontario Securities Commission Bulletin, the following sets forth our comments with respect thereto.

Introduction

In general terms, we believe that the Proposed Rule will enhance the ability of issuers to raise private capital without compromising the protections that are currently afforded to private placement investors under the existing regime in Ontario. We believe that the Proposed Rule constitutes a welcome step towards updating the regulatory regime applicable to private placements in Ontario, and we hope that other provinces will follow suit shortly in an effort to harmonize the private placement rules among the various provinces with a view to enhancing the overall efficiency of the Canadian private markets.

The Accredited Investor Exemption

In many respects, the accredited investor exemption set forth in Section 2.3 of the Proposed Rule mirrors the private offering regime in the United States under Section 4(2) of the United States Securities Act of 1933 (the "1933 Act") and Regulation D made thereunder. We believe that the approach taken by the Commission is, in general, a good starting point for modernizing and expanding on the categories of "sophisticated purchasers" who are deemed to be in a position to acquire securities without the benefit of the statutory protections afforded by the registration and prospectus regime. Currently, the $150,000 exemption effectively precludes most individuals from participation in a private offering notwithstanding that they may be sufficiently "sophisticated". The $150,000 minimum aggregate acquisition cost is an artificial threshold that, when applied to any single private investment, likely eliminates many "sophisticated" buyers from participation as a result of the risk inherent in allocating a large portion of available investment capital to any particular investment.

As a preliminary matter, we believe that it would be appropriate to clarify that the accredited investor exemption is available to an issuer in circumstances where an issuer "reasonably believes" at the time of sale, that the purchaser is an accredited investor. The purpose is to avoid a situation in which an issuer, which takes all due precaution (including, for instance, obtaining representations in a subscription agreement or statutory declarations as to the status and attributes of the investor) to establish the basis for reliance on the exemption, is subsequently subjected to a proceeding based on a violation of the registration and prospectus requirements of the Act in circumstances where the investor has fraudulently misrepresented or otherwise misled the issuer into believing that the statutory preconditions for the exemption have been met. We note that several of the proposed categories of accredited investor depend on specific factual determinations with respect to the investors that are not readily ascertainable by the issuer, unlike the existing private placement regime where most sales are effected under the $150,000 exemption. The concept of a "reasonable belief" standard is consistent with Regulation D made under the 1933 Act. The definition of "Accredited Investor" in Regulation D provides that an accredited investor means any person who comes within any of the enumerated categories, "or who the issuer reasonably believes comes within any of [such] categories, at the time of sale of the securities to that person". Similar wording could be included in the body of section 2.3 or in the definition of "Accredited Investor" in the Proposed Rule. Alternatively, the language of section 3.1 of the Companion Policy, which provides a due diligence standard in the context of the certification requirement of Form 45-501 F1 could be extended and clarified through the addition of the words "and the exemptions in respect of which such form is filed" after the existing words "for the purposes of the certificate required in Form 45-501 F1".

In terms of the various categories of "Accredited Investor", we have the following comments:

- Under paragraph (f) of the definition, subsidiaries of the entities referred to in paragraphs (a) through (e) only qualify as accredited investors if the parent entity in question owns all of the voting shares of the subsidiary. We believe that this is too onerous a test. There are many examples of subsidiaries of regulated financial institutions that may have a relatively small public float that are majority-owned by the institution which should qualify as accredited investors on the theory that there is no "need to know" that would be served by the prospectus and registration requirements. On that basis, we would suggest that the test be based on direct or indirect beneficial ownership, or the exercise of control or direction over, not less than a majority of the outstanding voting shares of the subsidiary, which is consistent with the concept of "subsidiary". Alternatively, if there is any concern that the majority threshold is inadequate, the test could be set at $66^{2}/_{3}\%$. By holding, or exercising control or direction over, $66^{2}/_{3}\%$ of the voting shares, the parent is generally in a position, under most corporate statutes, to approve any transaction (including fundamental changes) that require shareholder approval, subject to any oppression remedy provisions and related party transaction requirements.

- Paragraph (m) of the definition proposes what is, in substance, a net worth test for individuals to qualify as accredited investors. We believe that the concepts of "realizable value" and "financial assets" are overly vague and too restrictive. The application of the "realizable value" standard should be clarified. Is the intention to exclude assets that otherwise qualify as "financial assets" from the net worth calculation in circumstances where the value of the asset is not "realizable" (in the sense of being immediately realizable) or is the intention to include the asset, subject to whatever its "realizable" value may be (i.e. discounted due to illiquidity)? Does the concept of "realizable" value mean that the issuer would be required to apply a subjective valuation technique to the assets of a prospective investor, taking into account the particular situation of the investor? In the event that the "financial assets" definition as it currently exists is retained, we would have thought that the "realizable value" test is even less germane, given that the categories of permissible "financial assets" are, with few exceptions, liquid. In terms of the definition of "financial assets", we believe that there is no reason that real estate (other than, possibly, a principal residence being utilized as such) should be excluded from the net worth calculation. To exclude real estate assets but to include other illiquid investments (for example, private company shares) unfairly discriminates between investors of similar wealth based on their personal investment choices. Furthermore, private company shares, which qualify as "financial assets", are likely less liquid (in terms of both transferability as well as collateral for borrowings) than real estate. In our view, it is important that the categories of accredited investor be defined by reference to tests that are capable of objective determination to avoid the

uncertainties inherent in certain of the existing exemptions (particularly the private company exemption) which require subjective analysis.

- Paragraph 2.2(2) of the Companion Policy provides that "the Commission notes that paragraphs (m) and (n) of the "accredited investor" definition are designed to treat spouses as an investing unit such that either spouse may qualify as an accredited investor if both spouses, taken together, beneficially own the requisite amount of financial assets or earn the requisite net income." It appears to us that paragraphs (m) and (n) of the accredited investor definition deal with different concepts. In paragraph (m), an individual qualifies if the individual alone or jointly with a spouse owns the requisite financial assets. In other words, the fact that the spouse may own the requisite financial assets outright does not qualify the individual in question, notwithstanding paragraph 2.2(2) of the Companion Policy. In paragraph (n) of the accredited investor definition, an individual with no net income that has a spouse with net income in excess of $300,000 would qualify. On the basis that there is no need to provide a different spousal test for net income versus financial assets, we suggest that paragraph (m) be modified to accord with the approach in paragraph (n).

- In paragraph (n), the income test is framed in terms of "net income". We think that it would be useful for the Companion Policy to expressly reflect the Commission's view of the appropriate net income calculation, which is reflected in the responses to comments received that was published along with Proposed Rule.

- Paragraph (p) of the definition provides that an affiliated entity of a promoter of the issuer is an accredited investor. It is unclear why an affiliated entity of an officer or director of the issuer would not also be an accredited investor, particularly in light of certain provisions of OSC Rule 45-503 dealing with trades to directors, officers and their affiliated entities.

- Paragraph (t) of the definition qualifies corporate and similar purchasers having a certain net asset size. We would suggest clarifying the "net asset" test if the intention is that net assets means the value of all assets shown on the balance sheet less the value of all liabilities. A specific note to that effect in the Companion Policy would be useful guidance. Alternatively, we would suggest deleting the word "net" and replacing it with the word "total", which is consistent with the treatment of this category of accredited investor in the U.S. under Regulation D. In addition, the requirement to gauge asset size by the most recent financial statements does not work well for many private companies, partnerships and estates which do not typically prepare financial statements. We suggest that a representation from the purchaser should suffice, which is consistent with the manner in which an issuer would approach qualifying accredited investors in almost all of the other categories.

- Paragraph (y) of the definition provides that an accredited investor includes an account fully managed by a trust corporation. We would suggest broadening this

category to include accounts that are fully managed by any financial intermediary. There seems to be no reason for favouring trust companies over other financial intermediaries in that regard. We note that, under clause 209(10)(b) of the Regulation made under the Act, federally regulated financial intermediaries (and not just trust companies) are not required to be registered as dealers or financial advisors with respect to certain trading activity. In addition, the definition of "permitted client" in OSC Rule 35-502, dealing with non-resident advisors, contemplates a broader range of financial intermediaries than trust companies. Subsection 204(2) of the Regulation deems a portfolio manager or any financial intermediary acting as trustee or agent for fully managed accounts to be a designated institution for purposes of permitted trading activity by certain categories of registrants. Given these other provisions which do not discriminate between categories of financial intermediaries, it is unclear to us why the definition in paragraph (y) is restricted only to accounts fully managed by trust companies.

- Paragraph (aa) provides that an accredited investor includes a person or company in respect of which each owner of any interest therein is an accredited investor. We would suggest that a person or company should qualify if each owner of an equity interest therein is an accredited investor, which is consistent with the treatment in the U.S. under Regulation D. There would be no reason to exclude an entity in circumstances where all of its equity is held by accredited investors simply because the entity has outstanding debt or non-participating interests held by non-accredited investors.

With respect to the offering memorandum provisions of the Proposed Rule applicable to the accredited investor exemption, we have the following comment:

- Under the existing private placement regime in Ontario, a document that meets the definition of offering memorandum that is voluntarily provided to purchasers under the exemptions in clauses 72(1)(c), 72(1)(d), 72(1)(p) and section 2.11 of OSC Rule 45-501 triggers the requirement to provide and describe contractual rights of action. We note that Section 4.1 of the Proposed Rule makes statutory rights of action in respect of a voluntarily provided offering memorandum available to any accredited investor, which is a significant change from the current regime. We believe that certain "accredited investors", specifically those referred to in paragraphs (a), (b), (c), (d), (e), (f), (g), (h), (i), (j), (o), (p), (r) and (s) of the definition of accredited investor in the Proposed Rule, are entities which do not require the protections of a statutory right of action in connection with an offering memorandum. The current Ontario rules do not mandate the provision of contractual rights to purchasers under clause 72(1)(a) of the Act, or any other exemption but for clauses 72 (1)(c), 72(1)(d) and 72(1)(p) and section 2.11 of Rule 45-501, in the case of a voluntarily provided offering memorandum. We do not believe that there is any need to expand the categories of investors that are entitled to receive analagous rights under the statutory rights provision (particularly for accredited investors that are referred to in

existing clause 72(1)(a) of the Act). We would suggest that the statutory rights of action apply only to those accredited investors referred to in paragraphs (k), (l), (m), (n), (q), (t), (u), (v), (w), (x), (y), (z) and (aa) of the definition in the Proposed Rule.

The Closely-Held Issuer Exemption

As a preliminary matter, we believe that the definition of "closely-held issuer" should be modified as follows:

- The 35 non-employee and non-accredited investor limitations is problematic for existing private companies, many of which may have more than 35 but fewer than 50 "non-employee" investors and would be in a position to conduct additional exempt financing within the confines of the private issuer exemption. We suggest the inclusion of a grandfathering provision that, in effect, makes the 35 non-qualified investor limitation read 50 in respect of existing private companies, for the first year following implementation of the Proposed Rule.

- It is unclear why the exclusion for current or former employees is limited to those that beneficially own securities issued as "compensation under incentive plans or arrangements" of the issuer or an affiliated entity of the issuer. It seems to us that the manner in which employees acquire shares should be irrelevant in terms of how they are treated in the context of the closely-held issuer exemption. The fact that an employee may have acquired securities of the issuer other than under an incentive plan should not result in that employee being counted as a "non-employee" for purposes of the exemption. There are many examples of issuers that have distributed shares to employees, other than pursuant to incentive arrangements, that should not, in our view, be denied the status of a closely-held issuer. Furthermore, it is unclear whether contributory share purchase plans would qualify as "compensation under incentive arrangements".

We believe that further consideration should be given to the lifetime per issuer cap of $3 million of proceeds raised under the closely-held issuer exemption. In particular, we think that it would be preferable for the cap not to be an absolute, but to be linked to a rolling time period, as is the case with respect to the Regulation D exemptions in the U.S. The Regulation D exemptions are generally conditioned on the aggregate offering price of any particular offering not exceeding a certain dollar value less, in each case, the aggregate offering price for all securities sold under the exemption within the previous 12 months. We believe that this approach is sensible, in that it would preclude an issuer from taking advantage of what is in effect a limited offering exemption to offer securities on a continuous basis, while maintaining the flexibility of an issuer to raise capital periodically pursuant to the terms of the exemption. The requirement that the issuer maintain its status as a "closely-held issuer" following completion of any particular offering adequately addresses any concern that might exist concerning repeated use by the same issuer of this limited offering exemption. We believe that it would be much more useful to emerging enterprises to be able to utilize the exemption

periodically, provided that the caps in any particular time period are not exceeded. In addition, we believe that it would be useful to harmonize the Canadian regime with that of the U.S. in order to facilitate cross-border transactions and to avoid a built in incentive for a Canadian issuer to conduct a Regulation D offering in the United States, without making the offering available to Ontario investors, due to concerns related to a lifetime $3 million cap.

The restriction in paragraph 2.1(1)(c) of the Proposed Rule, which denies the exemption in circumstances where promotional or selling expenses are paid or incurred in connection with a trade, may be inconsistent with the offering memorandum provision of section 4.1, which clearly contemplates that an offering memorandum may be delivered to a prospective purchaser voluntarily in connection with a trade made under the closely-held issuer exemption. The preparation of an offering memorandum may involve the issuer incurring what are arguably "selling or promotional expenses". We would suggest that a statement be added in the Companion Policy indicating that professional expenses incurred in the preparation of an offering memorandum do not qualify as selling or promotional expenses for purposes of the restriction in paragraph 2.1(1)(c).

General Comments

We would suggest that section 2.8 be modified to include a third category of transaction, specifically a "bona fide corporate reorganization (whether by way of amendment to its capital structure or otherwise)". The theory behind the exemption in paragraph 2.8 is that transactions involving the provision of an information circular containing a prescribed standard of disclosure should be exempt from the registration and prospectus requirement. A number of discretionary orders have been issued in the past in circumstances where the reorganization exemption in clause 72(1)(f)(ii) of the Act was unavailable for technical reasons and the transaction did not fit within the parameters of section 2.8 since it did not involve a "statutory procedure". Typically, those orders have been granted on the basis that the transaction involved a capital reorganization of an issuer in circumstances where the issuer delivered an information circular containing a prescribed level of disclosure. We submit that the exemption should not be confined to "statutory" procedures alone, when there are a multitude of other corporate transactions in the nature of a reorganization that are not necessarily statutory procedures that involve the distribution of securities accompanied by a detailed disclosure document.

We believe that the offering memorandum provisions of the proposed Rule should be clarified as follows:

- Section 4.1 of the Proposed Rule suggests that statutory rights of action may be available to "prospective" purchasers. In our view, the right of action applies only to an <u>actual</u> purchaser and we would suggest the deletion of the word "prospective" or, alternatively, clarifying that the right of action is available to a purchaser in circumstances where an offering memorandum is furnished to one or more prospective purchasers. We note that subsection 130.1 of the Act, which deals with liability for a misrepresentation in an offering memorandum, provides

that the statutory right of action is available to a "purchaser" who purchases a security offered thereby during the period of distribution.

- Section 4.2 of the Proposed Rule, which deals with the delivery of the offering memorandum, should be clarified to provide that if an offering memorandum is furnished (i.e. regardless of by whom), the offering memorandum must contain a description of the statutory right of action. Currently, the wording contemplates that the right of action must be described only in circumstances where the seller delivers the offering memorandum. In contrast, section 130.1 of the Act contemplates that the right of action applies, and must be described, regardless of by whom the document was furnished to an investor (i.e. whether by the seller or a dealer in a best efforts or underwritten private offering).

We would also suggest that National Instrument 52-101 dealing with future-oriented financial Information ("FOFI"), when finalized, reflect that the FOFI rules not apply to offering memoranda provided to prospective investors under the accredited investor exemption. Currently, the FOFI rules do not apply to offering memoranda delivered to investors purchasing a minimum of $500,000 of offered securities. Given that the accredited investor exemption in the Proposed Rule is intended to be a modernization of the sophisticated purchaser concept, we believe that it should no longer be relevant to create artificial distinctions between certain groups of sophisticated purchasers in determining whether the FOFI rules should apply. In the United States, the content of private placement memoranda is generally left to the issuer and its advisors and there are no specific rules governing the provision of forecasts or projections in a private offering document made available to accredited investors, other than general concerns with respect to anti-fraud liability.

We suggest that section 2.11 of the Proposed Rule be expanded to include spousal RRSPs or RRIFs. This is consistent with other areas of the Proposed Rule in which individuals are treated as an investing unit with their spouse. See, for example, paragraph 2.2(2) of the Companion Policy.

We are unclear as to why section 3.4(2) of the Proposed Rule purports to restore only the section 2.3 exemption to market intermediaries that register as limited market dealers. In keeping with the spirit of Rule 31-503, which is intended to incent limited market dealer registration, we submit that section 3.4(2) should restore to registered limited market dealers all of the exemptions denied to market intermediaries by section 3.4(1).

Should you have any questions concerning the foregoing, please call the undersigned at (212) 785-6413.

Yours very truly,

McCARTHY TÉTRAULT

Per:

David A. Judson

cc: René Sorell
Michael Nicholas
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