

1.1.2 OSC Staff Notice 33-735 – Sale of Exempt Securities to Non-Accredited Investors

OSC STAFF NOTICE 33-735

SALE OF EXEMPT SECURITIES TO NON-ACCREDITED INVESTORS

Purpose of this Notice

Staff of the Ontario Securities Commission (staff or we) are concerned that some issuers (including companies and investment funds) and dealers are selling exempt securities in reliance on the accredited investor exemption (AI exemption) to individual investors who do not meet the definition of an Accredited Investor (as set out below). This Notice provides our view on the Accredited Investor definition and the AI exemption contained in National Instrument 45-106 *Prospectus and Registration Exemptions* (NI 45-106) and our expectations of issuers and dealers who sell exempt securities to Accredited Investors.

In Ontario, issuers and registered dealers are permitted to sell exempt securities without a prospectus if they sell to individual investors who meet minimum asset or income thresholds, referred to as Accredited Investors. However, we have found that many dealers do not collect adequate know-your-client (KYC) information to reasonably determine whether the investor is in fact an Accredited Investor. This raises significant investor protection concerns. Issuers and dealers should review their current practices for selling exempt securities to Accredited Investors.

We will continue to closely monitor the activities of issuers and dealers that sell exempt securities, including conducting compliance reviews of those firms. We will take enforcement proceedings or other regulatory action where issuers and dealers are acting contrary to securities law by selling exempt securities under the AI exemption to investors who are not Accredited Investors.

Accredited Investor

Generally, a security sold to an investor in Ontario must be issued pursuant to a prospectus. A prospectus is a comprehensive disclosure document that sets out detailed information about the company or investment fund, describing the securities being issued and the risk associated with purchasing those securities. However, in recognition of the relative sophistication of certain investors and their ability to withstand financial loss, securities laws permit the sale of securities to Accredited Investors without a prospectus. Securities that are exempt from the prospectus requirement are referred to as exempt securities. A sale of exempt securities to an Accredited Investor is referred to as a sale under the AI exemption. The definition of an Accredited Investor is set out in section 1.1 of NI 45-106. Issuers and dealers should refer to that section before selling a security to Accredited Investors.

Section 1.1 of NI 45-106 enumerates the specific circumstances in which an investor will be considered an Accredited Investor, some of which apply to corporations, and others of which apply to individuals. Dealers and issuers frequently rely on that portion of the Accredited Investor definition relating to an individual investor's income, financial assets, or net assets when determining if that individual investor meets the definition. Section 1.1 of NI 45-106 defines an Accredited Investor as:

- An individual who, either alone or with a spouse, beneficially owns *financial assets* having an aggregate realizable value before taxes, but net of any related liabilities, that exceeds \$1,000,000;
- An individual whose *net income* before taxes exceeded \$200,000 in each of the two most recent calendar years or whose net income before taxes combined with that of a spouse exceeded \$300,000 in each of the two most recent calendar years *and* who, in either case, reasonably expects to exceed that net income level in the current calendar year; or
- A individual who, either alone or with a spouse, has *net assets* of at least \$5,000,000.

Financial Assets versus Net Assets

As stated above, staff is concerned that some issuers and dealers are selling exempt securities in reliance on the AI exemption to individual investors who do not meet the Accredited Investor definition. A frequent misunderstanding of the Accredited Investor definition relates to the respective meanings of "financial assets" and "net assets". The two concepts are different and should not be confused with each other.

Financial assets include (i) cash, (ii) securities, or (iii) a contract of insurance, deposit or an evidence of a deposit that is not a security for the purposes of securities legislation. The value of an investor's personal residence or other real estate is **not** included in the calculation of financial assets. By comparison, *net assets* includes all of the investor's assets, minus all of his or her liabilities, and so could include an investor's personal residence and other real estate. For more guidance, please refer to section 3.5 of the Companion Policy to NI 45-106.

It has come to our attention that in assessing whether their clients meet the Accredited Investor definition, some dealers are not making it clear to their clients that the client's personal residence or other real estate cannot be included in their financial assets. As a result, these issuers and dealers may be selling exempt securities in reliance on the AI exemption to investors who do not, in fact, meet the definition of an Accredited Investor, contrary to securities laws.

Our Expectations for Issuers and Dealers Selling Securities to Accredited Investors

The issuer and dealer selling a security are responsible for determining whether an investor meets the definition of Accredited Investor and is therefore eligible to purchase exempt securities. Pursuant to NI 45-106, an issuer has an obligation to ensure that exempt securities are only distributed under the AI exemption to investors who meet the definition of an Accredited Investor. Generally, an issuer will engage a dealer to distribute its exempt securities to investors. It is important that an issuer ensure that the distribution of its securities through the dealer will be made in compliance with securities law.

The following is a non-exhaustive list of steps that dealers should take in order to meet their obligations under securities laws when selling exempt securities to an Accredited Investor:

- *Read and understand the definition of Accredited Investor:* Compliance with securities law begins with understanding securities law. Pursuant to Part 11 of NI 31-103 *Registration Requirements and Exemptions* (NI 31-103), we expect registered firms to provide adequate training to their chief compliance officers and dealing representatives to ensure that they understand the definition of an Accredited Investor and how to determine whether a client meets the definition. Dealers should pay specific attention to the difference between financial assets and net assets.
- *Develop an accurate form for collecting KYC information:* Section 13.2 of NI 31-103 requires registrants to collect KYC information, which includes the client's financial circumstances, their investment objective, and risk tolerance. Information collected on a KYC form should help to determine whether the client meets the definition of an Accredited Investor. Dealers should also review and update the KYC form to ensure that the dollar thresholds used for net assets and net financial assets are correct.
- *Explain the Accredited Investor definition to clients and ensure that their KYC forms are properly completed:* Dealers should explain the Accredited Investor definition to clients before they complete their KYC form. Many clients may not initially understand the distinction between financial assets and net assets, and are likely to include the value of their personal residence or other real estate in both cases. Dealers should explain to clients what a financial asset is, and should also make it clear to them that the value of their personal residence or other real estate is not to be included in calculating their financial assets.
- *Do not sell an exempt security if you do not have sufficient information to determine whether the client qualifies as an Accredited Investor:* Subscription agreements for exempt securities usually contain a statement (commonly referred to as the accredited investor certificate) that the investor is purchasing the security as an Accredited Investor, and investors are asked to initial or place a check mark in a box to indicate that the statement applies to them. It is not sufficient for issuers and their dealers to simply rely on the client's initialing or checking off of this box; the information contained in the client's completed KYC form or other documentation (see below) must also demonstrate that they meet the definition of an Accredited Investor.
- *Ensure the exempt security is suitable for the client:* Section 13.3 of NI 31-103 requires a registrant to take reasonable steps to ensure that a particular investment is suitable for a client. Even if a client qualifies as an Accredited Investor, a registrant must still assess whether the exempt security in question is suitable for the investor. As described in CSA Staff Notice 33-315 *Suitability Obligation and Know Your Product*, there are two key requirements for determining suitability in order to comply with NI 31-103. Registrants must understand (i) the general investment needs and objectives of their clients and any other factors necessary for them to be able to determine whether a proposed purchase or sale is suitable (KYC information), and (ii) the attributes and associated risks of the securities they are recommending to clients (commonly referred to as the know-your-product).
- *Review the KYC form:* The Chief Compliance Officer (CCO) of the dealer should review the completed KYC form to ensure that the information collected is complete and consistent with that portion of the Accredited Investor definition to be relied on and that the trade is suitable for the client. Where conflicting information exists between the accredited investor certificate and the KYC form, the dealer must take appropriate follow-up steps to ensure that the investor is in fact an Accredited Investor. Evidence of follow-up procedures should be documented in client files and reviewed by the CCO.
- *Retain documentation:* Dealers should maintain records to support the reliance on the Accredited Investor definition, including KYC forms and the dealing representative's notes. We do not consider a verbal

representation from the investor that they are accredited as sufficient support that they meet the Accredited Investor definition.

- *Establish policies and procedures:* Dealers should establish policies and procedures to ensure that exempt securities are only distributed under the AI exemption to investors who meet the Accredited Investor definition.
- *Report the sale of exempt securities to the OSC:* Issuers must ensure that sales of exempt securities made in reliance on the AI exemption are reported to the OSC by filing a Form 45-106F1 (as required by NI 45-106), and that full purchaser details are included in the completed form.

The content of this notice is to assist you in understanding the Accredited Investor definition and the AI exemption contained in NI 45-106. We also describe procedures that we expect a dealer to undertake in order to meet its obligations when selling exempt securities to an Accredited Investor. We encourage you to seek legal advice where further clarification is required.

Questions

If you have any questions regarding the contents of this Notice, please refer them to any of the following:

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