ONTARIO SECURITIES COMMISSION STAFF
NOTICE 45-702

FREQUENTLY ASKED QUESTIONS

ONTARIO SECURITIES COMMISSION RULE 45-501 - *Exempt Distributions*

Background

On November 30, 2001, revised Rule 45-501 *Exempt Distributions* (the "Rule") along with its Companion Policy and related Forms came into force. The Rule replaced the previous version of Rule 45-501 *Exempt Distributions*, which came into force on December 22,1998.

Frequently Asked Questions

As is often the case with the introduction of a new or revised rule, users of the Rule may find that they have questions regarding its application and interpretation. Therefore, to assist those persons and companies wishing to use the Rule, we have compiled a list of frequently asked questions ("FAQs") which, while not exhaustive, represent the types of inquiries we have received to date. We plan to update this Notice periodically.

We have divided the FAQs into the following categories:

A. The closely-held issuer exemption
B. Pooled funds
C. General inquiries

A. The Closely-held Issuer Exemption

1) **Q:** For the purposes of subparagraph (ii) of the closely-held issuer definition, does *"issued as compensation by, or under an incentive plan of, the issuer"* include securities issued as an incentive on a "one-off" basis i.e., not under an incentive plan, or must the securities be issued under an incentive plan?

A: Securities issued as an incentive need not be issued under an incentive plan. We are of the view that by issuing securities as an incentive on a "one-off" basis, the issuer is issuing securities as compensation.

2) **Q:** Why are directors and officers who do **not** receive securities *"issued as compensation by, or under an incentive plan of, the issuer*" included in the 35 securityholder test?

A: This is a drafting error and will be corrected. Current and former directors and officers, regardless of how they receive their securities, were not meant to count towards the 35 securityholder test. In the interim, where directors and officers do not otherwise qualify as accredited investors and the issuer would like to exclude the directors and officers from the 35 securityholder test, we recommend that affected parties apply for discretionary relief. No fees will be charged for such applications.

3) **Q:** Who is a "promoter" for the purpose of paragraph 2.1(1)(b) of the Rule?

A: The *Securities Act* (Ontario) (the "Act") defines a "promoter" as, among other things, "*a person or company who, acting alone or in conjunction with one or more other persons, companies or a combination thereof, directly or indirectly, takes the initiative in founding, organizing or substantially reorganizing the business of an issuer*". Because of the condition imposed by paragraph 2.1(1)(b) of the Rule, the closely-held issuer exemption is not available to the issuer or any securityholder reselling securities using the exemption if any "promoter of the issuer" has acted as a promoter of any other issuer that has issued a security in reliance upon the closely-held issuer exemption within the preceding twelve months.

We are of the view that, for the purpose of paragraph 2.1(1)(b), a "promoter of the issuer" is a person or company who actively participated in the formation and initial management of the issuer's business or otherwise actively contributed to its initial growth or prosperity, and who, at the time of the proposed trade, continues to be actively involved in the ongoing management of the issuer's business or actively contributing to its ongoing growth or prosperity. So, for example, a person who founds an issuer and then sells control of it to someone else would not, following the sale, continue to be a promoter of the issuer for the purpose of paragraph 2.1(1)(b) unless he, she or

it continues to be actively involved in the management of the issuer's business, or otherwise actively contributing to its ongoing growth or prosperity, even if he, she or it continues to be a shareholder of the issuer.

Finally, we are of the view that the initial shareholders of an issuer will not be promoters merely because they have subscribed for shares to facilitate its incorporation or as passive investors, even if the amount of the investment is significant.

4) Q: The closely-held issuer exemption cannot be used if a promoter of the issuer has acted on behalf *of* "*any other issuer that has issued a security in reliance upon this exemption within the twelve months preceding the trade*". What if an issuer wants to rely on the closely-held issuer exemption, but cannot confirm that its promoter has not acted on behalf of any other issuer within the past year?

A: We recognize that in certain circumstances it may be difficult for an issuer who wishes to rely on the closely-held issuer exemption to confirm that its promoter has not acted on behalf of another issuer. In these circumstances, the issuer can rely on the exemption provided that the issuer has, after reasonable inquiry, no grounds to believe that its promoter has acted on behalf of another issuer within the twelve months preceding the trade.

5) **Q:** When reselling a security using the closely-held issuer exemption, how do I comply with the requirements in paragraphs 2.1(1)(a),(b) and (c) of the Rule?

A: We recognize that in certain circumstances it may be difficult for a selling securityholder to confirm that these requirements have been met. Therefore, we are of the view that a selling securityholder can rely on this exemption provided that the selling securityholder has no reasonable grounds to believe that the requirements in paragraphs 2.1(1)(a),(b) and (c) of the Rule have not been met.

6) **Q:** Paragraph (c) of the closely-held issuer exemption requires that "*no selling or promotional expenses are paid or incurred in connection with the trade, except for services performed by a dealer registered under the Act"*. Specifically, what constitutes "*selling or promotional expenses*"?

A: The Commission has historically been concerned about closely-held issuers being promoted other than through a registered dealer. The prohibition on selling or promotional expenses, other than those incurred in connection with services performed by a registered dealer, is meant to address this concern. We believe that paragraph 2.1(1)(c) of the Rule is not meant to prohibit legitimate selling or promotional expenses such as printing, mailing and other administrative or *de minimis* expenses incurred in connection with the trade.

7) **Q:** Does a company that intends to use the closely-held issuer exemption need to include any restrictions in its articles?

A: Paragraph (a) of the definition of closely-held issuer requires restrictions on transfer to be contained in the issuer's constating documents or other agreements. Accordingly, to qualify under the exemption, the issuer must include such restrictions in its agreements or constating documents.

With respect to the 35 securityholder limit, the definition of closely-held issuer does not require that this limit be specified in the articles or elsewhere.

8) **Q:** What can an issuer do to ensure that it qualifies under both the closely-held issuer exemption in Ontario and the private company exemption, which used to exist in Ontario and remains in a similar form in other Canadian jurisdictions?

A: The closely-held issuer exemption broadens the scope of potential investors to include members of the public. Therefore, issuers who do not prohibit invitation to the public in their constating documents may be precluded from using the private company exemption under securities legislation in other Canadian jurisdictions.

Accordingly, issuers who find themselves in this position may wish to consider various alternatives including the following:

1. An issuer that plans to use the closely-held issuer exemption in Ontario and to concurrently rely on the private company exemption in other Canadian jurisdictions may wish to maintain or include in its constating documents a provision prohibiting the issuer from offering its securities to the public. The issuer will thus be able to utilize the private company exemption in other Canadian jurisdictions and will be able to rely on the closely-held issuer exemption in Ontario, albeit only for offerings to investors who are not members of "the public".

2. An issuer who wishes to utilize the full scope of the closely-held issuer exemption in Ontario, i.e., by offering its securities without regard to the concept of "the public", may be precluded from using the private company exemption in other Canadian jurisdictions, and as such, may wish to consider pursuing other exemptions in those jurisdictions.

B. Pooled Funds

1) **Q:** What is a "pooled fund"?

A: The term "pooled fund" is not a defined term under Ontario securities law. The term "pooled fund" is usually considered to include non-redeemable investment funds and mutual funds that are not reporting issuers. Non-redeemable investment funds[1] and mutual funds[2] are defined terms.

2) **Q:** Why does section 2.12 of the Rule provide, in subsection 2.12(1), automatic top-up relief for funds managed by a portfolio adviser or a trust corporation but, in subsection 2.12(2), not provide the same relief with respect to funds managed by a person or company relying on Part 7 of Rule 35-502 *Non-Resident Advisers?*

A: The provision was drafted intentionally this way because the top-ups referred to in subsection 2.12(1) have become standard relief granted by the Commission. As far as we are aware, no application has ever been made for relief for the type of funds described in subsection 2.12(2). Applications for top-up relief will be considered for exempt advisers on a case-by-case basis.

3) **Q:** Can hedge funds rely on the exemption provided by section 2.12?

A: Certain hedge funds may qualify and others would not. Section 2.12 applies, subject to certain conditions, to:

a) mutual funds that are not reporting issuers; and

b) non-redeemable investment funds that are not reporting issuers

As we point out in Question 1, the term "mutual fund" is defined in the Act and a definition of non-redeemable investment fund appears in Rule 14-501 *Definitions.* Trades in hedge funds that are structured as mutual funds or non-redeemable investment funds and otherwise meet the requirements of 2.12 can be made in reliance on that exemption.

4) **Q:** Paragraph 2.12(1)(c) refers to the fund being "*managed by a portfolio adviser*". Does this mean the manager of a pooled fund must be registered or is it sufficient for the pooled fund's portfolio manager or sub-adviser, who is not the manager of the pooled fund, to be registered?

A: The term "managed by" in paragraph 2.12(1)(c) refers to the functions that are carried out by a manager of a pooled fund and are distinguishable from the narrower portfolio management functions that are carried out by a portfolio manager or sub-adviser to a pooled fund. The exemption in section 2.12 will not be available for a pooled fund unless the manager of the pooled fund is itself registered as a portfolio adviser.

5) **Q:** Under section 3.2 of Rule 45-501, as it existed prior to November 30, 2001, the "acquisition cost" referred to in paragraph 72(1)(d) of the Act could be satisfied by the purchaser incurring or assuming liability where:

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[1] As defined in Rule 14-501 *Definitions*, a "non-redeemable investment fund" means an issuer:
(a) whose primary purpose is to invest money provided by its securityholders;
(b) that does not invest for the purpose of exercising effective control, seeking to exercise effective control, or being actively involved in the management of the issuers in which it invests, other than other mutual funds or non-redeemable investment funds; and
(c) that is not a mutual fund.

[2] As defined in the Act, a "mutual fund" includes an issuer of securities that entitle the holder to receive on demand, or within a specified period after demand, an amount computed by reference to the value of a proportionate interest in the whole or in apart of the net assets, including a separate fund or trust account, of the issuer of the securities.

"the purchaser is primarily liable for the liability and there is no understanding, arrangement or expectation that the liability or the obligation to pay it will be waived; and (b) the acquisition cost, including the liability that is incurred or assumed by the purchaser, has a fair value of not less than $150,000."

The current version of the Rule does not contain this provision. Would the requirements of section 2.12 be met if in making its investment the purchaser incurs or assumes liability which has a fair market value of not less than $150,000?

A: Yes. Section 2.12 provides a prospectus exemption for a trade involving an aggregate acquisition cost to the purchaser of at least $150,000. So long as the aggregate acquisition cost is $150,000, we do not consider it relevant that the acquisition may have taken place by way of the assumption of a liability by the purchaser.

6) **Q:** For the purpose of satisfying the $150,000 threshold in section 2.12 of the Rule, can I combine the amounts contributed by me directly with the amounts contributed by my RRSP?

A: Yes. For the purpose of the $150,000 threshold in section 2.12, we take the view that an individual may combine amounts purchased on his/her own account with amounts purchased by the individual's RRSP.

7) **Q:** Can a pooled fund use the closely-held issuer exemption?

A: If the pooled fund is a mutual fund or a non-redeemable investment fund, it cannot use the closely-held issuer exemption.

C. General Inquiries

1) **Q:** In what circumstances is it appropriate for a person or company to apply to the Commission to be recognized as an accredited investor under paragraph (u) of the accredited investor definition?

A: Paragraph (u) of the accredited investor definition in section 1.1 of the Rule contemplates that a person or company may apply to the Commission to be recognized as an accredited investor. The Commission will consider applications for accredited investor recognition submitted by or on behalf of investors that do not meet any of the other criteria for accredited investor status, but who nevertheless possess the requisite sophistication or financial resources. It should be noted, however, that paragraph (u) is **not** meant to replace the exempt purchaser exemption that was previously available under paragraph 72(1)(c) of the Act.

As explained in section 2.8 of the Companion Policy to the Rule, the Commission has not adopted any specific criteria for granting accredited investor recognition to applicants and is of the view that the accredited investor definition generally covers all of the accredited investor categories that do not require the protection of the prospectus and registration requirements under the Act. Furthermore, as stated in the Companion Policy, the Commission believes that a person or company that was previously recognized as an exempt purchaser should have little difficulty qualifying as an accredited investor under the Rule. Consequently, we expect that paragraph (u) of the accredited investor definition will be utilized on a limited basis.

2) **Q:** "I *just* missed the accredited investor thresholds in paragraphs 1.1(m) and (n) of the Rule. Can I still be an accredited investor"?

A: No. The accredited investor exemption for individuals is a "bright-line" test. You either satisfy the test or you are not an accredited investor.

3) **Q:** How does National Policy Statement 48 ("NP 48") *Future Oriented Financial Information* ("FOFI") apply to the Rule?

A: There are no requirements in the new Rule relating to FOFI. NP 48 is currently in the process of being reformulated as a rule (proposed National Instrument 52-101). In the meantime, NP 48 is a policy and is not enforceable as a rule under Ontario securities law.

4) **Q:** Paragraph (t) of the definition of accredited investor refers to a $5 million threshold of net assets as reflected in an entity's "*most recently prepared financial statements*". Must these financial statements be prepared in accordance with applicable generally accepted accounting principles?

A: Yes.

5) **Q:** Are you planning to amend the new Rule to reflect the views expressed in this Notice and, if so, when?

A: Yes, we are planning to amend the Rule. However, we will not commence the amendment process until, at the earliest, the one year anniversary of the new Rule. We believe it is important to allow the new Rule to operate for at least one year before making any amendments to it for a number of reasons, including:

- **!** to allow us time to gather and consider feedback on the new Rule from various market participants;
- **!** to allow us to consider applications for exemptive relief relating to all areas of the new Rule. Generally, applications for exemptive relief are a very important part of the process leading up to any amendments because they enable us to identify and address inconsistencies between new rules and the needs of the marketplace. To date we have received very few applications relating to the new Rule; and
- **!** to allow us to complete an economic analysis of the effect of the new Rule on small business financing. This study is currently underway and will require at least one year of data to be meaningful.