

Exempt Market Securities

Look Before
You Leap!

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With her real estate business booming, Marie was looking for ways to invest her savings and reduce her income taxes. She was very interested when she heard about an opportunity to make a sizeable investment in a limited partnership tax shelter with only a few thousand dollars down and the balance covered by a loan. The limited partnership promised substantial tax savings and a healthy return on her investment that would more than pay off the loan.

Marie listened to an enthusiastic sales pitch about the limited partnership, and then signed some forms, a promissory note for the loan and a cheque for \$5000. She took home copies of the forms and a 30-page offering memorandum about the investment, promising herself she'd read them when she had time. It was already too late.

The partnership invested in projects that were risky. Within a few months several had failed. The income Marie was counting on from her investment never materialized, and she had to come up with more money to pay the interest on her loan. She asked her broker to sell the investment but was told that she'd purchased exempt market securities and could not yet sell them under the securities laws. Even if she could sell, the broker told her, there was no market for the securities.

Marie finally read the offering memorandum. It explained that the partnership was a high-risk investment and that borrowing money to invest made it even riskier. It explained that Revenue Canada could disallow the tax deductions that led her to invest in the first place if the funds raised were not properly spent. Marie read about the resale restrictions that might prevent her from ever selling her investment, and about 10% commissions paid to those who found investors for the partnership. This was not a suitable investment for her.

Marie learned about exempt market securities the hard way – by not investigating before she invested.

What are exempt market securities?

In Canada, businesses and governments (called **issuers** in this brochure) can raise capital by selling securities – such as common shares, mutual fund units or bonds – in one of two ways.

The issuer can prepare a disclosure document – called a **prospectus** – that provides detailed information about the securities to be sold, the issuer's business, its management and its financial condition. Once the prospectus has been filed with and accepted by the securities regulators, the issuer can sell its securities to the public. (See our brochure "*The Prospectus – What it is and Why You Should Read it.*")

Or the issuer can rely on one of the **prospectus exemptions** to sell securities without a prospectus. Generally speaking, prospectus exemptions are only available in cases where investors do not need the detailed disclosure and the protection that a prospectus provides.

When an issuer distributes its securities under a **prospectus exemption**, it is issuing **exempt market securities** and raising capital in the **exempt market**.

Why are the exemptions allowed?

The prospectus is a valuable part of the investor protection system in Canada, but preparing a prospectus and having it accepted by the regulators can be a costly and time-consuming process for firms in need of capital. Our laws therefore remove the prospectus requirement when the securities being sold are very low risk (e.g., government savings bonds) or when the securities are being distributed only to qualified investors who do not need the protection of a prospectus (e.g., when the buyer is a large financial institution or a sophisticated investor).

Why do you need to know about the exempt market?

The exempt market is an important part of the Canadian financial system. Billions of dollars are raised each year by businesses and governments that use prospectus exemptions to raise capital from qualified investors.

Unfortunately, some issuers abuse the system by selling their securities to investors – like Marie – who don't understand the risks and resale restrictions that often apply to securities sold without a prospectus.

This brochure is designed to help you understand those risks and resale restrictions and determine whether exempt securities are suitable for you.

What do you need to know about exempt market securities?

When securities are distributed under a prospectus exemption:

- They can't normally be sold to the general public;

- As a purchaser, you won't receive a prospectus, so you won't receive the detailed disclosure or the same legal rights that a prospectus provides. For example, you may not have the same rights to withdraw from your purchase and you may not have the same legal rights to sue for damages if you were induced to invest on the basis of misrepresentations;
- The issuer doesn't become obliged to comply with **continuous disclosure requirements** (unless it is already required to). This means that it won't be required by securities laws to publish periodic financial statements or give prompt public notice of material changes in its affairs;
- The securities may well be subject to resale restrictions, meaning that you may not legally be able to sell them for a specified amount of time (unless you can qualify to resell them under another prospectus exemption). The resale restrictions, set by law, often apply for at least 12 months, but if the issuer isn't subject to continuous disclosure requirements in your jurisdiction, the restrictions could be indefinite; and
- Even if you comply with the resale restrictions, there may be no market for the securities when you want to sell.

In many cases, when a prospectus exemption is available to the issuer, a **registration exemption** is available as well. A registration exemption allows the issuer to offer the securities to investors without using the services of someone registered to sell securities. This means that investors may not have the important benefit of professional advice.

Who can invest in the exempt market?

The prospectus exemptions are quite similar in each province and territory. In most jurisdictions, exemptions are available to an issuer for distributing securities:

- to a government, bank or insurance company;
- to an investor who purchases, as principal, at least \$150,000 (\$97,000 in B.C., Alberta and Manitoba) of the securities being offered;
- to its employees, directors or senior officers, or those of its affiliates; and
- to its existing security holders by way of a rights offering, dividend reinvestment plan or stock dividend.

In some provinces, exemptions are also available to an issuer to distribute securities:

- to certain relatives of its directors or senior officers, although in most cases the purchasers must be given an **offering memorandum** (a document that provides detailed disclosure, similar to a prospectus, but that is not reviewed by any regulatory agency and that does not provide investors with the same legal remedies);
- to investors whose net worth and investment experience allow them to qualify under the law as **sophisticated purchasers** and who typically must be given an offering memorandum; and
- to investors who qualify as **informed purchasers** as a result of consultation with qualified, independent advisers.

Other prospectus and registration exemptions may also be available, but they generally apply to specialized corporate transactions that don't involve new investments by individual investors.

Who uses the exemptions?

Many types of issuers use prospectus exemptions. For example, governments use exemptions to sell savings bonds. Private companies use exemptions to sell common shares to their founders. Publicly traded companies use exemptions to raise capital from large institutional investors, like banks, pension funds or mutual funds. Limited partnerships use exemptions to raise capital from certain qualified investors.

How can you tell if securities are being sold under an exemption?

Consult your financial adviser, the issuer of the securities or your provincial or territorial securities regulator. If the issuer is selling the securities, the issuer must either provide a prospectus or use a prospectus exemption. If a prospectus hasn't been prepared, the securities can be legally sold by the issuer only under a prospectus exemption.

Remember that not all securities are being sold by an issuer. For example, millions of shares are sold through stock exchanges every day by individual investors who have no connection to the issuer (other than as shareholders). These are, in many cases, shares that were previously sold under a prospectus and that now trade freely in the market.

Investigate Before You Invest!

You have an opportunity to invest in exempt market securities. What questions should you ask?

Ultimately, you'll need to determine if the investment is suitable for you. Advice from a qualified financial adviser can be invaluable. You can start, though, with some basic questions. (See our brochures "*Getting Started*" and "*Choosing Your Financial Advisers*".)

Do you qualify as a purchaser?

If you're not a sophisticated purchaser making a very substantial investment, or if you're not a director, senior officer or employee of the issuer or its affiliate, chances are that the issuer can't legally sell its securities to you without a prospectus. Consult your financial adviser or a lawyer to make sure the distribution is legal before you consider participating.

Why is the investment being offered to you?

In some cases, issuers will pay salespeople commissions of 10% or more to find investors for exempt offerings. Make sure that any investment you make is based on *your* best interests, not on the best interests of the person selling the securities.

What information is available about this investment?

Depending on the exemption being used, the issuer may be required to give potential investors an offering memorandum that contains detailed information about the securities to be issued and about the issuer's business, management, financial condition and expenditure plans. It will also point out the potential risks of the investment and the legal rights of investors to sue the issuer if the offering memorandum contains misrepresentations.

If an offering memorandum isn't required, the issuer may choose to provide a great deal of information, or very little.

Where can you find out more about the issuer?

If the issuer is subject to continuous disclosure requirements (i.e., it's a **reporting issuer**), it is required by law to publish financial information on a quarterly basis and news releases whenever there are material changes in its affairs. These, along with past prospectuses and other disclosure documents, are part of a detailed **public disclosure record** that is available through the issuer, your financial adviser, the securities regulators and through internet sources such as **www.sedar.com**.

If the issuer isn't a reporting issuer, much less information will likely be available to you – now and in the future – as the issuer's disclosure obligations will be only those required by any corporate legislation that applies to it. The information that is available must usually be obtained directly from the issuer.

What legal remedies will you have if the information provided is wrong?

When you invest in the exempt market you generally won't have all of the legal remedies that you would have in a prospectus offering (eg., the right to sue the issuer's directors and its underwriter for damages). Even so, you may well have the right to sue the issuer or its agents if you were induced to invest by misrepresentations. The right to sue the issuer may be of limited value, however, if it has already lost or disposed of all of its assets. If you're unsure of your rights, get legal advice.

What about future information?

Ask the issuer or your financial adviser to tell you what information the issuer is bound by law or contract to give you in the future. Most corporate legislation requires companies to provide shareholders with at least some periodic financial information. As noted before, securities legislation requires reporting issuers to provide additional information as well. If the issuer doesn't provide the information that it's required to, that's a clear warning flag that something isn't right. Contact the issuer promptly and, if your inquiries aren't satisfied, contact the regulators in your province or territory.

Will there be any resale restrictions?

Almost all securities that are issued under prospectus exemptions are subject to resale restrictions. Find out what the hold period will be (remember, it could be indefinite if the issuer isn't a reporting issuer in your province or territory) and what other conditions you'll have to meet before you can sell the securities.

Is there, or will there be, any market for these securities?

There may never be a market for the issuer's securities. Be wary of any claims that an issuer will soon be listed on a stock exchange. Such statements are illegal in many jurisdictions and often don't come true.

Look Before You Leap!

It's important that you know about the issuer, its business and management, about the type of securities you're buying and how they're being offered to you. Many of the securities that are issued without a prospectus are appropriate for only the most experienced investors. If you're considering an investment in a private company, a limited partnership or some other exempt market offering, remember that you'll usually receive less information, that you will have fewer legal remedies available to you, and that the investment may well be very high-risk. Your ability to sell the securities may also be severely restricted.

Questions?

If you'd like to learn more about the exempt market, or about investing generally, ask your financial adviser about investment courses that are offered in your area, or contact your provincial or territorial securities regulator for a free copy of the Canadian Securities Administrators *Investor Education Kit*.

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