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Use of OM Exemption by Real Estate Issuers and Collective Investment Vehicles

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Executive Summary

Issuers engaged in the real estate sector (Real Estate Issuers) and issuers who pool money to invest in a portfolio of securities (Collective Investment Vehicles) are facing significant new disclosure requirements if they wish to continue to rely on the OM exemption in order to distribute their securities.

Real Estate Issuers will be required to file and deliver a signed appraisal for any interest in real property that (i) the Real Estate Issuer proposes to acquire from a related party, or (ii) is presented in the OM and the disclosure includes a value for the real property. Additionally, there is certain prescribed information about the real property which must be disclosed.

Collective investment vehicles or CIVs will be required to include additional information in their OMs. Most mortgage investment entities, as well as certain other credit funds will be considered to be CIVs under these rules. The required disclosure is extensive, and includes detailed information about the characteristics of the investment portfolio.

In Ontario, but not in the rest of Canada, OM issuers who are making continuous or ongoing distributions must update their OMs with six-month interim financial statements as well as annual audited financial statements. However, there is an exception to this requirement in Ontario which would allow issuers to not amend their OM to include an interim financial report for the most recently completed six month period if the issuer appends an additional certificate to the OM certifying that (i) Ontario OM issuers who are able to certify that the OM (without interims) does not include a misrepresentation as at the date of the certification, (ii) that there have been no material changes not disclosed in the OM, and (iii) that the OM, as at the date of certification, provides a reasonable purchaser with sufficient information to make an informed investment decision.

The new rules, contained in amendments to NI 45-106 published December 8, 2022 (the OM Amendments)[1] take effect March 8, 2023. With certain exceptions, OM issuers who were distributing under an existing OM prior to that date may continue to use that OM until such time as the OM becomes outdated.

The OM Exemption

National Instrument 45-106 *Prospectus Exemptions*[2] (NI 45-106) contains within it a series of rules which allow issuers to raise capital without becoming a reporting issuer[3]. The offering memorandum prospectus exemption (the OM exemption) offers an avenue for capital raising by small and medium sized businesses. It allows issuers to access capital from investors who do not qualify as “accredited investors”. Complying with all of the requirements of the OM exemption can be challenging, not least because the rules are not uniform across Canada. The OM exemption permits an issuer to prepare an offering document in prescribed form and to deliver that document to prospective investors prior to accepting a subscription for securities.

Securities regulatory authorities have expressed some consternation at the use to which the OM exemption has been put. The OM exemption was intended to be used "by relatively simple issuers for relatively small amounts of capital". Originally conceived as a stepping stone for early stage businesses on the way to the more comprehensive prospectus disclosure regime, regulators have found that the exemption is often used by "larger and more complex issuers than those originally envisioned." A review conducted by staff of the Canadian Securities Administrators (CSA) found that a significant proportion of OM issuers were engaged in real estate development, and over 40% of issuers were entities that would qualify as "collective investment vehicles". The CSA determined that the disclosure regime designed for "relatively simple issuers raising small amounts of capital" was insufficiently robust when it came to these larger and more complex issuers. To address these concerns, the CSA is introducing additional requirements for OM issuers who are engaged in "real estate activities" or who are "collective investment vehicles".

Real Estate Issuers

An OM issuer engaged in "real estate activities" is subject to additional disclosure requirements, and "real estate activities" are activities whose primary purpose is to generate income or gain from the lease, sale or other disposition of real property. The definition allows for certain exclusions, including for resource issuers involved in mineral extraction and oil and gas. Real estate issuers would include REITs as well as development projects and land banks, and also include parent companies or holding companies whose subsidiaries are engaged in real estate activities.

For Real Estate Issuers, the principal new obligation is the requirement to deliver to investors and file with regulators an appraisal prepared by a qualified independent appraiser. This appraisal requirement is triggered where one or both of the following circumstances apply: (i) the issuer proposes to acquire an interest in real property from a related party[4] and a reasonable person would believe that the likelihood of the issuer completing the acquisition is high; and (ii) except in its financial statements contained in the offering memorandum, the issuer discloses in the offering memorandum a value for an interest in real property. So, if the OM discusses the value of the subject real property, the appraisal requirement applies. And if the Real Estate Issuer expects to vend in, or otherwise acquire real property from, a non arms-length party, a qualified appraisal must be prepared, delivered and filed. Please note that for issuers who are doing ongoing distributions, the appraisal requirements can arise after the date of the OM. If that occurs (for example if the issuer negotiates a deal to acquire property from a related party), then the required appraisal must be prepared and delivered to investors together with the OM.

The appraisal must be prepared and signed by a professional appraiser independent of the issuer, dated within six months of the date of delivery to investors, and provide an "as-is" fair market value of the subject real property interest, without giving consideration to any proposed improvements or proposed development. Generally, the issuer must not make a representation or give an opinion for a value for the subject property other than the appraised value unless the issuer has a "reasonable" basis for any alternate value. Furthermore, if the issuer wishes to communicate any such alternate value for the subject property, the issuer is required to give equal or greater prominence to the appraised value, discuss the factors or assumptions relevant to the alternate determination and state whether the alternate value was arrived at by a person who is an independent qualified appraiser.

The OM of a Real Estate Issuer will have to include additional information; the prescribed form requires extensive and detailed disclosure.

Collective Investment Vehicles

The OM Amendments introduce a new category of issuer to the securities regulatory regime: the "collective investment vehicle" or CIV. OM issuers who meet the definition of CIV will be subject to significant additional prescribed disclosure requirements. A collective investment vehicle is defined as an investment fund and "any other issuer, the primary purpose of which is to invest money provided by its security holders in a portfolio of securities other than securities of subsidiaries of the issuer". Mutual funds, pooled funds and certain closed-end funds are examples of collective investment vehicles. Most jurisdictions in Canada (but not all) restrict

the ability of investment funds to raise capital in reliance on the OM exemption[5]. Most mortgage funds and mortgage investment entities (MIEs), including mortgage investment corporations, are generally not “investment funds”, but will meet the definition of collective investment vehicle.

Securities regulators believe that investors in CIVs need more information about the person making the investment decisions, how investments are chosen, and the composition and performance of the portfolio. As a result, Form 45-106F2 will require that the OMs of CIVs disclose the issuer’s investment objectives and strategy, including for MIEs, the type of properties, geographical focus, material mortgage terms, range of interest rates, length of term, and priority ranking. Personal information relating to an investment decision maker’s[6] principal occupation and any regulatory sanctions, bankruptcy, insolvency and criminal or quasi-criminal matters will have to be disclosed. The Form also prescribed detailed disclosure about the investment portfolio. MIEs will have to include information as to the average weighted interest rates, average weighted terms to maturity, and average Loan-to-Value (LTV). LTV must be calculated for each mortgage by dividing the total principal amount of the issuer’s mortgage and all other loans ranking in equal or greater priority to the issuer’s mortgage by the fair market value of the property, weighted by the principal amount of each mortgage. Detailed breakdown of the portfolio by property type, maturity, geographical location is required, and information as to mortgages that are impaired or in default must also be disclosed. Any mortgage that comprises over 10% of the total principal amount must be identified and detailed information regarding such mortgage must be disclosed.

CIVs are also required to calculate and disclosure performance information in the OM. Performance data, for the ten most recently completed financial years ended more than 120 days before the date of the OM must be shown. The methodology used to calculate performance must be the same as the methodology used in the issuer’s financial statements.

OM Updates and Financial Statements

The OM Amendments also impose additional requirements on issuers making “ongoing distributions,” and highlight the importance of keeping the OM updated to ensure that the OM does not contain a misrepresentation and moreover to enable an investor to make an informed investment decision. The current instructions for completing Form 45-106F2 state that if the distribution is ongoing, an issuer’s OM must be updated to include the annual audited financial statements and the accompanying auditor’s report. This update generally occurs within 120 days of the issuer’s fiscal year-end. Thus, the widely understood rule continues to exist which states that an OM becomes “stale dated’ 120 days following the issuer’s fiscal year-end, and the OM must be updated to include the most recent financial statements in order for the exemption to continue to be available.

With the coming into force of the OM Amendments, Ontario requires that an issuer’s OM be updated to include unaudited six-month financial reports within 60 days of period-end. This requirement, found in the original CSA proposal issued in 2020, was dropped by all jurisdictions other than Ontario. In Ontario, an OM issuer making ongoing distributions will have to either update its OM to include interim financial reports, or else amend the OM to include a certificate stating that that the OM (without interims) does not include a misrepresentation as at the date of the certification, that there have been no material changes not disclosed in the OM and that the OM, when read as at the date of the certificate, provides a reasonable purchaser with sufficient information to make an informed investment decision.

The practical result is that issuers making ongoing distributions will be required to update their OMs at least twice a year.

Other Amendments

In addition to the provisions affecting Real Estate Issuers and CIV, the OM Amendment contain certain amendments intended to clarify or streamline NI 45-106 and generally improve disclosure for investors. These general amendments include the requirement that an OM delivered to an investor must, in addition to not containing a misrepresentation, contain “sufficient information to enable a reasonable purchaser to make an informed investment decision”. The OM as filed with regulators must be in a format that allows for

the searching of words electronically using reasonably available technology.

Issuers should note that Form 45-106F2, *Offering Memorandum for Non-Qualifying Issuers* has been amended, together with the Instructions for Completion. In particular, the Form now places greater emphasis on disclosure of payments to, and transactions with, related parties. If the OM issuer provides investors with the right to redeem (right to require the issuer to repurchase the securities), any restrictions or qualifications on such rights must be more prominently disclosed.

Changes have also been made to the Risk Acknowledgement Form to be signed by investors and salespersons.

Moving Forward

Since its broader introduction in 2016[7], the OM exemption regime has been characterized by lack of uniformity across Canadian jurisdictions and complying with the myriad requirements has been challenging. The OM Amendments represent significant changes to the disclosure regime for OM issuers. Issuers, particularly CIVs who distribute on an ongoing basis will have to carefully consider the merits of "opting in" to the new disclosure regime earlier vs continuing to distribute under their existing OM. Dealers, both securities dealers and exempt market dealers, who advise issuers and distribute the securities of OM issuer will have to review and modify their due diligence and "Know Your Product" procedures.

The information and comments herein are for the general information of the reader and are not intended as advice or opinion to be relied upon in relation to any particular circumstances. For particular application of the law to specific situations, the reader should seek professional advice.

If you have questions regarding this or any other aspect of the OM exemptions and capital raising in reliance on various private placement exemptions, please contact Susan Han shan@weirfoulds.com ***or Jay Tomar*** dtomar@weirfoulds.com

[1] See https://www.osc.ca/sites/default/files/2022-12/ni_20221208_45-106-45-106cp.pdf

[2] See https://www.osc.ca/sites/default/files/2022-01/ni_20220105_45-106_unofficial-consolidation.pdf

[3] The OM exemption is provided in Section 2.9 of NI 45-106. Detailed disclosure requirements provisions are found in the prescribed forms for the OM, being Form 45-106F2 [Non qualifying issuers], Form 45-106F3 [Qualifying issuers] and Form 45-106F18 [Supplemental Disclosure for Syndicated Mortgages].

[4] The OM Amendments define a "related party" as (a) a director, officer, promoter or control person of an issuer; (b) in regard to an individual referred to in paragraph (a), a child, parent, grandparent, sibling or other relative living in the same residence; (c) in regard to an individual referred to in paragraph (a) or (b), the individual's spouse; (d) an insider of an issuer; (e) a person controlled by a person referred to in paragraphs (a) to (d), or controlled by a person referred to in paragraphs (a) to (d) acting jointly or in concert with another person; (f) in the case of a person referred to in paragraph (a) or (d) that is not an individual, a person that, alone or together with one or more persons acting jointly or in concert, controls that person.

[5] Under NI 45-106, British Columbia and Newfoundland and Labrador permit the use of the OM exemption by investment funds. Another five jurisdictions, namely Manitoba, Northwest Territories, Nunavut, Prince Edward Island and Yukon permit the use of the OM exemption by non-redeemable investment funds and mutual funds who are reporting issuers. In the other jurisdictions,

investment funds (mutual funds or non-redeemable investment funds) are precluded from using the OM exemption for capital raising.

[6] Most CIVs who use the OM exemption will not be “investment funds’ and will not have a registered advisor (portfolio manager) managing the investment portfolio.

[7] The OM exemption has been available to issuers in Ontario only since January 13, 2016.

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