

Exempt market securities.
The complete overview.



Commission des valeurs mobilières du Québec

OVERVIEW

Exempt market securities. The complete overview.

With her real estate business booming, Marie was looking for ways to invest her savings and reduce her income taxes. She was therefore 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.



PROSPECTUS



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 and relevant restrictions 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 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.

The prospectus is an invaluable 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 under certain conditions. The issuer may be granted exemption from preparing any disclosure document or the exemption may simply require that the issuer prepare only a brief disclosure document.

See our brochure:
“The Prospectus – what it is
and why you should read it”

- The issuer can rely on one of the *prospectus exemptions* to sell securities when the investor is properly informed of the firm's business, when the total number of investors is limited, when the securities offered present a guarantee as to the quality of the issuer (federal, provincial or municipal government), or when the investor is known to be a sophisticated purchaser.

In Quebec, the *Securities Act* grants issuers prospectus exemptions for essentially two reasons:

- Due to the nature of the securities;
- Due to the nature of the distribution.

As a result, the prospectus is not required in order to invest in low-risk securities such as securities issued by a government, for example government bonds. It should be noted that in this first case, there is in fact a market for these securities, even if they are exempt from preparing a prospectus.

However, investors must be careful of exemptions granted due to the nature of the distribution, in which case there may be some resale restrictions. The *Act* prescribes that, when securities are acquired through a prospectus exemption, they must be kept by the purchaser for a certain amount of time, i.e. they cannot be resold before the end date of the prescribed period, which may vary according to the nature of the acquired securities.

Investors may possibly never be able to dispose of their securities since, to be able to do so, the issuer must also be a reporting issuer as defined in the *Act*, i.e. the issuer would have already filed a prospectus for another investment.

It is clear that if Marie had read the disclosure document that was given to her before investing, she would have seen these different aspects.

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 are not careful enough and fail to either read the disclosure documents given to them, or to inform themselves before making a decision.

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

EXEMPT



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 a large number of people.
- As a purchaser, you won't receive a prospectus, so you won't receive the detailed disclosure or the same rights that a prospectus provides. For example, you may not cancel the transaction within two days of your purchase and you may not have the same legal rights to sue for damages in accordance with the *Québec Securities Act* if you were induced to invest on the basis of misrepresentations.
- If the issuer is not already a reporting issuer, if it prepares an offering memorandum when raising capital, or if the securities entitle the issuer to a tax break, you may possibly not receive periodic financial statements from the issuer.
- The securities may in fact be subject to resale restrictions, meaning that you may not be able to sell them for a specified amount of time. 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.
- Even if it is possible for you to sell your securities, there may be no market for the securities, i.e. you may not be able to find any buyers.

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 sophisticated purchaser, especially 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;
- 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 people already informed of the situation of the issuer and of its senior officers. In certain cases the purchasers will receive an offering memorandum, i.e. a disclosure document dealing with the company's primary business activities and the characteristics of the securities being offered;
- to investors whose net worth and investment experience allow them to qualify under the law as *sophisticated purchasers*.

Other prospectus exemptions are also available, but they generally apply to specialized corporate transactions that don't involve investors in general.

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 securities to people who do not have additional information on the company. 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.

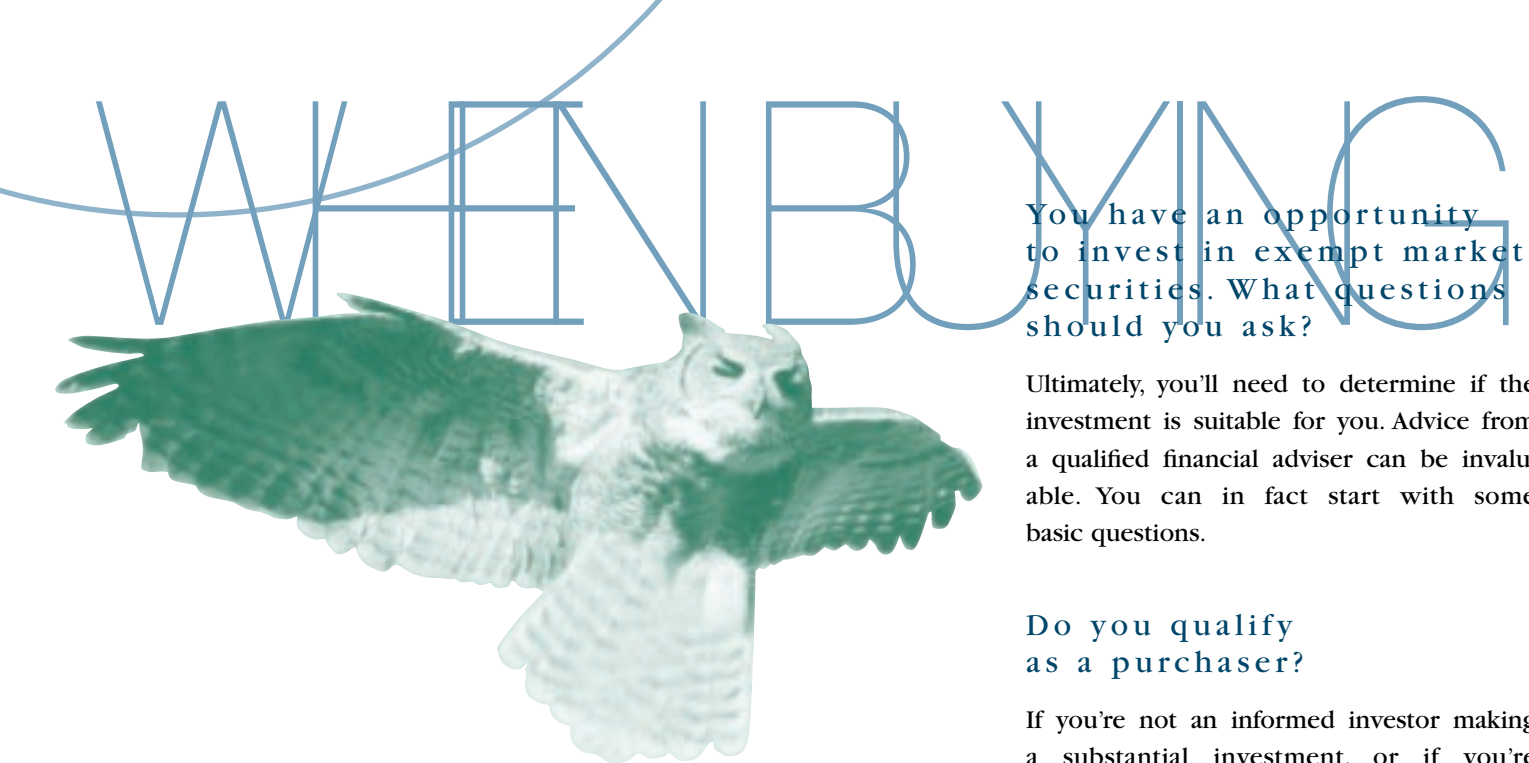
How can you tell if securities are being sold under an exemption?

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.

It should be noted that you may purchase securities without receiving any disclosure documents and without the issuer receiving a prospectus exemption. 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 in fact start with some basic questions.

Do you qualify as a purchaser?

If you're not an informed investor making a 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, a lawyer, or the securities administrator in your province to make sure the investment is legal before you consider participating.

See our brochures:
"Getting Started"
and **"Choosing Your**
Financial Advisers"

Why is the investment being offered to you?

Some issuers will pay people commissions of 10% or more to find investors for exempt offerings. Make sure that you are not being pressured into investing and 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 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 very little information.



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, or if the issuer has not prepared an offering memorandum to raise capital or to invest securities entitling it to a tax break, it is possible that you will not receive periodic financial statements from the issuer. The issuer is exempt from preparing a prospectus when investing its securities with a limited number of purchasers and when investing a tax-exempt amount.

INFORMATION

RECOURSE



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

When you invest in the exempt market you won't necessarily have access to all of the remedies that you would have in a prospectus offering (for example, 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 misrepresentation. However, the right to sue the issuer may be of limited value, 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?

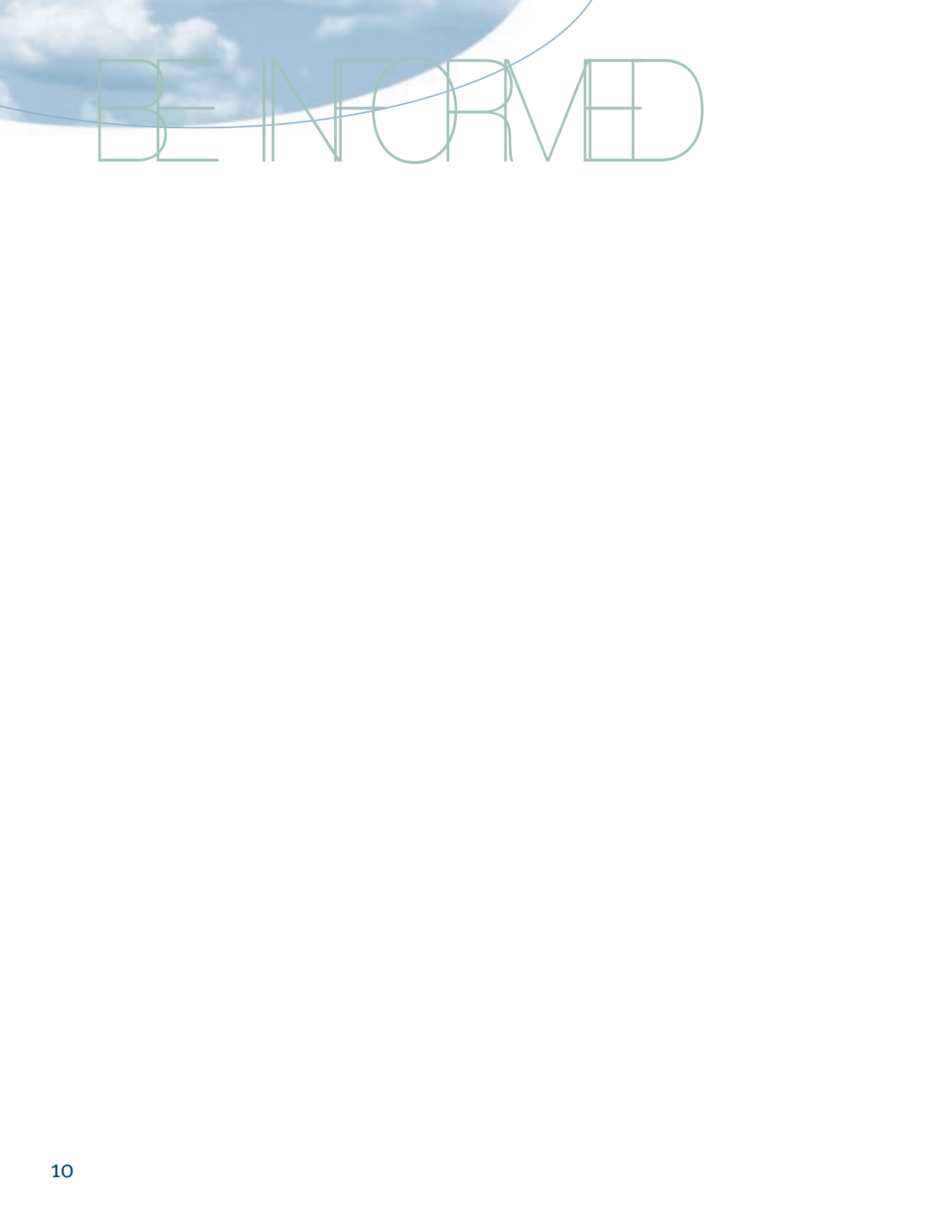
Ask the issuer or your financial adviser to tell you what information the issuer is bound by law or contract to give you in the future. Most corporate legislation requires companies to provide shareholders with at least some periodic financial information. As previously noted, securities legislation also requires reporting issuers to provide additional information. If the issuer doesn't provide the required information, that's a clear warning 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 a 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 are often false.



BE INFORMED

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. Most 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 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 their brochures.

Brought to you by the Canadian Securities Administrators.



QUÉBEC

Commission des valeurs mobilières du Québec

800 Square Victoria, 22nd Floor
P.O. Box 246, Tour de la Bourse
Montréal, QC H4Z 1G3

Telephone: (514) 940-2150
1-800-361-5072

(Quebec only)

Fax: (514) 873-3090

Web Site: www.cvmq.com

E-mail: courrier@cvmq.com

ALBERTA

Alberta Securities Commission

5th Avenue SW, Suite 410, 300
Calgary, AB T2P 3C4

Telephone: (403) 297-6454

Fax: (403) 297-6156

20th Floor, 10015 Jasper Avenue
Edmonton, AB T5J 3Z5

Telephone: (403) 427-5201

Fax: (403) 427-0777

BRITISH COLUMBIA

British Columbia Securities Commission

865 Hornby Street, Suite 200
Vancouver, BC V6Z 2H4

Telephone: (604) 899-6500

Fax: (604) 899-6506

1-800-373-6393
(elsewhere in B.C.)

Web Site: www.bcsc.bc.ca

PRINCE EDWARD ISLAND

Department of Community Affairs & Attorney General

95 Rochford Street, 4 Shaw North
P.O. Box 2000, Charlottetown, PE C1A 7N8

Telephone: (902) 368-4551

Fax: (902) 368-5283

Web Site: www.gov.pe.ca/

MANITOBA

Manitoba Securities Commission

405 Broadway Avenue, Suite 1130
Winnipeg, MB R3C 3L6

Telephone: (204) 945-2548

Fax: (204) 945-0330

NEW BRUNSWICK

Office of the Administrator of Securities

133 William Street, Suite 606
P.O. Box 5001 Saint-Jean, NB E2L 4Y9

Telephone: (506) 658-3060

Fax: (506) 658-3059

NOVA SCOTIA

Nova Scotia Securities Commission

Joseph Howe Building
1690 Hollis Street, 2nd Floor

P.O. Box 458

Halifax, NS B3J 2P8

Telephone: (902) 424-7768

Fax: (902) 424-4625

Web Site: www.gov.ns.ca

ONTARIO

Ontario Securities Commission

20 Queen Street West, Suite 800
P.O. Box 55 Toronto, ON M5H 3S8

Information: (416) 593-8314

Publications: (416) 593-8117

Fax: (416) 593-8122

Web Site: www.osc.gov.on.ca

SASKATCHEWAN

Saskatchewan Securities Commission

1920 Broad Street, Suite 800

Regina, SK S4P 3V7

Telephone: (306) 787-5645

Fax: (306) 787-5899

NEWFOUNDLAND

Securities Division

Department of Government Services & Lands

Government of Newfoundland and Labrador

2nd Floor, West Block, Confederation
Building

P.O. Box 8700

St. John's, NF A1B 4J6

Telephone: (709) 729-4189

Fax: (709) 729-6187

Web Site: www.gov.nf.ca/

NORTHWEST TERRITORIES

Registrar of Securities

Department of Justice

Government of Northwest Territories

P.O. Box 1320 Yellowknife, NT X1A 2L9

Telephone: (867) 920-7490

Fax: (867) 873-0243

YUKON

Registrar of Securities

Government of Yukon

2134 2nd Avenue

P.O. Box 2703

Whitehorse, YK Y1A 2C6

Telephone: (867) 667-5005

Fax: (867) 393-6251



Commission des valeurs mobilières du Québec

800 Square Victoria, 22nd floor, P.O. Box 246, Tour de la Bourse, Montreal, Quebec H4Z 1G3

Telephone: (514) 940-2150 or 1-800-361-5072 Fax: (514) 873-3090

Web Site: www.cvmq.com