

THE CANADIAN BAR REVIEW

LA REVUE DU BARREAU CANADIEN

Vol. LVII

JUNE 1979 JUIN

No. 2

VENDOR BEWARE: THE ISSUE AND SALE OF SECURITIES WITHOUT A PROSPECTUS UNDER THE SECURITIES ACT, 1978 (ONTARIO)

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Introduction

In terms of integrating the concepts of a continuous disclosure system and reporting issuers with prospectus exemptions, The Securities Act, 1978¹ is the modified but related progeny of the 1970 *Merger Report*.² Without describing it as such, the *Merger Report* in essence recommended what is sometimes referred to as the "closed

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¹ S.O., 1978, c.47, hereinafter cited as the new Act. As of the date of writing, the new Act has not been proclaimed in force and, once proclaimed, will replace The Securities Act, R.S.O., 1970, c. 426, as am., hereinafter cited as the Ontario Securities Act. The new Act is the successor to Bill 30 (1st Sess., 31st Legis. June, 1977), Bill 20 (4th Sess., 30th Legis. April, 1977), Bill 98 (5th Sess., 29th Legis. May, 1975), Bill 75 (4th Sess., 29th Legis. June, 1974) and Bill 154 (2nd Sess., 29th Legis. June, 1972).

For comments on certain of the predecessor Bills, see H. Garfield Emerson, An Integrated Disclosure System for Ontario Securities Legislation, in *Studies in Canadian Company Law*, ed. by J.S. Ziegel (1973), vol. 2, p. 400; H.S. Bray, Ontario's Proposed Securities Act: An Overview, Its Purpose and Policy Premises, (1975), O.S.C. Bulletin 235; Peter Dey, Securities Reform in Ontario: The Securities Act, 1975 (1975), 1 Can. Bus. L.J. 20 and David L. Johnston, Canadian Securities Regulation (1977) hereinafter cited as Johnston, which reviews Canadian securities law with reference to the proposals contained in Bill 20.

² Report of the Committee of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements (1970), hereinafter cited as the *Merger Report*. To place the philosophy behind the *Merger Report* in the broader context of North American developments one might refer to Disclosure to Investors — A Reappraisal of Administrative Policies under the '33 and '34 Securities Acts (1969), hereinafter cited as the *Wheat Report* submitted to the Securities and Exchange Commission, hereinafter cited as the SEC.

system”³ and this scheme is proposed to be ultimately adopted by the new Act.

Historically Canadian securities legislation has focused primarily on the initial distribution of securities rather than subsequent trading in the secondary markets. The *Merger Report* highlighted investor protection through adequate public disclosure of the affairs of security issuers and emphasized the needs of the secondary markets in issued securities for a system of continuous timely corporate disclosure that was integrated with the exemptions from the prospectus filing requirements. The new Act reflects the trend in securities legislation to move from the periodic though concentrated disclosure of the sale of specific securities on special occasions, such as a public underwriting, to continuous disclosure of the affairs of issuers of securities in which there is a secondary public market. The premise is that the “disclosure system should operate so that the public files contain at any given time information substantially equivalent to a current prospectus—in quantity, quality, currency and accessibility—with regard to any security in which there is active investor interest”.⁴ This shift from the *registration of securities* to the *registration of issuers* is also recommended by the Proposed Official Draft Federal Securities Code of The American Law Institute.⁵

³ In this context, the “closed system” means, at the first level, a situation where every trade in its own securities by an issuer and every sale of securities by a controlling person requires the filing of a prospectus or an Ontario Securities Commission ruling, hereinafter cited as the Commission, unless a specific statutory exemption from the mandatory prospectus requirements is available; at the second level, the “closed system” means a situation where every security holder who acquired his securities pursuant to a prospectus exemption in the new Act can only sell such securities to the general investing public without a ruling either after the filing of a prospectus or on the primary condition that the issuer of the securities is a “reporting issuer” and in compliance with new timely and continuous public disclosure requirements of the new Act. Accordingly, where an issuer that does not fall within the definition of a “reporting issuer” issues its securities under a prospectus exemption, those securities can only be resold without a ruling within a select and limited number of purchasers under specific statutory conditions, unless and until a prospectus is filed in respect of those securities or the “non-reporting issuer” otherwise becomes a “reporting issuer”; upon the happening of either of such events the “closed system” is broken in respect of the securities so acquired and the security holder then may, under certain conditions, sell such securities outside the “closed system” to the general investing public.

⁴ Milton H. Cohen, “Truth in Securities” Revisited (1966), 79 Harv. L. Rev. 1340, at p. 1368. The Wheat Report reflected this judgment generally and stressed the integration of sales of securities with continuous disclosure, noting, p. 328, that the improvement in public reporting would provide continuing sources of disclosure which could act as an acceptable substitute for the special but occasional disclosure at the time of a traditional public offering.

⁵ (1978) “In short, the basic theme is a shift in emphasis from the occasional, hit-or-miss, static registration statement under the 1933 Act to permanent company

A basic purpose of the new Act is to prevent the creation of public secondary markets in securities of those issuers for which there is not adequate current information available for the benefit of investors. This approach means basically that securities issued by an issuer without a prospectus or held by a controlling person should only reach the general investing public where the issuer of the securities is a "reporting issuer"⁶ in compliance with the timely and continuous public disclosure requirements of the new Act or where a prospectus is filed in respect of such securities.

The changes proposed by the new Act are not technical refinements of existing procedures; they are substantive changes in fundamental principles concerning the issue and sale of securities into the public secondary trading markets.

The new Act embraces the admonition of the *Wheat Report* that "the use of ostensible private purchasers as conduits for the sale of securities to the public without registration must be prevented".⁷ Not only can there be no disagreement with this statement, its principle must be endorsed. However, in view of the economic strains and restraints upon the important capital raising and formation functions of the Canadian securities markets, in the smaller and less developed Canadian economic environment, the ultimate conclusions flowing from this philosophic premise must not suppress other fundamental purposes of the capital markets and impose additional limitations upon small Canadian businesses by not permitting adequate access to needed venture and equity capital for development and expansion.⁸

registration followed by continual disclosure, on as current a basis as practical, more along the lines of the 1934 Act". Pp. xxvi-xxvii.

⁶ This term is defined in para. 1(1)38 of the new Act.

⁷ P. 199.

⁸ United States commentators as well as the SEC have been concerned whether some of the legislative rules flowing from the *Wheat Report* have unduly narrowed the access of small issuers to the United States capital equity markets. See William J. Carney, *Exemptions From Securities Registration for Small Issuers: Shifting From Full Disclosure—Part 1: The Private Offering Exemption, Rule 146 and an End to Access for Small Issuers* (1975), 10 *Land & Water L. Rev.* 507; William J. Casey, *SEC Rules 144 and 146 Revisited* (1977), 43 *Brooklyn L. Rev.* 571; and R.B. Campbell, Jr., *The Plight of Small Issuers under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, [1977] *Duke L.J.* 1139. In 1978 the SEC held public hearings concerning the special problems of the access of small issuers to the capital markets (Securities Act Release No. 5914 (March 6th, 1978)) and proposed simplified registration and reporting requirements for certain small United States and Canadian non-reporting companies for first time public issues not exceeding \$3 million (Securities Act Release No. 5915 (March 6th, 1978)). Such simplified registration procedures by way of a new Form S-18 for initial offerings of up to \$5 million designed to facilitate small companies to raise cash were subsequently adopted by the SEC (Securities Act Release No. 6049 (April 3rd, 1979)).

This article reviews the circumstances requiring the filing of a prospectus under the new Act and summarizes the exemptions from such prospectus requirements, the conditions for the sale to the general investing public of securities initially issued without prospectus disclosure and the rights of controlling persons to trade their securities.

A. Exempted Classes of Securities.

Under the new Act, a prospectus is not required in respect of a "distribution" of securities of a "private company"⁹ where they are not offered for sale to the public. This review assumes that the issuers involved are not private companies.¹⁰ Closely-held corporations may organize themselves to come within the "private company" definition in the new Act in order to avoid the technical restraints of the "closed system" in raising capital from non-public sources.¹¹ Other issuers, including unincorporated business enterprises such as partnerships, trusts and syndicates, cannot so avail themselves.

This review also assumes that the securities issued are not otherwise within those classes of securities listed in subsection 34(2) of the new Act which are exempted from the prospectus requirements by clause 72(1)(a).

B. Commission Ruling.

Under section 73 of the new Act, the Ontario Securities Commission may rule that an intended trade, which would otherwise constitute a "distribution" or "distribution to the public" requiring

⁹ Clause 72(1)(a) and para. 34(2)10 of the new Act provide that the prospectus requirements of s.52 do not apply to "securities of a private company where they are not offered for sale to the public". The current exemption under the Ontario Securities Act is provided by clause 58(2)(a) and para. 19(2)9. "Private company" is defined in para. 1(1)31 of the new Act in basically the same way as it is currently defined in para. 1(1)14 of the Ontario Securities Act.

¹⁰ In *Elsley's Frosted Foods Ltd v. Mid White Oak Square Ltd.* (1976), 14 O.R. (2d) 479, Stark J., held that a provision in the articles of a corporation that "the directors may decline to register a transfer of shares belonging to a shareholder who is indebted to the Company" was a sufficient restriction on the transfer of shares to constitute the corporation a "private company" under the Ontario Securities Act.

¹¹ It is important to note, however, that, 18 months after the new Act comes into force, by virtue of subsection 71(5) of the new Act, the first trade in previously issued securities of a company that has ceased to be a private company will be a "distribution" requiring the filing of a prospectus, a prospectus exemption or a ruling of the Commission under section 73 of the new Act. By way of contrast, non-controlling security holders of a company that has ceased to be a private company may trade freely within the first 18 months following the new Act coming into force. See footnote 23, *infra*.

the filing of a prospectus, is not subject to the prospectus requirements "where it is satisfied that to do so would not be prejudicial to the public interest". No attempt is made to discuss applications for rulings or the exercise by the Commission of its jurisdiction under this section or the present section 59 of the Ontario Securities Act.¹²

I. The Concept of a "Distribution" of Securities.

A. Extension of the Prospectus Requirements.

Under the new Act, it is a "distribution" of securities which will require the special efforts, time and expense of preparing, filing and clearing a prospectus with the Commission. Clause 52(1)(b) of the new Act prohibits, eighteen months after the new Act comes into force, a person or company from trading in a security "where such trade would be a distribution of such security" unless a preliminary prospectus and a prospectus have been filed with and accepted by the Commission. The term "distribution" is defined in paragraph 1(1)11 of the new Act.

The new Act provides, however, for an eighteen month transitional period following its proclamation before this new concept of a "distribution" becomes effective. During this interim, clause 52(1)(a) of the new Act prohibits a person or company from trading in a security "where such trade would be a distribution to the public of such security". The phrase "distribution to the public" is defined in paragraph 1(1)14 of the new Act as follows:

"distribution to the public", where used in relation to trading in securities, means a distribution that is made for the purpose of distributing to the public securities issued by an issuer, whether such trades are made directly to the public through an underwriter or otherwise; . . .¹³

The definition of "distribution to the public" incorporates within it the definition of "distribution" and is somewhat narrower than the concept of "distribution". During the first eighteen months after the new Act comes into force, clause 52(1)(a) of the new Act will require the filing of a prospectus where the trade is otherwise a "distribu-

¹² See Johnston, pp. 236-239. It would be difficult to discuss the exercise of that discretion in view of changing policy considerations and individual facts. For example, compare *Shelter Corporation of Canada Limited* (1977), O.S.C. Bulletin 6; 1 B.L.R. 25, with *Huron Heights Apartment Project* and *Mastercraft—Equus 3*, O.S.C. Weekly Summary (24th Nov. 1978); *DEB Canadian Resources* 1978, O.S.C. Weekly Summary (5th Jan. 1979); *Freehold Gas v. Oil Ltd.*, O.S.C. Weekly Summary (26th Jan. 1979); *Tormor Exploration Partnership* (1979), O.S.C. Weekly Summary (16th Feb. 1979); and *National Petroleum Corporation Ltd.*, O.S.C. Weekly Summary (16th March 1979).

¹³ Italics added.

tion'' (within paragraph 1(1)11) but only where the distribution is made for the purpose of distributing the securities ''to the public''; if the distribution is not made ''to the public'' during the first eighteen months after the new Act comes into force, a prospectus is not required. In general, this continues the basic structure of the Ontario Securities Act for this eighteen month period. After the eighteen month period, the qualifying requirement that the trade be made ''to the public'' will cease to apply and the definition of ''distribution'' will become effective with its full objective certainty.

To understand the ultimate consequences of the definition of ''distribution'' and to place the problems during the eighteen month transitional period in context while the above definition of ''distribution to the public'' is effective, it may be useful to refer to the present definition of ''distribution to the public'' in the Ontario Securities Act.¹⁴ A fundamental concept in Ontario securities law since the introduction of the first modern Canadian Securities Act in 1945 is that a prospectus is only required to be filed where securities are traded or distributed ''to the public''. This applies not only to the issue and sale of treasury shares by an issuer but also to the sale of issued securities by a controlling person. In such cases where securities are not sold ''to the public'', a prospectus is not currently required and an exemption from the prospectus requirements is not needed. This philosophy will continue to apply for the first eighteen months after the new Act comes into force.

By its very nature and particularly in the context of securities law, the concept of a sale of securities ''to the public'' is not precise and whether there have been trades ''to the public'' is a finding of fact depending on all the surrounding circumstances.¹⁵ The problems

¹⁴ The phrase ''distribution to the public'' is defined in para. 1(1)6a of the Ontario Securities Act. In substance, a trade in securities is only within this definition where it is made for the purpose of trading such securities ''to the public''.

¹⁵ References in Canadian texts and cases have often been made to the ''need to know'' test expressed in *SEC v. Ralston Purina Co.* (1953), 346 U.S. 119. In *Nash v. Lynde*, [1929] A.C. 158, Viscount Sumner noted, at p. 169: ''The public' . . . is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve: perhaps even one, if he is intended to be the first of a series of subscribers, but makes further proceedings needless by himself subscribing the whole. The point is that the offer is such as to be open to any one who brings his money and applies in due form, whether the prospectus was addressed to him on behalf of the Company or not. A private communication is not thus open. . . .'' See also, *R. v. Empire Dock Limited* (1940), 55 B.C.R. 34; *R. v. Chisholm*, [1954] O.W.N. 311; *R. v. Piepgrass Ltd* (1959), 23 D.L.R. (2d) 220; *R. v. Golden Shamrock Mines Ltd*, [1965] 1 O.R. 692; *R. v. McKillop*, [1972] 1 O.R. 164 (Prov. Ct); *In Re Forsythe* (1972), O.S.C. Bulletin 167; *R. v. Cottrelle* (1972), CCH Canadian Securities Law Reporter, para. 70-024; *In the Matter of Chandor Mines Ltd* (1972), CCH Canadian Securities Law Reporter, para. 70-066; *R. v. Kiefer*, [1976] 6 W.W.R. 541 (B.C.); *Sherwell v. Combined Incandescent Mantles Syndicate*

and issues involved in the analysis of trades "to the public" have been recently reviewed by David L. Johnston in his excellent book, *Canadian Securities Regulation*,¹⁶ and need not be discussed here. The issue of attempting to provide a clear meaning to the phrase "to the public" was also reviewed by the *Merger Report*. That *Report* concluded that, in light of the regulatory scheme provided by securities legislation, every member of the community should be included in the concept of the "public" and that the legislation was designed to protect "each and every one of us". The *Merger Report* therefore recommended that the reference "to the public" be removed from the Ontario Securities Act in connection with the prospectus requirements, correctly concluding that the result "would be that unless the trade [by the issuer or a controlling person] falls clearly within one of the exemptions a prospectus . . . is mandatory".¹⁷ As succinctly stated by the *Merger Report*, "this plan has the merit of both simplicity and certainty".¹⁸

B. General Definition of "Distribution": First Stage.

The new Act has implemented such recommendation of the *Merger Report* with the definition of "distribution" in paragraph 1(1)11.

(*Limited*) (1907), 23 T. L. R. 482 (Ch.D.) and *Lee v. Evans* (1964), 112 C.L.R. 276 (H.C. of Aust.).

In discussing the principal factors in distinguishing between public and private securities transactions in Canada, a former Chairman of the Commission, Arthur S. Pattillo, mentioned, among other things, the manner of offering the securities, the nature of the offeree and the number of offerees. See, *Application of Canadian Laws to Securities Transactions by United States Corporations in Canada* (1976), 31 Bus. L. 808. With respect to the nature of the offeree, Mr. Pattillo stated, at p. 811: "... any sale to a person who does not have the knowledge and experience in financial and business matters so as to be capable of evaluating the merits and risks of the prospective investment is a public transaction. Economic bargaining power and access to information through one's position in relation to the issuer are not decisive factors. Representation by an individual experienced in financial and business matters is not a decisive indication that a sale to the principal of the representative is a private transaction. Access to information necessary to verify the accuracy of information obtained by the offeree or a representative is not a decisive indication that a subsequent sale to the offeree is a private transaction."

In summarizing the issue, the Commission stated in *Shelter Corporation of Canada*, *supra*, footnote 12, at p. 30 (B.L.R.): "Several tests of the public have emerged through the case law. They are the 'need to know' test by which the offeree is deemed not to be a member of the public if he does not have the need for the type of knowledge about the issuer and the security ordinarily available from the prospectus. The second test is the test of common bonds of business association or friendship between the issuer and the purchasers and among the purchasing group."

¹⁶ Pp. 148-155.

¹⁷ Ch. III, "Who are the 'Public'?", para. 3.15.

¹⁸ Para. 3.20(a).

Subparagraphs i and ii of the definition of "distribution" and subsection 52(1) of the new Act, coupled with the definition of "distribution to the public" in paragraph 1(1)14, mean that (A) every sale by an issuer of its own securities "to the public" within eighteen months after the new Act comes into force and (B) every sale by an issuer of its own securities under any circumstances thereafter requires the filing of a prospectus unless a statutory exemption is available or a ruling is obtained from the Commission under section 73.

Similarly, subparagraph iii of the definition of "distribution" and subsection 52(1), coupled with the definition of "distribution to the public", mean that (A) every sale "to the public" within eighteen months after the new Act comes into force of issued securities from the holdings of any person or company, or combination of persons or companies, holding sufficient securities to affect materially the control of that issuer¹⁹ and (B) every sale of issued securities by a controlling person thereafter in all cases requires a prospectus unless a statutory exemption is available or a Commission ruling is obtained. Except for the significant removal eighteen months after the new Act comes into force of the requirement that a trade by a controlling person must be made "to the public" before the prospectus requirements arise, this result is similar to the current law, as set out in subparagraph ii of paragraph 1(1)6a of the Ontario Securities Act.

As both the definition of "distribution" and "distribution to the public" only cover the sale of unissued securities, except with respect to sales by controlling persons and underwriters, a non-controlling shareholder who acquired securities of a public company in a private non-public transaction under the Ontario Securities Act will be entitled freely to sell such securities once the new Act comes into force. Such a shareholder is currently restricted from selling such securities to the public under subparagraph i of paragraph 1(1)6a of the Ontario Securities Act.

The consequences of the new definition of "distribution" are important and clear. Subsequent to the transitional eighteen month period when the concept of "distribution to the public" is finally removed, the subsection 52(1) prohibition from selling securities without a prospectus will become all embracing—*every* sale by an issuer of its own securities and *every* sale by a controlling person will require a prospectus under the new Act, unless a specific statutory exemption is available or a section 73 ruling is obtained from the Commission.

¹⁹ Hereinafter referred to as a "controlling person".

Two new prospectus exemptions were added in the new Act evidently to compensate for the narrowing effect resulting from the removal of the phrase "to the public" and the useful non-public offering exemption which that phrase provided: firstly, the isolated trade exemption in clause 71(1)(b) and, secondly, the so-called "seed capital" exemption in clause 71(1)(p). While another new exemption for incorporators in clause 71(1)(o) might also fall within this category, its introduction is offset by the fact that the current exemption for trades to promoters in paragraph 19(1)9c of the Ontario Securities Act is not carried forward into the new Act. The regulations under the new Act may partially correct this omission.

C. Expanded Definition of "Distribution": Second Stage.

The second major change relating to the prospectus requirements of the new Act flows from the new and substantive limitations imposed on the rights of all security holders who are not controlling persons to trade issued securities which have been purchased or acquired by them under the statutory prospectus exemptions contained in subsection 71(1) of the new Act, other than clauses (g), (h) and (s). This second major change also becomes effective eighteen months after the new Act comes into force.

For some time securities administrators both in the United States and Canada have been concerned that the exemptions from the prospectus requirements might be used as conduits for the ultimate resale of securities into the hands of the general investing public without adequate disclosure in the secondary trading markets concerning the issuer and the securities so distributed.²⁰ As a matter of principle, purchasers and sellers of issued securities in the secondary trading markets should have available timely public disclosure of all material facts concerning the affairs of the issuers of such securities on which to base their investment decisions.

In effect, the new Act responds to this concern simply by treating secondary distributions or resales as if they were primary distributions without regard to the concept of control. By severely restricting the rights of security holders to resell securities of non-reporting issuers and by qualifying the rights of security holders to resell securities of reporting issuers acquired under the new prospectus exemptions set out in subsection 71(1),²¹ the new Act will effectively prevent securities from finding their way into the hands of the general investing public where the issuers of such securities are not subject to nor in compliance

²⁰ Wheat Report, pp. 174-175; Merger Report, para. 5.04.

²¹ See subsections 71(4), 71(5), 71(6) and 71(7) of the new Act. Resales of securities by non-controlling persons acquired under clauses 71(1)(g), (h) and (s) are not restricted under these subsections.

with the new timely and continuous public disclosure requirements contained in the new Act for reporting issuers.

Subsections 71(4), 71(5), 71(6) and 71(7) are included in the new Act to prevent the resale to the general investing public of issued securities in respect of which there is not available a base of public information substantially akin to that provided by a prospectus. These provisions replace the legally imprecise and somewhat subjective current concepts of "to the public" and "investment intent" with statutory objective criteria. Under subsection 143(2) of the new Act, subsections 71(4), 71(5), 71(6) and 71(7) come into force eighteen months after the new Act becomes effective, and for the purposes of the prospectus prohibition in clause 52(1)(b), the definition of "distribution" includes in its final provision a distribution as referred to in those subsections.

Subsections 71(4) and 71(5) provide that the first trade of securities acquired pursuant to the exemptive clauses of subsection 71(1) referred to therein is a "distribution" requiring a prospectus, unless the further trade is exempted by subsection 71(1) or such sale is made in accordance with the conditions contained in such subsections. For example, eighteen months after the new Act comes into force, a private placement purchaser who acquires treasury shares from a non-reporting issuer under clause 71(1)(d) cannot resell such securities without a prospectus or a section 73 ruling unless he sells to another purchaser under an exemptive clause in subsection 71(1).²² Where a second private placement purchaser then acquires the securities under clause 71(1)(d) from the first purchaser, the second purchaser would again be subject to the resale restrictions of subsection 71(4) in respect of such securities and so on from time to time, until the circle or the "closed system" was broken by the filing of a prospectus, the use of subsection 71(4) after the issuer became a reporting issuer or a section 73 ruling was obtained.

Subsection 71(5) also extends the definition of a "distribution" to the first trade in any of the previously issued securities of a company that has ceased to be a private company. Under clause 72(1)(a) and paragraph 34(2)10, the issue of securities of a private company is exempt from the prospectus requirements if they are not issued "to the public". This provision in subsection 71(5) was considered necessary to prevent attempts to circumvent section 52 of the new Act by issuing securities of a private company and subsequently deleting the private company charter provisions to permit the security holders to resell freely without restriction. Where, however, a company ceases to be a private company, *all* holders of *all* securities and not just controlling persons

²² Subsection 71(4).

are subject to the resale restrictions of subsection 71(5) when they become effective.²³

During the transitional eighteen month period following the new Act becoming effective, an issuer may trade its treasury securities to a purchaser pursuant to any subsection 71(1) prospectus exemption, other than clause b thereof which is not then in force. As subsections 71(4), 71(5), 71(6) and 71(7) are also not then in effect,²⁴ a resale to the public within such eighteen month period of securities acquired under a subsection 71(1) exemption would not constitute a "distribution" and would therefore not constitute a "distribution to the public" unless the initial purchaser was also a controlling person or acting as an underwriter. With respect to those exemptions covered by resale restrictions under subsection 71(5), for example, a non-controlling shareholder who acquires securities through a stock dividend under subclause 71(1)(f)(i), an amalgamation under subclause 71(1)(i)(i) or a securities exchange take-over bid under clause 71(1)(j) after the new Act comes into force may, during the first eighteen months after the new Act comes into force, resell such securities without restriction because subsection 71(5) is not then effective. Such resale rights are consistent with those in similar circumstances under the Ontario Securities Act. However, any resale of the same securities, whether or not to the public, by the same non-controlling shareholder more than eighteen months after the new Act comes into force will constitute a "distribution" under subsection 71(5) and will require, not only compliance with clauses 71(5)(b) and (c), but will also be subject to the primary condition that the issuer be a reporting issuer for a least twelve months in accordance with clause 71(5)(a). The same substantial narrowing of resale rights resulting from the full implementation of the second stage of the "closed system" eighteen months after the new Act comes into force also applies to securities acquired under the other exemptions of subsection 71(1) referred to in subsection 71(5) and to securities acquired by incorporators under clause 71(1)(o) by virtue of subsection 71(6).

The following rather anomalous result could arise, for example, as a result of the postponement of the effectiveness of subsection 71(5): a substantial non-reporting company could make a share exchange take-over bid for the shares of a reporting issuer fifteen months after the

²³ Somewhat inconsistent results arise in that non-controlling shareholders of a company that was formerly private and that issues its securities to the public by a prospectus have full resale rights for the first 18 months after the new Act comes into force but thereafter are restricted by subsection 71(5). Such non-controlling shareholders will not be limited by subsection 71(5), however, if the prospectus is filed before a date that is six months after the new Act comes into force. On the other hand, non-controlling purchasers under the prospectus will have full resale rights before and after such 18 month period.

²⁴ Subsection 143(1).

new Act comes into force and file a securities exchange take-over bid circular under the new Act containing full prospectus disclosure concerning the offered securities and its affairs. The offeror would then become a reporting issuer upon such filing. Shareholders of the offeree company who accepted the offer and were not controlling persons of the offeror could immediately resell the offeror's securities taken in exchange for a period of three months; thereafter, notwithstanding that there had been full prospectus disclosure, the new shareholders of the offeror could not sell for a period of nine months until the issuer had been a reporting issuer for twelve months and satisfied the condition in clause 71(5)(a). If this offeror makes such an offer after subsection 71(5) becomes effective, the accepting shareholders must hold for a twelve month period, notwithstanding the prospectus disclosure. This is similar to requiring a purchaser of securities under a prospectus by an issuer that is going public for the first time to hold the securities so acquired until twelve months after the prospectus was filed.²⁵

*D. Eighteen Month Transitional Period,
"Investment Intent" and "Change of Circumstances".*

During the eighteen month transitional period the prospectus exemptions in clauses a, c, d, l and p of subsection 71(1) are not, however, available on an unqualified basis. By virtue of subsection 143(2) of the new Act such exemptions "are available only where each purchaser takes the securities for investment only and not with a view to resale, distribution or distribution to the public". This investment intent requirement to the availability of the prospectus exemptions in these clauses is necessary to prevent an unrestricted right of resale for securities acquired pursuant thereto during this eighteen month period and is substantially the same requirement that is contained in the Ontario Securities Act for the equivalent exemptions.²⁶ However, subject to complying with such investment commitment and provided he is not a controlling person, a purchaser

²⁵ As indicated in the Commission's Weekly Summary for the week ending 17th Nov. 1978, the Commission issued for comment draft regulations (hereinafter cited as "Draft Regulations") under the new Act. In order to rectify the anomaly referred to above, the Draft Regulations propose a prospectus exemption for the first trade by a non-controlling shareholder in securities acquired under clause 71(1)(j) where a securities exchange take-over bid circular was filed in respect of the securities so acquired.

²⁶ The prospectus exemptions under clauses a, c, d and l of subsection 71(1) are equivalent to the exemptions in para. 19(1)3, subsection 19(3) and para. 19(1)9b of the Ontario Securities Act, respectively. There is no current equivalent statutory prospectus exemption for clause 71(1)(p) of the new Act in the Ontario Securities Act. The current prospectus exemptions of paras 19(1)3 and 19(1)9b and subsection 19(3) are each conditional upon the purchaser taking the securities "for investment only and not with a view to resale or distribution": see such provisions and clause 58(1)(a) of the Ontario Securities Act.

acquiring securities under such clauses of subsection 71(1) within the first eighteen months following the proclamation of the new Act may resell such securities within that eighteen month period without making either a "distribution" or a "distribution to the public" requiring a prospectus, another exemption or a section 73 ruling.

Such a purchaser has a substantial burden to prove, if he resells within that eighteen month period, that he originally purchased "for investment only and not with a view to resale or distribution". In the *Matter of Warren Explorations Limited*,²⁷ the Commission had the opportunity of expressing some views concerning the meaning of "investment intent" and in so doing acknowledged the United States experience in this area. In particular, the Commission demolished the notion that a six month holding period was satisfactory, emphasized the requirement that there be *bona fide* investment intent at the date of purchase and noted that:

The United States jurisprudence suggests that much longer periods of time must elapse, ranging from two to five years, coupled with a change of circumstance in the investment intent in order to rebut the inference that the declared investment intent at the time of purchase was not *bona fide*.

In its reasons the Commission also clearly adopted the United States principle of "change of circumstances" and stated:²⁸

The buyer's declaration that he is purchasing for investment is a statement of present fact. It cannot be said to impose an indefinite restraint on the private placee. The fact the buyer does not resell is evidence that he purchased for investment. The fact the buyer does sell is not conclusive proof that he had no investment intent at the time of the purchase. But the U.S. law is clear that the shorter the period before resale the stronger the inference that there was an intention to resell from the beginning unless the original purchaser can show some plausible reason why he has changed his mind.

The change of circumstance doctrine was relied on in 1978 in a resale of privately placed securities by The Bank of Nova Scotia.²⁹

²⁷ (1976), O.S.C. Bulletin 111, at p. 114.

²⁸ *Ibid.*, at p. 116. Prior to promulgation of Rule 144 (Securities Act Release No. 5223 (Jan. 11th, 1972)) and Rule 146 (Securities Act Release No. 5487 (April 23rd, 1974)), the problems of determining investment intent focused in the United States on whether a sale of securities was exempt from registration under subsection 4(2) of the Securities Act of 1933 as a transaction "not involving any public offering". See, Gary L. Wood, *The Investment—Intent Dilemma in Secondary Transactions* (1964), 39 N.Y.U.L. Rev. 1043.

²⁹ The "change of circumstances" doctrine was evidenced in Canada in connection with a private placement on May 2nd, 1977 of Series "A" floating rate preferred shares of Inco Limited to The Bank of Nova Scotia. On Jan. 23rd, 1978, The Bank of Nova Scotia filed a Form 12 under s. 11(2) of the regulations to the Ontario Securities Act disclosing that on Jan. 16th, 1978, eight months after the original purchase, it resold 80,000 of such Series "A" preferred shares to Wood Gundy Limited, the agent of the issuer. The reasons for resale stated in the Form 12 were: "To take advantage of opportunity which was not available at the time of issue of the Series A preferred shares of switching from a floating

The Commission considers that there is a duty upon the issuer to investigate the *bona fides* of the purchaser's declared investment intent at the time of the purchase.³⁰

Where a purchaser acquires his securities under clause 71(1)(a), (c), (d), (1) or (p) within the first eighteen months after the new Act comes into force with the required investment intent and holds such securities until subsection 71(4) becomes effective, the purchaser would then be entitled to comply with clauses 71(4)(b) and (c) in reselling such securities provided the issuer is a reporting issuer and he is not a controlling person. However, such a purchaser may still be subject to his original investment intent given at the time of purchase, notwithstanding that he may have held for the applicable statutory period set out in clause 71(4)(b).³¹ The original investment intent required by subsection 143(2) of the new Act includes a denial of a purchase with a view to distribution, which would include a sale under subsection 71(4).³²

During the eighteen month transitional period, it also appears that the definition of "distribution to the public" does not cover the resale of issued securities by non-controlling persons who acquire their securities after the new Act becomes effective in a non-public transaction and without the use of a subsection 71(1) exemption. While the ambit of such trades is rather narrow, such purchasers of securities in non-public transactions during the first eighteen months of the new Act without using a subsection 71(1) exemption are also not restricted on resale after such eighteen month period because they would not fall within subsections 71(4), 71(5) or 71(6).

II. The Reporting Issuer.

The status of a "reporting issuer" under the new Act is fundamental to the resale of securities without the use of a prospectus where such trade falls within the expanded definition of a "distribution" after

rate instrument into the fixed rate Series B shares of the same issue in order to obtain a more attractive rate of return."

³⁰ *Warren Explorations Limited*, *supra*, footnote 27; *Chemalloy Minerals Limited* (1974), O.S.C. Bulletin 60. In *Chemalloy Minerals Limited* the Commission stated, at p. 63: "We do not believe that the vendor has shown the degree of responsibility in determining who its real purchaser is and satisfying itself as to the *bona fides* of the purchaser's certificate of investment intent."

³¹ Ontario Securities Commission Policy No. 3-33 currently states that it is the Commission's policy to make enquiries when the private placee sells two years or less from the date of the original purchase.

³² It may be appropriate to consider regulations under the new Act to permit resales under subsection 71(4) if its conditions (including the requisite holding period) have been complied with notwithstanding an investment intent given in connection with the original trade as required under subsection 143(2).

subsections 71(4), 71(5) and 71(7) come into force. Eighteen months after the new Act becomes effective, only securities of a reporting issuer acquired under a subsection 71(1) exemption may be resold without a prospectus, another exemption or a section 73 ruling, subject to the conditions in subsections 71(4), 71(5) or 71(7) of the new Act.

Reporting issuers are subject to the timely and continuous public reporting requirements of the new Act. Accordingly, on the theory that the secondary market place has not received adequate investor information about the affairs of non-reporting issuers, eighteen months after the new Act becomes effective only the securities of reporting issuers that are issued without a prospectus may ultimately be freely traded in the hands of the general investing public.

The new Act clearly intends to promote issuers to become reporting issuers if they wish to raise capital from outside sources. Many investors may be reluctant to acquire debt or equity securities of a non-reporting issuer³³ where their rights to transfer or assign such securities are severely restricted to the voluntary use of only three of the exemptions in subsection 71(1) or to obtaining a section 73 ruling from the Commission.

A. Definition of Reporting Issuer.

Paragraph 1(1)38 of the new Act defines those issuers³⁴ which are "reporting issuers". This is an exhaustive definition and all issuers that do not fall within the legislative criteria set out in the five subparagraphs are not reporting issuers.

Subparagraph i of the definition includes issuers of "voting securities"³⁵ issued after May 1st, 1967³⁶ through a prospectus or a

³³ S. 63 of the new Act theoretically allows a security holder to obtain from the issuer the necessary information to file a prospectus but in practice a purchaser would not rely on this provision. A purchaser under a subsection 71(1) prospectus exemption may wish to protect himself by obtaining a covenant from the issuer in his purchase agreement that the issuer would become a "reporting issuer" under the new Act or that the issuer would qualify his securities for sale under a prospectus either directly or under a "piggyback" arrangement.

³⁴ "Issuer" is defined in para. 1(1)18. "Company" and "person" are defined in paras 1(1)4 and 1(1)28, respectively.

³⁵ "Voting security" is defined in para. 1(1)44. Only issuers of "equity securities" under a prospectus are subject to the reporting requirements of the Ontario Securities Act: clauses 101(a), 109(1)(b) and 118(1)(b). For the constitutional reasons referred to in footnote 36 below, subpara. i of para. 1(1)38 refers only to "voting security". Issuers which filed a prospectus in respect of debt securities after May 1st, 1967 and prior to the new Act are not reporting issuers under this subpara.

The Report of The Attorney General's Committee on Securities Legislation in Ontario (March, 1965), hereinafter cited as the Kimber Report, referred to the

securities exchange take-over bid circular³⁷ filed under a predecessor of the new Act.

Subparagraph ii of the reporting issuer definition includes any issuer that has filed a prospectus or a securities exchange take-over bid circular under the new Act, irrespective of the type of security offered and, technically, whether or not a security was issued. It appears that once an issuer has filed a prospectus and obtained a receipt or has filed a securities exchange take-over bid circular under the new Act, it is a reporting issuer even if the prospectus offering is not closed or the take-over bid abandoned and no securities are issued. Subsection 52(2) of the new Act does, however, permit an issuer, which does not otherwise fall within the definition of a reporting issuer, to file a prospectus in order to achieve that status without being required to issue securities under that prospectus.

Subparagraph iii of the definition includes issuers any of whose securities have been listed and posted for trading on a recognized stock exchange in Ontario³⁸ at any time after the new Act comes into force³⁹, regardless of when such listing and posting for trading commenced. Accordingly, all issuers that have securities listed and posted for trading on The Toronto Stock Exchange on the day the new Act becomes effective will be reporting issuers under the new Act.

Subparagraph iv of the definition includes issuers subject to The

disclosure needs of the long-term creditor (para. 4.03) and the Merger Report (para. 2.36) recommended that the distinction between debt and equity securities be eliminated with respect to disclosure requirements. This is adopted in the new Act by subpara. ii of the definition of reporting issuer.

³⁶ The date The Securities Act, 1966, S.O., 1966, c. 142, a predecessor of the present Ontario Securities Act, came into effect. The Kimber Report raised certain constitutional issues concerning the jurisdiction of the Province of Ontario to regulate the internal operations (such as reporting requirements) of non-Ontario unlisted corporations that sought access to the Ontario capital markets prior to Ontario law first requiring such disclosure as a condition of access: para. 9.05.

³⁷ Securities exchange take-over bid circular is not a defined term in the new Act. A "take-over bid" is defined in clause 88(1)(k) and presumably a securities exchange take-over bid circular is the kind referred to in subsection 94(3) of the new Act. See subsection 86(3) of the Ontario Securities Act.

³⁸ For the purposes of the new Act, this will be limited to The Toronto Stock Exchange.

³⁹ The wording in subclauses 101(a)(ii) and 118(b)(ii) of the Ontario Securities Act is "any of whose shares are listed and posted for trading on any stock exchange in Ontario recognized by the Commission." Under subpara. 1(1)38iii, an issuer whose securities are listed after the new Act comes into force but which are subsequently delisted will continue to be a reporting issuer. If, for instance, the delisting is a result of a successful take-over bid or "going private" transaction, the reporting issuer may be able to obtain an order deeming it to have ceased to be a reporting issuer. See *Ripley's International Ltd.*, O.S.C. Weekly Summary (14th April 1978).

Business Corporations Act (Ontario)⁴⁰ and which are offering their securities to the public, as defined in subsection 1(9) of that Act. This expands the definition broadly and in effect includes by reference all Ontario corporations which have at any time filed a prospectus, a statement of material facts or a securities exchange take-over bid circular under applicable Ontario legislation in respect of any securities (not just voting securities) if such securities, or securities into which such securities are converted, are still outstanding.

Subparagraph v of the definition of a reporting issuer includes companies continuing from a statutory amalgamation or arrangement or form of merger provided one of the amalgamating or merged companies or the continuing company has been a reporting issuer for at least twelve months.⁴¹

Subsection 71(11) of the new Act provides that for the purposes of section 71 an issuer is deemed to have been a reporting issuer from the date that it first met the appropriate condition in paragraph 1(1)38, provided it is currently in compliance with the new Act. Subsection 71(11) has the important effect of enabling issuers to qualify as reporting issuers upon the new Act coming into force for the purposes of the prospectus exemptions in clauses 71(1)(g) and (h) and of commencing the requisite time periods in clauses 71(4)(b), 71(5)(a) and 71(7)(b) for secondary distributions of securities when those subsections come into force.

B. Issuers that Are not Reporting Issuers.

Many issuers whose securities are traded by the general investing public in Ontario will, however, not be reporting issuers under the new Act. For instance, non-Ontario corporations whose securities are not listed and posted for trading on The Toronto Stock Exchange that issued debt or voting securities to the public, whether by way of a prospectus or otherwise, prior to May 1st, 1967, that issued debt securities to the public, whether by way of a prospectus or otherwise, after May 1st, 1967 and before the new Act comes into force or that issued debt or voting securities to the public after May 1st, 1967 under an exemption to the prospectus requirements (for instance through a reorganization or by a rights offering but not by a take-over bid) will not be reporting

⁴⁰ R.S.O., 1970, c. 53, as am.

⁴¹ The final proviso in subpara. v is somewhat confusing where none of the amalgamating or merging companies has been a reporting issuer and the continuing amalgamated or merged company files a prospectus under the new Act and apparently qualifies as a reporting issuer under subpara. 1(1)38ii. Is the continuing amalgamated or merged company not a reporting issuer until 12 months after the issuance of the receipt for that prospectus?

issuers under the new Act. Similarly, Ontario corporations whose securities are not listed and posted for trading on The Toronto Stock Exchange that issued debt or voting securities to the public, other than by way of prospectus or securities exchange take-over bid circular, will not be reporting issuers.

Many substantial non-Ontario corporations whose shares are listed on a stock exchange outside Ontario will not be reporting issuers under the new Act, even though their securities are actively traded by Ontario investors. Many companies listed, for instance, on other Canadian stock exchanges or on the New York or American Stock Exchanges in which there is active investment interest in Ontario may not be reporting issuers under the new Act. Ontario holders of securities of any such non-reporting issuer who acquire securities of such an issuer after the new Act comes into force under certain of the prospectus exemptions in subsection 71(1)⁴² will therefore be subject to substantial restrictions on their right to resell such securities eighteen months after the new Act comes into force unless the issuer files a prospectus under subsections 52(1) or (2) of the new Act, files a securities exchange take-over bid under the new Act or lists and posts its securities for trading on The Toronto Stock Exchange and thereby becomes a reporting issuer. For example, an Ontario shareholder of a Delaware company, which is listed only on the New York Stock Exchange and which has never filed a prospectus or securities exchange take-over bid circular in Ontario, who receives new securities on a reorganization or merger after the new Act comes into force will be able to resell his shares of such a company freely only for the first eighteen months after the new Act comes into force and thereafter will be restricted by the provisions of subsection 71(5). Such result will flow notwithstanding that such an issuer is subject to the continuous disclosure requirements of the New York Stock Exchange and the Securities Exchange Act of 1934.

C. Non-Offering Prospectus Filing.

Subsection 52(2) of the new Act permits an issuer, whose securities may or may not be closely held but which is not a reporting issuer within the definition, to file a prospectus in order to come under subparagraph ii of paragraph 1(1)38, notwithstanding that an issue of securities is neither contemplated nor made. While the public reporting and disclosure obligations of a reporting issuer under the new Act are significant, this status may become virtually mandatory for an issuer that wishes to raise capital from outside investors. In terms of

⁴² For example, as a result of stock dividend under subclause 71(1)(f)(i), a *bona fide* reorganization or winding up under subclause 71(1)(f)(ii), the exercise of a right to purchase, convert or exchange under subclause 71(1)(f)(iii), a statutory amalgamation under subclause 71(1)(i)(i), a merger under subclause 71(1)(i)(ii), an exempted take-over bid under clause 71(1)(k) or as an employee under clause 71(1)(n).

prospectus exemptions and rights of resale, the new Act differentiates only between reporting issuers and all other issuers. An investor may have no real liquidity if he acquires securities of a non-reporting issuer. Non-controlling investors may require non-reporting issuers to qualify as a reporting issuer as a condition of investment in order that the resale rights under subsections 71(4), 71(5) and 71(7) are available.

D. "Blue Sky" Aspects of Becoming a Reporting Issuer.

Unlike the United States Securities Act of 1933,⁴³ securities legislation in Canada, as a matter of principle, has combined "blue sky" aspects with mechanisms for disclosure to investors. Under the Ontario Securities Act, while the filing of a prospectus is a statutory right, the acceptance of that prospectus is a matter of discretion.⁴⁴ The new Act proposes to add several additional statutory provisions to this "blue sky" aspect and thereby to confirm that not all issuers, as a matter of right, may become reporting issuers, notwithstanding that the issuer's prospectus may provide "full, true and plain disclosure of all material facts".⁴⁵

Refusal to issue a receipt for a prospectus, as presently, cannot be made without giving the issuer an opportunity to be heard. A new and useful provision has been added as subsection 60(4) of the new Act whereby the Director may refer a "material question involving the public interest" under subsection 60(1) or a "new or novel question of interpretation" under subsection 60(2) to the Commission for determination. The issuer has the right to appeal an adverse decision of the Commission to the Supreme Court.⁴⁶

⁴³ USCA, Title 15, §77a—§77aa (1970 & Supp. V, 1975).

⁴⁴ Ontario Securities Act, s. 61. In *Voyager Explorations Ltd v. Ontario Securities Commission*, [1970] 1 O.R. 237, the court stated, at p. 244: "It seems to me that the Commission exercises the function of an administrative body and not a judicial body when it accepts a prospectus and issues a receipt therefor." See, *Shoppers Investments Ltd.* (1972), O.S.C. Bulletin 215; *Galaxy Gold Mines Ltd.* (1975), O.S.C. Bulletin 97; *New Niawatha Gold Mines Ltd.* (1976), O.S.C. Bulletin 82; J. Cowan, *The Discretion of the Director of the Ontario Securities Commission* (1975), 13 O.H.L.J. 735; and *Re Mosport Film Productions Ltd.* (1978), 5 B.L.R. 120.

⁴⁵ Subsection 60(1) of the new Act provides that the Director of the Commission "shall issue a receipt for a prospectus . . . unless it appears to him that it is not in the public interest to do so". This provision may not change the Director's present discretion to accept a prospectus for filing in any substantive way. However, three new statutory factors have been added whereby the Director loses his discretion and is directed by the statute not to issue a receipt. See clauses 60(2)(d), (3) and (i).

⁴⁶ S. 9. The courts are hesitant to interfere with an exercise of discretion by the Commission. In *Re Western Ontario Credit Corp. Ltd and Ontario Securities Commission* (1975), 9 O.R. (2d) 93, Hughes J., stated, at p. 103: ". . . where a regulatory tribunal, acting within its jurisdiction, makes an order in the public interest with the experience and understanding of what that interest consists of in a specialized field accumulated over many years, the Court will be especially loath to interfere."

E. Reporting Requirements of a Reporting Issuer.

A reporting issuer is immediately subject to the timely and continuous public reporting requirements set out in Parts XVII and XVIII of the new Act which will be amplified in the regulations. It is on the basis of these requirements and the flow of material information into the hands of the investing public through the "filtration process" of the investment community that the foundations are to be completed for the use of the more objective secondary resale prospectus exemptions set out in subsections 71(4), 71(5) and 71(7) of the new Act and for the ultimate distribution of securities into the secondary trading markets without specific prospectus-type disclosure in respect of such securities.⁴⁷ This basic theory has developed from the premise that, through public and current information concerning the affairs of reporting issuers, "there may be available in the public file at all times, in readily identifiable and accessible form, substantially the equivalent of a current prospectus of every continuous registrant".⁴⁸ As stated by the *Merger Report*:⁴⁹

The purpose of the whole is to provide an equality of opportunity for all investors in the market place, sellers as well as buyers. The object is to make available on a timely basis all material facts the investor requires to make an informed investment judgment.

Subsection 74(1) of the new Act is one of the new principal statutory requirements upon which the continuous disclosure system will be created. Subject to subsection 74(3), where a "material change"⁵⁰ occurs in the affairs of a reporting issuer, it is forthwith required to issue and file a press release authorized by a senior officer of

⁴⁷ Under s. 137, all material filed is available for public inspection, except material filed under subsection 74(3) or material in respect of which the Commission rules that it should not be made available for public inspection based on public security or intimate financial or personal matters. See Supplement "X" to the Commission's Weekly Summary (8th Dec. 1978) concerning the availability of material filed under s. 137.

⁴⁸ Milton H. Cohen, *op. cit.*, footnote 4, at p. 1406.

⁴⁹ Para. 2.01.

⁵⁰ "Material Change" is defined in para. 1(1)21 of the new Act as follows: " 'Material change' where used in relation to the affairs of an issuer means a change in the business, operations or capital of the issuer that *would reasonably be expected to have a significant effect on the market price or value* of any of the securities of the issuer and includes a decision to implement such a change made by the board of directors of the issuer, or by senior management of the issuer *who believe that confirmation of the decision by the board of directors is probable.* " (emphasis added.)

Currently, under Uniform Act Policy No. 2-12, disclosure of a material change should be made of a proposal or proposed change when a decision accepting or recommending acceptance of such proposal or proposed change has been made and in other cases of a material change when such change has occurred or when such change has been agreed upon by the relevant parties, notwithstanding that all the details may not have been documented. Under the terms of that Policy a material change is stated to include, in addition to specific items, "any other material change in the affairs of the company which

the reporting issuer disclosing the nature and substance of such change. The reporting issuer is also required to file a report of such change in accordance with the regulations as soon as practicable and in any event within ten days of the date on which the change occurs, subject to subsection 74(3).⁵¹ Clause 74(3)(a) alleviates the mandatory requirement to issue a press release and to file a press release and a report with the Commission where, in the opinion of the reporting issuer, the required disclosure would be "unduly detrimental to the interests of the reporting issuer". In addition, clause 74(3)(b) permits the reporting issuer not to issue and file such press release and report where the material change consists of a decision to implement a change made by senior management of the reporting issuer who believes that confirmation of the decision by the board of directors is probable, provided that senior management has no reason to believe that persons with knowledge of the material change have "made use of"⁵² such knowledge in purchasing or selling securities of the issuer. Where

could reasonably be expected to affect materially the value of the security". See also Ontario Securities Policy No. 3-23.

In *TSC Industries, Inc. v. Northway, Inc.* (1976), 426 U.S. 438, 96 S. Ct 2126, the United States Supreme Court held, without dissent, that omission of a fact from a proxy statement is material if there is "substantial likelihood that a reasonable shareholder would consider [the omitted fact] important in deciding how to vote. This standard is fully consistent with *Mills'* general description of materiality as a requirement that 'the defect have a significant propensity to affect the voting process'. It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder". In so holding, the United States Supreme Court rejected the conclusion of the United States Court of Appeals for the Seventh Circuit that material facts include "all facts which a reasonable shareholder *might* consider important" as too suggestive of mere possibility: *Northway Inc. v. TSC Industries, Inc.* (1975), 512 F.2d 324, at p. 330. See, J.O. Hewitt, *Developing Concepts of Materiality and Disclosure* (1977), 32 Bus. L. 887; R.K. Hagan and L. Herzel, *Materiality and the Use of SEC Forms* (1977), 32 Bus. L. 1177; and M.T. Lambert, *Utilization of Investment Analysis Principles in the Development of Disclosure Policy under the Federal Securities Laws* (1977), 25 U.C.L.A. L. Rev. 292.

The Proposed Official Draft Federal Securities Code of The American Law Institute defines "material" as follows: "A fact is 'material' if there is a substantial likelihood that a reasonable person would consider it important under the circumstances in determining his course of action."

⁵¹ Subsection 74(2). The material change report (Form 29) set out in the Draft Regulations requires the disclosure to include "a full and plain description of all significant facts relating to the material change" and a certificate of a senior officer to the effect that "the foregoing constitutes full, true and plain disclosure of the material change reported herein".

⁵² See *Green v. Charterhouse Group Canada Ltd.*, [1973] 2 O.R. 677 (H.C.); (1976), 12 O.R. (2d) 280 (C.A.); *Harold P. Connor* (1976), O.S.C. Bulletin 149; F.H. Buckley, *How to Do Things with Inside Information* (1977), 2 Can. Bus. L. J. 343; and J.C. Baillie and V.P. Alboini, *The National Sea Decision—Exploring the Parameters of Administrative Discretion* (1977), 2 Can. Bus. L. J. 454.

clauses (a) or (b) of subsection 74(3) are applicable, the reporting issuer may file the report required under subsection 74(2) with the Commission on a confidential basis, together with written reasons for non-disclosure to the public. Where a reporting issuer has filed a confidential report with the Commission, subsection 74(4) requires it to advise the Commission in writing every ten days thereafter that it believes that the report should continue to remain confidential until the material change has been generally disclosed to the public or, if applicable, the board of directors of the issuer decides not to proceed with a proposed change.

III. Subsection 71(1) Exemptions from Prospectus Requirements.

Eighteen months after the new Act comes into force every sale by an issuer of its own securities and every sale of issued securities by a controlling person is a "distribution" under the new Act requiring a prospectus unless an exemption from the prospectus requirements is available or a section 73 ruling is obtained. In addition, eighteen months after the new Act comes into force, where a security holder acquired his securities under a prospectus exemption in subsection 71(1), other than clauses (g), (h) or (s) thereof, the sale of those securities by such a holder will require a prospectus unless there is another prospectus exemption available or the issuer of the securities is a reporting issuer and the resale is made in compliance with subsection 71(4) or 71(5) and, in the case of a controlling person, in compliance with subsection 71(7), or a section 73 ruling is obtained.

Under subsections 71(4) and 71(5), the rights of security holders to sell securities previously acquired under the various subsection 71(1) exemption clauses varies depending on which exemptive clause was used to acquire or purchase the security. For this reason, the exemptive clauses of subsection 71(1) may be divided for convenience and reviewed on the basis whether the resale rights fall within subsection 71(4) or subsection 71(5). Subsection 71(6) is not a resale provision but rather only part of the extended definition of a distribution.

The Commission has indicated that regulations may be passed under the new Act to restrict the availability of the exemptions in clauses 71(1)(a), (d) and (p). Where a trade is made through an advertisement, the exemption in clauses 71(1)(a) and (d) may not be available unless an offering memorandum is provided to the investor. Subclause 71(1)(p)(iii) prohibits the use of an advertisement in connection with a trade under that clause. Further, where an offering circular is used in connection with a trade under clauses 71(1)(a), (d) or (p) (other than for the purpose of providing current information for the benefit of prospective investors previously

familiar with the issuer through prior business contacts), the exemptions in those clauses may not be available unless the offering memorandum provides a contractual right of rescission if the offering memorandum contains a misrepresentation and unless the offering memorandum is filed with the Commission currently with the filing of the report of the trade under subsection 71(3).⁵³

A. Subsection 71(1) Prospectus Exemptions Covered by Resale Restrictions Under Subsection 71(4).

1. Banks, Insurance, Loan and Trust Companies, the Crown, Municipalities and Public Boards.

A distribution is exempt under clause 71(1)(a) if the purchaser purchases as principal and is (i) a Canadian chartered bank or the Federal Business Development Bank; (ii) a loan corporation or trust company registered in Ontario; (iii) an Ontario licensed insurance company; (iv) Her Majesty in right of Canada or a province or territory of Canada; or (v) a Canadian municipal corporation, public board or commission.

This exemption does not expand the current exemptions under the Ontario Securities Act.⁵⁴ Subject to the regulations a trade under this clause, as well as under clauses b, c, d, l, p or q of subsection 71(1), must be reported by the vendor within ten days under subsection 71(3). Subsection 71(3) of the new Act does not require the filing of a report, however, where the trade is to a Canadian chartered bank or to a loan corporation or trust company registered in Ontario that acquires an evidence of indebtedness from its customer or an equity investment in the customer concurrently with an evidence of indebtedness.

Subsection 143(1) provides that, for the first eighteen months following the new Act coming into force, the exemptions in clauses a, c, d, l and p of subsection 71(1) are only available where the purchaser takes the securities "for investment only and not with a view to resale, distribution or distribution to the public". The resale rights of purchasers who acquire securities under such clauses of subsection 71(1) within the first eighteen months will be subject to such investment intent restrictions in connection with any resale.

In this prospectus exemption, as well as in clauses c, d, p and q of subsection 71(1) referred to later, it is a condition to the use of the exemption by the vendor that the purchaser purchase "as principal". The vendor has a positive duty to attempt to determine who the real

⁵³ Supplement "X-1" to the O.S.C. Weekly Summary (30th March 1979), pp. 4-6.

⁵⁴ Clause 58(1)(a) and para. 19(1)3. See Johnston, pp. 192-193.

purchaser is and that his purchaser is acquiring as principal. In *Chemalloy Minerals Limited*, the Commission noted:⁵⁵

We do not believe that the vendor has shown the degree of responsibility in determining who its real purchaser is and satisfying itself as to the bona fides of the purchaser's certificate of investment intent. We do not accept the submission of the company's counsel that it should not be expected to make any enquiries as to its purchaser and that purchaser's status.

The Commission also confirmed in that decision that a purchaser is not purchasing as principal when he is purchasing for discretionary accounts. In this connection, subsection 71(2) of the new Act continues the provisions of subsection 58(1a) of the Ontario Securities Act by providing that only an Ontario registered trust company is deemed to be acting as principal when it trades as trustee or, under the new Act, as agent, for accounts fully managed by it. Portfolio managers and other advisers and investment managers and fiduciaries cannot so act.

2. *Isolated Trade.*

Clause 71(1)(b) provides that an issuer, but not a controlling person or a security holder acquiring under a prospectus exemption, has an exemption where it makes "an isolated trade in a specific security" for its own account provided such trade "is not made in the course of continued and successive transactions of a like nature" and the usual business of the issuer is not trading in securities.

This new and important exemption from the prospectus requirements⁵⁶ only becomes available eighteen months after the new Act comes in force⁵⁷ when the phrase "to the public" is dropped. It is a significant, though narrow, exemption because it provides a final safety valve for issuers from the otherwise mandatory prospectus requirements. Unlike the other exemptions set out in subsection 71(1), this exemption is not based on the premise that the purchaser of the security can fend for himself or has "no need" for the protections afforded by prospectus disclosure. This exemption looks solely to the position of the vendor. None of the relationship of the purchaser to the vendor (as a shareholder,

⁵⁵ (1974), O.S.C. Bulletin 60, at p. 63.

⁵⁶ Para. 19(1)2 of the Ontario Securities Act is an exemption from registration only. The present prospectus exemption contained in clause 58(2)(c) of the Ontario Securities Act is an exemption only for sales by controlling persons of issued securities through the facilities of a stock exchange. See, *Re V.G.M. Holdings Ltd.*, [1942] Ch. 235; *J.M.P.M. Enterprises Ltd v. Danforth Fabrics (Humbertown) Ltd.*, [1969] 1 O.R. 785; and Johnston, pp. 125-126.

This new exemption is added as a *quid pro quo* for the removal of the concept of a distribution "to the public". See Johnston, pp. 221 and 122-126.

⁵⁷ Subsection 143(2) of the new Act.

creditor, employee), the "access" of the purchaser to prospectus-type information nor the status of the purchaser (as an institution, exempt purchaser, experienced investor, registrant) is relevant. Similarly, neither the type of transaction (amalgamation, take-over bid, exempt offer) nor the size of the trade (\$97,000.00 or \$100,000.00) is a factor. All the circumstances surrounding the trade are irrelevant except those relating to the issuer. The exemption is basically available for the sale of an issuer's securities to any purchaser under any circumstances for any amount.

Caution, however, must be raised as to its use by virtue of its very words. The trade must be "an isolated trade in a specific security" which is not made in the "course of continued and successive transactions of a like nature". The provincial court in the *McKillop* case, in discussing paragraph 19(1)2 of the Ontario Securities Act, stated:⁵⁸

In my opinion something that is isolated is kept alone. In other words, an isolated trade is a single transaction, the word "isolated" connoting the singular as opposed to the plural.

This may be true as it applies to "isolated", that is, the trade must be one single transaction. However, it cannot mean that this exemption can only be used once because the phrase, "an isolated trade", is modified by the phrase "not made in the course of continued and successive transactions of a like nature". This connotes that there may be more than a single "isolated trade" provided they cannot be integrated with other trades and are not "continued" and "successive" and of a "like nature". The phrase "continued and successive" was considered by a Manitoba court in the *Zinman v. Baldry* case in reviewing a provision of the Real Estate Agents Act (Manitoba) which provided that that Act did not apply "to an isolated transaction in real estate by or on behalf of the owner thereof and for the owner's account, where such transaction is not made in the course of continued and successive transactions of a like character."

The court stated:⁵⁹

The words "in the course of continued and successive transactions" deserve consideration as well. They qualify the phrase "an isolated transaction". Two different ideas, it seems to me, are connoted by the words "continued" and "successive". The former appears to be concerned with number—it suggests repetition or plurality of acts. The latter has regard to time—the acts should be sufficiently close together to qualify as "successive".

When and how often this exemption may be used will depend on the circumstances surrounding each transaction, including the

⁵⁸ *Supra*, footnote 15, at p. 167.

⁵⁹ (1954), 13 W.W.R. (N.S.) 622, at p. 627.

differing facts, if any, between each transaction, the conduct of the issuer in respect of prior transactions, the time interval between each transaction and the then present intent of the issuer with respect to future transactions.

3. *Exempt Purchaser.*

A distribution is exempt under clause 71(1)(c) if the purchaser purchases as principal and is recognized by the Commission as an exempt purchaser. An "exempt purchaser" is a select status granted by the Commission on application and generally reflects a recognition by the Commission that the applicant has substantial pools of capital for investment usually managed by experienced advisers. As currently provided in the Ontario Securities Act, this exemption is not available for a trade to an individual.⁶⁰ The benefit of this exemption is solely that an exempt purchaser may acquire securities having an aggregate purchase price of less than \$97,000.00. Otherwise the private placement exemption referred to below could be used. This clause does not expand the current exemptions under the Ontario Securities Act.⁶¹ For the first eighteen months after the new Act comes into force, this prospectus exemption is only available, as it currently is, where the "purchaser takes the securities for investment only and not with a view to resale, distribution or distribution to the public".

4. *Private Placement.*

During the first eighteen months after the new Act comes into force, clause 71(1)(d) provides that a prospectus is not required where the purchaser purchases as principal with the requisite subsection 143(2) investment intent and, after such eighteen month period, where the purchaser purchases as principal only, provided that in all cases the aggregate acquisition cost of the security to such purchaser is not less than \$97,000.00.⁶²

The private placement exemption has been a significant exemption

⁶⁰ Merger Report, para. 5.13 and para. 19(1)3 of the Ontario Securities Act.

⁶¹ Clause 58(1)(a) and para. 19(1)3. See Johnston, p. 193.

⁶² Does the phrase "aggregate acquisition cost" refer only to a cash consideration received by the issuer or may it include the amount of any financial obligations or guarantees that are incurred by the purchaser in whole or partial satisfaction of the consideration for the trade? See Johnston, p. 200, n. 224. While it may be argued that it is the "cost to such purchaser" that is relevant and not whether the vendor receives net cash proceeds of at least \$97,000.00, the Commission has stated that "a commitment not immediately satisfied by cash payment should be included only if the purchaser is certain, or virtually certain, to be called upon to make payment". Where a commitment is by way of a promissory note, such a liability is to be treated on a present value basis. See Supplement "X-1" to the O.S.C. Weekly Summary (30th March 1979), p.2.

under the Ontario Securities Act and may constitute one of the principal exemptions under the new Act. The use of clause 71(1)(d) is not circumscribed by the limitations imposed in clause 71(1)(p) and it is available for trades by an issuer, a controlling person and a holder of securities acquired under a subsection 71(1) exemption. Where, however, an advertisement is used in connection with a trade under clause 71(1)(d), the regulations under the new Act may require an offering memorandum prepared in compliance with the regulations to be provided to investors and filed with the Commission.⁶³

This exemption technically extends the present law because the current private placement exemption in subsection 19(3) and clause 58(1)(b) of the Ontario Securities Act does not permit an individual to be a purchaser in a private placement.⁶⁴ It is understood however, that in practice individuals or groups of individuals may bring themselves within the current exemption by incorporating a company which is the actual *bona fide* purchaser.⁶⁵ This procedure will no longer be required.

A legally more troublesome procedure under the Ontario Securities Act was the formation of a partnership by a group of individuals for the purpose of pooling capital to reach the \$97,000.00 level for a private placement. The *Merger Report* was of the view that the current private placement exemption was not properly available in such circumstances⁶⁶ and the Commission has taken the opportunity to cast doubt on the validity of private placements to partnerships, especially where they are formed for the purpose and then subsequently dissolved in order to distribute their assets.⁶⁷ Under clause 71(1)(d) of the new Act, it is contemplated, however, that a *bona fide* existing partnership may act as the purchaser in a private placement.⁶⁸

⁶³ See Supplement "X-1" to the O.S.C. Weekly Summary (30th March 1979) and the text with respect to footnote 53, *supra*.

⁶⁴ See Johnston, pp. 194-201.

⁶⁵ A corporate purchaser cannot act as an agent for its shareholders in this regard. See *A.E. Ames & Co. Ltd.* (1972), O.S.C. Bulletin 98.

⁶⁶ The theory is that, with the partnership as the purchaser, a "person" (as defined in para. 1(1)12 of the Ontario Securities Act) was acquiring the securities and not an "individual" (as defined in para. 1(1)9) and the subsection 19(3) exemption is available. The *Merger Report* noted at para. 5.13: "It was certainly not intended to permit pools of individuals to be formed having collectively \$97,000.00 to invest but whose individual investment was less." In footnote 88, the *Merger Report* stated that "the assembly of several purchasers into a \$97,000.00 unit, whatsoever its ultimate appearance, would appear to constitute unlawful primary distribution since the exemption is only available when the issuer is offering units of \$97,000.00 or more."

⁶⁷ See *Warren Explorations Limited*, *supra*, footnote 27. Johnston, pp 195-196.

⁶⁸ See the terms of the Commission's section 59 ruling in *National Petroleum Corporation Ltd.*, *supra*, footnote 12.

5. *Purchase of Assets.*

An issuer, but not a controlling person or a security holder acquiring under a prospectus exemption, has an exemption under clause 71(1)(l) if it trades its own securities as consideration for a portion or all the assets of any person or company if the purchased assets have a fair value of not less than \$100,000.00.

This exemption also extends the present exemption under The Ontario Securities Act because currently an individual cannot be a vendor of the assets under the exemption in paragraph 19(1)9b and clause 58(1)(c) of that Act. However, the securities traded must be those which are issued by the issuer, which is not a current requirement. As required by subsection 143(2) of the new Act, during the first eighteen months after the new Act comes into force, a purchaser must take the securities "for investment only and not with a view to resale, distribution or distribution to the public".

6. *Purchase of Mining Claims.*

An issuer, but not a controlling person or a security holder acquiring under a prospectus exemption, has an exemption⁶⁹ if it trades its own securities as consideration for mining claims where the vendor enters into such escrow or pooling agreement as the Director of the Commission considers necessary. This exemption does not substantially expand the current exemption under the Ontario Securities Act.⁷⁰

7. *"Seed Capital"—The Knowledgeable Investor with "Access".*

Clause 71(1)(p) introduces a new but severely narrow one-time prospectus exemption for issuers that is sometimes referred to as the "seed capital" exemption. It is only available for issuers trading their own securities and is not available for sales by controlling persons or purchasers holding securities acquired under a subsection 71(1) exemption. Prior drafts of the new Act permitted qualified purchasers under this exemption to trade within their select group under certain conditions.⁷¹ Notwithstanding that resales outside the group would constitute a distribution, this accommodation has been deleted in the new Act.

Clause 71(1)(p) was evidently drafted for the principal purpose of providing a single opportunity for a new enterprise to raise "seed

⁶⁹ Clauses 71(1)(m). The equivalent exemption from the registration requirement of the new Act is only available, however, where the issuer of the securities is a mining company or a mining exploration company: para. 34(2)14 of the new Act.

⁷⁰ Clause 58(2)(a) and para. 19(2)12a.

⁷¹ See Bills 98, 20 and 30 and clause 73(1)(m) therein and Johnston, p. 222.

capital" by an initial financing from a select class of investors.⁷² This low horizon which may account for the restrictions on its availability and usefulness. The exemption has special conditions relating to the number of persons who may be solicited, the number of purchasers, the time within which the initial sales must be completed, the "access" of each purchaser to prospectus-type information, the class or type of purchaser who is acceptable or suitable, the manner of offering, the status of the promoter of the issuer and a prohibition against prior use by the same issuer. It may be that all of these rigorous, though in some cases rather uncertain, statutory requirements must be met in respect of each purchaser under the clause or else an issuer relying in good faith on the exemption may have made an illegal distribution under the new Act.

Clause 71(1)(p) is the most rigid of all the prospectus exemptions in the new Act. Firstly, the concluding words of the clause provide a unique condition that an issuer may only rely upon this exemption *once*. In view of the philosophy of the "closed system" in requiring continuous public disclosure concerning the material affairs of reporting issuers for the sale of securities without a prospectus into the secondary trading markets, the other qualifications circumscribing the use of clause 71(1)(p) and the restrictions on the resale of securities of any purchaser who acquires such securities under this clause, the denial of the right to an issuer to use the exemption again appears unnecessary and unduly restrictive. The other exemptions in subsection 71(1) and the prospectus exemptions under the Ontario Securities Act may be used as often as needed and available. Rule 146, which is not limited to a single use, does provide that there be no more than thirty-five purchasers "in any offering" under the Rule and this requires consideration of whether

⁷² See Supplement "X-1" to the O.S.C. Weekly Summary (30th March 1979), p. 3. In 1974 the SEC adopted Rule 146 under the Securities Act of 1933 effective June 10th, 1974 (Securities Act of 1933, Release No. 5487 (April 23rd, 1974)). Subsection 4(2) of the Securities Act, *supra*, footnote 43, provides an exemption from the registration or prospectus requirements of that Act in transactions of an issuer "not involving any public offering". Rule 146 was adopted to provide more objective standards for determining when offers and sales by an issuer would be deemed to be transactions not involving a public offering. See, R.H. Kinderman, Jr., *The Private Offering Exemption: An Examination of Its Availability Under and Outside Rule 146* (1975), 30 Bus. L. 921 and B. Cedarbaum and A. Kramer, *The Private Placement, PLI, Sixth Annual Institute on Securities Regulation* (1975), p. 125.

In approach though perhaps not in concept or purpose, clause 71(1)(p) is not dissimilar to the prospectus exemption provided by Rule 146. The new "limited offering" exemption contained in the Proposed Official Draft Federal Securities Code of The American Law Institute (s. 242(b)) is also significantly broader than clause 71(1)(p). However, neither Rule 146 nor such "limited offering" exemption is as broad as the private placement exemption in clause 71(1)(d) where the aggregate acquisition cost of the security to the purchaser is not less than \$97,000.00.

the sales are part of a larger or prior offering with which they should be integrated.⁷³

Secondly, the exemption is only available if the issuer does not make "solicitations" to more than fifty prospective purchasers.⁷⁴ If an issuer solicits more than fifty prospective purchasers, the exemption is not available. In view of the general prohibition on advertising contained in subclause (iii) and the special suitability standards for purchasers contained in subclause (ii), one may have sympathy for the comment in the American Law Institute's tentative draft Federal Securities Code that "it is difficult to see how an offeree who does not buy is hurt".⁷⁵ If this restriction is to require the issuer to focus on a preselected group of potentially qualified investors for whom the investment seems appropriate, should an issuer do so and then apply for a ruling under section 73?

⁷³ With respect to integration of offerings, see Adoption of Rule 146, Securities Act, Release No. 5487 (April 23rd, 1974), pp. 18-19, Preliminary Note 3, and Non-Public Offering Exemption, Securities Act, Release No. 4552 (Nov. 6th, 1962), pp. 4-5. See also s. 299.13 of the Proposed Official Draft Federal Securities Code of The American Law Institute concerning the definition of "offering".

If a company amalgamates after it raises "seed capital" under clause 71(1)(p), may the amalgamated company rely on that clause?

⁷⁴ "Solicit" is not defined in the new Act with respect to trading in securities. Subpara. 1(1)42 v of the definition of "trade" provides, however, that trading includes any solicitation in furtherance of a sale. May a preliminary inquiry be made without constituting a solicitation? If an issuer, or a dealer on behalf of an issuer, phones a contact and asks whether he is interested in investing generally, is this a solicitation? See *Livens v. William D. Witter Inc.* (1974), 374 F. Supp. 1104 (D. Mass.)

Do only solicitations "in Ontario" count? The Commission is of the view that one counts solicitations wherever made. See Supplement "X-1" to the O.S.C. Weekly Summary (30th March 1979), p. 3.

If solicitations for prospective sales are made but a particular trade may be concurrently completed under clause 71(1)(d), does this count as a solicitation in respect of the trades computed under clause 71(1)(p)?

⁷⁵ Tentative Draft No. 1 (1972), p. 16. Under the Proposed Official Draft Federal Securities Code (1978), there is no limit or restriction on the number of offerees that a "limited offering" may be made to, provided the buyers are institutional investors and not more than 35 other persons (s. 242(b)).

Professor Louis Loss stated in Codification of the Federal Securities Laws (1973), 28 Bus. L. 381, at p. 385: "Section 227(b) [of Tentative Draft No. 1] defines a limited offering as an offering that results in not more than 35 buyers, plus any number of institutional investors. It is of no consequence how many offerees there are. First of all, why no limit on the number of offerees? There are two reasons. First it occurred to us half way through our deliberations that the tremendous emphasis on offerees was illogical. . . . Secondly, as 'offer' is defined, . . . it will be impossible to get a degree of definiteness unless we get away from counting offerees. So we shall count buyers." See also Professor Louis Loss, The "Limited Offering" under the American Law Institute's Federal Securities Code, PLI, Fourth Annual Institute on Securities Regulation (1973), pp. 35-47.

Thirdly, the exemption is available only if the trades result in sales to not more than twenty-five purchasers, each of whom acquires as principal. It appears that separate but affiliated purchasers that are controlled by the same person or related purchasers who are not dealing at arm's length may each be counted in this numerical test.⁷⁶ In addition, under subclause (i) of clause 71(1)(p), all of the purchases must be completed within a period of six months from the first purchase, except that subsequent sales may be made to the same purchasers if made in compliance with written agreements entered into during that six month period. It would appear that an issuer may trade its securities, for example, to fifteen purchasers in one transaction and subsequently be entitled to use the exemption to sell its securities to ten additional purchasers within six months of the first purchase. The issuer could then continue to rely on the exemption provided it traded its securities to all or some of the same group of twenty-five purchasers in compliance with written agreements entered into during that six month period.⁷⁷ The exemption provided in clause 71(1)(p), therefore, provides the issuer with a once-in-a-lifetime six month period to make sales to and to enter into written agreements with not more than twenty-five buyers after soliciting not more than fifty prospective purchasers (including the buyers). After this six month period, the particular purchasers under this clause are frozen and subsequent sales under this exemption may be made only to these specific purchasers and only if they entered into written agreements during that six month period to purchase further securities.

Fourthly, only the specific classes of purchasers referred to in subclause (ii) are qualified to acquire securities under this exemption. This is a suitability test and *each* purchaser must satisfy the

Similarly Rule 146(g) does not impose any limitations on the number of offerees and only sets restrictions on the number of purchasers.

⁷⁶ The opening phrase of clause 71(1)(p). Under Rule 146(g)(1), there cannot be more than 35 purchasers "in any offering". An exposure draft of Rule 146 (Securities Act, Release No. 5336 (Nov. 28th, 1972)) that would have restricted the number of purchasers to 35 in any consecutive 12 month period was rejected by the SEC as "too rigid". There is no restriction on the number of security holders as a result of trades under Rule 146. In addition, under Rule 146(g)(2), certain purchasers are excluded in calculating the numerical limitation, including the purchaser's spouse and relatives, a trust or estate in which a purchaser has a 100% beneficial interest and a corporation wholly owned by a purchaser.

⁷⁷ As subsequent trades to the same purchasers may be carried out if made "in compliance with" written agreements, it is not clear if the exemption is still available where the issuer and the purchaser subsequently amend the terms of the original written agreements or the securities subsequently issued have terms or attributes that vary from those set out in such written agreements due to changed economic or business factors or unforeseen circumstances. Accordingly, these written agreements should provide a certain flexibility.

required criteria; if it turns out, by subsequent court interpretation, that one of the twenty-five purchasers did not come within the statutory provisions of subclause (ii), the exemption may not have been available to the issuer. The issuer does not have the benefit of a "good faith reliance" defence of the type that is provided in Rule 146(d) which only requires that the issuer "shall have reasonable grounds to believe and shall believe" that the status of the buyers is such that they fall within the requirements of that Rule. In clause 71(1)(p) the issuer is at risk and, notwithstanding its reasonable review of the suitability of the purchasers, a court or the Commission may subsequently determine that the somewhat unclear statutory tests were not satisfied.

Subclause (ii) of clause 71(1)(p) specifically requires that "each purchaser has access to substantially the same information concerning the issuer that the filing of a prospectus" would provide under the New Act. While the clause 71(1)(p) requirements were "designed to replace the subjective tests for the concept public with objective criteria which limit the range of interpretive variance",⁷⁸ it is hoped that some of the problems of American jurisprudence in this area have not been imported by reference. The concept of "access" to information derives in part from the decision in the *Ralston Purina Co.*⁷⁹ case where the United States Supreme Court considered whether the offerees needed the protection afforded by registration as evidence whether they had access to the same kind of information that registration would disclose. Several subsequent United States decisions⁸⁰ have led a commentator to conclude that under United States law:⁸¹

... "access" means that the offeree has the power to obtain the information, rather than that he has it already.

... [R]eceipt of the information which might be obtained through access is not intended as a substitute for the power to obtain information. The SEC and the courts have consistently taken the position that the access requirement cannot

⁷⁸ Johnston, p. 222.

⁷⁹ *SEC v. Ralston Purina Co.*, *supra*, footnote 15.

⁸⁰ *SEC v. Continental Tobacco Co.* (1972), 463 F. 2d 137 (5th Cir.); *Hill York Corp. v. American International Franchises Inc.* (1971), 448 F. 2d 680 (5th Cir.) and *Lively v. Hirschfeld* (1971), 440 F. 2d 631 (10th Cir.). In the *Continental Tobacco* case, there was no fraud and most offerees were given a brochure and signed a statement that they had "been offered access to any and all records of the company and I do not desire any further information or data concerning your company". In granting injunctive relief against the company, the court pointed out that it was not enough that the issuer's brochure disclose all that would be in a statutory prospectus and stated, at p. 158: "The record does not establish that each offeree had a relationship with Continental giving access to the kind of information that registration would have disclosed."

⁸¹ B. Cedarbaum and A. Kramer, *op. cit.*, footnote 72, p. 143.

be fulfilled simply by handing an offeree a document containing substantially the information that would be required in a statutory prospectus.

In addition to corporate insiders, such as directors and senior officers, other classes of purchasers that meet the requirement of "access" under United States interpretations are those with sufficient economic bargaining power in relation to the issuer, such as financial institutions.⁸²

Within the Canadian context it is not clear whether the "access" test under subclause 71(1)(p)(ii) may be satisfied only by the proof of a special relationship with or to the issuer that provides the purchaser the power to obtain the required information during the offering period or whether the test may be satisfied either by the issuer providing an offering circular or memorandum containing substantial prospectus disclosure or by the issuer simply making an offer to provide all information a purchaser requests. The Commission has initially answered this question by stating that, whether or not an offering memorandum is prepared, the condition of access is, in its view, "not satisfied unless the purchaser (and his adviser, if any) has a meaningful opportunity to ask questions of a knowledgeable representative of the issuer".⁸³ In the same release, the Commission also said, however, that where the prospective purchasers are not persons previously involved with the enterprise and closely acquainted with its principals, each purchaser should be provided with, and the Commission would expect him to be provided with, an offering memorandum complying with the regulations proposed under the new Act.

The type of information that a purchaser must have access to in order to permit the issuer safely to trade its securities under this

One of the alternate provisions of Rule 146(e) is that each offeree shall have access to the same kind of information that is specified to be included in a registration statement to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense. Rule 146(e) notes with respect to access: "Access can only exist by reason of the offeree's position with respect to the issuer. Position means an employment or family relationship or economic bargaining power that enables the offeree to obtain information from the issuer in order to evaluate the merits and risks of the prospective investment." See also *Woolf v. S. D. Cohn & Co.* (1975), 515 F. 2d 591 (5th Cir.), rehearing 521 F. 2d 225, vacated on other grounds (1976), 426 U.S. 944; and *Doran v. Petroleum Management Corp.* (1977), 545 F. 2d 893 (5th Cir.).

⁸² See generally, Securities Act of 1933: Business Experience and Access to Corporate Records Required for Private Offering Exemption, [1971] Duke L. J. 1017; Ray Garrett, Jr., The Private Offering Exemption Today and G. Bradford Cook and Alan B. Levenson, SEC Staff Views on "Continental Tobacco" and the Need for Regulatory Guidelines in the Private Offering Area, in PLI, Fourth Annual Institute on Securities Regulation (1973); and William J. Carney, *op. cit.*, footnote 8.

⁸³ Supplement "X-1" to the O.S.C. Weekly Summary (30th March 1979), p. 3.

exemption is also unclear. The provisions of and regulations to the Ontario Securities Act contain and the regulations to the new Act will contain detailed and extensive informational requirements for the preparation of the filing of a statutory prospectus with the Commission. For instance, under subclause 71(1)(p)(ii), must the purchaser have access to substantially all this information, including audited financial statements of the issuer prepared within 120 days of the offering?⁸⁴

In addition, under subclause 71(1)(p)(ii) *each* purchaser must be: (a) an investor who "by virtue of his net worth and investment experience" is able to evaluate the prospective investment on the basis of information presented to him by the issuer; or (b) an investor who by virtue of consultation with or advice from a registered adviser, or dealer exempt from registration as an adviser, (other than a promoter) is able to evaluate the prospective investment on the basis of information presented to him by the issuer; or (c) a senior officer or director of the issuer; or (d) a spouse, parent, brother, sister or child of a senior officer or director of the issuer.

These are not broad classes of purchasers. Nor are these additional conditions which each purchaser must satisfy totally clear in order for an issuer to come within this exemption. Is the phrase "net worth and investment experience" an objective standard or a sliding test depending on the type (debt or equity) and amount of the security purchased, the business and financial condition and stage of development of the issuer, the degree of risk of the investment and the extent and quality of the disclosures set out in information respecting the investment presented by the issuer? How important is the "net worth" of a purchaser in evaluating the prospective investment—must the purchaser be able to sustain the economic loss of his investment or be financially able to bear the risk of holding securities of a non-reporting issuer for an indefinite period or of holding the securities of a reporting company for the appropriate statutory period set out in subsection 71(4)? What does "investment experience" mean—does it require the actual buying and selling of securities for one's own account or may general financial and business acumen suffice?

Under subclause 71(1)(p)(ii), a purchaser who is neither "rich" nor "sophisticated" may be suitable if he consults with or receives

⁸⁴ Rule 146 permits an issuer that is subject to the reporting requirements of the Securities Exchange Act of 1934 to provide the most recent public filings under the Act and the latest proxy statement, together with a brief description of the securities being offered, the use of proceeds and material changes not disclosed in the public filings. Where the issuer is not subject to such reporting requirements, it must provide the information required for a registration statement, but it may provide unaudited financial statements if it does not have audited financial statements and cannot obtain them without unreasonable effort and expense.

advice from an appropriate registrant who is not a promoter of the issuer. There apparently is no restriction upon a dealer who may be acting as soliciting agent for and receiving compensation from the issuer to act also in giving advice and consultation to the purchaser. As the purpose of any such dealer in acting on behalf of a purchaser is to provide a degree of understanding and evaluation of the investment to the purchaser, any relationship of the dealer to the issuer would have to be fully disclosed.⁸⁵

In addition, under subclause 71(1)(p)(iii), the offer and sale of the securities cannot be accompanied by any advertisement and no selling or promotional expenses may be paid in connection with the offering except for professional fees and services of a registered dealer.

Subclause 71(1)(p)(iv) introduces a further and somewhat novel condition. No "promoter" of the issuer (other than a registered dealer) can have acted as a promoter of any other issuer which has traded securities under this exemption within the previous twelve months.⁸⁶ This restriction is presumably to prevent promoters from making a living through raising capital under this exemption by a succession of new private ventures formed primarily for that purpose.

A purchaser under clause 71(1)(p) must purchase as principal and, during the first eighteen months after the new Act comes into force, he must also have the requisite investment intent required by subsection 143(2) of the new Act.

8. *Registered Dealer.*

A distribution is exempt under clause 71(1)(q) where the trade is from one registered dealer to another registered dealer who purchases as principal. This exemption does not expand the current exemption under clause 58(1)(d) of the Ontario Securities Act.

B. *Subsection 71(1) Exemptions Covered by Resale Restrictions Under Subsection 71(5).*

Securities acquired after the new Act comes into force under the subsection 71(1) prospectus exemptions covered by resale restrictions under subsection 71(5) may be freely resold by a non-controlling person for the first eighteen months after the new Act comes into force;

⁸⁵ National Policy No. 25.

⁸⁶ "Promoter" is defined in para. 1(1)33 of the new Act. Where the other conditions of clause 71(1)(p) are satisfied, a promoter may be able to obtain a section 73 ruling for a further trade where he has previously used this exemption within the 12 month period. See Supplement "X-1" to the O.S.C. Weekly Summary (30th March 1979), p. 3. That release also raises the question whether the promoter may be regarded as the issuer where the fund is simply a convenient technique for the pooling of money to be invested and administered by the promoter.

however, once subsection 71(5) becoming effective, such non-controlling persons will then be subject to the resale restrictions under that subsection with respect to the same securities.

1. *Stock Dividend, Reorganization, Winding Up and Issues through Warrants, Conversions and Exchanges.*

Under clause 71(1)(f) a trade by an issuer is exempt (i) where it distributes its own securities to holders of its securities as a stock dividend or other distribution out of earnings or surplus;⁸⁷ (ii) where it distributes securities, whether of its own issue or not, to holders of its securities as incidental to a "*bona fide* reorganization⁸⁸ or winding up"⁸⁹ of such issuer or distribution of its assets for the purpose of winding up its affairs "pursuant to the laws" of its jurisdiction of incorporation, organization or continuance; or (iii) where it distributes its own securities through the exercise of a right to purchase, convert or exchange previously granted by the issuer. In each case the issuer may not make any commission or other remuneration payments except for ministerial or professional services or for services performed by a registered dealer.

These exemptions do not substantially expand the exemptions under the Ontario Securities Act.⁹⁰ The exemptions in subclauses

⁸⁷ See Johnston, pp. 203-204.

⁸⁸ "Reorganization" is not defined in the new Act nor in the Ontario Securities Act. See the Merger Report, paras 6.10, 6.15 and 6.16 and Johnston, pp. 204-207.

In *Twentieth Century Explorations Inc.* (1977), O.S.C. Bulletin 187, the Commission stated, at p. 189 that: "Explorations Inc. is the successor company to Explorations Ltd. and as such took over all the rights and liabilities of Explorations Ltd. By virtue of the exemption contained in s. 19(1)(8)(ii) of The Securities Act . . . the distribution of the shares of Explorations Inc. to its shareholders as a result of the re-organization of the affairs of Explorations Ltd did not require prospectus disclosure in Ontario."

In *R. v. Santiago Mines Ltd.* [1947] 1 D.L.R. 642 (B.C.C.A.), Sidney Smith J.A., stated, at p. 648, that the word "reorganization" has substantially the same meaning as "reconstruction", the word mostly used in the English authorities. In *Hooper v. Western Counties & South Wales Telephone Co. Ltd* (1892), 68 L.T. 78 Chitty J., stated, at pp. 79-80, that "the usual mode of reconstruction is when a company resolves to wind itself up and proposes the formation of a new company which is to consist of the old shareholders, and to take over the old undertaking, the old shareholders receiving shares in the new company." In *Re South African Supply & Cold Storage Co.*, [1904] 2 Ch. 268, a reconstruction was effected even though not all the assets were transferred nor all of the shareholders of the old company became shareholders of the new company. See also *Brooklands Selangor Holdings Ltd v. Inland Revenue Comm.*, [1970] 2 All E.R. 76 (Ch.).

⁸⁹ With respect to a *bona fide* winding up, see *Panacea Mining and Exploration Limited* (1971), O.S.C. Bulletin 163.

⁹⁰ Clause 58(1)(c) and subparas i and ii of para. 19(1)(8) and section 88 of the regulations. S.88 of the regulations under the Ontario Securities Act is restricted to

71(1)(f)(i) and (ii) above are available under the new Act to any issuer and not limited to companies as in the Ontario Securities Act. The exemption in subclause 71(1)(f)(iii) is now also available to "exchanges" by an issuer of its own securities. The right to purchase referred to in subclause 71(1)(f)(iii) is a separate "security" and must itself be issued or granted under a prospectus exemption in the Ontario Securities Act or the new Act or pursuant to a prospectus or a Commission ruling. A right to convert or exchange may form part of the attributes attached to already issued securities, such as debt or preferred shares, and the issuance of such securities also requires an exemption, a prospectus or a ruling.

Where that warrant or right to purchase, convert or exchange is granted by the issuer prior to the effective date of the new Act and is exercised after the new Act comes into force, the holder of the security distributed as a result of the exercise of the right may, eighteen months after the new Act becomes effective, be subject to the resale restrictions provided in subsection 71(5) of the new Act.⁹¹

Does subclause 71(1)(f)(iii) permit a security holder who acquires a convertible debenture under clause 71(1)(d) and converts that debenture into common shares to sell such common shares under subsection 71(5), as opposed to subsection 71(4), when such subsections become applicable?

2. *Statutory Amalgamation, Arrangement and Merger.*

By virtue of clause 71(1)(i) a prospectus is not required where securities are exchanged by or for the account of one company with another company or the security holders of that other company in connection with (i) a statutory amalgamation or arrangement;⁹² or (ii) a statutory procedure whereby one company acquires the assets of the other company which loses its existence by operation of law, or under which the existing companies merge into a new company.⁹³ This exemption does not expand the current exemptions under the Ontario Securities Act.⁹⁴

trades by a reporting issuer as therein defined in respect of rights previously granted under sections 35 or 58 of that Act.

⁹¹ In *J. D. Carrier Shoe Co. Ltd* (1967), O.S.C. Bulletin 32, the Commission held, in effect, that share purchase warrants purchased by an underwriter and disclosed in a prospectus amounted to the distribution of the shares themselves.

⁹² See the Merger Report, paras 6.11, 6.16 and 6.17 and Johnston, pp. 211-214. It would appear that the words in clause 71(1)(i) are broad enough to include an exchange of shares "in connection with" a statutory amalgamation where, under clause 176(1)(d) of the Canada Business Corporations Act, S.C., 1974-75, c. 33, as am., shares of an amalgamating corporation are to be converted into securities of another body corporate instead of securities of the amalgamated corporation.

⁹³ See the Merger Report, paras 6.13, 6.14 and 6.22 and Johnston, p. 214.

⁹⁴ Clause 58(1)(c) and subparas (a) and (b) of para. 19(1)9.

3. *Take-Over Bid.*

Clause 71(1)(j) provides that a prospectus is not required where securities of an issuer are exchanged by or for the account of such issuer with the security holders of another issuer in connection with a take-over bid. A "take-over bid" is defined in clause 88(1)(k) of the new Act and there are significant differences from the definition currently contained in clause 81(g) of the Ontario Securities Act. In addition the term "exempt offer" in the Ontario Securities Act has been deleted and replaced with the more complex exemptions from the take-over bid requirements that are set out in subsection 88(2) of the new Act. The take-over bid prospectus exemption does not expand the current prospectus exemption under the Ontario Securities Act.⁹⁵

There is not a prospectus exemption in subsection 71(1) for an "issuer bid" as defined in clause 88(1)(d) of the new Act. An issuer that makes an offer to its security holders to exchange their presently held securities for other securities of the issuer will have to file a prospectus or apply for a section 73 ruling of the Commission.

4. *Exempt Take-Over Bid.*

A distribution is exempt under clause 71(1)(k) if a security is traded in connection with a take-over bid exempted from the requirements of Part XIX by subsection 88(2) or by the Commission under section 99 of the new Act. The provisions of subsection 88(2) exempt the five kinds of take-over bids referred to in clauses (a) to (e) of that subsection from the requirements of Part XIX of the new Act. The provisions of subsection 88(2) differ materially from the present definition of "exempt offer" in clause 81(b) of the Ontario Securities Act.

Clause 88(2)(a) is a new prospectus exemption that is not contained in the Ontario Securities Act. It is not, however, a useful exemption because take-over bids made through the facilities of a stock exchange are cash bids and do not involve the issue of securities.

Clause 88(2)(b) expands slightly the prospectus exemption in the Ontario Securities Act which is presently available for "an offer to purchase all of the shares in a private company".⁹⁶ Under the new Act it will not be necessary to offer to purchase all the shares of a private company in order to come within the exemption.

Clause 88(2)(c) of the new Act continues, with significant modifications, the present prospectus exemption for the issuance of securities in connection with a take-over bid by way of private

⁹⁵ Clause 58(1)(c) and subpara. 19(1)9(c). See Johnston, p. 219.

⁹⁶ Clause 58(1)(c) and para. 19(1)9a. See Johnston, pp. 214-219, with respect to the current exemptions for the private company and the private agreement.

agreement with fewer than fifteen shareholders. Under clause 71(1)(k) and clause 88(2)(c), securities may be issued in connection with a take-over bid that constitutes an offer to purchase securities by way of private agreements with fewer than fifteen security holders. By virtue of subclause 88(2)(c)(i) the issuer will, however, be under an obligation to make reasonable inquiry to determine that it is dealing with fewer than fifteen security holders as principal and whether such shareholders are acting "as trustee, executor, administrator or other legal representatives" on behalf of others who have a "direct beneficial interest"⁹⁷ in the securities. If other persons or companies have a "direct" beneficial interest in the securities, then they must be counted in determining whether the issuer is dealing with fewer than fifteen security holders. In addition, under subclause 88(2)(c)(ii) an issuer will be required to make reasonable inquiry to determine that the offeree did not acquire the securities to be transferred to the issuer within the two preceding years with the intent that such securities be sold under the private agreement. If securities have been acquired or consolidated within a two year period with the intent that they be sold under the private agreement take-over bid exemption, then the persons from whom these securities were acquired must also be counted.⁹⁸

While Part XIX of the new Act introduces material fundamental changes concerning take-over bids which are not within the scope of this review, the two current prospectus exemptions under paragraph 19(1)9a and clause 58(1)(c) of the Ontario Securities Act are maintained in clauses 88(2)(b) and (c) of the new Act.

Clause 88(2)(d) of the new Act introduces a new exemption from the take-over bid requirements that is not currently included within the definition of "exempt offer" in clause 81(b) of the Ontario Securities Act. Under this new clause, a take-over bid is exempt provided the issuer or offeror, together with his associates and affiliates, acquires within any twelve consecutive month period not more than five per cent of the voting securities of the offeree

⁹⁷ The difference between a "direct" beneficial interest, an "indirect" beneficial interest or simply a beneficial interest is not clear. The word "direct" may have been added to avoid counting individual investors in a trustee investment vehicle whose constating document provides that the investors have no direct beneficial interest in any specific investment held by the fund. From the context of subclause 88(2)(c)(i) and the use of the words "trustee, executor, administrator" and "other legal representatives" it seems to be intended that certain beneficiaries of a trust or of an estate have a "direct" beneficial interest. An issuer may have to be particularly careful in dealing with trust companies or portfolio managers who are acting for a number of separate accounts.

⁹⁸ See *Farnham v. Fingold*, [1972] 3 O.R. 688, [1973] 2 O.R. 132, where it was alleged that the control group artificially caused its number to be lowered to less than 15 shareholders in order to effect an exempt take-over bid.

company, calculated at the beginning of such period, in reliance on all the exemptions in subsection 88(2) at prices, where there is a published market, not in excess of the market price at the date of purchase plus reasonable brokerage fees or other commission.⁹⁹ This clause also operates to provide, in effect, a somewhat parallel take-over bid exemption for the *de minimus* acquisition of unlisted securities to that provided in clause 88(2)(a) for listed securities and for the acquisition of securities listed on stock exchanges that are not recognized by the Commission for the purpose of subsection 88(2). However, to the extent that an issuer may be able to acquire voting securities in connection with the take-over bid under the provisions of clause 88(2)(d) in consideration for the issuance of its securities, such issuer will also have an exemption from the prospectus requirements of the new Act for such a distribution.

Clause 88(2)(e) of the new Act introduces another new exemption from the take-over bid requirements that is not within the "exempt offer" definition in the Ontario Securities Act. Under this clause an offer to acquire voting securities is exempt from the take-over bid requirements if it is made by and accepted by controlling persons. Where an issuer is a controlling person of an offeree company and proposes to make an exempt take-over bid by purchasing additional voting securities of the offeree company from another controlling person of the offeree company under clause 88(2)(e), such an issuer would have a prospectus exemption under clause 71(1)(k) if it issued its own securities to the other controlling person in consideration for the purchase of the additional voting securities of the offeree company.

5. Employees.

A distribution is exempt under clause 71(1)(n) where an issuer trades its own securities to its employees, or the employees of an affiliate, provided the employees are not induced to purchase by the expectation of employment or continued employment. This exemption does not expand the current exemption under the Ontario Securities Act, except to the extent that it is now available to all issuers and not just to companies.¹⁰⁰

C. Subsection 71(1) Exemptions Covered by Resale Restrictions Under Subsection 71(6).

1. Incorporator.

Under the Ontario Securities Act a prospectus is not currently

⁹⁹ "Published market" is defined in clause 88(1)(j) of the new Act and "market price" will be defined in the regulations.

¹⁰⁰ Clause 58(1)(c) and para. 19(1)10. See *R. v. Oliver*, [1967] 1 O.R. 300 and Johnston, p. 203.

required in respect of a trade by a company in the securities of its own issue to its promoters.¹⁰¹ A "promoter" includes a significantly larger class of persons than those who may act in connection with the formal incorporation or organization of an issuer. The promoter prospectus exemption has been deleted from the new Act and the ambit of its availability is narrowed and replaced by the more technical exemptions for trades to incorporators under clause 71(1)(o) and for trades to knowledgeable investors under clause 71(1)(p).¹⁰²

Under clause 71(1)(o) a distribution is exempted from the prospectus requirements where an issuer trades its own securities for a nominal consideration to not more than five incorporators or organizers provided such trade is "reasonably necessary to facilitate the incorporation or organization of the issuer". Where there is an applicable statutory requirement, for instance, in connection with the incorporation of banks or trust and insurance companies, specifying a larger consideration or a larger number of incorporators or organizers, then that larger amount or number will apply.

Eighteen months after the new Act comes into force, the first trade in securities, whether or not of a reporting issuer, purchased under clause 71(1)(o) is a distribution requiring a prospectus or a Commission ruling, unless that first trade can fall within another exemption in subsection 71(1).¹⁰³ To avoid this harsh result it might be advisable to form corporate issuers as private companies and use the prospectus exemption in clause 72(1)(a) and paragraph 34(2)10 of the new Act for trades to the promoters.¹⁰⁴ Even if the corporate issuer is not to remain a private company, the security holders will have the more appropriate and flexible resale rights set out in subsections 71(5) or 71(7) and would not be bound by the tight issue restrictions in clause 71(1)(o). This alternative is not available to unincorporated issuers and the combined provisions of clause

¹⁰¹ Clause 58(1)(c) and para. 19(1)9c. See Johnston, p. 202. "Promoter" is defined in para. 1(1)15 of the Ontario Securities Act and para. 1(1)33 of the new Act in substantially the same way.

¹⁰² Johnston says that the promoter exemption is to disappear because the new limited offering exemption, clause 71(1)(p), will satisfy its purpose: p. 202. The promoter exemption, which is a classic example of the "need to know test", was introduced by The Securities Amendment Act, 1971, S.O., 1971, c. 31, ss 3(2) and 13(1), as a result of a recommendation by the Merger Report (para. 8.08) to compensate for the deletion of the phrase "to the public" in relation to the prospectus requirements.

¹⁰³ S. 143 and subsection 71(6) of the new Act.

¹⁰⁴ As the trades would be to the promoters of that issuer, presumably such trades of the securities of the private company would not be offered "for sale to the public" within the meaning of para. 34(2)10.

71(1)(o) and subsection 71(6) create technical and unnecessary problems for the incorporation or organization of issuers.¹⁰⁵

Even though subsection 71(6) does not become effective until eighteen months after the new Act comes into force, a resale of securities purchased under clause 71(1)(o) within such eighteen month period could, if made to the public, constitute a distribution to the public because of the provisions of subparagraph iii of paragraph 1(1)11. Where such a resale of securities purchased under clause 71(1)(o) does not fall within those provisions, there would appear to be no restriction on resale during the first eighteen months after the new Act becomes effective.

2. *Underwriter.*

Under clause 71(1)(r) a prospectus is not required where a person or company trades securities to an underwriter acting as purchaser or securities are traded between or among underwriters.¹⁰⁶ This exemption is, of course, necessary to enable an issuer or a controlling person to sell securities to an underwriter without filing a prospectus in respect of such trade in connection with a public offering of such securities by the underwriter. This prospectus exemption is only available where the underwriter is the purchaser on the securities; it is not available where the underwriter is acting in an agency capacity. Under subsection 71(6) of the new Act, which becomes effective eighteen months after the new Act comes into force, the first trade by an underwriter of the purchased securities is a distribution, unless the further trade is made under an exemption in subsection 71(1). Where the underwriter sells the securities to the general investing public, a prospectus will be filed under subsection 52(1) of the new Act.

A trade in securities to the public within the first eighteen months after the new Act comes into force that are purchased by an underwriter under clause 71(1)(r) will constitute a distribution to the public requiring an exemption, a prospectus or a ruling because of the effect of subparagraph v of paragraph 1(1)11, paragraph 1(1)14 and clause 52(1)(a) of the new Act. A trade in such securities before

¹⁰⁵ The Draft Regulations propose to alleviate this result by providing a new prospectus exemption for the first trade in securities previously acquired under clause 71(1)(o) where the purchaser is a promoter of the issuer. Where this exemption is used, the Draft Regulations also provide that the first trade by the promoter is a distribution unless exempted by subsection 71(1) or made in accordance with subsection 71(5) or 71(7), as applicable.

¹⁰⁶ See Johnston, p. 201. "Underwriter" is defined in para. 1(1)43 of the new Act. The prospectus exemption is not restricted to persons or companies registered as an underwriter. However, it is an offence for anyone to "act as an underwriter" unless so registered: clause 24(1)(b).

subsection 71(6) becomes effective by an underwriter that is not "to the public" would not appear to fall within a "distribution to the public" nor the clause 52(1)(a) prohibition. Similarly, by virtue of subparagraph iv of paragraph 1(1)11, a trade in securities that were acquired by an underwriter prior to the new Act coming into force and not pursuant to clause 71(1)(r) will constitute a distribution to the public if sold to the public within the first eighteen months after the new Act comes into force and will constitute a distribution if sold under any circumstances thereafter.

D. Subsection 71(1) Exemptions Without Resale Restrictions.

1. *Dividend in Specie.*

The new Act introduces a new prospectus exemption in clause 71(1)(g) for trades by an issuer in securities of a reporting issuer held by it that are distributed to its security holders as a dividend in specie. This prospectus exemption may be required under the new Act where an issuer that holds sufficient outstanding securities of a reporting issuer to comprise a control block of that reporting issuer, or where an issuer acquired securities of a reporting issuer the resale of which constitutes a distribution, wishes to distribute such securities to its shareholders by way of a dividend *in specie*. There is no comparable prospectus exemption under the Ontario Securities Act. Dividends *in specie* of securities of other issuers may be accomplished under the Ontario Securities Act without a prospectus or a ruling where such a trade would be incidental to a *bona fide* reorganization or winding up.

The securities acquired under clause 71(1)(g) are not covered by the provisions of subsections 71(4), 71(5) or 71(6) and securities so acquired by a non-controlling person are therefore not subject to resale restrictions, whether during or after the first eighteen months following the date on which the new Act comes into force. It is presumably not considered necessary to restrict the right of a non-controlling person to resell such securities because the exemption is restricted to the distribution of securities of a reporting issuer and there will be sufficient material information in the public files concerning the affairs of such an issuer permitting the secondary trading market.

2. *Rights' Offering and Trades in Securities of a Reporting Issuer through Warrants, Conversions and Exchanges.*

An issuer has an exemption under clause 71(1)(h) in respect of the following trades: (i) the issue of a right, transferable or otherwise, granted by it to its security holders to purchase additional securities of its own issue and the issue of securities pursuant to the exercise of that right; and (ii) trades in securities of a reporting issuer held by it that are transferred or issued on the exercise of a right to purchase.

convert or exchange previously granted by the issuer; provided, in either situation, the Commission does not object to the proposed trade or the issuer provides the Commission with requested additional information.

The prospectus exemption for a rights' offering referred to in subclause 71(1)(h)(i) continues the exemption provided in the Ontario Securities Act.¹⁰⁷ As in the case of securities acquired by a dividend *in specie* under clause 71(1)(g) and securities acquired by a rights' offering under the Ontario Securities Act, there are no resale restrictions on non-controlling shareholders affecting the securities acquired pursuant to a rights' offering under the new Act. However, in practice it may be assumed that only reporting issuers, or issuers that agree to become reporting issuers, will be able to make a significant distribution of securities under this exemption without a prospectus. The right to use this exemption depends on the exercise of the Commission's discretion that it has received sufficient information relating to the securities to be distributed. Under Ontario Securities Commission Policy No. 3-22, the Commission has stated that, where a rights' offering is proposed to be made by a non-reporting issuer, it may object to any disclosure short of an acceptable prospectus under subparagraph iii of paragraph 19(1)8 of the Ontario Securities Act unless the issuer assumes the responsibilities of a reporting issuer. The continuance of this policy would be consistent with the aim of permitting secondary trading markets only in securities of reporting issuers.

Subclause 71(1)(h)(ii) is similar to subclause 71(1)(f)(iii) except that the securities traded through the exercise of the right to purchase, convert or exchange are those of a reporting issuer and not securities of the issuer that granted such right. There is no equivalent exemption under the Ontario Securities Act. Presumably in view of the fact that the securities acquired are those of a reporting issuer, there are no resale restrictions attached to such securities as a result of the exercise of the right. As in the case with rights to purchase, convert or exchange granted by an issuer under subclause 71(1)(f)(iii), the issuer granting such right must file a prospectus, have an exemption or obtain a ruling with respect to the granting of the right in view of the fact that the right is itself a security.

IV. *Sales of Securities under Subsection 71(4) and Subsection 71(5).*

A. *Subsection 71(4).*

Subsection 71(4), which becomes effective eighteen months after

¹⁰⁷ Clause 58(1)(c) and subpara. iii of para. 19(1)8. See Johnston, pp. 207-211 and Uniform Act Policy No. 2-05.

the new Act comes into force, provides that the first trade in securities acquired under the eight prospectus exemption clauses of subsection 71(1) referred to therein is a "distribution" requiring a prospectus unless either the further trade is exempted by subsection 71(1) or the conditions of subsection 71(4) are satisfied. During the first eighteen months after the new Act comes into force, purchasers who acquire securities under clauses a, c, d, l and p of subsection 71(1) must take the securities, as required by subsection 143(2), for investment only and not with a view to resale, distribution or distribution to the public. The resale rights of such security holders will be subject to such investment intent, whether before or after subsection 71(4) becomes effective.

A non-controlling security holder who holds securities of a non-reporting issuer that were acquired under one of such eight exemptions will find that his right to resell such securities without a prospectus after subsection 71(4) becomes effective is very limited. He must either obtain a section 73 ruling from the Commission or sell only to (A) banks, loan, trust and insurance companies, the Crown or a municipal corporation under clause 71(1)(a); (B) an exempt purchaser, other than an individual, under clause 71(1)(c); or (C) a purchaser whose aggregate acquisition cost for the securities is at least \$97,000.00 under clause 71(1)(d). The other sixteen exemption clauses of subsection 71(1) are applicable only to trades made by issuers,¹⁰⁸ to trades made by controlling persons who wish to pledge securities as collateral for a debt,¹⁰⁹ to trades made by or to registered dealers or underwriters,¹¹⁰ or are applicable only to corporate amalgamations, arrangements or mergers¹¹¹ or to take-over bids¹¹² or must be trades in a commodity futures option or commodity futures contract.¹¹³

Potential investors in securities of non-reporting issuers may be hesitant to purchase in view of these limited rights of resale. The substantial illiquidity of securities of non-reporting issuers issued after the new Act comes into force, of course, may promote issuers to become reporting issuers in order to have access to outside capital. Under the Ontario Securities Act, non-controlling holders of securities acquired under the prospectus exemptions of that Act are free to sell their securities to the general investing public, subject only to the requirements of their investment intent at the time of purchase. Where the securities acquired pursuant to the exemptions referred to in subsection 71(4) are those of a reporting issuer that is "not in default of

¹⁰⁸ Clauses 71(1)(b), (f), (g), (h), (l), (m), (n), (o) and (p).

¹⁰⁹ Clause 71(1)(e).

¹¹⁰ Clauses 71(1)(q) and (r).

¹¹¹ Clause 71(1)(i).

¹¹² Clauses 71(1)(j) and (k).

¹¹³ Clause 71(1)(s).

any requirement of this Act or the regulations'', then, subject to any applicable investment intent and the requirement that the non-controlling security holder hold such securities for the requisite statutory period of six months, one year or eighteen months, depending on the facts relating to the issuer, the securities may be sold to the general investing public through normal transactions.

Before a security holder may proceed to sell securities of a reporting issuer, he must be satisfied not only that the issuer is a reporting issuer but also that the reporting issuer is not in default of the requirements of the new Act or the regulations.¹¹⁴ In order to satisfy this condition, the seller may obtain and rely on a certificate to that effect issued by the Commission under section 136 of the new Act, or, if he knows the issuer is a reporting issuer, the seller may rely on a list of defaulting reporting issuers maintained at the Commission's offices.¹¹⁵ However, a seller cannot rely on such information if he "knows or ought reasonably to know that a reporting issuer is in default".¹¹⁶

Subsection 71(4) also imposes statutory holding periods that must be complied with before a security holder may sell the securities of a reporting issuer under that subsection. These statutory holding periods all commence from the date of the initial exempt trade or the date on which the issuer became a reporting issuer, whichever is later. If a holder acquires securities of a non-reporting issuer that subsequently becomes a reporting issuer, the period of time that he held the securities before the issuer became a reporting issuer cannot be counted. The statutory holding periods are six months, one year or eighteen months depending on whether securities of the issuer are listed on a recognized stock exchange and whether such securities are authorized for investment by insurance companies subject to The Insurance Act (Ontario).¹¹⁷ A distinction is made, in effect, between the securities of "seasoned" reporting issuers and reporting issuers whose securities are not listed on a stock exchange and which do not have the requisite earnings record. The three-stage statutory holding periods under clause 71(4)(b) may be summarized as follows: (A) six months for preferred or common shares listed on a recognized stock exchange that comply with the

¹¹⁴ Subclause 71(4)(a).

¹¹⁵ Subsections 71(8) and (9).

¹¹⁶ Subsection 71(10). A reporting issuer may be in default of a requirement of the new Act or the regulations notwithstanding that from the public file it appears that all required documents are filed. For instance, the filed documents may not be in compliance with the regulations or a material change may not have been reported under s. 74.

¹¹⁷ R.S.O., 1970, c. 224, as am.

respective requirements for investments in such shares authorized under The Insurance Act (Ontario); (B) six months for bonds, debentures or other debt issued or guaranteed by an issuer or for preferred shares of an issuer that comply with the respective requirements for investments in such securities authorized under The Insurance Act (Ontario); (C) one year for securities that do not comply with the requirements for investments authorized under The Insurance Act (Ontario) but which are listed on a recognized stock exchange; (D) one year for bonds, debentures or other debt that do not comply with the requirements for investments authorized under The Insurance Act (Ontario) but which are issued or guaranteed by a reporting issuer whose securities are listed on a recognized stock exchange; and (E) eighteen months for all other securities.

A seller under subsection 71(4) cannot prepare the market, create a demand for the securities or pay an extraordinary commission or consideration for the trade and the securities can only be sold under subsection 71(4) in normal brokerage transactions without special efforts. The seller must file a report of his sale within ten days with the Commission.

B. Subsection 71(5).

Subsection 71(5) provides that, eighteen months after the new Act comes into force, the first trade in securities acquired under the five prospectus exemptive clauses of subsection 71(1) referred to therein or the first trade in issued securities of a company that has ceased to be a private company is a "distribution" requiring a prospectus unless either the further trade is exempted by subsection 71(1) or the conditions of subsection 71(5) are satisfied. During the initial eighteen month transitional period, securities acquired under clauses f, i, j, k or n of subsection 71(1) may be resold by a non-controlling person without restriction or compliance with the conditions of subsection 71(5) and irrespective whether the issuer is a reporting issuer. After such eighteen month period, the second stage of the "closed system" descends and the transferability by non-controlling persons of securities so acquired is then subject to the restrictions of subsection 71(5), including the primary conditions that the issuer fall within the statutory definition of a reporting issuer and maintain that status for twelve months.

A security holder who acquires securities of a non-reporting issuer under one of the five exemptions referred to in subsection 71(5) or who holds securities of a company that has ceased to be a private company has very limited voluntary rights of resale without a prospectus eighteen months after the new Act comes into force. He is limited, in effect to using only three of the subsection 71(1)

exemptions¹¹⁸ or obtaining a section 73 ruling. Where, however, the securities held are those of an issuer which has been a reporting issuer for at least twelve months and is not in default of any requirements of the new Act or the regulations then, subject to the issuer having made disclosure of its exempt trade to the Commission, the securities may be sold to the general investing public through normal transactions. Where the purchaser acquires his securities under clause 71(1)(i), for instance in an amalgamation, it is only necessary that one of the amalgamating corporations has been a reporting issuer for twelve months.

The rights of sale under subsection 71(4) are more restrictive by virtue of the imposition of the statutory holding periods than those under subsection 71(5). A security holder permitted to use the provisions of subsection 71(5) may, however, be required to hold the securities for a period of at least twelve months if the issuer was not a reporting issuer when he acquired the securities. On the other hand, if a security holder acquires the securities of an issuer that has had the status of a reporting issuer for at least twelve months, then subject to the other provisions of subsection 71(5), he may immediately sell such securities to the general investing public through normal transactions.

Clause 71(5)(b) also requires that the reporting issuer has "made disclosure of its exempt trade" or, where the company has ceased to be a private company, the issuer has filed a report with the Commission concerning its outstanding securities as required by the regulations,¹¹⁹ before the security holder may sell.

V. Sales of Securities by Controlling Persons.

A. Definition of a Controlling Person.

For the purposes of regulating trades in securities by controlling persons, subparagraph iii of the definition of "distribution" in paragraph 1(1)11 of the new Act defines a controlling person as

... any person, company or combination of persons or companies holding a sufficient number of *any securities* of that issuer to *affect materially the control of that issuer*, but any holding of any person, company or combination of persons or companies holding more than 20 percent of the outstanding *voting securities* of an issuer shall, in the absence of evidence to the contrary, be deemed to affect materially the control of that issuer.¹²⁰

¹¹⁸ Clauses 71(1)(a), (c) and (d).

¹¹⁹ A public announcement would normally accompany the transactions covered by subclauses 71(1)(f)(i) and (ii) and clauses 73(1)(i), (j) and (k). A public announcement would not, however, be usually made in respect of trades to employees under clause 73(1)(n).

¹²⁰ Italics added.

This definition of a controlling person is substantially similar to that contained in the Ontario Securities Act in subparagraph ii of paragraph 1(1)6a.

While it is not within the scope of this article to consider the ambit of the definition of a controlling person, several factors may be briefly noted. Whether a person or company, or a "combination" of persons or companies, holds sufficient securities of an issuer "to affect materially the control of that issuer" is a question of fact depending on all the surrounding circumstances.¹²¹ The definition applies to effective, working or *de facto* control as well as to legal or *de jure* control. Assuming that the phrase "control of that issuer" may refer principally to the power, arising out of the holding of securities, to select or affect the selection of at least a majority of directors, or other governing body, of the issuer,¹²² the number and type of securities required to be held to affect control materially will vary widely, depending, among other things, on the number of shareholders, the dispersal of the voting securities and the relationships among the shareholders.¹²³ The definition is phrased, however, not in terms of control of an issuer itself, but in terms of being able "to affect" materially the control of an issuer. It appears that the power "to affect materially the control" of an issuer, even if unexercised, may be sufficient to constitute a security holder a controlling person.¹²⁴

The latter part of subparagraph iii of the definition of a controlling person in the new Act deems a person, company or combination thereof who holds more than twenty per cent of the outstanding "voting securities" of an issuer to be a controlling person, unless there is

¹²¹ The controlling concept, and the problems of identifying a "combination" of controlling persons or companies and those who constitute the group, have not been fully explored in the context of Canadian securities law. On the issue of controlling persons generally, see Johnston, pp. 143-147 and A.A. Sommer, Jr., Who's "In Control"?—SEC (1966), 21 Bus. L. 559.

¹²² A classic statement is contained in Berle and Means, *The Modern Corporation and Private Property* (1932), p. 69: "Since direction over the activities of a corporation is exercised through the board of directors, we may say for practical purposes that control lies in the hands of the individual or group who have the actual power to select the board of directors (or its majority), either by mobilizing the legal right to choose them—'controlling' a majority of the votes directly or through some legal device—or by exerting pressure which influences their choice. Occasionally a measure of control is exercised not through the selection of directors, but through dictation to the management, as where a bank determines the policy of a corporation seriously indebted to it."

¹²³ In *Deer Horn Mines Ltd* (1968), O.S.C. Bulletin 12, the Commission noted that "the question of whether or not a block of shares materially affects control is not one capable of arithmetic measurement alone." In that case, 14.6% of the issued shares was sufficient to establish control.

¹²⁴ Merger Report, para. 4.02.

"evidence to the contrary". This twenty per cent threshold level was recommended originally by the *Merger Report* because it was the standard of control established by the take-over bid provisions. In order to rebut this deeming provision, the security holder would have to show that, in the circumstances of the situation, his holding of more than twenty per cent of the outstanding voting securities of the issuer did not enable or permit him to affect materially the control of that issuer, whether he wished to do so or not.

The effect of defining a controlling person within the definition of a "distribution" means that every trade "to the public" in any previously issued security of that issuer by a controlling person within the first eighteen months after the new Act comes into force and every trade by a controlling person thereafter requires the filing of a prospectus by the controlling person with the Commission under subsection 52(1) of the new Act, unless the controlling person has an exemption from such prospectus requirements in respect of that trade or has obtained a section 73 ruling. The securities that are traded by the controlling person in order to raise the prospectus requirements are not limited to voting securities. The trade of any security of the issuer under any circumstances brings the controlling person within the subsection 52(1) prohibition.¹²⁵

B. *Pledge of Securities by Controlling Persons.*

Under the new Act, a pledge of securities by a controlling person for the purpose of giving collateral for his indebtedness, or that of another person, is a "trade"¹²⁶ and thereby a "distribution" as defined. Clause 71(1)(e), however, provides an exemption from the prospectus requirements for such a trade provided it is made "for the purpose of giving collateral for a *bona fide* debt".¹²⁷ In view of the fact that a

¹²⁵ See *Famous Players Canadian Corporation Limited* (1969), O.S.C. Bulletin 83.

¹²⁶ Subpara. iv of para. 1(1)42.

¹²⁷ Where the securities are pledged with the predetermined intention that the lender will sell the securities for the benefit of the pledgor upon default in payment of the indebtedness, the clause 71(1)(e) exemption and the resale exemption for the lender under subsection 71(7) may not be available. In discussing an analogous problem, a United States court stated in *SEC v. Guild Films Co. Inc.* (1959), 178 F. Supp. 418 (S.D.N.Y.), at p. 423: "The touchstone to the transaction is the good faith of the parties—a good faith consisting not of an absence of intent to evade the statute, but an absence of intent on the part of the one delivering the property that it be sold and an absence of intent on the part of the one receiving it, at the time he receives the property, to sell it."

See, Sargent, *The Guild Films Case; The Effect of "Good Faith" in Foreclosure Sales of Unregistered Securities Pledged as Collateral* (1960), 46 Va. L. Rev. 1573.

pledgee of securities stands in the shoes of the pledgor,¹²⁸ the exercise by a pledgee of his special rights to sell the pledged securities on default and the unrestricted sale of the controlling person's securities by the pledgee in realizing his collateral for the debt would also constitute a distribution to the public or distribution within the prospectus requirements of subsection 52(1) of the new Act. It is with this problem in mind that subsection 71(7) of the new Act includes an exemption from the prospectus requirements for a trade by lenders for the purpose of liquidating a *bona fide* debt by selling pledged securities "encumbered in good faith as collateral for the debt".

C. Rights of Sale Under Subsection 71(7).

Subsection 71(7) of the new Act contains the principal exemption from the prospectus requirements for trades of securities by a controlling person and by a pledgee liquidating a *bona fide* debt by selling securities of a controlling person. However, as provided in subsection 143(2), subsection 71(7) does not become effective until eighteen months after the new Act comes into force. During this eighteen month period neither a controlling person nor a pledgee of control block stock has the availability of this exemption to sell securities to the public. Any sale of securities to the public during this transitional period must be effected through a subsection 71(1) exemption or under a prospectus or a ruling.¹²⁹ As a result of the enactment of the new Act, a controlling person and a pledgee selling on behalf of a controlling person in the course of realizing on the pledged securities will lose the current prospectus exemption set out in clause 58(2)(c) of the Ontario Securities Act. While the removal of the clause 58(2)(c) exemption is ultimately replaced when subsection 71(7) of the new Act becomes effective, there is a substantial narrowing of the rights of controlling persons to trade listed securities in view of the absence of both clause 58(2)(c) of the Ontario Securities Act and subsection 71(7) of the new Act during the first eighteen months after the new Act comes into force. As a result of the postponement of the effectiveness of subsection 71(7) and the few available prospectus exemptions under subsection 71(1), a pledgee of securities of a reporting issuer from a controlling person may not have a very marketable security during this eighteen month transitional period.

¹²⁸ See *The Odessa*, [1916] 1 A.C. 145. The Privy Council stated, at p. 159: "If the pledgee sells he does so by virtue and to the extent of the pledgor's ownership and not with a new title of his own."

¹²⁹ During this transitional period it may be anticipated that a controlling person or a pledgee of his securities may apply to the Commission under s. 73 and Ontario Securities Commission Policies No. 3-18 and No. 3-19 for a ruling permitting sales in an orderly fashion during a limited period. In addition, the Draft Regulations propose another prospectus exemption where a trade is made from one controlling person to another.

Once subsection 71(7) becomes effective, the controlling person may still use the applicable prospectus exemption clauses of subsection 71(1)¹³⁰ discussed earlier. These exemptive clauses might be used where the issuer is not a reporting issuer or where the provisions of clause 71(7)(b) cannot be satisfied. However, as in the case of a security holder of a non-reporting issuer who acquired his securities under subsection 71(1), a controlling person of a non-reporting issuer and a controlling person of a reporting issuer before subsection 71(7) becomes effective have limited rights to sell any securities without a prospectus. Such a controlling person or a pledgee of his securities must either obtain a section 73 ruling or sell only to (A) banks, loan, trust and insurance companies, the Crown or a municipal corporation under clause 71(1)(a); (B) an exempt purchaser, other than an individual, under clause 71(1)(c); or (C) a purchaser whose aggregate acquisition cost is at least \$97,000.00 for the securities, under clause 71(1)(d). The balance of the prospectus exemption clauses in subsection 71(1) is not applicable to the voluntary sale of securities by or on behalf of a controlling person, whether they are securities of a reporting issuer or not. Where, eighteen months after the new Act comes into force, a controlling person, or a lender holding securities pledged by a controlling person, has securities of a reporting issuer which has been a reporting issuer for at least eighteen months and which is not in default of any requirement of the new Act or the regulations, the controlling person or the lender in liquidating the pledged securities may use the provisions of clause 71(7)(b) to sell such securities to the general investing public through normal transactions.

In exercising the rights of sale under clause 71(7)(b), there is no statutory holding period during which a controlling person must have held the securities and there is no restriction on the amount of securities which can otherwise be sold in normal transactions. While the reporting issuer of the securities must have been a reporting issuer for at least eighteen months, a controlling person might not necessarily have held the securities he wishes to sell for that period of time. A controlling person will have to consider, however, whether there is any investment intent attached to any of his securities and whether the provisions of subsections 71(4), 71(5) or 71(6) are also applicable to any of his securities he proposes to trade.

As previously referred to, a person who acquires securities of a reporting issuer eighteen months after the new Act comes into force under one of the eight prospectus exemptive clauses of subsection 71(1) referred to in subsection 71(4) or under one of the five prospectus exemptive clauses referred to in subsection 71(5) may resell such

¹³⁰ Clause 71(7)(a). This clause appears unnecessary in view of subsection 71(1) which exempts all distributions from s. 52.

securities under the provisions of subsection 71(4) or subsection 71(5), as the case may be, without a prospectus. Where the person so acquiring such securities is also a controlling person, it might be argued that he is entitled to sell such securities under subsection 71(4) or subsection 71(5) without a prospectus without being required to comply with subsection 71(7). However, a controlling person in such circumstances should be cautioned that he might be effecting an illegal "distribution" without a prospectus if he sold under subsection 71(4) or subsection 71(5) without regard to subsection 71(7) because, notwithstanding his sale was not a "distribution" as defined by subsections 71(4) and 71(5), it would still constitute a "distribution" as defined by subparagraph iii or paragraph 1(1)11. The concluding words at the end of subsection 71(5) make this clear with respect to this subsection. It appears that the only prospectus exemption for a "distribution" within the meaning of subparagraph iii of paragraph 1(1)11 is pursuant to the provisions of subsection 71(7). Accordingly, a controlling person who acquires securities under any of the subsection 71(1) clauses referred to in subsections 71(4) and 71(5) may be required, in reselling such securities, to comply with the applicable provisions of subsection 71(4) or 71(5), as the case may be, as well as with the provisions of subsection 71(7). A controlling person may also have to consider the impact of subsection 71(6) if he acquires securities under clause 71(1)(o).

Following the eighteen month transitional period after the new Act comes into force, a controlling person, or a lender who wishes to liquidate securities pledged by a controlling person as collateral for a debt, may sell securities of a reporting issuer, which has been a reporting issuer for at least eighteen months and which is not in default of any requirement of the new Act or the regulations, under the procedures set out in clause 71(7)(b).

As section 137 of the new Act provides that all material filed with the Commission is available for public inspection unless determined otherwise by the Commission in special circumstances, a controlling person's intention to sell all or part of his securities may become public knowledge prior to the time of any actual sale by virtue of the notice requirements of subclause 71(7)(b)(i). The requirement for seven days' prior notice of intention to sell will mean that a controlling person who decides to sell any of his securities of the reporting issuer in respect of which he has the control position may sell, at the earliest, on the eighth day following his decision, assuming he files his required documents on the day of his decision. The seven day prior notice of sale requirement will also mean that a lender, who decides to liquidate securities pledged by a control person as collateral for a debt, will not be able to realize the collateral security as quickly as he would normally like to do. In addition a lender, in realizing such collateral security, cannot pay any

extraordinary commission or other consideration to facilitate the liquidation of his debt.

The procedures outlined in clause 71(1)(b) apply in all cases where a controlling person or a lender desires to trade such securities of a reporting issuer, whether through the facilities of a stock exchange or otherwise.

SCHEDULE A

Concordance Table of Subsection 71(1) Prospectus Exemptions

For convenience a summary of the subsection 71(1) prospectus exemptions is included below with reference to comparable prospectus exemptions under the Ontario Securities Act.

| | <i>Ontario Securities Act</i> | <i>New Act first 18 months</i> | <i>New Act after 18 months</i> |
|---------------------------------------------------------------------------------------|---------------------------------------|----------------------------------------|----------------------------------------|
| 1. Trade not "to the public". | 1(1)6a | 1(1)14 52(1)(a) | — |
| 2. Banks, insurance and trust companies, the Crown, municipalities and public boards. | 19(1)3 58(1)(a) | 71(1)(a) 143(2) | 71(1)(a) |
| 3. Isolated trade by issuer. | — | — | 71(1)(b) 143(1) |
| 4. Exempt purchaser. | 19(1)3 58(1)(a) | 71(1)(c) | 71(1)(c) 43(2) |
| 5. Private Placement. | 19(3) 58(1)(b) | 71(1)(d) 143(2) | 71(1)(d) |
| 6. Control block pledge. | — | 71(1)(e) | 71(1)(e) |
| 7. Stock dividend. | 19(1)8(i) 58(1)(c) | 71(1)(f)(i) | 71(1)(f)(i) |
| 8. Reorganization or winding-up. | 19(1)8(ii) 58(1)(c) | 71(1)(f)(ii) | 71(1)(f)(ii) |
| 9. Warrants, convertibles, exchangeables—own issue. | 88(Regs) | 71(1)(f)(iii) | 71(1)(f)(iii) |
| 10. Dividend <i>in specie</i> . | — | 71(1)(g) | 71(1)(g) |
| 11. Rights' offering. | 19(1)8(iii) 58(1)(c) | 71(1)(h)(i) | 71(1)(h)(i) |
| 12. Warrants, convertibles, exchangeables—another issuer. | — | 71(1)(h)(ii) | 71(1)(h)(ii) |
| 13. Statutory amalgamation. | 19(1)9(a) 58(1)(c) | 71(1)(i)(i) | 71(1)(i)(i) |

| | | | |
|-----------------------------------------------------|-----------------------|--------------------|-----------------|
| 14. Arrangement. | 19(1)9(a) 58(1)(c) | 71(1)(i)(i) | 71(1)(i)(i) |
| 15. Merger. | 19(1)9(b) 58(1)(c) | 71(1)(i)(ii) | 71(1)(i)(ii) |
| 16. Take-over bid. | 19(1)9(c) 58(1)(c) | 71(1)(j) | 71(1)(j) |
| 17. Exempt take-over bid. | 19(1)9a 58(1)(c) | 71(1)(k) | 71(1)(k) |
| 18. Asset purchase. | 19(1)9b 58(1)(c) | 71(1)(l) 143(2) | 71(1)(l) |
| 19. Mining claims. | 19(2)12a 58(2)(a) | 71(1)(m) | 71(1)(m) |
| 20. Employees. | 19(1)10 58(1)(c) | 71(1)(n) | 71(1)(n) |
| 21. Incorporators. | 19(1)9c 58(1)(c) | 71(1)(o) | 71(1)(o) |
| 22. "Seed capital" — Knowledgeable investor. | — | 71(1)(p) 143(2) | 71(1)(p) |
| 23. Dealers. | 58(1)(d) | 71(1)(q) | 71(1)(q) |
| 24. Underwriters. | 19(1)(6) 58(1)(c) | 71(1)(r) | 71(1)(r) |
| 25. Commodity hedgers. | — | 71(1)(s) | 71(1)(s) |
| 26. Promoters. | 19(1)9c 58(1)(c) | — | — |
| 27. Listed securities of controlling persons. | 58(2)(c) | — | 71(7) 143(2) |
