



## STAFF NOTICE 45-704

### REVIEW OF OFFERING MEMORANDUMS UNDER NI 45-106 *Prospectus and Registration Exemptions*

#### Background

Multilateral Instrument 45-103 *Capital Raising Exemptions* (MI 45-103) came into force on June 16, 2003. It contained new exemptions from the prospectus and registration requirements that issuers can use to raise capital. One of the exemptions, the “Offering Memorandum Exemption” permitted issuers to sell their own securities to investors in Saskatchewan using an offering memorandum (OM). Each investor must receive a copy of an OM prepared in accordance with MI 45-103. Issuers are not required to have Commission staff review the OM before they use it in a distribution of securities.

MI 45-103 was repealed and replaced by National Instrument 45-106 *Prospectus and Registration Exemptions* (NI 45-106) on September 14, 2005. NI 45-106 contains the Offering Memorandum Exemption in section 2.9.

In Staff Notice 45-703 *Monitoring the Use of the Exemptions Under National Instrument 45-106 Prospectus and Registration Exemptions*, we set out how we will monitor the use of exemptions under NI 45-106. We state that we will review OMs filed by issuers who have their head office in Saskatchewan to confirm that they contain the disclosure in the required form.

Since MI 45-103 was implemented, and subsequently replaced by NI 45-106, we have selected a sample of OMs filed under these instruments and reviewed them. We continue to select and detail review OM’s filed under NI 45-106 on an ongoing basis. All of the OM’s reviewed were filed by non-qualifying issuers under MI 45-103 and NI 45-106. The non-qualifying issuers subject to review were prepared by non-qualifying issuers that were primarily not reporting issuers. For the majority of these issuers, this was their first significant offering of securities.

This Staff Notice sets out the results of our detailed review of the OMs filed by these non-qualifying issuers.

#### General Comments

Staff identified material disclosure deficiencies in all of the OMs reviewed. In general, the OMs were poorly prepared and did not provide the disclosure required.

Since we commenced reviewing OM's, we observed no noticeable improvement in the quality of disclosure provided by first time users of the OM Exemption. We did observe significant improvement in subsequent OM filings received from parties having been subject to an OM review.

**If issuers trade securities under an OM that does not comply with NI 45-106, they have not met the requirements of the OM Exemption. The trades will be in contravention of Saskatchewan securities laws and will be illegal.**

It is fundamental that individuals preparing an OM under NI 45-106 read the relevant sections of NI 45-106, Companion Policy 45-106CP *Prospectus and Registration Exemptions* (45-106CP), Form 45-106F2 *Offering Memorandum for Non-Qualifying Issuers* (Form 45-106F2), and the *Instructions for Completing - 45-106F2 Offering Memorandum for Non-Qualifying Issuers* (the "Form Instructions") before they attempt to prepare an OM.

Form 45-106F2 provides an Item-by-Item guide about what information is to be provided in the OM, with the Form providing instruction within each Item. Accompanying the Form 45-106F2 are the Form Instructions. The Form Instructions provide additional guidance in completing the form, as well as substantial guidance on financial statement disclosure requirements for the OM. Companion Policy 45-106CP provides further detailed guidance for issuers preparing an OM.

If issuers or issuers' professional advisers have questions on the disclosure requirements for these OMs, we encourage them to contact the staff in the Corporation Finance Branch of the Commission's Securities Division to discuss their questions before they prepare or use the OM to sell securities.

**Issuers may pre-file a draft OM on a voluntary basis for staff review and comment before it is used. Staff Notice 45-706 *Voluntary Review of Offering Memoranda Under NI 45-106 Prospectus and Registration Exemptions* gives details.**

### **Consequences to Issuers of failing to comply with the OM disclosure requirements**

The following are the main consequences for issuers who fail to comply with the OM disclosure requirements:

1. *Offering suspended.* Staff may request that the offering be suspended until investors are provided with proper disclosure.
2. *Remedial information provided.* Staff may request that an issuer provide remedial information to investors.

3. *OM amended and redelivered.* Staff may request that the OM and related documents be amended and delivered to investors.
4. *Money refunded.* Staff may request that the issuer refund investors' money to them.
5. *Cease trade order.* The Director may issue an order that the issuer cease trading in securities.
6. *Enforcement hearing before the Commission.* Staff may take the parties signing a certificate in an OM to a hearing before the Commission. The Commission has the ability to levy sanctions against these parties, including removing their right to use exemptions, and imposing an administrative penalty of up to \$100,000.
7. *Civil action.* If an OM contains a misrepresentation, investors have a right of action against everyone who signed the certificate in an OM. Also, if an offering of securities is made in contravention of the *Act*, investors have a right of action pursuant to section 141.

## **Summary of Disclosure Deficiencies**

The following are our observations based upon a review of a sample selection of OMs filed under MI 45-103 and NI 45-106:

### *General Disclosure Problems*

1. Failure to follow Form 45-106F2.
2. Failure to follow the order of Items in Form 45-106F2 (Refer to A.2 of the Form Instructions).
3. Failure to follow the guidance outlined in 45-106CP and the Form Instructions.
4. General lack of attention to detail, poorly prepared, disorganized (Refer to Section A of the Form Instructions).

### *Attachments*

1. The majority of OM's had attachments and appendices (eg: projections, financial reports, and supporting documents). In many cases, Form 45-106F2 disclosure was partially provided in the body of the OM, with the balance being provided in an attachment. In most cases, this information should have been provided in the body of the OM, as required by Form 45-106F2. Providing the required information in one location substantially improves the clarity and readability of the OM. Where attachments are necessary (eg: providing a full copy of the limited partnership agreement) the

attachments must be incorporated by reference into the OM.

### *Material Agreements*

1. Failure to properly summarize key terms of material agreements in the OMs in a manner that will fully inform investors (Refer to Item 2.7 of Form 45-106F2).
2. Failure to properly identify material agreements as material agreements, and provide the details in the OM to properly inform investors (Refer to Item 2.7 of Form 45-106F2).

### *Future-Oriented Financial Information (FOFI)*

(FOFI included in an OM are most commonly presented in the form of projections.)

1. Projections included in the OM were prepared far in advance of the date of the OM. In one case, there was substantial economic turmoil that occurred after the date used in the projections but before the date of the OM. It did not make sense to include information based on assumptions made prior to the economic downturn. The projections should have been updated given the circumstances.
2. Figures provided in projections were not arithmetically correct in relation to the supporting assumptions on calculation methodology.
3. Narrative body of the OM indicated that the projections were not audited, when in fact they were audited.
4. Narrative provided in the body of the OM contradicted details provided in the projections. For example, projections included in the OM were based upon an offering size that differed from that contemplated by the narrative of the OM.
5. The projections included in the OM were not accompanied by supporting hypotheses and assumptions, making them of little use to investors (Refer to Part 4A and Part 4B of National Instrument 51-102 *Continuous Disclosure Obligations* (NI 51-102)).
6. It was not clearly distinguished whether projected cash distributions to investors were a return of original capital invested, or based upon operating earnings.
7. Projections covered an unreasonably lengthy period of time (Refer to NI 51-102 Part 4B.2).
8. Audit reports on projections referred to an incorrect number of years.
9. Audit reports on projections were not clearly identified as audit reports (Refer to CICA Handbook AuG-6.40-.45).

10. Audit reports referred to the hypotheses and assumptions accompanying the projections when there were no hypotheses provided.

### *Financial Statements*

1. In many cases, the financial statements provided in the OM did not include all of the required statements (Refer to B.4 of the Form Instructions).
2. The Issuer did not provide financial statements in the OM (Refer to section B of the Form Instructions).
3. The Issuer did not provide financial statements of companies to be acquired in the OM (Refer to C.4 of the Form Instructions).
4. Financial statements for the general partner were not included in the OM (Refer to B.15 of the Form Instructions).
5. Failure to update the OM for more current audited financial statements (Refer to B.12 of the Form Instructions).
6. In one case, an issuer provided audited financial statements for a period ended just prior to their actual year end. The issuer's most recently completed financial year ended more than 120 days before the date of the OM. The OM should have been updated to include the audited financial statements for the issuer's most recently completed financial year by no later than 120 days following the issuer's financial year end (Refer to B.12 of the Form Instructions).
7. An issuer's actual financial year end that was discussed in the narrative of the OM did not agree to the year end of the statements included in the audited annual financial report (Refer to section B of the Form Instructions).

### *Promoters*

1. Many issuers did not identify which officers and directors were considered promoters (Refer to Item 3.1 of Form 45-106F2).

### *Related Party Transactions*

1. When providing information on the use of available funds, many issuers did not disclose the amounts paid or payable to related parties, and the relationship of the related party (Refer to Item 1.2 of Form 45-106F2).
2. Issuers did not specifically identify and disclose information on material agreements with related parties (Refer to Item 2.7 of Form 45-106F2).

3. Issuers did not disclose information in regards to the principal amount, repayment terms, due date and interest rate of any debenture or loan due to or from a related party (Refer to Item 3.4 of Form 45-106F2).
4. Issuers are required to identify any long term debt payable to a related party in the narrative of the OM (Refer to Item 4.2 of Form 45-106F2).

### *Investors Rights / Certificates*

1. Failure to properly document purchasers' rights in the OM, in terms of the parties that may be sued if there is a misrepresentation (Refer to NI 45-106 section 2.9(6), (7), and Item 11 of Form 45-106F2).
2. In the case of offerings by limited partnerships, there was a failure to provide required certificates of the issuer, general partner, and promoters (Refer to NI 45-106 section 2.9(11)).
3. Failure to follow instructions relating to the signing of the certificate. The certificate is to be signed by the chief executive officer, chief financial officer, and any two directors authorized to sign, as well as by each promoter of the issuer (Refer to NI 45-106 section 2.9(9)).
4. Audit reports on projections and financial statements were dated by the auditor on a date after the date of the certificate of the issuer, raising questions on the validity of the certificate provided.
5. Completing the disclosure required by Form 45-106F2 without giving full consideration to additional disclosure that may be required to ensure that a misrepresentation does not occur. Misrepresentation includes an omission to state a material fact that is required to be stated or that is necessary to make a statements not misleading in the light of the circumstances in which it is made. Officers and Directors should be asking this question prior to signing the certificate.

### *Other*

1. Failure to state "There is no minimum. You may be the only purchaser" in bold type when no minimum offering was provided (Refer to "The Offering" section of Form 45-106F2).
2. Failure to identify risk factors in order of importance (Refer to Item 8 of Form 45-106F2).
3. For a resource issuer, the required disclosure in accordance with Form 51-101F1

*Statement of Reserve Data and Other Oil and Gas Information* was not provided (Refer to A.9 of the Form Instructions).

4. When describing long term and short term objectives, the issuer failed to provide the specific time period in which each event was expected to occur and the related costs to each event (Refer to Items 2.4 and 2.5 of Form 45-106F2).
5. Structuring the offering as an indirect offering, with little detail in the OM on the actual operating company/providing financial statements for the actual operating company, or the investment details in the operating company.
6. Complete failure to properly describe the indirect investment and how returns will be calculated on that investment.
7. Describing securities as redeemable without providing details on how the redemption will be funded and possible effects on the overall investments of the issuer.
8. Using Form 45-106F2 for a continuous offering, without updating the OM for material changes, effectively resulting in the marketing of securities with a stale-dated OM. (Refer to 3.8(3) of 45-106CP).
9. Using a substantial portion of the proceeds of an offering to pay down recently incurred debt, without providing details in the OM on why the debt was incurred, or what specifically was acquired with the proceeds from the debt.
10. Failure to identify in the OM funds from other sources required in addition to the proceeds of the offering for a project to proceed (Refer to Item 1.1 of Form 45-106F2).
11. Failure to provide sufficient meaningful detail on the use of available funds raised as a result of the OM (Refer to Item 1.2 of Form 45-106F2).
12. Failure to provide sufficient information relating to the business to enable a potential investor to make an informed investment decision. This disclosure may include information on principal products or services, operations, market, marketing plans, and business strategies (Refer to Item 2.2 of Form 45-106F2).
13. Failure to properly identify an existing working capital deficiency and the portion of the proceeds of the offering that will be applied against the working capital deficiency (Refer to Item 1.1 of Form 45-106F2).
14. Failure to clearly identify the directors and officers of the issuer (Refer to Item 3 of Form 45-106F2).
15. Failure to provide details relating to the directors and officers of the company who will

manage the operations of the issuer, including their business/management experience (Refer to Item 3.2 of Form 45-106F2).

16. Failure to identify the compensation paid, directly or indirectly, to officers, directors, principal shareholders, and promoters of the issuer including cash, shares, and options paid in the most recently completed financial year and the compensation anticipated to be paid in the current financial year (Refer to Item 3.1 of Form 45-106F2).
17. Identifying a trustee to hold subscription receipts until the minimum offering amount has been raised, when the identified trustee has not agreed to act in this capacity.
18. Identifying the business risk in the OM as being very low, when in fact, the opposite is true.
19. Failure to clearly identify the material terms of the securities being offered, such as required disclosure on the terms of options, warrants, and broker warrants (Refer to Item 4.1 of Form 45-106F2).
20. Failure to provide adequate information on a proposed future investment in a related operation without explaining the purpose and role of this additional entity in relation to the operations of the issuer, how the investment will be funded, and the ownership percentages and rights attached to the investment.
21. Failure to keep the business model for the OM simple. In some instances, too many related companies are involved in various key roles with the issuer, each of which needs and has failed to provide Form 45-106F2 disclosure relating to each company, for a reader to properly comprehend the offering and the operations of the issuer.
22. Failure to use Form 45-106F5 *Risk Acknowledgement – Saskatchewan Close Personal Friends and Close Business Associates* for investors that would be considered close personal friends or business associates when using the exemption for family, friends and business associates under section 2.6(1) of NI 45-106.
23. Providing oil and gas reserve information in the OM, derived from a supporting technical report, when the technical report indicates that use of select information from the report is not permitted. Further, the reserve information in the OM is accompanied by numerous footnotes, but the table in the technical report has no footnotes.

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