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Dealer Bulletin

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Changes to Prospectus Offering Requirements – Ten Developments Every Dealer Needs to Know

The Canadian securities regulators have adopted new rules and guidance for prospectus offerings that harmonize and consolidate existing requirements across Canada, but also introduce new requirements that will affect dealers. The new rules and guidance came into force on March 17, 2008.

There are ten developments under the new prospectus rules (*National Instrument 41-101 - General Prospectus Requirements*) and guidance (*Companion Policy to National Instrument 41-101*) that every dealer should be aware of:

1. Dealer compensation securities qualified by a prospectus cannot exceed 10% of the offering.

A prospectus may only qualify securities issued as compensation for acting as a dealer (e.g. brokers' warrants and corporate finance fees payable in shares) where the number of those securities, on an as-if-converted basis, does not exceed 10% of the offering. Prior to the new prospectus rule, it was possible to qualify compensation securities in excess of 10% of the offering in certain jurisdictions of Canada. This does not preclude additional compensation securities being issued to dealers that are not qualified by the prospectus, but those securities would be subject to applicable resale restrictions.

2. Over-allotment option terms fixed.

The new prospectus rules codify existing practice for over-allotment options, with some modifications. An over-allotment option is permitted in a prospectus, provided it:

- is granted for the purpose of covering the "over-allotment position";
- expires not later than 60 days after the closing date; and
- is exercisable for the lesser of the "over-allotment position" and 15% of the base offering.

The "over-allotment position" is the amount by which the number of securities sold at closing exceeds the number of securities distributed under the prospectus (excluding any over-allotment option or securities issued as compensation). Accordingly, securities held by a dealer at closing for sale at a future date will not be considered part of the over-allotment position.

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3. Dealer Options to increase the size of the offering may not be qualified by a prospectus.

The Canadian Securities Administrators are concerned about “backdoor underwritings”, i.e. where securities acquired under a prospectus are purchased by a dealer and are then sold by that dealer into the secondary market without the purchasers in the secondary market receiving a prospectus. To prevent “backdoor underwritings”, the new prospectus rules limit the securities that may be distributed to dealers under a prospectus to:

- permitted over-allotment options (described above); and
- permitted compensation securities (described above).

As a result, a dealer option to increase the offering size cannot be qualified by a prospectus. This limitation does not preclude a dealer option that is exercised prior to filing the prospectus. However, it is important to note that, in the case of a bought deal, the Canadian Securities Administrators have taken the position (*CSA Staff Notice 47-302*) that the ability for dealers to solicit expressions of interest before the filing of a preliminary prospectus does not extend to dealer options.

4. New legend requirements for green sheets and other communications.

Green sheets and any notice, advertisement or other communication used in connection with a prospectus offering during the period between the preliminary prospectus and final prospectus must now contain the following legend:

“A preliminary prospectus containing important information relating to these securities has been filed with securities commissions or similar authorities in certain jurisdictions of Canada. The preliminary prospectus is still subject to completion or amendment. Copies of the preliminary prospectus may be obtained from [insert name and contact information for dealer or other relevant person or entity.] There will not be any sale or any acceptance of an offer to buy the securities until a receipt for the final prospectus has been issued.”

A different legend is required for such communication following the issuance of a receipt for a final prospectus.

The legend must be in bold face and at least as large as that used in the body of the text. Prior to the new prospectus rule, there were no prescribed legend requirements for such communication.

5. Where securities are to be distributed under a prospectus, marketing activities may not be undertaken on a prospectus exempt basis.

Some dealers have undertaken marketing activities on the basis that where an exemption from the prospectus requirement is available, e.g. the distribution is marketed to an “accredited investor”, marketing related to that distribution is exempt from the prospectus requirement. The new prospectus guidance provides that if marketing activities are undertaken where the distribution is anticipated to be made pursuant to a prospectus, marketing activities must be viewed as an activity in furtherance of the prospectus distribution and a prospectus exemption may not be relied on.

Where a private placement is abandoned in favour of a prospectus offering, the rules relating to marketing activities in furtherance of a prospectus offering will apply from the time it is reasonable for a dealer to expect that a bona fide exempt distribution will be abandoned in favour of a prospectus offering.

6. Marketing activities that are prohibited prior to the filing of a preliminary prospectus have been clarified.

The new prospectus guidance clarifies what marketing activities are prohibited prior to filing a prospectus. In general, any marketing intended to promote an offering of securities by prospectus prior to the filing of a prospectus is prohibited. This prohibition includes oral, written and electronic communication and includes television or radio commentaries, market letters, printed articles, research reports, telemarketing scripts and excerpts of sales literature.

In contrast, marketing activities which are not in furtherance of a distribution of securities are not prohibited. These include:

- an advertising or publicity campaign aimed solely at products or services or raising public awareness of the issuer;
- communication of factual information consistent with past practice, as long as it does not refer to or suggest the distribution of securities; and
- information required to be released pursuant to securities laws.

The new prospectus guidance cautions that any activities that form part of a plan or series of activities undertaken in anticipation or in furtherance of a distribution would usually be prohibited, even if they would be permissible if viewed in isolation. Also, marketing activities that do not indicate that a distribution is contemplated may be prohibited by virtue of their timing and content even where they do not indicate that a distribution is contemplated. In particular, where a private placement or other exempt distribution occurs prior to or contemporarily with a prospectus offering, it may be considered as part of the prospectus offering and, consequently, be prohibited.

As a result, dealers should, as part of their due diligence, review the marketing activities of issuers leading up to the filing of a preliminary prospectus and use caution with contemporaneous private placements.

7. Ordinary course communications between a dealer and its clients concerning their interest in purchasing various securities is acceptable, but must be terminated upon commencement of a distribution.

Many dealers communicate on a regular basis with clients and prospective clients regarding their interest in purchasing various securities of various issuers. The new prospectus guidance provides that such ordinary course communication is not prohibited. However, from the “commencement of the distribution”, a representative of the dealer who has knowledge of the distribution discussions, or who is acting at the direction of another person who has such knowledge, may not communicate with any person for the purposes of determining their interest in purchasing the securities contemplated to be distributed.

The “commencement of a distribution” occurs when a dealer has had distribution discussions with an issuer, selling securityholder, or dealer that had discussions with the issuer or selling securityholder, and those discussions are of sufficient specificity that it is reasonable to expect that the dealer will propose to the issuer or selling securityholder an underwriting of securities.

8. Limited marketing activities are permitted for prospectus offerings.

It is permissible during the period between the preliminary prospectus and the final prospectus and after a receipt for a final prospectus to distribute notices, advertisements or other communication that:

- “identify” the securities proposed to be issued, by indicating:
 - whether it is debt, shares, an interest in a non-corporate entity or a partnership interest;
 - the issuer’s name if the issuer is a reporting issuer, or the name and a brief description of the business of the issuer if the issuer is not already a reporting issuer (the description of the business should be cast in general terms and should not attempt to summarize the proposed use of proceeds);
 - without giving details, whether the security qualifies the holder for special tax treatment; and
 - how many securities are available;
- state the price (if then determined); and
- state the name and address of a person/company from whom purchases of securities may be obtained.

Any such communication must also state the name and address of a person/company from whom a preliminary prospectus may be obtained. The purpose of the permitted marketing activities is essentially to alert the public to the availability of the preliminary prospectus or prospectus. The use of any other marketing information (other than a prospectus) is prohibited.

9. Guidance on green sheets confirms existing practice.

Typically, green sheets include more information than that described above in “Limited marketing activities are permitted for prospectus offerings”. In such circumstances, the new prospectus guidance confirms that the distribution of a green sheet to a potential investor is prohibited.

Information in a green sheet should be consistent with the prospectus. The new prospectus guidance provides that where material information included in a green sheet or other marketing communication is not contained in the preliminary prospectus, it could indicate a failure to provide all necessary disclosure in the prospectus. Also, any discrepancies between the content of a green sheet and the preliminary prospectus could result in the delay or refusal of a receipt for a final prospectus and, in appropriate circumstances, could result in enforcement action.

10. Dealers have the “responsibility” of ensuring that an issuer is aware of marketing restrictions.

The new prospectus guidance provides that dealers (and legal counsel) have the “responsibility” of ensuring that the issuer and its directors and officers who may come in contact with the media are fully aware of the marketing restrictions applicable during the period of distribution of securities. It is not sufficient to make those restrictions known only to the officers comprising the working group. Also, dealers (as well as issuers and other market participants) should develop, implement, maintain and enforce procedures to ensure that marketing activities that are prohibited are not undertaken intentionally or through inadvertence.

At a minimum, dealers (as well as other participants in a prospectus offering) should ensure the following practices:

- Directors or officers of an issuer should not give interviews to the media immediately prior to or during the period between the preliminary prospectus and the final prospectus. Directors and officers should normally limit themselves to responding to unsolicited inquiries of a factual nature made by shareholders, securities analysts, the media and others who have a legitimate interest in such information; and
- No director or officer of an issuer should make any statement during the period from the commencement of the distribution until the closing which constitutes a forecast, projection or prediction with respect to future financial performance, unless that statement relates to and is consistent with a forecast contained in the prospectus.

As a result of this new “responsibility”, dealers should take steps to ensure that the issuer and its directors and officers are notified of their obligations with respect to prohibited marketing activities. This notification may take the form of a “scare letter”, delivered to the issuer concurrently with the execution of an engagement letter, that describes prohibited marketing activities.

Additional Information

If you wish to discuss any aspect of this commentary, please contact Trevor R. Scott at 604-661-1732 tscott@farris.com or any of the members of Farris’ Securities Practice Group.



About Trevor Scott

Trevor Scott is a solicitor at Farris and provides strategic and legal advice in diverse business areas. He has extensive experience in debt and equity financings for public and private companies, representing both issuers and investment banks. He also regularly advises on business acquisitions, divestments and take-over bids, including compliance issues with the Competition Act and assisting foreign investors with Investment Canada Act matters. Trevor also advises on corporate governance matters. Trevor can be contacted by phone (604) 661-1732 or email: tscott@farris.com

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