CROSS BORDER SECURITIES UPDATE

October 2007

Inside This Issue:

- **Supreme Court of Canada Decision Clarifies No Obligation to Disclose Material Fact Which Occurs After Receipt for Prospectus but Before Closing the Offering.**
- **Under the Radar: Proposed Changes to Regulation D**

Supreme Court of Canada Decision Clarifies No Obligation to Disclose Material Facts Which Occur After Receipt for Prospectus but Before Closing the Offering.

The Supreme Court of Canada Justices' decision in Kerr v. Danier Leather Inc., 2007 SCC 4 (Oct. 12, 2007) has put to rest a class action suit that has been going on for nine years. It has also clarified that a company and its officer and directors will not be held liable for failing to disclose material facts that become known to them after the filing of the prospectus at issue but before the closing of the offering. Liability only emerges on failure to disclose a material change post filing.

The facts of the Danier case are relatively straight forward. The initial public offering prospectus for Danier ("Prospectus") contained projections for its fourth quarter. The Prospectus was filed and a receipt provided. The underwriters began selling the shares offered under the Prospectus. During this period management for Danier received notice that their fourth quarter results were lagging behind the forecast contained in the Prospectus. The offering closed and two weeks later Danier issued a press release announcing it had revised its earnings forecast downwards for the fourth quarter. The stock price for Danier's common shares fell 26% on this news. A class action lawsuit was launched for Prospectus misrepresentation under s. 130(1) of the Ontario Securities Act (the "OSA"). Given the money at stake and the nature of the questions at issue the case moved from the lower courts of Ontario to the Supreme Court of Canada.

Four issues were considered by the Supreme Court of Canada Justices:

Q1. Whether s.130(1) of the OSA requires company to disclose material facts arising after prospectus filed?
Q2. Whether change in a company's results amounted to material change requiring disclosure?
Q3. Whether forecast contained implied representation of objective reasonableness?
Q4. Whether Business Judgment Rule has any application to disclosure requirements of OSA?

Q1 Section 130(1) New Material Fact is Not a Misrepresentation

Section 130(1) reads " Where a prospectus together with any amendment to the prospectus contains a misrepresentation, a purchaser who purchases a security offered thereby during the period of distribution or distribution to the public shall be deemed to have relied on such misrepresentation if it was a misrepresentation at the time of purchase and has a right of action for damages against: (a) the issuer or a selling security holder on whose behalf the distribution is made;…."

In the facts provided in this case the Justices held that the Prospectus did not contain a misrepresentation at the time of filing and there was no obligation on the issuer to update the prospectus to disclose a material fact or material facts that did not amount to a "material change" as defined in section 57(1) of the OSA.

Q2 Definition of a Material Change

Section 57(1) of the OSA limits the obligation of post-filing disclosure to notice of a "material change", which the OSA defines in section 1 as "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".

The Justices held Danier did not experience a material change that required disclosure under section 57(1) of the OSA. There was no evidence that Danier made a change in its business, operations or capital during the period of distribution. The revenue shortfall instead was caused by the unusually hot weather, a factor external to Danier. A material change

continued…

is limited to changes in the issuer's business, operations or capital. The concept is not intended to capture factual developments that may have an impact on the results that the issuer's business or operations is able to generate but which are external developments that do not amount to a material change to the issuer's business, operations or capital.

Q3 Objective Reasonableness

The Justices held that the forecast provided in the Prospectus clearly stated it was based on information available to management on a date certain and the forecast was reasonable as of that date. There was no implied representation of reasonableness or duty to update past this date. Forecasting is a matter of business judgment and disclosure is a matter of legal obligation. Issuers have no statutory obligation to make timely disclosure of intra-quarterly results of operations per se, absent a material change or contractual obligation.

Q4 Business Judgment Rule

The business judgment rule was confirmed by the SCC in *People's Department Store v Wise* [2004] S.C.J. No. 64. In that decision the Justices held: "Many decisions made in the course of business, although ultimately unsuccessful, are reasonable and defensible at the time they are made, with high stakes and under considerable time pressure, in circumstances in which detailed information is not available. It might be tempting for some to see unsuccessful business decisions as unreasonable or imprudent in light of the information that becomes available ex post facto. Because of this risk of hindsight bias, Canadian courts have developed a rule of deference to business decisions called the "business judgment rule", adopting the American name for the rule." [para 64].

The Justices in Danier held that the traditional justifications for the business judgment rule did not apply in this case. It was their opinion disclosure decisions, unlike business decisions, were not entitled to judicial deference as to whether an issuer has made the right decision about its disclosure obligations under the OSA. The court could and should decide whether an issuer has met their disclosure obligations.

Conclusions

The distinction between a "material fact" and a "material change" and when a "material fact" is deemed to be a "material change" are difficult concepts for some securities professionals to grasp never mind mom and pop investors. Arguably, those individuals would want to know all material facts as well as material changes at the time of their actual investment. According to the decision in Danier they will now have to contract for access to material facts that may emerge post filing the final prospectus and prior to closing of the offering. This is in fact what has been occurring since lower court decision of Danier. Underwriters and their counsel engage in a due diligence session the day before or day of closing with the issuer and its directors, officers and legal counsel providing certificates outlining any material facts or changes post filing the prospectus. Time will tell if this will remain industry practice post the Supreme Court of Canada decision in Danier.

Under the Radar: Proposed Changes to Regulation D

The SEC issued two proposed rules for comment which would change the current Regulation D exemption. The changes proposed on June 29, 2007, relate to the actual content of Form D and how it is filed. Most of the changes are housekeeping in nature. The need for 10% holders to be disclosed is eliminated. The federal and state signature blocks are combined. Gross revenue disclosure is added back in with an option not disclose.

The new form would be electronically filed through a designated SEC filer website similar to that currently used to file insider reports on Forms 3, 4 and 5. The SEC would also like state securities regulators to permit this electronic filing with the SEC to satisfy state law filing requirements for offerings covered by a federal Form D filing. This new electronic filing system could provide companies with substantial savings if also adopted by state regulators. The SEC proposal is silent as to how state filing fees due in connection with the offering would be received and whether the new electronic system will include Form U-2, Form U-2A and other related state filing forms.

The second set of rule change proposals to Regulation D was issued for comment on August 3, 2007. These changes are far more extensive and include:

- adopting a new "large accredited investor" exemption (Rule 507);
- clarifying the existing definition of "accredited investor";

- defining the term "accredited natural person".
- shortening the timing required by the integration safe harbor in Regulation D;
- to apply uniform disqualification provisions to all offerings seeking to rely on Regulation D; and
- blocking Rule 504(b)(1)(iii) state offerings purporting immediate resale rights.

New Exemption: Rule 507

The SEC is proposing the adoption of a new exemption from registration: Rule 507. Rule 507 would be limited to sales of securities to "large accredited investors," and would permit an issuer to publish a limited announcement of the offering. An entity would be considered a "large accredited investor" if their investment assets exceed $10 million. Individuals would be required to own $2.5 million in investments or have annual income of $400,000 (or $600,000 with one's spouse) to qualify as large accredited investors. Legal entities that are not subject to dollar-amount thresholds to qualify as accredited investors (government-regulated entities) would not be subject to dollar-amount thresholds to qualify as large accredited investors. Large accredited investors that participate in these exempt offerings would be considered "qualified purchasers" under Section 18(b)(3) of the Securities Act, and thereby be provided "covered security" status and the resulting preemption of certain state securities regulation.

Issuers relying on the proposed Rule 507 exemption would:

- be allowed to sell an unlimited amount of its securities to an unlimited number of "large accredited investors";
- be allowed to pay a commission or similar transaction-related compensation in support of the offering;
- be able to claim any other available exemption without the benefit of the rule;
- be required to place a "restricted securities" legend on the securities sold in the offering;
- be required to exercise reasonable care to assure that the purchasers of the securities are not underwriters;
- be required to file a Form D notice of sales in the offering with the SEC;
- be able to engage in limited advertising that satisfies the rule; and
- not be allowed to sell securities to any investor who does not qualify as a large accredited investor. (Rule 506 permits issuers to sell securities to an unlimited number of accredited investors and up to 35 non-accredited investors).

A More Complicated Definition of Accredited Investor

The current definition of "accredited investor" in Regulation D provides that a person who comes within, or who the issuer reasonably believes comes within, one of the following eight categories at the time of sale:

- Institutional investors;
- Private business development companies;
- Corporations, partnerships and tax exempt organizations with total assets in excess of $5 million;
- Directors, executive officers and general partners of the issuer;
- Individuals with a net worth exceeding $1 million, either alone or with their spouses;
- Individuals with income in excess of $200,000 in each of the two most recent years or joint income with the individual's spouse in excess of $300,000 in each of those years;
- Trusts with total assets in excess of $5 million; and
- Entities in which all of the equity owners are accredited investors.\

The proposed SEC revisions if adopted will add a layer of complication to who is an "accredited investor" for the purpose of Regulation D. The proposed changes to the accredited investor definition includes:

- adding an alternative "investments-owned" standard to Rule 501(a);
- defining the term "joint investments";
- establishing a mechanism to adjust the dollar-amount thresholds in the definitions in the future to reflect inflation; and
- adding several categories of permitted entities to the list of accredited and large accredited investors.

I am personally not that keen on this proposed definition change. Issuers will need to consult legal counsel each and every time they conduct a private placement to an "accredited investor" solely to confirm the inflation formula is correct. Regulation D should be simplified to the point issuers can read the rule and be in compliance without the assistance of legal counsel. Over 85% of the companies relying on Regulation D are private issuers.

Adding in a definition of an Accredited Natural Investor

The SEC received over 600 comments about its proposed definition of "accredited natural investor" proposed in December 2006 in conjunction for certain pooled investment vehicles in Securities Act of 1933 Rules 216 and 509 relying on Rule 506 of Regulation D. The majority of the comments were adamantly against this new definition. The SEC has made a couple of tweaks to its original proposed definition. The new definition of an "accredited natural person" would be a two-part test—investors would be required to satisfy the current standard to qualify

continued…

as accredited investors, as defined in (i) Rule 501(a)(5) or (6) for transactions under Rule 506 or (ii) Rule 215(e) or (f) for transactions under Section 4(6) of the Securities Act, and also to own at least $2.5 million in "investments," as that term would be defined in proposed Rule 509 or proposed Rule 216, as applicable.

This new definition is really only of concern to those involved in selling pooled investment vehicles. Hopefully, the SEC will make that clear when and if it revises the definition section of Regulation D.

Integration Safe Harbor

Rule 502(a) provides that two similar offerings conducted six months from one another will not be treated one and the same offering for the purpose of Regulation D. This is particularly important when issuers are relying on an exemption that restricts the total capital to be raised or the number of unaccredited investors who may participate in the offering. The SEC is proposing to shorten the existing time frame for the integration safe harbor for Regulation D offerings from six months to 90 days to help provide increased flexibility to issuers. .

Bad Actor Disqualification

The SEC is proposing a new provision as part of Rule 502 which would bar all issuers from relying on the exemptions provided in Regulation D where the issuer, any of its predecessors, any affiliated issuers, any director, officer or general partner of the issuer, any beneficial owner of 20 percent or more of any class of its equity securities, any promoter of the issuer presently connected with the issuer, have committed relevant violations of laws and regulations. These violations include:

- having filed a registration statement within the last five years that is the subject of a currently effective permanent or temporary injunction or an administrative stop order;
- having been convicted of a criminal offense in the last 10 years that was in connection with the offer, purchase or sale of a security or involved the making of a false filing with the Commission;
- having been subject to an adjudication or determination within the last five years by a federal or state regulator that the person violated federal or state securities or commodities law or a law under which a business involving investments, insurance, banking or finance is regulated;152
- being subject to an order, judgment or decree by a court entered within the last five years that restrains or enjoins the issuer or a person from engaging in any conduct or practice involving securities and other similar businesses, including an order for failure to comply with Rule 503 (the filing of Form D);153
- being subject to a cease and desist order entered within the last five years issued under federal or state securities or similar laws;154 or
- being subject to a suspension or expulsion from membership in or association with a member of a national securities exchange or national securities association for an act or omission constituting conduct inconsistent with just and equitable principles of trade.

The length of disqualification from reliance on Regulation D in the proposal is five to ten years depending on the nature of the violation.

Blocking Abusive Rule 504(b)(1)(iii) State Offerings

Issuers purporting to rely on the exemption provided in Rule 504(b)(1)(iii) have been conducting Rule 504 offerings of non-restricted securities. It is a loophole which has been abused by some companies and promoters to conduct what is known as "pump and dump" securities frauds. The SEC is proposing amending Rule 504 to make the shares issued in such offerings "restricted securities" for the purpose of Rule 144. The SEC is also considering amending Rule 144 to provide that non-affiliates receiving restricted securities of non-reporting companies would be eligible to resell those securities after 12 months without any restrictions.

The information in this newsletter is of a general nature only about recent developments of interest to our clients. You are encouraged to contact legal counsel before acting on any information provided.

Author Alixe Cormick has assisted small and micro cap companies through each stage of their growth from inception to graduation to junior and more senior trading forums.

VENTURE LAW CORPORATION
618 - 688 West Hastings Street
Vancouver, British Columbia, V6B 1P1
Phone: 604-659-9188
Fax: 604-659-9178
Web: www.venturelawcorp.com