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The Trigger Test: How to Determine if you need an EMD to Raise Capital in the Exempt Market

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With the introduction in 2009 of National Instrument 31-103 Registration Requirements, Exemption and Ongoing Registrant Obligations (NI31-103) and the substantial amendments to National Instrument 45-106 Prospectus and Registration Exemptions (NI45-106), the Exempt Market changed significantly respecting the need to be registered as a dealer trading in securities. Over four years later the regulatory requirement regarding Exempt Market registration under NI31-103 remains misunderstood, particularly by smaller securities issuers that wish to access the exempt market to help raise start-up capital.

Issuers wishing to participate in the Exempt Market to raise capital must address how its securities will be sold, who will sell them, and to whom. Most issuers understand the capital requirements necessary to carry out the objectives of its business plan, but few are equipped to sell securities and raise the necessary capital, particularly given the level of regulatory compliance required. With advice from professional advisors, issuers learn that the typical approach to raising capital in the Exempt Market is to retain one or more registered Exempt Market Dealers (EMDs) to distribute the issuer's offering.

An EMD is a registered securities dealer with a specialty of raising capital and advising investors in the Exempt Market. To become registered an EMD must demonstrate that it meets the registration and proficiency requirements prescribed by NI31-103. EMDs, through their registered dealer representatives, meet with potential investors, complete the required 'know your client' analysis, and provide suitability advice on the various Exempt Market products they have in their portfolios. An EMD will also conduct due diligence on the issuers who wish to retain them. In fact, the EMDs may also provide advice to issuers on how to structure their offering. The introduction of the EMD into the Exempt Market has facilitated a safer more regulated marketplace for investors, issuers and regulators alike.

Issuers may be disappointed, however, to discover that it is not easy to attract the commitment of an EMD. There are many Exempt Market issuers competing for 'shelf space' in EMDs' product portfolios. EMDs will naturally select what they believe are the better products being offered by Exempt Market issuers, which are

often those offered by issuers the EMDs are familiar with. Commissions and fees may also play a role. This can lead to greater demand from issuers than there is a supply of EMDs willing to sell.

Some issuers find that they cannot afford the up front due diligence, legal and accounting costs that may be required by an EMD in order to be considered. It can be an expensive proposition to seek an EMD without any assurances the EMD will ultimately accept the issuer. Similarly, if accepted, there is no assurance the EMD will market and promote the sale of the issuer's securities successfully as EMDs are usually engaged on a non-exclusive agency basis and do not underwrite Exempt Market offerings. This may mean the issuer will have to refer potential investors to the EMD in order to obtain investments; a result that eliminates one primary benefit of engaging an EMD.

Some prevailing perceptions suggest that an issuer must either retain an EMD or become registered itself under NI31-103 if it wants to distribute securities in the Exempt Market. These perceptions can leave issuers uncertain how it can distribute its securities and maintain regulatory compliance if an EMD cannot be engaged or the EMD is not successfully selling the issuer's product. Despite these perceptions, an issuer may still be able to distribute its securities without being registered or without an exemption from registration (such as retaining an EMD), depending whether or not the issuer is 'in the business of dealing in securities.' To make this determination we must consider the registration regime under securities legislation and, in particular, NI31-103 and the application of the business trigger test as set out in the Companion Policy to NI31-103 (NI31-103CP). For the purposes of this analysis it is assumed that the issuer is an Alberta issuer and such issuer controls and operates its own assets, and is not an 'investment fund' as that term is defined in the Securities Act (Alberta) (the Act). The analysis for an issuer in another province may be similar but requires the application of the specific and applicable securities laws and policies of that jurisdiction.

By way of background, section 75 of the Act requires that a dealer must register (as an EMD, for example) in accordance with applicable securities laws. A dealer is defined under the Act as "a person or company engaging in or holding itself out as engaging in the business of trading in securities..." In other words, if an issuer is a dealer it must register under NI31-103, or alternatively rely upon an exemption from registration. The exemptions from registration are found in Part 8 of NI31-103. A common exemption is to retain a registered dealer who is permitted to make the trade on behalf of the issuer, such as an EMD.

However, let's first consider the analysis on whether an issuer is, in fact, a dealer. For this we must consider the business trigger test. Simply put, the 'business trigger' for registration is where an individual, firm or issuer is trading or advising in securities for a business purpose. The next step is to consider what factors are relevant in determining whether or not there is a business purpose to the issuer's activities. NI31-103CP sets out a list of factors to be considered. In considering these factors the regulators do not assume that one of the factors on its own will determine whether someone is 'in the business of trading or advising in securities.' Therefore, we must consider whether the issuer is involved in one or more of the following activities and to what extent they are engaging in them.

THESE FACTORS INCLUDE:

- Engaging in activities similar to a registrant
- Intermediating trades or acting as a market maker (brokerage)
- Directly or indirectly carrying on the activity with repetition, regularity & continuity
- Being, or expecting to be, remunerated or compensated
- Directly or indirectly soliciting

These factors come from prior case law and regulatory decisions but the list is not considered by the regulators to be exhaustive. Other factors may be considered; for example, whether or not the issuer has a primary active business it carries on other than dealing in securities. Generally most, if not all, the factors are subjective and it

is often a question of degree whether undertaking a specific activity or a combination of activities will trigger a business purpose.

Let's apply these factors to a securities issuer that issues or trades in its own securities in the Exempt Market. Generally speaking, a securities issuer that does not hold itself out as being in the business of trading in securities, infrequently distributes its own securities without compensation and does not produce a profit from such distributions would not have to register as a dealer or retain an EMD. However, if an issuer is frequently or continually offering its securities to the public, is actively soliciting investors for profit and compensation, or has retained persons to perform sales activities similar to those performed by a registrant, then such issuer may trip the business trigger and registration or a registration exemption is required.

Although a careful and thorough analysis of the activities specific to the issuer is always required, it is the opinion of the authors that many of the issuers participating in the Exempt Market are not required to either register under NI31-103 or retain an EMD. Fundamentally, issuers are permitted to distribute securities and in most cases the issuer is selling its securities as a means to an end (i.e. to raise capital to finance a non-securities related business) and not as an end in itself (i.e. dealing in securities as its business purpose).

It is the authors' experience that many issuer's in the Exempt Market are there for the sole purpose of raising capital to advance its business plan, and are not in the Exempt Market with a view to pursue dealing with a business purpose. It is suggested that too many Exempt Market issuers are either not aware of the business trigger test or are misapplying it, resulting in regulatory confusion and frustration over the challenges and vagaries of retaining an EMD.

On December 5, 2013 the Canadian Securities Administrators (CSA) issued a Notice and Request for Comment on Proposed Amendments to NI31-103 and NI31-103CP (Proposed Amendments). The Proposed Amendments have added some additional and helpful guidance to the business trigger test. The Proposed Amendments acknowledge that start-up issuers are considered to have an 'active non-securities business' even though they may not empirically qualify as having an active business. This presumption must be supported by a business plan setting out how the issuer wishes to grow its business using the proceeds from its offering.

The Proposed Amendments further recognize that start-up issuers tend to trade and solicit more actively and frequently during the start-up phase in order to raise the capital required to launch its business. The key is that such activity and frequency must tie back to advancing the business and not merely to sustain the issuer.

If an issuer concludes that it is not in the business of dealing in securities, it is free to distribute its offering without registration under NI31-103 or without retaining an EMD provided that it has appropriate prospectus exemptions available under NI45-106. As a safe harbour, it is recommended that issuers raising capital in the exempt market have a comprehensive business plan to support their 'active non-securities business.' However, this may still leave the issuer with the question of who can help them sell their securities.

In 2010, shortly after the introduction of NI31-103, the regulatory Blanket Order 31-105 was issued in 2010 by the four western based and three northern based Securities Commissions. This Blanket Order provided registration exemptions for trades in connection with certain prospectus exempt distributions (Northwest Order). The Northwest Order provides relief from registration as an EMD under NI31-103 provided that the securities are being distributed under the one of the following prospectus exemptions under NI45-106: i) accredited investor, ii) friends, family and business associates, iii) offering memorandum or iv) minimum investment amount.

There are seven conditions contained in the Northwest Order that must also be met before it can be relied upon. One of the key conditions is that the person or company relying on the Northwest Order is not otherwise registered or required to be registered under the applicable securities legislation. Although not specifically

mentioned in the Northwest Order, the feedback from regulators suggests that the Northwest Order is intended only for unregistered salespersons and market intermediaries, not an issuer.

However, if an issuer is not dealing in securities for a business purpose then it could distribute its own securities through its directors and officers, or an affiliate, without the need for registration or reliance on the Northwest Order. For greater certainty, the Proposed Amendments make it clear that although officers, directors and other employees can solicit investment, a business purpose may be found if the principal purpose of the employment is raising capital; the majority of the person's time is spent raising capital; or the person's remuneration is tied to capital raising activities.

In summary, an issuer wishing to enter the Exempt Market should first consider whether it is dealing in securities for a business purpose by application of the business trigger test. The issuer should also establish if it requires, or can retain, the services of an EMD. It is important to keep in mind that there are valid and beneficial market and compliance reasons for retaining an EMD to facilitate an offering regardless of any regulatory requirement. However, if the issuer has not tripped the business trigger test and an EMD is either not required, or one cannot be engaged, then an issuer with appropriate prospectus exemptions can take its offering to the Exempt Market in compliance with securities legislation for registration. Furthermore, unregistered salespersons and market intermediaries retained by the issuer who comply with the requirements and conditions of the Northwest Order can assist the issuer in the sale of its offering.

As a final word of caution, securities analysis is complex, subjective and often convoluted. Therefore, an issuer should always consult its professional advisors in considering whether or not it is dealing in securities for a business purpose, and whether or not reliance upon the Northwest Order is a practical and an appropriate alternative to achieve its capital raising objectives.