



## When Is “Close” Close Enough? Assessing the Availability of the Family, Friends and Business Associates Prospectus Exemption

The introduction of the family, friend and business associate exemption (the “FFBA”) to the prospectus requirement in the *Ontario Securities Act* promised to “provide a cost effective way for issuers (other than investment funds) to raise capital from their networks of family, close personal friends and close business associates.”<sup>[1]</sup> While this exemption, which is set out in National Instrument 45-106 (“NI 45-106”), does increase opportunities for issuers to fund their ventures, registrants relying on the FFBA should be aware of the potential pitfalls arising from the imprecise categories of relationships involved. As the onus is on the registrant to establish that the exemption claimed applies to the specific transaction at issue, registrants intending to rely on this exemption must take reasonable steps to get it right, and must be able to prove that they did so.

In order to understand the FFBA, it is important to recall that the purpose of the prospectus requirement is to ensure that investors are making informed investment decisions by providing them with full, plain and true disclosure about the material attributes of the investment under consideration.<sup>[2]</sup> Any exemption to the prospectus requirement must meet the same goal. The FFBA ensures that investors may be appropriately informed by permitting the sale of securities to individuals who are in a position to assess the “capabilities and trustworthiness” of the issuer by virtue of their “close” relationships with particular insiders of the issuer. In other words, if the purchaser *really* knows someone who *really* knows the issuer, then they are presumably able to evaluate the risk associated with their investment and to obtain current information about their investment, the purpose of the prospectus requirement is met, and the exemption is available.

The FFBA exemption involves unique challenges for registrants engaged in such transactions. First, there is uncertainty over who is a control person or an executive officer. Second, there is the question of who qualifies as the friend, family member or business associate. Finally, the registrant must confirm the bona fides of the relationship in order to meet regulatory obligations – leaving aside KYP, KYC and suitability.

Prospectus exemptions are narrowly construed and registrants must strictly comply with all of the requirements, conditions and restrictions associated with the exemption.<sup>[3]</sup> This means that registrants must take reasonable steps to satisfy themselves that the exemption is available at the time of the trade.<sup>[4]</sup> For example, accepting standard representations in a subscription agreement or accredited investor form will not be sufficient; registrants must take reasonable steps to verify the purchaser’s representations as set out in the transaction documents.<sup>[5]</sup> While the content of the required investigation will depend on a number of case-specific factors, generally applicable considerations are set out below.

As previously discussed, the FFBA exemption is premised on the assumption that those close to certain insiders of an issuer will, by the nature of that close relationship, have access to the information usually provided in a prospectus. In other words, the closeness of the relationship is a proxy for the prospectus. Therefore in assessing whether this exemption applies, a registrant must consider both the status of the insider and the investor.

### Step One: Who Qualifies as an Insider?

The FFBA exemption defines an insider as “a director, executive officer or control person of the issuer, or of an affiliate of the issuer”<sup>[6]</sup> Only individuals who fall within those categories may serve as the required close relationship to the issuer.

While the identification of directors, control persons and affiliates is relatively straightforward, the new term “executive officer” poses more of a challenge. NI 45-106 defines “executive officer” to include anyone who has a “policy-making function”<sup>[7]</sup> with the issuer. The scope of the term “policy-making function” has not been defined, but given the other positions that qualify as an



“executive officer”, being chairs, vice-chairs, presidents and vice presidents who are in charge of a business unit, it is safe to say that the intention is for “executive officers” to be the issuer’s top decision makers.

Registrants should be very careful when they are told that an individual is an “executive officer” because they have a policy-making function. As noted above, registrants are required to make reasonable efforts to verify the information about the individuals seeking to use the FFBA exemption. A registrant assessing whether an individual is an “executive officer” within the meaning of NI 45-106 by virtue of their policy-making powers should query the scope of the policies the “executive officer” has been involved in creating, their degree of authority and/or authorship in respect of those policies, and the length of time that the “executive officer” has held such a position. Where the involvement in policy making is new, minimal, or in a subordinate role, the registrant should engage in a further and more detailed investigation of the “executive officer’s” role within the issuer.

#### Step Two: Who Qualifies as Family, Friends and Business Associates?

Family is defined to be “a spouse, parent, grandparent, brother, sister, child or grandchild of” the insider or “a parent, grandparent, brother, sister, child or grandchild of” the insider’s spouse.[8]

Both “close personal friend” and “close business associate” require a sufficiently close relationship, in length of relationship, frequency of contact, and content of the relationship, to place the friend or associate in a “position to assess their capabilities and trustworthiness of the issuer and to obtain information from them with respect to the investment.”[9] Relationships based solely on shared interests, relationships involving frequent/regular but shallow contact, and new relationships are unlikely to pass the regulator’s scrutiny. Being connected by social media, whether via Facebook, LinkedIn or Twitter is, on its own, unlikely to be viewed as evidence of the type of relationship that qualifies as a “close personal friend” or a “close business associates”.

A further criteria that the regulator will consider in assessing whether someone is a “close personal friend” or a “close business associate” is the overall number of investors the insider is seeking to qualify under this part of the exemption, presumably on the grounds that someone can only have so many “close personal friends” and “close business associates”.

Clearly, there is a broad spectrum of relationships that could potentially qualify as a “close personal friend” or a “close business associates”. It is the registrant’s obligation to conduct sufficient due diligence to make this determination on a case-by-case basis. Not only must a registrant ask specific questions about the relationship to satisfy themselves that the FFBA applies to the situation, they must also keep notes and document their due diligence.[10]

As with any exemption, the onus rests on the registrant to get it right. This article only provides an overview of the relationship aspect of the FFBA exemption, which also involves, amongst other things, specific documentary, reporting and administrative requirements. Before seeking to rely on this, or any other exemption to the prospectus requirement, you should review the applicable sections of NI 45-106 and the associated sections of the Companion Policy, and keep in mind the policy reasons for a prospectus (to inform investors) and the overall goal of securities laws (to protect investors).

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[1] Ontario Securities Commission News Release, *OSC Adopts Family, Friends and Business Associates Prospectus Exemption*, online: Ontario Securities Commission, [http://www.osc.gov.on.ca/en/NewsEvents\\_nr\\_20150219\\_family-friends-business.htm](http://www.osc.gov.on.ca/en/NewsEvents_nr_20150219_family-friends-business.htm).

[2] *Arbour Energy Inc.* 2012 ABASC 131 (“*Arbour*”) at para. 724.

[3] *Lydia Diamond Exploration of Canada* Reasons for Decision dated December 13, 2002 at paras. 83-84; see also *Arbour* at para. 737.

[4] *Re Robinson*, 2013 ABASC 203 at para. 151.

[5] Companion Policy to National Instrument 45-106 (“46-106CP”), section 1.9(3) and (4).

[6] NI 45-106, section 2.5

[7] NI 45-106, section 1.1

[8] NI 45-106, section 2.5

[9] 45-106CP, section 2.7 and 2.8

[10] These notes are in addition to the risk acknowledgment form required by NI 45-106, section 2.6.1