

1.1.6 CSA Staff Notice 41-307 – Corporate Finance Prospectus Guidance – Concerns regarding an issuer’s financial condition and the sufficiency of proceeds from a prospectus offering

CSA Staff Notice 41-307 – *Corporate Finance Prospectus Guidance – Concerns regarding an issuer’s financial condition and the sufficiency of proceeds from a prospectus offering* is reproduced on the following internally numbered pages. Bulletin pagination resumes at the end of the Staff Notice.

CORPORATE FINANCE PROSPECTUS GUIDANCE

Concerns regarding an issuer's financial condition and the sufficiency of proceeds from a prospectus offering

CSA Staff Notice 41-307

March 2, 2012

The purpose of this staff notice is to alert issuers (other than investment fund issuers) and their advisors about our approach where there are concerns regarding the financial condition of an issuer and/or the sufficiency of proceeds in the context of a prospectus offering.¹ In limited circumstances, these concerns may affect our ability to recommend that a receipt be issued for a prospectus. This staff notice applies to all prospectus reviews, regardless of whether the offering is an IPO, new issue or secondary offering.

In this notice, we describe issues that have arisen in past prospectus reviews and explain the types of comments we have raised about an issuer's financial condition and/or the sufficiency of proceeds.

This guidance applies to issuers that have short-term liquidity concerns and/or offerings that do not appear to be raising sufficient proceeds. We recognize the importance of capital formation in Canada, and this guidance is not intended to inhibit capital raising through a prospectus offering other than where there are significant investor protection concerns.

Significant concerns may result in receipt refusal

Securities legislation provides that the authorized decision maker must issue a receipt for a prospectus unless it appears to the decision maker that it is not in the public interest to do so or for motives enumerated in securities legislation.²

Securities legislation also provides that the decision maker shall not issue a receipt for a prospectus or an amendment to a prospectus in specified circumstances. For example, a decision maker is prohibited from issuing a receipt for a prospectus if it appears that the proceeds from the prospectus offering, along with the issuer's other resources, will be insufficient to accomplish the purpose of the issue stated in the prospectus (the sufficiency of proceeds receipt refusal provision).³

As a result of these statutory provisions, consideration of an issuer's financial condition is a critical part of every prospectus review. A prospectus must contain clear disclosure on how the issuer intends to use the proceeds raised in the offering as well as disclosure of the issuer's financial condition, including any liquidity concerns. This disclosure is important to investors because it provides warnings about significant risks that the issuer is facing or

¹ For additional guidance see OSC Staff Notice 52-719 *Going Concern Disclosure Review* (OSC Staff Notice 52-719).

² Relevant statutory provisions include: s. 120(1) of the *Securities Act* (Alberta), s. 65(2) of the *Securities Act* (British Columbia), s. 61(1) of the *Securities Act* (Ontario) and ss. 14 and 15 of the *Securities Act* (Quebec).

³ See s. 120(2)(c) of the *Securities Act* (Alberta), s. 120(2)(c) of the *Securities Act* (British Columbia), s. 61(2)(c) of the *Securities Act* (Ontario) and s. 15(3) of the *Securities Act* (Quebec).

may face in the short term and may help investors avoid or minimize negative consequences when making investment decisions. Relevant information in this context may include disclosure on negative cash flow from operating activities, working capital deficiencies, net losses and significant going concern risks.

However, disclosure on its own may not be sufficient to satisfy receipt refusal concerns in certain circumstances. For example, a recommendation of receipt refusal may be appropriate where an issuer lacks sufficient funds to continue operations, or if the proceeds from the prospectus offering will be insufficient to accomplish the purpose of the offering. When conducting prospectus reviews, we may consider the anticipated proceeds from a prospectus offering to be insufficient if they are raised:

- for a specific purpose but do not address the issuer’s short-term liquidity requirements
- through a best efforts offering without a minimum subscription, or a minimum subscription that does not appear to be sufficient to satisfy the issuer’s short-term liquidity requirements, or
- through a shelf prospectus offering that can be drawn down in small increments that, when considered separately, may not be sufficient to satisfy the issuer’s short-term liquidity requirements.

A principal purpose of the sufficiency of proceeds receipt refusal provision is to protect the integrity of the capital markets, which would be harmed if an issuer ceased operations on account of insufficient funds shortly after completing a public securities offering.

We have concerns with the potential implications to investors who invest in issuers that may not be able to continue operations for a reasonable period of time. We consider that an issuer should have sufficient resources to meet its short-term liquidity requirements. This will vary depending on the circumstances of each issuer. The table below sets out some guidelines.

Type of Issuer	Resources to meet short-term liquidity requirements
Exploration stage issuer	Sufficient to reach completion of the next phase of a project
Development stage issuer	Sufficient to achieve the issuer’s next significant milestone
Research & development issuer	Sufficient to achieve progress on the development of a key product
Issuer with active operations	Ability to continue operations for the short term

<p>Potential receipt refusal</p> <p>The decision maker will not issue a receipt for a prospectus where:</p> <ul style="list-style-type: none"> • it appears that the prospectus inadequately discloses an issuer’s financial condition and going concern risk, or • there is adequate disclosure about the issuer’s financial condition, but it appears that either the sufficiency of proceeds receipt refusal provision is applicable or that it is not in the public interest to issue the receipt.

Areas of focus

We may raise comments during the prospectus review process where we have identified concerns about an issuer's financial condition and/or sufficiency of proceeds. This staff notice discusses the following five issues in respect of which we may raise comments:

1. Missing information regarding offering amount and pricing
2. Offering structure
3. Use of proceeds disclosure
4. Risk factor disclosure
5. Representations to support ability to continue operations

This list of issues is not exhaustive. The types of comments we raise in these circumstances may change and we will continue to assess and review each prospectus on its own merits.

1. Missing information regarding offering amount and pricing

We require information regarding the size of the offering to assess whether the sufficiency of proceeds receipt refusal provision is applicable and whether it is in the public interest for the decision maker to issue a receipt. If a preliminary prospectus is filed with the offering amount and pricing information bulleted, we will issue a comment that we require a reasonable opportunity to review a blackline of the draft form of final prospectus (using strike through format for deletions of text) before being in a position to clear the final prospectus. The blackline should include the information currently bulleted in the preliminary prospectus, such as the offering amount, pricing and use of proceeds. If providing this information is not practicable, we may accept an estimate or range of these figures, as applicable. Issuers should note that we may have additional comments based on any new information disclosed in the blackline.

Practice point

In order to avoid unanticipated delays, issuers should ensure that the blackline of the draft form of final prospectus is filed not less than two business days prior to filing final materials.

We may also request a copy of any green sheets (and/or similar marketing materials) used in connection with an offering. A review of the green sheet allows us to assess at an early stage the financial condition of the issuer in the context of the then anticipated offering amount. It will also show whether the final offering amount is substantially less than originally anticipated.

2. Offering structure

We will review the overall structure of the proposed offering in the context of the issuer's financial condition. While there is no requirement to have a minimum subscription for an offering (in National Instrument 41-101 *General Prospectus Requirements* or National Instrument 44-101 *Short Form Prospectus Distributions*), the absence of a minimum subscription could be a significant concern where there are questions about the issuer's financial condition

or where a minimum amount of proceeds appears necessary to meet the stated purpose of the offering. Accordingly, we may raise the following types of comments depending on the structure of an offering, tailored to the particular circumstances of the issuer. Ultimately, an issuer may need to change the structure of an offering to address concerns regarding the issuer's financial condition.

Best efforts agency offering

1. Is there a minimum subscription?
2. If not, explain how the stated purpose of the offering and the use of proceeds will be achieved absent a minimum subscription.
3. Disclose and discuss, both qualitatively and quantitatively:
 - how the proceeds will be used by the issuer, with reference to various potential thresholds of proceeds raised, in the event the issuer raises less than the maximum subscription, and
 - the impact (if any) on its liquidity, operations, capital resources and solvency.

Base shelf prospectus offering

We may take the view that a base shelf prospectus is not appropriate given the issuer's financial condition and uncertainty of financing. Under a base shelf prospectus, an issuer may raise small amounts of capital in increments over the period of 25 months. We may request submissions on the following:

- the issuer's rationale for filing a base shelf prospectus
- whether the issuer intends to file a prospectus supplement in the near future, and if so, the type of securities to be offered, the proceeds that are contemplated to be raised and the manner in which the proceeds will be used
- the availability of other sources of financing to provide working capital and fund the issuer's business if sufficient financing cannot be raised
- the proposed nature and timing of the offerings under the base shelf prospectus, including:
 - involvement of an agent or underwriter, if any
 - use of a minimum subscription amount below which an offering will not proceed
 - specific use of proceeds for offerings contemplated in the next 12 months
- details regarding concrete development milestones that would advance the issuer's business objectives and are expected to be completed in the next 12 months, including:
 - a description of the milestone
 - expected timing of completion, and
 - financing requirements.

In order to address the concern that incremental drawdowns may be insufficient to satisfy an issuer's short-term liquidity requirements, we may request that the issuer:

- file a short form prospectus with a minimum subscription
- file a short form prospectus with a fully underwritten commitment, and/or
- arrange for additional sources of financing.

Rights offering

We may raise a comment regarding alternatives to a minimum subscription, such as a stand-by commitment, where there is a concern about the sufficiency of proceeds to meet the stated objectives of the offering or there is a concern about the issuer's financial condition.

3. Use of proceeds disclosure

The use of proceeds disclosure in a prospectus informs our consideration of whether the proceeds of the offering will be sufficient to accomplish the stated purpose of the offering. We will assess whether the use of proceeds disclosure complies with all of the applicable requirements in Item 6 of Form 41-101F1 *Information Required in a Prospectus* (Form 41-101F1) or Item 4 of Form 44-101F1 *Short Form Prospectus* (Form 44-101F1).

We have noted inadequate use of proceeds disclosure in the following areas:

- principal purposes of the proceeds
- business objectives and milestones, and
- negative cash flow from operating activities.

An example of the type of disclosure that does not provide sufficient detail on the allocation of proceeds is set out below.

Example of insufficient use of proceeds disclosure

The net proceeds to the Corporation will be combined with the Corporation's working capital for total available funds of approximately \$3,000,000. The estimated net proceeds to the Corporation from this Offering are estimated as indicated below:

Principal Purpose	Amount
Exploration Activities	\$2,000,000
General Corporate Purposes	\$1,000,000
Total Available Funds	\$3,000,000

The net cash proceeds from the Offering will be used by the Corporation for exploration activities and general corporate purposes. The Corporation expects to accomplish the business objectives described in this Prospectus using the Total Available Funds. The Corporation intends to spend the funds available to it as stated in this Prospectus. There may be circumstances where, for sound business reasons, a reallocation of funds may be necessary.

The guidance below sets out the type of information we would expect to be included in the use of proceeds disclosure.

Principal purposes of the proceeds

Where the disclosure is overly general, we may request that the issuer provide additional information, such as:

- a breakdown of the proceeds towards a certain phase of a project, in the case of an exploration or development stage issuer
- a breakdown of the proceeds towards capital expenditures
- a breakdown of proceeds allocated to general and administrative expenditures, and
- clarification of how proceeds raised under recent financings have been or are being allocated.

If the offering is subject to a minimum subscription, the use of proceeds for both the minimum and maximum subscription must be disclosed. The disclosure should provide adjustments in spending if the proceeds raised are less than the maximum amount. This disclosure should be provided where:

- closing of the distribution is not subject to a minimum offering amount
- the distribution is on a best efforts basis, and
- the issuer has significant short-term non-discretionary expenditures.

Short-term non-discretionary expenditures include those for general corporate purposes, or significant short-term capital or contractual commitments, and an issuer may not have other readily accessible resources to satisfy those expenditures or commitments. We may request that the issuer discuss, both quantitatively and qualitatively, how the proceeds will be used with reference to various potential thresholds of proceeds raised, in the event the issuer raises less than the maximum subscription, and the resulting impact on the issuer's liquidity, operations, capital resources and solvency.

Finally, we remind issuers that statements such as "for general corporate purposes", are not considered to be sufficient disclosure⁴.

Business objectives and milestones

Where an issuer has not sufficiently described each significant event that must occur for the business objectives to be accomplished, we will request additional disclosure of each event as well as the specific time period in which each event is expected to occur and the costs related to it. Generally, we expect that the proceeds from the offering will be sufficient to meet the issuer's working capital and operational needs until its next significant milestone.

In the case of a mining issuer, the use of proceeds disclosure should be consistent with the recommendation and budget in the issuer's technical report(s). We take the view that general statements referring to completion of a "phase" of an exploration program may not be sufficient. We may request a further breakdown of the exploration activities contemplated in each phase, as the case may be, and the relevant time period to complete such activities.

⁴ As stated in subsection 4.3(2) of *Companion Policy to National Instrument 41-101 General Prospectus Requirements* (Companion Policy 41-101CP) and subsection 4.4(2) of *Companion Policy to National Instrument 44-101 Short Form Prospectus Distributions* (Companion Policy 44-101CP),

Negative cash flow from operating activities

An issuer with negative cash flow from operating activities in its most recently completed financial year for which financial statements have been included in the prospectus should:

- prominently disclose that fact in the use of proceeds section of the prospectus
- disclose whether, and if so, to what extent, it will use the proceeds of the distribution to fund any anticipated negative cash flow from operating activities in future periods, and
- disclose negative cash flow from operating activities as a risk factor⁵.

We may also request additional information be disclosed in the prospectus relating to:

- the issuer's most current working capital amount
- the issuer's cash burn rate on a monthly or quarterly basis
- the period of time that the proceeds of the offering are expected to fund operations, and
- any significant debt obligations maturing in the short term.

Item 6.2 of Form 41-101F1 requires additional disclosure of certain information relating to junior issuers, such as disclosure of the total funds available, and the following breakdown of those funds:

- the estimated net proceeds from the sale of the securities offered under the prospectus
- the estimated consolidated working capital (deficiency) as at the most recent month end before filing the prospectus, and
- the total other funds available to be used to achieve the principal purposes identified by the junior issuer pursuant to this item.

Practice Point

Depending on the circumstances, we may take the view that this disclosure is a material fact for issuers that are not technically junior issuers and that this disclosure should be included in a prospectus in order to meet the requirement to provide "full, true and plain disclosure of all material facts".

4. Risk factor disclosure

Item 21.1 of Form 41-101F1 and item 17.1 of Form 44-101F1 require disclosure of risk factors relating to an issuer and its business, such as cash flow and liquidity problems. The accompanying instructions provide guidance that the risks should be disclosed in order of seriousness, from the most serious to the least serious. We have noted insufficient or boilerplate disclosure in the prospectus for many key risk factors related to an issuer's financial condition.

⁵ See the guidance set out in subsection 4.3(1) of Companion Policy 41-101CP and subsection 4.4(1) of Companion Policy 44-101CP.

Example of insufficient boilerplate risk factor disclosure

The Corporation's ability to continue as a going concern is dependent upon its ability to obtain adequate financing and to reach profitable levels of operation. The Corporation has no proven history of performance, earnings or success.

Issuer's financial condition

A prospectus should clearly disclose an issuer's going concern risk to allow readers to make an informed investment decision. This disclosure should explain the uncertainties that may create going concern risk and how the issuer is addressing that risk. As previously noted, even if the risk is adequately disclosed, we will exercise judgement to assess whether the sufficiency of proceeds receipt refusal provision is applicable or if there is a public interest concern in issuing a receipt.

When preparing risk factor disclosure about financial condition, issuers should consider disclosing the following:

- quantification of losses, working capital deficit, negative cash flow from operating activities, debt levels
- how the issuer expects to remedy the liquidity or solvency issues
- other sources of financing available to the issuer
- the implications to the issuer's liquidity, capital resources, operations (i.e. scaling back exploration activities, capital expenditures, research and development expenditures, general and administrative expenditures etc.) and its ability to remain a going concern, and
- the period of time the proceeds raised under the prospectus are expected to fund operations.

In many circumstances, an issuer with going concern risk should include the disclosure required by item 8.7 of Form 41-101F1 for junior issuers. This item requires disclosure of:

- the period of time the proceeds raised under the prospectus are expected to fund operations
- the estimated total operating costs necessary for the issuer to achieve its stated business objectives during that period of time, and
- the estimated amount of other material capital expenditures during that period of time.

Practice Point

While item 8.7 of Form 41-101F1 applies specifically to junior issuers, this information may constitute a material fact for other issuers depending on their particular circumstances, and in that case, we may request this disclosure.

Risk associated with negative cash flow from operating activities

Issuers are reminded that section 4.3 of Companion Policy 41-101CP and section 4.4 of Companion Policy 44-101CP provide that issuers should disclose negative cash flow from operating activities as a risk factor.

Risk associated with offering structure - no minimum subscription

Where the offering is being conducted on a best efforts agency basis and we have accepted that a minimum subscription is not required, we generally expect the issuer to include on the face page of the prospectus disclosure that there is no minimum amount of funds that must be raised under the offering. This disclosure should clearly state

that an investor will not generally be entitled to a return of its investment if only a small proportion of the disclosed offering amount is in fact raised.

5. Representations to support ability to continue operations

We take the view that an issuer contemplating an offering should be able to continue its operations for a reasonable period of time and meet its short-term liquidity requirements as described on page two of this staff notice. The length of time the issuer will be able to continue operations will vary among industries and among issuers within an industry group. Accordingly, issuers should anticipate comments regarding their ability to continue operations as a going concern.

Representation regarding ability to continue operations

In order to assess whether we have a receipt refusal concern, we may ask the issuer to provide us with a written representation of the number of months that it will be able to continue its operations given its financial condition. The proceeds from the offering should only be considered when making this determination where the offering is a bought deal, or where there is a minimum subscription or stand-by commitment. We will generally also request that this representation be disclosed in the prospectus. The rationale for requiring this disclosure is that, in our view, this information is a material fact in the particular circumstances of the issuer due to concerns over its financial condition. We may take the view that the absence of this information may either be an omission of a material fact or raise a public interest concern.

Support for representations regarding ability to continue operations

It is the issuer's responsibility to determine the number of months during which it expects to be able to continue its operations given its financial condition. In some instances, the issuer's representations about its ability to continue as a going concern and the period during which it expects to be able to continue operations may:

- be inconsistent with the issuer's historical statement of cash flows (in particular, its cash flows from operating activities)
- be inconsistent with the disclosure in the preliminary prospectus, including disclosure regarding current and expected profitability, debt repayment schedules and potential sources of additional financing, or
- otherwise appear to be unreasonable.

In these cases, we may request that the issuer provide us with a cash flow forecast to support its assumed period of liquidity (i.e. ability to continue operations). As noted above, the proceeds of the offering should only be considered in an issuer's cash flow forecast where the offering is a bought deal or where there is a minimum subscription or stand-by commitment. If a forecast is provided, we will assess whether the assumptions are consistent with the disclosure made in the prospectus as well as the issuer's historical financial performance.

The cash flow forecast should project the issuer's cash flow from operating activities for the period of time the issuer has represented that it can continue operations. The forecast should take the form of a statement of cash flows as presented in the issuer's financial statements in accordance with International Financial Reporting Standards (IFRS). The forecast must be accompanied by a set of robust assumptions to support management's estimates. We may

need supporting schedules and further details in order to assess the reasonableness of the assumptions made by the issuer. See the discussion below about whether this disclosure constitutes forward-looking information (FLI) and forward looking financial information (FOFI).

Practice Point

In the limited circumstances where we request a cash flow forecast, we may request additional disclosure in the prospectus. Specifically, we may ask that the following be included in the prospectus:

- the forecast in its entirety along with all significant assumptions and the material risk factors that could cause actual results to differ materially from the forecast, or
- significant portions of the forecast or material factors and assumptions used to develop the forecast.

This information supports the representation regarding the issuer's ability to continue operations and may inform investors' investment decisions. We may conclude that, in certain cases, the forecast represents a material fact in the particular circumstances of the issuer due to concerns over its financial condition. Any disclosure included in the prospectus is subject to liability provisions.

Forward-looking information and future oriented financial information

A representation regarding an issuer's ability to continue operations constitutes FLI as defined in securities legislation. Generally, FLI means disclosure regarding possible events, conditions or results of operations that is based on assumptions about future economic conditions and courses of action⁶. Depending on its content, this representation may or may not also be FOFI. When this disclosure is included in the prospectus, the disclosure must comply with the FLI and FOFI requirements in Parts 4A and 4B of National Instrument 51-102 *Continuous Disclosure Obligations* (NI 51-102).

Any cash flow forecast and related factors and assumptions provided to support this representation may also be subject to FLI and FOFI requirements.

Issuers will be required to update previously disclosed material FLI in Management's Discussion & Analysis in accordance with section 5.8 of NI 51-102.

Conclusion

We will continue to raise comments in respect of the financial condition of an issuer and the sufficiency of proceeds from a prospectus offering where the concerns discussed above are identified. Additional disclosure may be required in a prospectus, depending on the particular circumstance of the issuer. In some cases where there are significant investor protection concerns, we may recommend that a receipt for a prospectus not be issued.

⁶ For the definition of FLI see s. 1(1) of the *Securities Act* (Alberta), s. 1(1) of the *Securities Act* (British Columbia), s. 1(1) of the *Securities Act* (Ontario) and s. 5 of the *Securities Act* (Quebec).

Questions

Questions may be referred to any of:

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