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MARKET PARTICIPANTS TAKE NOTE: SECURITIES REGULATORS TO SUBJECT SPECIAL TRANSACTIONS TO GREATER SCRUTINY AND ON A REAL-TIME BASIS

By Rick Moscone, Eric Roblin and Russell Sanders

Introduction

On July 27, 2017, the securities regulatory authorities of Ontario, Quebec, Alberta, Manitoba and New Brunswick (collectively, "**Staff**") published comments in a Notice (the "**Notice**") on Multilateral Instrument 61-101 *Protection of Minority Security Holders in Special Transactions* ("**MI 61-101**"), advising market participants of their collective intention to subject material conflict of interest transactions ("**Special Transactions**") to greater scrutiny by reviewing them in "real time." The Notice also addresses Staff views regarding:

- the role of boards of directors and special committees;
- enhanced disclosure obligations in Special Transactions; and
- fairness opinions.

Staff focus is directed at Special Transactions, namely insider bids, issuer bids, business combinations and related party transactions, that raise substantive concerns as to the protection of minority security holders, who are not interested parties in connection with the said transaction. Staff are not concerned with transactions that are incidentally captured by MI 61-101, such as those that are business combinations only as a result of employment-related collateral benefits.

"Real-Time" Review of Special Transactions

To assess a Special Transaction's compliance with MI 61-101 and identify whether public interest concerns are raised, Staff will commence their review upon the filing of the disclosure documents for the transaction (e.g. press releases, material change reports). Any complaint lodged with Staff will factor into their review. The review will focus on compliance with disclosure requirements, compliance with the conditions for the exemptions in MI 61-101 from the formal valuation and minority approval requirements, and the process employed by the issuer's board of directors in considering whether to proceed with a Special Transaction. Staff may request supplemental information from the issuer and supporting documentation (e.g. board of directors and/or special committee minutes, work product associated with a formal valuation). Where non-compliance is identified or public interest concerns are raised, Staff may seek corrective disclosure, appropriate orders under securities legislation (e.g. cease-trade), and enforcement action. Such actions could delay the closing of Special Transactions, which raises the importance of providing robust disclosure upon the initial filing with Staff and adopting rigorous board processes that comply with MI 61-101.

Rick Moscone
Partner

t: 416.941.8858
rmoscone@foglers.com

Eric Roblin
Partner

t: 416.941.8811
eroblin@foglers.com

Russell Sanders
Associate

t: 416.864.7624
rsanders@foglers.com

The Role of Boards of Directors and Special Committees

Staff note that the formation of a special committee of independent directors is one of the primary means of managing conflicts of interest in a Special Transaction in that they ensure the interests of minority security holders are fairly considered in the transaction's negotiation and review. However, Staff also note that alternative measures can be taken without forming a special committee, such as having a wholly independent board or taking steps to deliberate away from board members with conflicts of interest. While MI 61-101 only mandates the use of a special committee in the context of an insider bid, Staff advise that this practice be applied to all Special Transactions.

Where a special committee is employed, Staff note the following points to consider:

(a) *It must be formed early and cannot sit on the sidelines* - Before a Special Transaction is substantially negotiated is the time to form a special committee. Once formed, the special committee must thoroughly review the circumstances prior to the Special Transaction, the reasonable alternatives to the Special Transaction, and the Special Transaction itself.

(b) *Who can sit at the table* - While a special committee may invite non-independent board members to meet with, provide information to, and execute instructions from the committee, such members must be excluded from the special committee's decision-making process.

(c) *Indicia of an effective special committee* - An effective special committee will include a robust mandate, engage independent advisors, supervise or facilitate negotiations, keep accurate records and insulate the process from interested parties' coercive conduct.

(d) *Mandates* - A special committee is expected to:

  (i) negotiate or oversee the negotiation of a Special Transaction, rather than merely review it after it has been negotiated;

  (ii) consider reasonable alternatives, including maintaining the status quo;

  (iii) recommend whether to proceed with the Special Transaction; if a recommendation is not provided, explain why not;

  (iv) engage independent legal and financial advisors.

(e) *Negotiations* - Staff recognize that the nature of a special committee's involvement in negotiations will vary depending on context. Where a special committee has not been involved in preliminary negotiations, it is important that the board of directors and special committee not be bound by any such negotiations and that it be free to review, negotiate further and consider alternatives.

(f) *Fairness opinions* - The board of directors and special committee are responsible for determining the necessity of a fairness opinion for helping make a recommendation to minority security holders. Where an opinion is obtained, the board of directors and special committee must also determine the terms of the fairness opinion provider's compensation (e.g. flat fee or contingency fee). The special committee must consider the fairness of a Special Transaction from both a financial perspective and non-financial perspective. In deciding whether a Special Transaction is in the best interests of an issuer, it is important that a special committee use its own judgment despite having obtained a fairness opinion.

Enhanced Disclosure Obligations in Special Transactions

The objective of enhanced disclosure is to enable minority security holders to make an informed decision with the benefit of unbiased information on how to vote in connection with a Special Transaction. Accordingly, Staff maintain that disclosure requires a thorough and impartial discussion of: a) the review and approval process; b) the reasoning and analysis of the board of directors and/or special committee; c) the views of the board of directors and/or special committee regarding the fairness of the transaction, addressing the advisor's analysis and how it impacted their recommendation; d) reasonably available alternatives, including the status quo; and e) the pros and cons of the Special Transaction. Where the board of directors and/or special committee do not provide a recommendation, Staff expect reasons why one was not provided and that minority security holders receive "substantially the same information and analysis that the special committee received in considering and addressing the legal and business issues raised by the proposed transaction."

Fairness Opinions

While MI 61-101 does not mandate that a board of directors and/or special committee obtain a fairness opinion in the context of a Special Transaction, if an advisor does not provide a fairness opinion after one is requested, Staff expect the issuer's disclosure to address reasons why this occurred, how the board of directors and/or special committee took this decision into account, and its relevance to any recommendation made to minority security holders. Where a fairness opinion is provided, Staff expect disclosure to give minority security holders a clear understanding of the fairness opinion and how it factored into the board of directors' and/or special committee's decision making process. Specifically, the disclosure should address: a) the advisor's compensation structure, although the quantum need not be provided; b) how the advisor's compensation structure impacted the board of directors' and/or special committee's consideration of the advisor's advice; c) any relationship between the advisor and the issuer or an interested party that may affect the perception of independence; and d) the basis for the advisor's opinion, including financial metrics, without overburdening minority security holders with too much information. Relevant to the preparation and disclosure of fairness opinions, Staff note, are Rules 29.21 and 29.24 of the Investment Industry Regulatory Organization of Canada and Standard No. 510 of the Canadian Institute of Chartered Business Valuators.

Conclusion

Through this Notice, Staff have communicated to market participants that they will become more actively involved in clearing Special Transactions to protect minority security holders—the underlying purpose of MI 61-101 - and the public interest. In doing so, Staff will make inquiries, seek corrective disclosure, make other unfavorable orders, and take enforcement steps. Such involvement by Staff could interfere with the timing of the Special Transaction. To avoid this result, issuers ought to establish procedures that are consistent with Staff views, namely the formation of a robust special committee to oversee all forms of Special Transactions or take steps to insulate the board of directors from conflicted board members, and produce comprehensive disclosure in a manner that minority security holders can understand.