Goodmans LLP Update

Corporate Securities Law

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OSC and AMF Announce Important New Guidance on Conflict of Interest Transactions

On July 27, 2017, Staff of the Ontario Securities Commission (the "**OSC**") and the Autorité des marchés financiers (the "**AMF**"), in conjunction with the securities regulatory authorities of Alberta, Manitoba and New Brunswick, published CSA Staff Notice 61-302 – *Staff Review and Commentary on Multilateral Instrument 61-101* (the "**Staff Notice**"). The Staff Notice discloses the details of Staff's proactive review program (the "**Review Program**") for transactions subject to Multilateral Instrument 61-101 *Protection of Minority Security Holders in Special Transactions* ("**MI 61-101**") and their views on the role of boards of directors/special committees and issuers' disclosure obligations in the context of such transactions. The Staff Notice conveys that in order to fully comply with MI 61-101 issuers (and their counsel) when undertaking conflict of interest transactions should apply a purposive interpretation of MI 61-101 that focuses on the principles enunciated in the companion policy to MI 61-101 ("**61-101CP**") and related decisions of Canadian securities regulatory authorities.

The requirement that issuers and their counsel look beyond the strict language of MI 61-101 has created a gap between Staff expectations and current market practice. The Staff Notice is intended to clarify Staff's expectations in relation to MI 61-101 transactions, set out the guiding principles utilized in the Review Program and communicate that Staff will scrutinize transactions and could take enforcement action to ensure compliance when they are not conducted in a manner consistent with the spirit of MI 61-101, or the guidance in 61-101CP and past decisions of securities regulatory authorities.

Background

MI 61-101 establishes a securities regulatory framework which is intended to mitigate risks to minority security holders when "related parties" (including insiders) of the issuer are involved in certain transactions (including take-over bids and other business combinations). Fundamentally, MI 61-101 is intended to ensure all security holders are treated in a manner that is fair and perceived to be fair in the context of material transactions where the interests of related parties differs materially from the interests of minority security holders. MI 61-101 implements these principles through procedural protections, including formal valuations, enhanced disclosure, and approval by a majority of minority security holders and the involvement of a special committee of independent directors in certain circumstances.

Staff Review Program

The Staff Notice confirms the OSC and AMF have implemented a formal process to proactively review transactions subject to MI 61-101 on a real-time basis. Key features of the Review Program include the following:

- Staff will generally initiate a review of a transaction upon the filing of a disclosure document for the transaction (i.e., a take-over bid circular or proxy circular). While Staff indicated that it will seek to identify and resolve issues in real-time, they reserve the right to take appropriate action (such as a temporary cease-trade order) that may delay a proposed transaction if Staff believe it is in the public interest to do so.
- Staff's review will focus on both technical compliance with MI 61-101 and public interest issues, such as whether the process employed by the issuer's board of directors in negotiating and reviewing a proposed transaction raises concerns that the interests of minority security holders have not been adequately protected.

- Upon identifying potential compliance or public interest issues, Staff may contact the issuer (or its legal counsel) and ask detailed questions and/or request supporting information (including board of directors and special committee minutes, special committee mandates, work product associated with a formal valuation, and other relevant materials).
- Staff will factor into their review any complaints received from third parties.
- When Staff identifies non-compliance with MI 61-101 or public interest concerns as part of a review, they may seek timely corrective disclosure or other appropriate orders under securities legislation in relation to the transaction, or enforcement action in certain circumstances (e.g., where materially misleading disclosure has been made or other requirements of applicable securities law have not been complied with).

Historically, Canadian securities regulators have only engaged in this type of detailed review upon receiving a complaint from an interested party. This is the first program by Canadian securities regulators involving a proactive review of such a broad class of transactions, and illustrates the heightened sensitivity of securities regulators to transactions involving potential conflicts of interest.

Staff Guidance

The Staff Notice also provides Staff's views regarding a number of other important aspects of MI 61-101, including the role of special committees, disclosure obligations and fairness opinions.

Special Committees

Staff's overarching concern is to ensure an issuer's board of directors appropriately manages conflicts of interest that arise in the context of transactions subject to MI 61-101. While Staff recognizes a special committee is not the only mechanism that can protect minority security holders' interests in a conflict of interest transaction, the Staff Notice reiterates Staff's view that a special committee is advisable for all material conflict of interest transactions. The Staff Notice also expresses the view that "the active engagement of a special committee in the process, free from interference or undue influence by persons with a conflict of interest, assists issuers in complying with MI 61-101 and mitigates potential public interest concerns" and that "[t]his practice should also reduce the risk of a transaction being the subject of a complaint to securities regulatory authorities and the likelihood of Staff raising procedural issues when reviewing the transaction."

The Staff Notice goes on to provide specific guidance regarding the role of special committees in the context of conflict of interest transactions, including the following:

- *Mandate.* While special committee mandates should be appropriately tailored to the particular circumstances of a proposed transaction, generally, a special committee should have a broad mandate which includes the authority to (i) negotiate, or supervise the negotiation of, a proposed transaction (rather than to simply review and consider it); (ii) consider alternatives to the proposed transaction; (iii) make a recommendation regarding the fairness of a proposed transaction; and (iv) hire its own independent legal and financial advisers, without any involvement of, or interference from, interested parties or their representatives.
- *Independence.* Special committees should be comprised entirely of independent directors (as defined in MI 61-101) who are free from any conflict of interest in connection with the proposed transaction. As importantly, a special committee must *act* independently and discharge its mandate without undue influence from, or deference to, related parties whose interest in the transaction may differ from those of minority security holders. Special committees are encouraged to engage their own independent legal and financial advisors.
- *Role and Process.* A special committee should be formed early in the process and engage in a robust review of the circumstances leading to the transaction, the transaction itself and available alternatives. The special committee should also actively engage in, or actively supervise, the negotiation of the proposed transaction (and, in circumstances where a proposed transaction is negotiated at the preliminary stages between interested parties, the special committee should

have the authority to negotiate further and consider alternatives to the proposed transaction). Staff are unlikely to view a special committee that is formed late in the process or that does not actively participate in the negotiation process and appears to simply act as a "rubber stamp" as achieving the policy rationale of MI 61-101.

Enhanced Disclosure

Enhanced disclosure – in addition to disclosure for a transaction that is generally required under applicable corporate and securities laws – is one of the fundamental protections available to minority security holders in transactions governed by MI 61-101. The Staff Notice emphasizes the importance of complying with the spirit and intent of the enhanced disclosure requirements in MI 61-101, and cautions against tactical or self-serving disclosure intended primarily to further the interests of an interested party. The Staff Notice clarifies Staff's expectations regarding the substance of certain of these disclosure requirements:

- *Background Disclosure.* The Staff Notice highlights a number of issues that Staff have identified regarding disclosure of the background to, and approval process for, a proposed transaction – an area where market practice has differed considerably. Specific issues include: (i) inadequate disclosure of the context and background to a proposed transaction, (ii) failure to provide a meaningful discussion of the board's or special committee's process and their rationale for supporting a proposed transaction, (iii) failure to provide disclosure of dissenting views of directors in respect of a transaction, (iv) failure to provide disclosure on reasonable alternatives to the transaction; (v) failure to disclose the pros and cons of the transaction, and (vi) overly one-sided disclosure regarding a recommended transaction that did not identify potential concerns with the transaction or available alternatives to the transaction.
- *Analysis of Desirability and Fairness.* 61-101CP instructs directors to disclose their reasonable beliefs as to the desirability or fairness of a proposed transaction and make useful recommendations regarding the transaction. The Staff Notice clarifies that this disclosure should address the interests of minority security holders and not be limited to whether the transaction is in the best interests of the issuer (which is the standard by which directors' conduct is judged under Canadian corporate law).
- *Recommendations.* 61-101CP expresses the view that failure of the directors to make a recommendation about how minority security holders should vote on a proposed transaction, without detailed reasons, generally would be viewed as insufficient disclosure. The Staff Notice acknowledges there may be circumstances where it is appropriate for the directors not to make a recommendation. The Staff Notice reiterates the view – originally expressed by the OSC in its decision regarding Magna International's disclosure of the transaction involving the collapse of its dual class share structure in 2011 – that where a transaction is proposed to security holders without a recommendation, (i) directors must disclose the reasons for the decision not to make a recommendation and the basis upon which the board of directors expects minority security holders to vote on the transaction in the absence of a recommendation, and (ii) minority security holders should be provided "with substantially the same information and analysis that the special committee received in considering the proposed transaction".

Fairness Opinions

Fairness opinions are not expressly required by MI 61-101, and the Staff Notice recognizes it is the responsibility of an issuer's board of directors or special committee to determine whether a fairness opinion is necessary. Nonetheless, the Staff Notice outlines certain expectations of Staff where a fairness opinion is obtained, including the following:

- It is generally the responsibility of the board or special committee to determine the terms and financial arrangements for the engagement of an advisor to provide a fairness opinion.
- A special committee cannot substitute the results of a fairness opinion for its own judgment about whether a transaction is in the best interests of the issuer and its minority security holders.
- A special committee should engage in a thorough review of any fairness opinion that is obtained and should not blindly accept the assumptions and methodologies utilized by the financial advisor.
- A special committee should consider any prior financial work product produced by the financial advisor or any other financial advisors that is relevant to the committee's recommendation, and

whether such work product needs to be disclosed to security holders.

The Staff Notice expresses concern that current market practice regarding disclosure of fairness opinions for transactions regulated by MI 61-101 does not provide security holders with a meaningful understanding of the fairness opinion and how it was considered by the board or special committee. The Staff Notice expressly adopts IIROC Rules 29.21 and 29.24 and Standard No. 510 of The Canadian Institute of Chartered Business Valuators as reasonable approaches to meeting the appropriate disclosure standards. Furthermore, the Staff Notice indicates such disclosure should include:

- the compensation arrangement, including whether the financial advisor is being paid a flat fee, a fee contingent on delivery of the final opinion, or a fee contingent on the successful completion of the transaction;
- an explanation of how the board or special committee took the compensation arrangements into account when considering the advice provided;
- disclosure of any other relationship or arrangement between the financial advisor and the issuer or an interested party that may be relevant to a perceived lack of independence in respect of the advice received or opinion provided;
- a summary of the methodology, information and analysis (including, as applicable, financial metrics, and not merely a narrative description) underlying the opinion sufficient to enable a reader to understand the basis for the opinion; and
- an explanation of the relevance of the fairness opinion to the board of directors and special committee in coming to the determination to recommend the transaction.

Notably, the Staff Notice also states that if a fairness opinion has been requested and a financial advisor is not able or willing to provide one, the disclosure document should set out the financial advisor's reasons for not providing the fairness opinion and should explain how the special committee and board of directors took the financial advisor's decision into account and its relevance to any recommendation made to security holders concerning the transaction.

Conclusion

With a few exceptions, the Staff Notice largely reflects the policy considerations that inform MI 61-101 and recent commission decisions. One notable exception is for disclosure regarding fairness opinions, which appears to require significantly more detailed disclosure than historical practice in the market.

The formalization of Staff's Review Program is a strong reminder to issuers contemplating a potential transaction that would be subject to MI 61-101, that the transaction will be scrutinized carefully by regulators to ensure not only technical compliance with MI 61-101, but that the process by which the transaction was negotiated, reviewed and approved does not give rise to public interest concerns. Disclosure that merely "checks the box" on technical form requirements risk potential delays, administrative burdens, and potential reputational issues for the issuer and its directors.