

# SIGNIFICANT CHANGES PROPOSED IN M&A REGULATION IN CANADA

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## SECURITIES REGULATORS' PROPOSALS FOR REFORM OF RIGHTS PLAN REGULATION AND EARLY WARNING REQUIREMENTS WOULD SIGNIFICANTLY CHANGE THE REGULATORY LANDSCAPE FOR CANADIAN M&A TRANSACTIONS

ALTHOUGH IN MANY respects Canadian securities laws have been substantially reformulated and updated in recent years, there are elements of the regulatory framework that have avoided comprehensive policy review or revision for some time. Ironically, some of these elements relate to the regulation of public M&A, a fast-evolving and highly scrutinized category of corporate activity. The absence of regulatory reform in this area does not mean that there has been no pressure for reform or change; on the contrary, questions concerning the regulation of defensive tactics in particular have been extensively and enthusiastically debated in Canada for many years.

Recently, Canadian securities regulators published proposals that would significantly change the regulatory system for M&A transactions in this country. Those changes, if adopted in the form proposed, would (i) significantly change the rules concerning common defensive tactics in the face of hostile take-over bids and the manner in which contests for corporate control are regulated and conducted, and (ii) update the requirements for disclosure of securities ownership to more closely align with the requirements of other jurisdictions and to reflect the complexities of contemporary securities markets.

### RIGHTS PLANS IN CANADA

Rights plans (also commonly referred to as poison pills) are often used in Canada by publicly traded issuers in anticipation of, or in response to, unsolicited (or "hostile") take-over bids. Similar to those used in other jurisdictions, rights plans in Canada typically provide for the issuance of rights that are exercisable, in the event of a hostile bid, by all securityholders (other than the bidder) for additional shares of the issuer at a deep discount. As a technical matter, the triggering of a rights plan would result in dramatic dilution of the bidder, rendering completion of the hostile bid uneconomic. In practical terms, a rights plan forces a hostile bidder to negotiate for the waiver, or to seek legal nullification, of the plan to proceed with its bid.

#### *The Current Framework*

The current Canadian regulatory approach to rights plans is based on the principles outlined in National Policy 62-202, Take-Over Bids—Defensive Tactics ("NP 62-202"), adopted (in its original form) in 1986. The policy reflects a concern that the interests of the board and management of an issuer subject to a take-over bid may not be aligned with the interests of securityholders, and that defensive measures adopted by the issuer may deny securityholders the opportunity to respond to a bid. The policy endorses the paramountcy of securityholder choice, supported by oft-cited passages expressing the regulators' view that "unrestricted auctions produce the most desirable results in take-over bids" and "regulators will intervene if defensive tactics are adopted that will likely deprive shareholders of their ability to tender to a bid or a competing bid."

Hostile bidders in Canada faced by a rights plan commonly apply to the securities regulators for an order to "cease trade" (effectively, to invalidate) the plan. The typical approach of securities regulators in those cases, consistent with the principle of securityholder choice, is that the only legitimate purpose of a rights plan is to give the target issuer more time to develop superior alternative transactions to the proposed hostile bid. The over-arching principle is that "there comes a time when the pill has got to go." Specifically, securities regulators generally apply NP 62-202 to intervene and cease trade rights plans if no competing bid or transaction is likely to arise. The focus at regulatory hearings is typically on how much additional time a target issuer should have to develop such alternatives.

A number of concerns have been expressed about the existing framework. One frequently mentioned issue is that the current Canadian approach generally is too bidder-friendly. In particular, the practice of intervention by securities regulators is said to limit the leverage available to a target issuer to negotiate with, or defend itself against, a hostile bidder, and more generally to restrict board and securityholder discretion, potentially frustrating efforts to maximize value for the issuer's stakeholders. The Canadian framework is often contrasted to the American approach, where rights plans are not generally nullified if no alternative transaction is promptly developed. For this reason, the current regulatory approach to rights plans is often cited as contributing to the "hollowing out" of corporate Canada by making Canadian issuers easier to acquire.

Another common criticism of the current Canadian approach is that hearings before securities regulators are not the proper forum for regulation of rights plans; proponents of this view argue that courts are best positioned to regulate defensive tactics and assess whether the members of a target issuer's board have discharged their fiduciary duties, and whether other corporate remedies, such as the "oppression remedy," are available in the context of a proposed control transaction.

The approach described has generally been applied by regulators in Canada for more than two decades, and a relatively settled set of factors considered in determining whether rights plans should be nullified has been developed. Nevertheless there have been exceptions, and because of the discretion embedded in those factors and in the core test of whether a rights plan has outlived its usefulness, there has been some inconsistency in the regulatory approaches and consequently some uncertainty.

Whatever one's perspective on the regulation of rights plans, what is clear is that the Canadian regulatory approach evolved through a series of securities commission decisions rather than any coordinated policy reform process, and that reconsideration of the approach should take into account contemporary phenomena such as the common incidence of multi-jurisdictional take-over bids and the

increasing trend of shareholder activism and proxy contests.

#### *Proposals for New Frameworks*

On March 14, 2013, Canadian securities regulatory authorities published two proposals for reform of the system for review and oversight of rights plans. The proposals of the Canadian Securities Administrators (the "CSA") are outlined in National Instrument 62-105 Security Holder Rights Plans ("NI 62-105"). The Autorité des marchés financiers (the "AMF") (the Québec securities regulatory authority) published its own proposals in a separate consultation paper.

The CSA's proposals would provide the board of an issuer targeted by a hostile bid with greater flexibility to use a rights plan as a defense tactic. The new rules would give target boards the flexibility, with securityholder support, to "just say no" to a hostile bid. The key element of the CSA's proposals is the concept of collective securityholder determination; proposed NI 62-105 reflects the CSA's view that the ultimate decision about the adoption or maintenance of a rights plan should remain with the securityholders as a group, and not with the board of directors, regulators or courts.

This approach is different from the paradigm of securityholder choice under the current framework, with the focus on each securityholder ultimately having the opportunity to choose whether or not to accept a proposed offer. Securityholder support under NI 62-105 refers to the collective will of the securityholders (in recognition of the collective action problem that exists with unwelcome take-over bids). Additionally, though the proposals would eliminate securities commissions' active role of evaluating when and whether to nullify each rights plan brought before them, there would still be a limited continuing role for securities regulators where a rights plan is being used in a manner contrary to the public interest.

## HIGHLIGHTS OF PROPOSED NI 62-105

NI 62-105 proposes a framework where a rights plan can provide enduring protection from a hostile bid provided that it receives securityholder approval (unlike the current system where, as described, rights plans are generally not permitted to endure, and are typically cease traded by securities regulators after a relatively short time).

#### *Approval, Renewal and Termination of a Rights Plan*

As is the case under the current regulatory framework, under NI 62-105 a rights plan would be effective from the date it is adopted by the issuer's board. However, in order for the plan to remain effective it must be approved by securityholders within 90 days of its adoption by the board (or, if implemented after a take-over bid has been launched, within 90 days of the date of the bid). A rights plan previously approved by securityholders would not need to be re-approved in the event of a take-over bid. Securityholder approval would be by simple majority, with the bidder and its joint actors excluded from voting. Once approved, a rights plan would remain effective if re-approved no later than at each annual meeting following the initial securityholder approval.

Predictably, a rights plan would terminate automatically if the requisite majority securityholder approval were not obtained within the prescribed 90 day time-frame. In addition, securityholders could terminate a rights plan by a majority vote at any time. This could allow a bidder to challenge the rights plan by requisitioning a securityholders' meeting to approve the termination of the plan, and allow securityholders to remove a rights plan if they desired to accept a take-over bid blocked by the plan.

The clear implication of the proposed rule is that a target issuer could maintain a rights plan indefinitely, and in the face of a hostile take-over bid, if the plan is approved by the target issuer's securityholders. Additionally, the proposed rule would take the battle from the arena of a regulatory hearing to the forum of a securityholders' meeting. The rule would facilitate the ability of hostile bidders to directly challenge a rights plan through the securityholder approval process (and without the need to initiate a proxy contest to seek to replace the board itself).

Conversely, if a rights plan were not approved, or if the securityholders voted to terminate a plan, the issuer would be prohibited from approving a new rights plan for a period of 12 months except with prior securityholder approval. If a formal take-over bid were made, however, a rights plan could be adopted. Any such plan would be subject to the normal requirement for securityholder approval within 90 days.

#### *Application of Rights Plans*

Proposed NI 62-105 also contains certain provisions concerning the operation of rights plans. Consistent with the regulators' concerns about a possible misalignment of interest between an issuer's board and its securityholders, the proposals require that, if a board waives or modifies a rights plan in favor of a particular take-over bid, it must do so with respect to all take-over bids. This would ensure that the rights plan is applied consistently, and the target board cannot discriminate between bidders. Further, and notably in an era of increasingly common proxy contests, the proposals stipulate that rights plans could only be effective for acquisitions of securities, and not in the context of proxy contests.

## HIGHLIGHTS OF AMF'S PROPOSED ALTERNATIVE APPROACH

As noted, on the same date on which the CSA published proposed NI 62-105, the AMF published a consultation paper contemplating a different approach to the regulation of rights plans. The AMF stated that if its proposal does not receive broad support then it will support the changes proposed in NI 62-105.

The AMF's proposed approach would provide target issuers with even more latitude than NI 62-105. The AMF proposes replacing NP 62-202 with a new policy that would recognize the fiduciary duties of directors in responding to a hostile take-over bid and only allow regulator intervention on the grounds of public interest. This alternative approach would allow target boards to implement a poison pill without securityholder approval for an unlimited period of time.

The AMF's consultation paper emphasizes reasons for reform similar to those cited in support of proposed NI 62-105, including the perception that the current approach is too bidder-friendly and that target issuers lack the necessary flexibility to respond to hostile bids. The AMF cites the example of the contest for control of Fibrex Inc., where the AMF (based on the principles set out currently in NI 62-202), overruled a defensive tactic that would have facilitated a higher valued alternative to a hostile bid. Under the AMF proposal, challenges to rights plans would be reviewed under the lens of the exercise by board members of their fiduciary duties, with regulatory intervention limited to clear cases of abuse. One unique and related element of the AMF proposal concerns the nature of bids themselves. The AMF is proposing that all bids be required to have an irrevocable minimum tender condition of 50 percent of "independent" securityholders, and a mandatory 10-day tendering period extension after the minimum tender condition has been satisfied. The proposal to require "permitted bid" conditions (other than a specified minimum bid period) in all bids is intended to address the structural coercion that securityholders may face in the context of a take-over bid.

## RIGHTS PLANS – LOOKING FORWARD

Both NI 62-105 and the AMF proposal are subject to public comment, with the comment periods scheduled to end in June 2013. The implementation of either proposal in the form published would represent a fundamental shift in the treatment of rights plans in Canada. Both proposals would give target boards significant discretion to adopt and, with securityholder approval, maintain a poison pill in the face of a hostile bid that the board determines is not in the issuer's best interests.

Canadian issuers could become less vulnerable to hostile take-over bids and have more leverage when negotiating with hostile bidders. Canadian issuers would also have more time to negotiate with hostile bidders, since it is expected that bids would, as a result of the new framework, generally be open (or if not, then extended) for 90 days rather than the statutorily required minimum 35-day deposit period. In the context of hostile bids, the fight over the continuation of rights plans would shift from hearings in front of the securities regulators to proxy battles over their implementation or termination, although regulatory intervention could still occur where the regulators consider intervention to be "in the public interest."

## PROPOSED AMENDMENTS TO THE EARLY WARNING DISCLOSURE REQUIREMENTS

One day before the release of the rights plan proposals, the CSA proposed a broad set of amendments to the early warning regime, the system for disclosure of significant ownership positions and of the acquirors' investment intentions. There are parallels between the proposals beyond the timing of publication. Though there have been periodic reforms, and proposals for reform, of the early warning rules, the key elements of the regime had not been amended since their introduction in the 1980s.

As with rights plans, an impetus for reform may have been triggered by the increase in shareholder activism (in addition to other phenomena, such as the use of increasingly complex derivatives by sophisticated investors to avoid disclosure requirements, and so-called "empty voting" tactics, which

enable the accumulation of significant voting stakes through derivatives and securities lending arrangements without holding a corresponding economic interest). Additionally, the current Canadian early warning system (specifically, the reporting threshold) has a different reporting threshold than the reporting system in the United States.

#### *Reduction in Reporting Threshold*

The key proposal that garnered much of the immediate attention was to reduce the early warning reporting threshold from 10 percent to 5 percent. In the CSA's view, increasing shareholder activism and the ability under Canadian corporate statutes of holders of at least 5 percent of a corporation's shares to requisition a shareholders' meeting prompted the need for increased market transparency and a lowering of the reporting threshold to 5 percent.

#### *Calculation of the Threshold*

In its proposals the CSA expressed concern that hidden ownership strategies can significantly undermine the early warning regime since an investor may have access to securities held by a derivative counter-party without triggering a disclosure obligation. The proposals seek to improve disclosure by requiring an investor to include within the early warning calculation certain equity derivative positions (defined in the proposals as "equity equivalent derivatives") that are substantially equivalent in economic terms to conventional equity holdings. A derivative would substantially replicate the economic consequences of ownership of a specified number of reference securities if a dealer that took a short position on the derivative could substantially hedge its obligations under the derivative by holding 90 percent or more of the specified number of reference securities.

Examples of equity equivalent derivatives include total return swaps, contracts for difference and other derivatives that provide the party with an economic interest that is substantially equivalent to the economic interest the party would have if it held the securities directly. Partial exposure instruments, such as an option and collar that provides only limited exposure to the reference securities, would not constitute "equity equivalent derivatives."

#### *Other Reporting Triggers*

The proposed amendments would also clarify, or fill gaps in, other reporting requirements. Under present rules investors who have made early warning disclosures are required to disclose increases in ownership of 2 percent or more of the issuer's securities, and changes in any material fact previously disclosed. Consequently, it is for the investors to determine whether a decrease in their ownership constitutes a material fact requiring disclosure. Under the proposed amendments, disclosure would be required for a decrease in ownership of 2 percent or more. Additionally, where under current rules it is not clear that a decrease in ownership below the reporting threshold (as proposed, 5 percent) would require disclosure, the CSA proposes that securityholders be required to issue a press release and file a report if their ownership decreases below the 5 percent threshold.

Under the current rules, an investor required to make early warning disclosure is required to issue a press release promptly (and to file a report within two business days). Under the proposals the timing of the press release is more clearly specified; it would have to be issued before market open on the first trading day following the reportable event.

#### *Enhanced Disclosure*

The proposals require enhanced disclosure in early warning reports relating to the purpose of the reported event (acquisition, disposition or other change in a material fact in a previous report), including detailed disclosure of the investor's intentions. The CSA, expressing concern that under the current early warning regime unhelpful "boilerplate" language is overused, included in the proposals more detailed disclosure requirements relating to the investor's intentions, with a view to making the disclosure more specific and meaningful.

It is not clear how transition to the more detailed disclosure would work if the proposals were adopted, specifically whether investors that had crossed the threshold before implementation of the new requirements would be required to provide updated disclosure. However, the CSA will have an opportunity to clarify these matters once it receives feedback from market participants.

#### *Reporting on Securities Lending Arrangements*

Through its proposals, the CSA seeks to provide greater transparency about, and ensure appropriate disclosure of, securities lending arrangements for the purposes of early warning disclosure requirements. Given the increasing use of securities lending arrangements, the CSA clarified in its proposals how the early warning requirements apply to such arrangements. The CSA proposals confirmed that securities lending arrangements are captured by early warning disclosure requirements (as acquisitions of interests for the borrower, and as dispositions of interests by the lender).

An exemption is contemplated for certain lending arrangements where the lender has the ability to recall the loaned securities prior to any securityholder meeting. The views expressed by the CSA on securities lending arrangements are consistent with its perspective that greater detail and clarity must be provided to the market concerning complex transfers of interests in publicly traded securities.

#### *Changes to Alternative Monthly Reporting*

The early warning regime currently permits a party qualifying as an eligible institutional investor (an "EII"), having a passive intent with respect to its ownership or control of securities, to report changes on a more relaxed timetable. Under these rules (known as the alternative monthly reporting system (the "AMR")), an EII may defer reporting changes until 10 days after the end of the month in which the change occurred unless it (i) makes, or intends to make, a take-over bid or (ii) proposes, or intends to propose, a reorganization, amalgamation, arrangement or similar business combination. The policy underlying the AMR is that there is less market sensitivity to changes involving passive investors, and therefore less urgency for disclosure of those changes.

Currently, an EII that solicits, or intends to solicit, proxies from the securityholders of a reporting issuer may use AMR even though its intent may be to actively engage with the securityholders of the reporting issuer. The CSA stated its belief that allowing an EII access to AMR in this circumstance would not be consistent with the policy intent of the AMR regime. As a result, the CSA proposes to exclude from AMR any EII which solicits, or intends to solicit, proxies from securityholders on matters relating to the election of directors or a reorganization, amalgamation, merger, arrangement or similar corporate action involving the securities of the reporting issuer.

## **IMPLICATION OF THE PROPOSED AMENDMENTS**

If implemented, the proposed amendments would bring Canada's early warning disclosure regime into closer conformity with the requirements in the US and other jurisdictions, and would provide investors and issuers with more detailed information about the ownership activity and intentions of significant securityholders. At the same time, the changes would extend the disclosure requirements for some derivative positions. Taken together, the changes might be said to eliminate some of the perceived "activist friendly" features of the Canadian securities regulatory regime. As with the rights plan proposals, the comment period is scheduled to expire on June 12, 2013.

## **CONCLUSION**

If adopted, the Canadian securities regulators' proposals for reform of rights plan regulation and early warning requirements would significantly change the regulatory landscape for M&A transactions in Canada. Though the comment periods are scheduled to end mid-June, given the high-profile and complex nature of the subject matter, the finalization of the proposals may be extended. The timing for adoption of the proposals, if they are to be adopted, is difficult to predict.