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CSA Adopt Incremental Amendments to Early Warning Regime – Reporting Threshold Stays at 10%

FEBRUARY 25, 2016 13 MIN READ

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Coincident with the adoption of amendments to the take-over bid regime (see our separate Osler Update), the Canadian Securities Administrators (CSA) have adopted amendments to the "early warning" reporting regime [PDF] (the Amendments) that are expected to come into force on May 9, 2016. These Amendments are not as extensive as the amendments originally proposed by the CSA in March 2013, which would have lowered the reporting threshold to 5% and required "equity equivalent derivatives" to be included in determining whether the reporting threshold was triggered. While the Amendments are more incremental than fundamental, the CSA have stated that they are intended to enhance the quality and integrity of the early warning reporting regime by:

- requiring disclosure when a securityholder's ownership decreases by 2% or falls below the 10% reporting threshold;
- making the alternative monthly reporting system (AMRS) unavailable to eligible institutional investors that solicit proxies in certain circumstances;
- exempting lenders from including securities lent or transferred for purposes of determining whether they have an early warning reporting obligation for a loan (disposition) if they lend securities pursuant to a "specified securities lending arrangement";
- exempting borrowers that engage in short selling from including securities borrowed for the purposes of determining whether they have reached an early warning threshold in certain circumstances;
- enhancing the disclosure requirements in the early warning report including, in particular, with respect to the purpose and intentions of the investor and in respect of disclosure of "related financial instruments" such as equity derivatives, securities lending arrangements and other agreements, arrangements or understandings that have the effect of altering, directly or indirectly, the investor's economic exposure to the securities of the issuer to which the report relates;
- requiring the early warning report to be certified and signed;
- clarifying the timeframe to issue and file a news release and file an early warning report; and
- further streamlining the information required in a news release filed in connection with the early warning requirements.

Background

Canadian securities laws currently impose "early warning" obligations relating to the acquisition of securities of public companies. When a purchaser acquires beneficial ownership or control or direction over 10% or more of a class of voting or equity securities, the purchaser is required to promptly issue and file a press release and within two business days file an early warning report with the securities regulators. Further press releases and reports are required upon the acquisition of each additional 2% or more of the outstanding securities or a change in a material fact contained in an earlier report. The disclosure required in the press releases and reports must cover, among other things: (i) the number and percentage of securities acquired; (ii) the purpose for which the securities are acquired; and (iii) any future intention to acquire additional securities. There is also a cooling-off period that prohibits further purchases by the purchaser until the expiry of one business day after each report is filed (the Moratorium). The Moratorium ceases at the 20% ownership level, at which point the take-over bid rules are engaged. Eligible institutional investors, including financial institutions, pension funds and certain hedge funds, can avail themselves of the AMRS unless disqualified as discussed below.

No Change to 10% Reporting Threshold

As previously indicated in its October 2014 update, the CSA have decided not to proceed with their original proposal to reduce the early warning reporting threshold from 10% to 5%, which would have put Canada in line with the reporting threshold in the United States and many other countries. Activist investors and hostile bidders will continue to be able to accumulate toeholds of up to 9.9% without having to make public disclosure unless the class of securities is already subject to an outstanding take-over bid or issuer bid.

Treatment of Derivatives

The CSA have previously acknowledged [PDF] the complexity and difficulty of including "equity equivalent derivatives" (equity derivative positions that are substantially equivalent in economic terms to conventional equity holdings) for the purpose of determining whether the early warning reporting threshold has been reached under the early warning system. Accordingly, the CSA have decided not to proceed with this aspect of their original proposal. The CSA's original proposal sought to provide greater transparency to potential "hidden ownership" positions through the use of derivatives, which allow such investors to achieve economic exposure to public companies while avoiding public disclosure.

Under the amended early warning reporting regime, cash-settled derivatives and physically-settled derivatives (except to the extent such derivatives entitle the holder to acquire equity securities within 60 days) will generally not be included for purposes of determining whether the early warning reporting threshold has been reached. However, the CSA have added guidance to National Policy 62-203 *Take-Over Bids and Issuer Bids* (NP 62-203) regarding the circumstances under which an investor may have to include in the early warning threshold calculation an equity swap or similar derivative arrangement. This may be required where the investor has the ability, formally or informally, to obtain the equity securities or to direct the voting of voting securities held by any counterparties to the transaction.

Although not generally relevant to determining whether the early warning reporting threshold has been reached, the Amendments do require new disclosure for early warning reports in respect of "related financial instruments", which are agreements, arrangements or understandings that affect the economic interest or exposure to the issuer. This disclosure requirement will capture cash-settled derivatives and physically-settled derivatives.

Disclosure will also be required in respect of securities lending arrangements and other agreements, arrangements or understandings that have the effect of altering, directly or indirectly, the investor's economic exposure to the securities of the issuer to which the report relates. Canadian insider reporting rules already require disclosure of "related financial instruments" for insider reports, and filers under AMRS reports relying upon an exemption from insider reporting are already required to report the institutional investor's interest in any related financial instrument. Accordingly, the Amendments will improve consistency of disclosure across insider reports, conventional early warning reports and AMRS reports. We note that the CSA have indicated that this enhanced disclosure need not include disclosure of the identity of the counterparty or commercially sensitive information. Investors will also need to consider whether any change in such holdings of related financial instruments, securities lending arrangements or other agreements, arrangements or understandings that have the effect of altering, directly or indirectly, the investor's economic exposure to the securities of the issuer to which the report relates is a change in a material fact in a previously filed report.

Reporting and Application of Moratorium for Decreases in Ownership

Currently, decreases in ownership are only reportable under the early warning system if they represent a change in a material fact in the last filed report, although decreases below fixed thresholds in increments of 2.5% must be reported under the AMRS. Likewise, there is currently no specific requirement for disclosure under the early warning system when a holder's ownership falls below the 10% early warning report threshold (although such disclosure is required under the AMRS). The Amendments will result in disclosure being required under the conventional early warning system for both a 2% decrease in ownership as well as when ownership falls below the 10% early warning threshold and will impose the Moratorium on purchases in such circumstances.

Disqualifications from Alternative Monthly Reporting

A key difference between the conventional early warning system and the AMRS is that while the conventional system currently requires the prompt issuance of a press release and the filing of an early warning report within two business days of a reporting trigger, the AMRS generally allows the reporting of ownership positions to be made only on a monthly basis, with each filing due within ten days of the end of the month.

Under the current early warning regime, eligible institutional investors are disqualified from using the AMRS if they make or intend to make a formal take-over bid, or propose or intend to propose a reorganization, amalgamation, merger, arrangement or similar business combination with respect to a reporting issuer that would result in the eligible institutional investors having effective control of the issuer.

Concerns have been raised that activist investors can use the AMRS to avoid the Moratorium and delay reporting share accumulations in circumstances where they intend to actively engage with the issuer to bring about change in the issuer's strategy, thereby undermining the justification for allowing them to continue to utilize a reporting regime designed for passive investors.

As a result of the Amendments, an eligible institutional investor will also be excluded from the AMRS if it solicits proxies from securityholders in any of the following circumstances: (i) in support of one or more director nominees other than persons proposed by management; (ii) in support for a reorganization, amalgamation, merger, arrangement or other similar

corporate action that is not supported by management; or (iii) in opposition to a reorganization, merger, arrangement or other similar corporate action that is proposed by management. The term "solicit" has the meaning ascribed that term in National Instrument 51-102 *Continuous Disclosure Obligations*, and therefore will exclude certain actions, such as a public announcement of how the eligible institutional investor intends to vote. We note that the amendments as originally proposed would have disqualified an eligible institutional investor from using AMRS not only if it solicits but if it "intends to solicit" proxies in specified circumstances. The omission of the words "intends to solicit" in the Amendments, while providing more certainty to investors, leaves open the possibility for activist investors to use AMRS as part of an accumulation strategy before commencement of a solicitation campaign.

Securities Lending

Securities lending arrangements, in which securities are temporarily transferred from one party to another in exchange for a fee, will generally be included in determining whether an early warning reporting requirement has been triggered. An exemption from reporting loans (dispositions) will be available for lenders that engage in "prescribed securities lending arrangements", which will include an unrestricted ability by the lender to recall all securities under the lending arrangement prior to the record date for a meeting of security holders or require the borrower to vote at the direction of the lender. Standard industry forms of securities lending agreements, such as the Global Master Securities Lending Agreement (GMSLA), may require amendment to fit within the definition of a prescribed securities lending arrangement.

In a change from the original proposal, a new exemption for short selling borrowers has also been introduced. The exemption is subject to certain conditions, including that the borrowed securities are disposed of by the borrower within three business days and that the borrower does not intend to vote and does not vote the securities.

The Amendments require any securities lending arrangements in effect at the time of a reportable transaction to be disclosed in the report, even if the triggering transaction did not involve a securities lending arrangement.

Enhanced Disclosure Obligations

Prescribed disclosure must be made in connection with the filing of an early warning report, including disclosure in respect of the purpose of the transaction and any future intention to acquire ownership or control over securities.

The Amendments require additional disclosure regarding the purpose of the transaction and future intentions to acquire securities, and descriptions of any agreements with respect to securities and voting. These additional disclosure requirements are aimed, in particular, at requiring investors to provide more detailed and customized disclosure regarding the intentions of the person acquiring securities and the purpose of the acquisition, the CSA noting that currently this disclosure often consists of boilerplate language that in their view provides little useful information for the market. These additional disclosure requirements also apply to investors reporting under the AMRS. These additional disclosure requirements move the conventional early warning system in Canada closer to the corresponding reporting requirements in the United States under Schedule 13D which require more detailed disclosure than required under the current Canadian requirements of the investor's purpose in acquiring the securities and also require disclosure of its plans and proposals regarding the issuer. In the United States, investors eligible to report under the more simplified reporting requirements on Schedule 13G must only certify that the investor has not acquired the securities for the purpose or with the effect of changing or influencing the

control of the issuer.

The Amendments also require new disclosure in respect of "related financial instruments", securities lending arrangements and other agreements, arrangements or understandings that have the effect of altering, directly or indirectly, the investor's economic exposure to the securities of the issuer to which the report relates, as noted above under "Treatment of Derivatives".

Timeframe for Filing

The Amendments clarify that the early warning news release must be filed promptly and no later than the opening of trading on the business day following acquisition and the early warning report must be filed promptly and no later than two business days following acquisition.

Comparison with Corresponding U.S. Reporting Requirements

In addition to the lower 5% reporting threshold, there are a number of other significant differences between the Canadian regime and the corresponding U.S. reporting requirements. Unless eligible for simplified reporting on Schedule 13G, shareholders holding 5% or more must file a report on Schedule 13D, disclosing in a fair amount of detail the investor's purpose in acquiring the securities and its plans and proposals regarding the issuer. A Schedule 13D must be filed with the U.S. Securities and Exchange Commission within ten days of crossing the 5% threshold. However, there are no restrictions on further acquisitions by the investor during the period between when the requirement to file an initial report of ownership on Schedule 13D is triggered and when the report is actually filed, which may be up to ten days later. As a result, a holder can acquire significantly more than 5% before any public disclosure is required.

Many investors are eligible to file a simplified report on Schedule 13G (corresponding in concept to the AMRS), unless they are disqualified from simplified reporting because they have acquired the securities "...with any purpose, or with the effect, of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect...". This disqualification from simplified reporting goes to the heart of whether the investor is active or passive, and is broader than the corresponding disqualifications from AMRS eligibility under the Canadian rules, even after the addition of the new disqualification in the Amendments related to proxy solicitation. Unless disqualified, holders of less than 20% of the class of securities, as well as specified types of institutional investors even if they hold more than 20%, are generally eligible for simplified Schedule 13G reporting.

Perhaps the most significant difference between the Canadian reporting regime and the U.S. reporting regime is that, in the United States, a failure to file Schedule 13D on time or with sufficient detail is often the subject of class action litigation. For example, a shareholder that holds more than 5% of the outstanding voting shares of an issuer may be viewed as having an intention to change or influence control if it sends a letter to the board of directors of the issuer outlining the various actions which the shareholder thinks should be taken to improve the issuer's performance. If the shareholder had previously reported its ownership on Schedule 13G, it may well, depending on the content and tone of the letter, be required to file a Schedule 13D and become subject to the consequences of disqualification from Schedule 13G reporting, which include restrictions on the ability to purchase or vote any shares for ten days thereafter.

Effectiveness of Amendments

The Amendments are reflected in National Instrument 62-104 *Take-Over Bids and Issuer Bids* which will now apply in all jurisdictions in Canada, National Instrument 62-103 *Early Warning System and Related Take-Over Bid and Insider Reporting Issues* and NP 62-203 that are expected to come into force on May 9, 2016.