

Securities Commission staff raise the bar for conflict transactions

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Authors: [Alex Gorka](#), [Jeremy Fraiberg](#), [Emmanuel Pressman](#), Donald Gilchrist

In an important [Staff Notice \(Notice\)](#) [PDF] published on July 27, 2017, staff of the securities regulatory authorities in each of Ontario, Québec, Alberta, Manitoba and New Brunswick (Staff) have indicated that they intend to subject material conflict of interest transactions regulated by Multilateral Instrument 61-101 *Protection of Minority Security Holders in Special Transactions* (MI 61-101) to greater regulatory scrutiny. Material conflict of interest transactions will now be reviewed on a real-time basis to assess compliance with the requirements of MI 61-101 and to determine whether a transaction raises potential public interest concerns.

Staff have also provided guidance regarding their expectations of enhanced disclosure and the active role to be played by special committees of independent directors.

Moreover, where a fairness opinion is obtained for a material conflict of interest transaction, Staff are requiring disclosure of the structure of a financial advisor's compensation (but not the amount of the advisor's fee) as well as the financial analysis underlying the opinion.

“Real-time” transaction review

Since the creation of the Ontario Securities Commission's (OSC) Office of Mergers & Acquisitions, OSC staff have taken a more active role in reviewing unfolding transactions. The Notice makes clear that Staff monitor and review material conflict of interest transactions on a real-time basis for compliance purposes and with a view to identifying and addressing public interest concerns.

The trigger for a real-time review will typically be the filing of the disclosure document for the transaction. Staff have indicated that they may reach out to issuers and their legal counsel with questions and requests for supplemental information. Where Staff identify non-compliance or public interest concerns, they may seek corrective disclosure or other appropriate orders, and may take enforcement action.

By contrast, in the United States, proxy circulars for transactions are reviewed and commented on by the SEC before they are sent to shareholders. Since Staff are not proposing to review proxy circulars before they are mailed, there is a risk that issuers may have to make supplemental or corrective disclosure to shareholders as a result of Staff's comments, resulting in potential delays to the transaction. This recently occurred in the proposed share consolidation of Frontier Rare Earths Limited, which was delayed by six months following comments from OSC staff relating to Frontier's disclosure and process.

In order to avoid transaction execution risk and delay, boards of directors will need to adopt rigorous processes and ensure that the issuer's disclosure can withstand heightened regulatory scrutiny.

Special committees

The Notice also provides guidance regarding Staff's expectations of the active role to be played by special committees of independent directors in the context of material conflict of interest transactions.

While Staff acknowledge that special committees are only strictly required in the case of insider bids, and that there are other ways to protect the interests of minority shareholders, Staff are of the view that a special committee is generally advisable for all material conflict of interest transactions. Staff note that there may be circumstances where the board of directors can address the concerns set out in the Notice and adequately protect minority security holders without forming a special committee, for example, where the board of directors is comprised entirely of independent directors or where the board of directors takes appropriate steps to conduct its deliberations free from interference or influence by directors with a conflict of interest.

Staff are of the view that special committees should be formed and engaged early in the process, be composed of independent directors, be given a robust mandate, engage independent advisors, and supervise or directly conduct negotiations. Other indicia of a well-run special committee process include accurate record keeping and non-coercive conduct on the part of interested parties. Staff recognize that while a special committee may invite non-independent board members and other persons possessing specialized knowledge to meet with, provide information to, and carry out instructions from the committee, non-independent persons should not be present at or participate in the decision making deliberations of the special committee.

One noteworthy development is Staff's expectation that where a board of directors or a special committee discloses its reasonable beliefs as to the desirability or fairness of a material conflict of interest transaction, the disclosure should address the interests of minority security holders and not be limited solely to whether the transaction is in the best interests of the issuer. This focus on the interests of minority shareholders potentially conflicts with the fiduciary duties of directors under corporate law, which are owed to the corporation and not the shareholders. The Notice acknowledges this potential conflict and provides a safety valve: where the board of directors determines that such a conflict exists, Staff expect that the disclosure document for the transaction will explain the conflict and how it factored into the board's determination to propose the transaction for approval by minority security holders.

Enhanced disclosure

The enhanced disclosure standards described in the Notice are derived from a mixture of legislative requirements, prior Staff guidance and case law. The Notice explicitly links good process to good disclosure, stating that "... the enhanced disclosure requirements... presuppose that an effective process has been undertaken such that the board of directors is able to appropriately inform security holders as to the desirability or fairness of the transaction proposed to them."

Without an effective process, Staff believe that the disclosure to security holders will be substandard. As a result, and as part of their real-time review of transactions, the identification by Staff of perceived disclosure deficiencies may unearth procedural deficiencies, which in turn may lead to enhanced regulatory scrutiny, requests for corrective disclosure, other appropriate orders or enforcement action.

Staff note as a general matter that disclosure for a material conflict of interest transaction generally requires a thorough 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 as to the desirability or fairness of the transaction, (d) reasonably available alternatives to the transaction, including the status quo, and (e) the pros and cons of the transaction.

In addition, Staff have identified problems with respect to disclosure of the background to and approval process for a transaction, including: (a) inadequate disclosure of the context and background to a proposed transaction, (b) failure to provide a meaningful discussion of the board of directors' or special committee's process and their rationale for supporting a proposed transaction, (c) failure to provide disclosure of dissenting views of directors in respect of a transaction, and (d) overly one-sided disclosure regarding a recommended transaction that did not identify potential concerns with the transaction or available alternatives to the transaction.

Staff's requirements for enhanced background disclosure will move Canadian practice closer to that in the United States, where issuers have tended to provide more robust and detailed disclosure than their Canadian counterparts.

Fairness opinions

Since the Yukon Court of Appeal's decision in *InterOil*, there has been considerable debate in the M&A community as to whether Canadian practice relating to fairness opinions should evolve in response to the decision. To date, practice has been mixed. Market participants have not uniformly adopted the three main practices endorsed by the Court of Appeal: disclosure of the financial analysis underlying the opinion, disclosure of the specific amount of advisor fees, and retaining an advisor to provide a fixed fee fairness opinion where the fee is not contingent on the conclusion of the opinion or outcome of the transaction.

The Notice acknowledges that fairness opinions are not strictly required for material conflict of interest transactions and that it is the responsibility of the board of directors and any special committee to determine whether a fairness opinion is necessary. Staff have also deferred to boards of directors and special committees as to the appropriateness of financial arrangements for the engagement of an adviser to provide a fairness opinion, including the payment of a success fee.

However, in the context of material conflict of interest transactions and where a fairness opinion has been obtained, Staff expect the disclosure document for the transaction to:

- disclose 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,
- explain how the board or special committee took into account the compensation arrangement with the financial advisor when considering the advice provided,
- disclose any other relationship or arrangement between the financial advisor and the issuer or an interested party that may be relevant to a perception of lack of independence in respect of the advice received or opinion provided,
- provide a clear 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, without

overwhelming security holders with too much information, and

- explain the relevance of the fairness opinion to the board of directors and special committee in coming to the determination to recommend the transaction.

Staff have specifically referred market participants to Investment Industry Regulatory Organization of Canada (IIROC) rules on fairness opinions, which apply to fairness opinions rendered by IIROC dealer members in MI 61-101 transactions. Market practice has varied in terms of the level of compliance and disclosure provided in connection with IIROC opinions, and there has been an ongoing debate and uncertainty as to whether the IIROC rules require disclosure of the quantum of the fee received by a financial advisor in both valuations and fairness opinions.

It is now clear that Staff expect the financial analysis underlying the fairness opinion to be disclosed and that, as a general matter, Staff will not require disclosure of the quantum of the fee received by a financial advisor. Interestingly, Staff did not mandate or endorse the use of fixed fee opinions or disclosure of the amount of the advisor's fee, two of the key holdings in the recent *InterOil* decision.

The enhanced disclosure obligations set out in the Notice will bring Canadian practice more closely in line with practice in the United States. Under U.S. practice, where a fairness opinion is included in an information circular, detailed financial analysis is typically disclosed. However, in the U.S. the prevailing practice is to disclose the quantum of the financial advisor's fee, and not merely the structure of the compensation arrangement.

Conclusion

Beginning in 1977 with OSC Policy 3-37 and culminating with the adoption of MI 61-101 in 2008, there were periodic revisions to the regulatory framework applicable to Canadian material conflict of interest transactions. In the years since 2008, the developments in this area have largely emerged from regulatory decisions rendered in the context of contested transactions. With the exception of the enhanced disclosure expectations in respect of fairness opinions, significant portions of the Notice should be viewed as a distillation of Staff's views regarding the commissions' approach to material conflict of interest transactions since 2008. Accordingly, the process of well-advised boards of directors and special committees in the context of material conflict of interest transactions will not be significantly impacted.

What is most noteworthy is that Staff are clearly signalling that they will be taking a more active role in reviewing unfolding transactions. In order to avoid transaction execution risk and delay, boards of directors will need to adopt rigorous processes and provide enhanced disclosure that can withstand heightened regulatory scrutiny.

It is important to note that the Notice is limited to "material conflict of interest transactions" regulated by MI 61-101, meaning insider bids, issuer bids, business combinations and related party transactions that give rise to substantive concerns as to the protection of minority security holders. The Notice does not generally include transactions that give rise to an incidental conflict, such as transactions that are business combinations only as a result of employment-related collateral benefits accruing to insiders. Time will tell whether Staff's guidance "spills over" or informs market practices in the context of non-conflict transactions.

We note that the securities regulators in Alberta, Manitoba and New Brunswick adopted MI 61-101 on July 20, 2017. As the majority of Canadian public companies were already subject to MI 61-101 by virtue of being reporting issuers in Ontario or Québec or being listed on the TSX-V, there will be no additional change for such issuers arising from the application of MI

61-101 other than the potential involvement of the securities regulators in Alberta, Manitoba and New Brunswick on matters that engage MI 61-101.

Alex Gorka was one of the primary drafters of Multilateral CSA Staff Notice 61-302 – Staff Review and Commentary on Multilateral Instrument 61-101 while on special secondment to the Office of Mergers & Acquisitions of the Ontario Securities Commission.