CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

Multilateral CSA Staff Notice 61-302

Staff Review and Commentary on *Regulation 61-101 respecting Protection of Minority Security Holders in Special Transactions*

July 27, 2017

Introduction

We, staff of the securities regulatory authorities in each of Ontario, Québec, Alberta, Manitoba and New Brunswick (collectively, **Staff** or **we**), are publishing this notice to advise market participants of our:

1. current and proposed review and oversight of transactions subject to *Regulation 61-101 respecting Protection of Minority Security Holders in Special Transactions* (**Regulation 61-101**), and

2. views with respect to

   (a) the role of boards of directors and/or special committees of independent directors in negotiating, reviewing, and approving or recommending material conflict of interest transactions, and

   (b) disclosure obligations that enable security holders to make informed decisions to vote or tender in favour of proposed material conflict of interest transactions.

This Staff notice reflects the recent experience of staff in Ontario and Québec in reviewing material conflict of interest transactions. This notice also outlines for market participants the transaction review approach of staff in Ontario and Québec, which staff in Alberta, Manitoba and New Brunswick intend to adopt.

In this Staff notice, "material conflict of interest transaction" refers to insider bids, issuer bids, business combinations and related party transactions, each as defined in Regulation 61-101, that give rise to substantive concerns as to the protection of minority security holders. Therefore, for purposes of this Staff notice, "material conflict of interest transaction" would generally not include transactions that are captured incidentally within the scope of Regulation 61-101, such as transactions that are business combinations only as a result of employment-related collateral benefits.

Further, in this Staff notice, the term "minority security holder" refers to equity security holders of a reporting issuer that are not an "interested party" (as such term is defined in Regulation 61-101) in connection with the material conflict of interest transaction.

Purpose of Regulation 61-101

Regulation 61-101 establishes a securities regulatory framework that mitigates risks to minority security holders when a related party of the issuer, who may have superior access to information or significant influence, is involved in a material conflict of interest transaction.
The principles underlying Regulation 61-101 are described in s. 1.1 of *Policy Statement to Regulation 61-101 respecting Protection of Minority Security Holders in Special Transactions* (**Policy Statement 61-101**), namely, that all security holders be treated in a manner that is fair and that is perceived to be fair.

Regulation 61-101 implements these principles through procedural protections for minority security holders that include formal valuations, enhanced disclosure, and approval by a majority of minority security holders. Regulation 61-101 also mandates the involvement of a special committee of independent directors in specific circumstances and Policy Statement 61-101 recommends their use in all material conflict of interest transactions.

Staff recognize that Regulation 61-101 is supplemental to the duties and remedies that may be applicable to issuers or available to minority security holders under applicable corporate, contract, or other law. While Regulation 61-101 focuses on the interests of minority security holders, boards of directors have a broader duty to the issuer under corporate law. Staff believe that the best interests of the issuer and its minority security holders will generally not be in conflict when considering transactions regulated under Regulation 61-101; however, if in the view of the board of directors there is such a conflict, we expect that the disclosure document for the transaction will explain the conflict and how it was addressed by the board of directors in reaching its determination to propose the transaction for approval by minority security holders.

Interpretive approach

Staff apply a broad and purposive interpretation to the requirements of Regulation 61-101 that emphasizes its underlying policy rationale. We also consider how security holder and market expectations have evolved over time in light of the application by securities regulatory authorities of their public interest jurisdiction, as well as developments in corporate law and market practice.

We expect market participants to take a similarly broad and purposive interpretation of the requirements of Regulation 61-101 and to adopt practices designed to effectively mitigate conflicts in material conflict of interest transactions. Where it appears to Staff that a transaction may not have been conducted in a manner consistent with Regulation 61-101, or the guidance in Policy Statement 61-101 and decisions of securities regulatory authorities, we will scrutinize the transaction to assess compliance with Regulation 61-101 and identify potential public interest issues.

Reviews of special transactions

Staff review material conflict of interest transactions on a real-time basis to assess compliance with the requirements of Regulation 61-101 and to determine whether a transaction raises potential public interest concerns.

Timing and scope of reviews of special transactions

The objective of Staff's review program is to identify and resolve issues in real time, before a transaction is approved by security holders or closed, so as to reduce the risk of harm to minority security holders.

Staff will generally initiate a review of a material conflict of interest transaction upon the filing of a disclosure document[1] for the transaction. Our reviews focus on compliance with disclosure requirements, compliance with the conditions for exemptions in Regulation 61-101 from the formal valuation and minority approval requirements, and the substance and disclosure of the process conducted by an issuer's board of directors or special committee in considering a material conflict of interest transaction. Any complaints received by Staff will factor into the review.

When reviewing disclosure documents for material conflict of interest transactions, we will generally consider the following:

(a) whether the disclosure requirements that enable security holders to make informed decisions have been complied with, including whether the enhanced disclosure required by Regulation 61-101 has been provided,
(b) if a formal valuation is required, whether the issuer has obtained one that complies with Regulation 61-101 and included either a summary or the entirety of the valuation in its disclosure document,
(c) if minority security holder approval is required, whether or not the issuer has excluded all parties that are not properly part of the minority,
(d) if an issuer states that it is relying on an exemption from the formal valuation and/or minority approval requirement, whether the disclosure document provides a reasonable basis on which to conclude that the exemption is available, and
(e) whether the process employed by the issuer's board of directors in negotiating and reviewing a proposed transaction (including the existence or non-existence of a special committee of independent directors) raises concerns that the interests of minority security holders have not been adequately protected and whether that process is adequately disclosed.

Information gathering

Staff may contact the issuer or its legal counsel upon identifying potential compliance or public interest issues as part of a review. We may ask detailed questions, orally or in writing, 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) for the purposes of our review of a transaction.

Recognizing the time constraints associated with transactions, we endeavour to conduct our reviews in a manner that is as direct and expeditious as possible. However, we may apply for a temporary cease-trade or other appropriate order in respect of a proposed transaction if we believe it is in the public interest to do so.

[1] Disclosure documents include information and bid circulars, as well as press releases and material change reports filed in relation to transactions that are exempt from the minority approval requirements of Regulation 61-101.

Remedies

When Staff identify non-compliance with Regulation 61-101 or potential public interest concerns as part of a review, we may seek one or more of the following:

(a) timely corrective disclosure or other actions on the part of the issuer,
(b) appropriate orders under securities legislation in relation to the transaction, or
(c) enforcement action in certain circumstances, such as where we believe that materially misleading disclosure has been made or that other requirements of applicable securities law have not been complied with.

Staff views on special committees and enhanced disclosure

The following discussion of Staff views regarding special committees of independent directors and enhanced disclosure requirements is based on the requirements of Regulation 61-101 and associated guidance in Policy Statement 61-101, decisions of securities regulatory authorities addressing compliance and public interest considerations related to Regulation 61-101, and issues identified in reviews of material conflict of interest transactions.

Special committees

Introduction

Staff expect that an issuer's board of directors will appropriately manage the conflicts of interest that arise in the context of a material conflict of interest transaction. The formation of a special committee of independent directors to, among other things, ensure that the interests of minority security holders are fairly considered in the negotiation and review of such a transaction is one of the primary means of managing such conflicts of interest.

We recognize that the formation of a special committee of independent directors is not the sole governance arrangement that can protect the interests of minority security holders in a manner consistent with the principles that underlie Regulation 61-101. There may be circumstances where the board of directors can address the concerns set out in this Staff 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. For purposes of this Staff notice, references to a "special committee" include a board of directors acting in this manner.

While the use of a special committee of independent directors is mandated by Regulation 61-101 only in the case of insider bids, Staff are of the view that a special committee is advisable for all material conflict of interest transactions. A properly constituted special committee with a robust mandate can ensure that the interests of minority security holders are appropriately taken into account and may thereby alleviate the conflicts that underlie material conflict of interest transactions. Our view is consistent with the guidance found in ss. 6.1(6) of Policy Statement 61-101.

In Staff's view, 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 Regulation 61-101 and mitigates potential public interest concerns. This 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.

In addition, we believe that the enhanced disclosure requirements under Regulation 61-101, as well as relevant guidance in Policy Statement 61-101, presuppose that an effective process has been undertaken so that the board of directors is able to appropriately inform security holders as to the desirability or fairness of the transaction proposed to them.

Timely formation and effectiveness of special committees

As part of our reviews, Staff have identified occasions where special committees were formed after a proposed transaction had been substantially negotiated or where it appeared that the special committee was passive and failed to conduct a robust review of the circumstances leading to the transaction, alternatives to the transaction that were available in the circumstances, and the transaction itself. In Staff's view, in those circumstances the special committee was ineffective and failed to fulfill the important functions of considering the interests of security holders and assisting the board of directors in determining whether to recommend the transaction to security holders.

Composition of special committees

In light of our reviews, we believe that the composition of a special committee impacts its effectiveness. While we recognize that 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, we are of the view that non-independent persons should not be present at or participate in the decision making deliberations of the special committee.

Staff may also consider whether:

(a) the members of a special committee are independent within the meaning of Regulation 61-101, and
(b) the special committee conducts itself independently and is given the authority and opportunity to discharge its mandate without undue influence from interested parties or undue deference to the interests of interested parties.

Role and process of special committees

A special committee should appropriately manage conflicts of interest to be effective.[2] Indicia of a well-run special committee process in the context of a material conflict of interest transaction generally include a robust mandate, the engagement by the committee of independent advisors, supervision over or direct conduct of negotiations, accurate record keeping, and non-coercive conduct on the part of interested parties. Staff recognize that the conduct of a special committee process is also subject to corporate law and fiduciary duty considerations; however, as stated in *Re Hudbay Minerals Inc.*,[3] "[t]hese kinds of issues are not solely matters for the courts."[4] Securities regulatory authorities have, over the course of multiple decisions, considered the role

[2] *Re Magna International Inc.* (2011), 34 OSCB 1290 [*Magna*] at para 229.
[3] (2009), 32 OSCB 3733.
[4] *Ibid* at para. 235.

and process followed by a board of directors or a special committee in reviewing and approving, or recommending approval of, a transaction or matter.[5]

Mandates

Through our reviews we have identified occasions where the mandate of a special committee was narrowly circumscribed, as well as instances where a special committee did not appear to fulfil the full scope of its mandate. We encourage a broad special committee mandate that authorizes the special committee to address the key issues relating to a transaction.[6]

Staff recognize that special committee mandates will be tailored to the context of the relevant transaction. We generally expect that a special committee mandate will include the ability to do the following:

(a) either negotiate or supervise the negotiation of a proposed transaction, rather than simply review and consider it,[7]
(b) consider alternatives to the proposed transaction that may be available, including maintaining the status quo or seeking other transactions that would enhance value to minority security holders,
(c) make a recommendation regarding the proposed transaction,[8] or, if it does not, provide detailed reasons why not, and
(d) hire its own independent legal and financial advisors, without any involvement of, or interference from, interested parties or their representatives.

Staff may be concerned by any mandate that limits a special committee to considering only one or both of the following:

(a) a proposal developed by executive management in conjunction with a related party;[9] or
(b) whether a proposed transaction should be put to security holders for a vote.[10]

Negotiations

The *Magna* decision stated that "the process of negotiation [is] a key aspect of the process that should [be] conducted or overseen by the Special Committee."[11] Staff recognize that the exact nature of the involvement of a special committee in negotiations will depend on the context of a particular transaction. In some circumstances, it may be appropriate for a special committee to negotiate a transaction from the outset, whether directly, through advisors, or in some other manner that is supervised by the special committee. In other circumstances, it may be appropriate for the transaction to be negotiated at a preliminary stage by key interested parties. However,

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[5] See, for instance, *Re Standard Trustco Ltd* (1992), 15 OSCB 4322, *Re YBM Magnex International Inc* (2003), 26 OSCB 5285, *Re Sears Canada Inc* (2006), 25 OSCB 8766 [*Sears*], *Re AiT Advanced Information Technologies Corp* (2008), 31 OSCB 712, *Re Rowan* (2008), 31 OSCB 6515, *Re Neo Material Technologies Inc* (2009), 32 OSCB 6941, *Magna supra* note 2.
[6] *Magna supra* note 2 at para 229.
[7] *Ibid* at para 222.
[8] *Ibid* at para 224.
[9] *Ibid* at para 221.
[10] *Ibid* at para 224.
[11] *Ibid* at para 218.

where the special committee has not been involved in preliminary negotiations, we believe it is critical that the board of directors and special committee not be bound by any such negotiations and that other aspects of the role of the special committee be robust, such as a mandate to review, negotiate further, and consider alternatives that may be available.

Financial advisors and fairness opinions

Staff recognize that fairness opinions obtained by special committees and boards of directors from financial advisors in connection with material transactions are not required under Regulation 61-101 or addressed in Policy Statement 61-101.

In our view, apart from a requirement under Regulation 61-101 to obtain a formal valuation, it is the responsibility of the board of directors and special committee to determine whether a fairness opinion is necessary to assist in making a recommendation to security holders on a proposed transaction. Staff believe that it is generally the responsibility of the board of directors and the special committee to determine the terms and financial arrangements for the engagement of an advisor to provide a fairness opinion.

As part of our reviews, we have identified occasions where special committees requested a fairness opinion but otherwise did not appear to adequately consider the desirability or fairness of a proposed transaction. A fairness opinion opines on the fairness of a transaction from a financial point of view. Staff believe that a special committee cannot substitute the results of a fairness opinion for its own judgment as to whether a transaction is in the best interests of the issuer and its minority security holders; a properly mandated and effective special committee should generally consider the transaction from a broader perspective. A special committee should also engage in a thorough review of any fairness opinion that is obtained and bring its own experience and knowledge of the issuer to bear on the assumptions and methodologies utilized by the financial advisor.

In our reviews, we have also identified occasions where special committees have failed to consider previous financial work product, including whether such work product constituted a prior valuation or material information that needed to be disclosed, and to what extent such work product was relevant to the committee's recommendation with respect to the transaction.

Coercive conduct on the part of interested parties

In Staff's view, a special committee can play a particularly important role in safeguarding the rights and interests of minority security holders during the course of a contested material conflict of interest transaction such as an unsolicited insider bid or an attempt by an interested party to exert undue influence when negotiating a transaction with the issuer. The special committee should be permitted to carry out its responsibilities "free from undue influence, coercion or threats, whether express or implied."[12] Any attempt by an interested party to exert undue influence may undermine security holders' confidence in the special committee process and in capital markets generally. Staff believe that related parties involved in a transaction should co-operate with the special committee and refrain from conduct that could be construed as improper or coercive.

[12] *Re Hollinger Inc* (2005), 28 OSCB 3309 at para 80.

Enhanced disclosure

Introduction

Enhanced disclosure requirements constitute one of the fundamental minority security holder protections imposed by Regulation 61-101. They are intended to address the asymmetry of information that may exist when minority security holders are asked to consider and approve, or tender into, a material conflict of interest transaction.

We remind issuers that a bid circular provided to security holders by an offeror in the context of an insider bid or an issuer bid must comply with the requirements of *Regulation 62-104 respecting Take-Over Bids and Issuer Bids* (**Regulation 62-104**), as well as the additional disclosure requirements of Regulation 61-101. An information circular provided to security holders by the management of an issuer for the purpose of soliciting their proxies in the context of a business combination or related party transaction must comply with Form 51-102F5 *Information Circular* (**Form 51-102F5**), and the additional disclosure requirements of Regulation 61-101.

Disclosure standards

The disclosure standards set out in Regulation 62-104, Form 51-102F5, and Regulation 61-101 should be considered in light of the relevant legal requirements under corporate and securities legislation, as well as court decisions and securities regulatory authority decisions. The disclosure document provided to security holders should contain sufficient detail to enable them to make an informed decision on how to vote or whether to tender in respect of a material conflict of interest transaction and should avoid misrepresentations.

Insiders and issuers discharging their disclosure and other obligations under Regulation 61-101 are expected to ensure the fair treatment of minority security holders and comply fully with the "spirit and intent" of Regulation 61-101.[13] This means that minority security holders should receive the disclosure necessary to make an informed decision and that tactical or self-serving disclosure intended primarily to further the interests of a related party in the transaction is not appropriate.[14]

We believe that disclosure in the context of 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.

[13] *Sears supra* note 5 at para 196.
[14] *Ibid* at para 195.

Disclosure regarding background and process

Through our reviews, we 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 encourage issuers to provide a meaningful and full discussion of the review and approval process adopted by the board of directors and special committee in compliance with the requirements of Regulation 61-101.

Desirability or fairness of transaction

In our reviews, we identified instances of inadequate disclosure of a board of directors' or special committee's analysis as to the desirability or fairness of the transaction to security holders. Subsections 6.1(2) and 6.1(3) of Policy Statement 61-101 provide guidance in this regard.

Disclosure should also contain a meaningful discussion of the analysis provided by advisors[15], and how the board of directors and special committee considered the advice provided in concluding that the transaction should be recommended to security holders.

In our view, 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, such 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.

Board of directors and special committee recommendation

Staff recognize that applicable corporate or securities legislation do not require a board of directors or a special committee to make a recommendation as to how minority security holders should vote on a proposed material conflict of interest transaction.[16] While boards of directors generally make a recommendation to security holders in connection with a proposed transaction, there may be exceptional circumstances where the board or special committee determines that a transaction should be put to security holders for their consideration without a recommendation on how to vote or whether to tender their securities. Where a transaction is proposed to security holders without a board recommendation, we believe that there should be a high level of disclosure such that minority security holders are provided "with 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."[17] Staff expect disclosure of a board of directors' review and approval process for a transaction to explain why the transaction is

[15] *Magna supra* note 2 at para 145.
[16] *Ibid* at para 151.
[17] *Ibid* at para 129.

being proposed without a recommendation, including 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.

Fairness opinions

As noted above, applicable securities legislation does not require a reporting issuer to obtain a fairness opinion as a condition of proceeding with a material conflict of interest transaction. However, if a fairness opinion has been requested and a financial advisor is not able or willing to provide one, Staff are of the view that 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.[18]

In reviewing material conflict of interest transactions Staff found that disclosure concerning fairness opinions was often limited and did not provide security holders with a meaningful understanding of the fairness opinion and how it was considered by the board or special committee. Where a fairness opinion is obtained for a material conflict of interest transaction, the disclosure document should:

(a) 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,
(b) explain how the board or special committee took into account the compensation arrangement with the financial advisor when considering the advice provided,
(c) 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,
(d) 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
(e) explain the relevance of the fairness opinion to the board of directors and special committee in coming to the determination to recommend the transaction.

With respect to the preparation and disclosure of fairness opinions in the context of Regulation 61-101 transactions, Staff refers market participants to Rules 29.21 and 29.24 of the Investment Industry Regulatory Organization of Canada, as well as Standard No. 510 of The Canadian Institute of Chartered Business Valuators, which may apply to the party providing a fairness opinion, or, if not, set out a reasonable approach to meeting the appropriate standard for fairness opinions.

[18] *Ibid* at paras 162 and 164.

Conclusion

This Staff notice is intended to remind market participants that the requirements in Regulation 61-101 should be interpreted with a view to their underlying policy purpose of protecting minority security holders in the context of material conflict of interest transactions.

In particular, Staff believe that a special committee of independent directors may provide important protection for minority security holders in connection with the negotiation, review, and recommendation of a material conflict of interest transaction. We are also of the view that compliance with the disclosure requirements and standards applicable to material conflict of interest transactions requires that the disclosure document fully disclose the substance of the transaction being considered and the reasons why the board of directors has determined to recommend or proceed with the transaction over other alternatives.

Staff will consider appropriate remedies in circumstances where it appears that a material conflict of interest transaction has not been conducted in accordance with applicable securities legislation or raises public interest concerns that impact the interests of minority security holders.

Questions

Please refer your questions to any of the following:

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