Autorité des marchés financiers

Consultation Paper

An Alternative Approach to Securities Regulators' Intervention in Defensive Tactics

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1. Introduction

The *Autorité des marchés financiers* ("**AMF**" or "**we**") is publishing for comment, along with the other members of the Canadian Securities Administrators ("**CSA**"), *Proposed National Instrument 62-105 Securities Holder Rights Plans* ("**CSA Proposal**"). The AMF is also publishing concurrently this consultation paper inviting comment on an alternative approach to that contemplated by the CSA Proposal ("**AMF Proposal**").

The CSA Proposal relates only to rights plans and the accompanying Notice and Request for Comment states that participating CSA members will consider in the future whether further changes should be made to National Policy 62-202 *Take-Over Bids – Defensive Tactics* ("**NP 62-202**")[1] with respect to other defensive tactics. We are of the view that recent decisions, among other factors, have created the proper context to review at this time our regulatory framework with respect to all defensive tactics, not only rights plans.

The primary objective of the AMF Proposal is to restore the regulatory balance between bidders and target boards and update the policy framework of our take-over bid regime to reflect the current legal and economic environment and market practices respecting unsolicited take-over bids. We therefore propose to reconsider the current approach to defensive tactics embedded in NP 62-202 and introduce two significant changes to our take-over bid regime.

The purpose of this consultation paper is to provide a forum for discussion on the issues concerning the regulation of defensive tactics in Canada, including the role of boards of directors facing unsolicited take-over bids, and to seek comment on the AMF Proposal. We are initiating this consultation while remaining committed to maintain a cohesive and harmonious approach across the CSA regarding take-over bids and the regulation of defensive tactics.

1.1 The CSA Proposal

The CSA Proposal contemplates that securities regulators in Canada ("**Regulators**[2]") would no longer consider rights plans on a case-by-case basis to determine when they "have to go". Instead, under the CSA Proposal, a rights plan would be permitted to remain in place provided it is approved by a majority of security holders within a specified time period.

The CSA Proposal will potentially have the effect of reducing the circumstances where regulatory intervention would occur because rights plans will not be cease traded if security holders approve them, thereby providing greater certainty to the market.

However, since the CSA Proposal only addresses rights plan, it does not provide a complete answer to certain fundamental issues regarding our take-over bid regime which, in our view, should all be addressed at this time. These issues include the structural imbalance between

[1] In Québec, *Notice 62-202 Relating to take-over bids – Defensive tactics*, Bulletin of the *Autorité des marchés financiers*, 2003-07-18, Vol. XXXIV n° 28.

[2] For the purposes of this consultation paper, the term "Regulators" may include, in Québec, the *Bureau de décision et de révision*, the impartial and independent tribunal specialized in the financial sector for the AMF, financial sector participants and the public in general.

bidders and target boards, the lack of deference to the decisions and actions of boards, the inability of directors to contemplate measures other than the sale of the target corporation, and the prevalence of security holders' decision to tender in all circumstances.

We are of the view that a broader approach to defensive tactics could provide an answer to some of these fundamental issues.

1.2 The AMF proposal

Since the adoption of NP 62-202 in 1986[3], there have been significant changes in the legal and economic environment and market practices respecting unsolicited take-over bids.

The decision by the Supreme Court of Canada in BCE Inc. *v.* 1976 Debentureholders[4] ("**BCE**"), the implementation of more rigorous corporate governance standards, increased shareholder activism, and the growing influence of hedge funds and other arbitrageurs on the outcome of take-over bids have created an opportunity to review a policy that has practically remained unchanged since its adoption.

We would propose to replace NP 62-202 with a new policy on defensive tactics that would clearly recognize the fiduciary duty of directors to the corporation in responding to an unsolicited take-over bid and would redefine Regulators' intervention on the ground of public interest.

We believe that appropriate deference should be given to directors of target corporations in the exercise of their fiduciary duty. Our belief is based on the premise that possible conflicts of interest and entrenchment issues facing target boards are appropriately identified and managed, and that directors demonstrate the appropriate degree of competence and skill, including careful and informed deliberation, as part of their duty of care.

We would further propose to change our take-over bid regime to require, as an irrevocable condition of any bid for all securities of a class, and for any partial bids, that more than 50% of the outstanding securities of the class held by persons other than the offeror and those acting in concert with it be tendered and not withdrawn on the date the bid would otherwise expire. We would also propose that the bid be extended for 10 days following the announcement that this percentage of securities has been tendered.

We believe the implementation of the AMF Proposal would have the following effects:

- it would give directors more latitude to exercise their fiduciary duty and consider all alternatives to maximize security holder value, without Regulators' intervention;
- it would create a revised framework for the regulation of all defensive tactics, not only rights plans;

[3] NP 62-202 is the successor policy to National Policy No. 38 *Take-Over Bids – Defensive Tactics*.
[4] [2008] 3 S.C.R. 560

- it would mitigate the coercion effect[5] of our take-over bid regime for all bids and not just those subject to rights plans;
- it would provide a direct regulatory solution to some gaps in our take-over bid regime;
- it could minimize the ability of arbitrageurs to exert influence on the sale of target corporations;
- it could encourage bidders to negotiate with boards and, as a result, possibly maximize security holder value.

In addition to the publication of a new policy replacing NP 62-202, the implementation of the AMF Proposal would also entail amendments to the *Securities Act* (Québec)[6] ("**QSA**") and Multilateral Instrument 62-104 *Take-Over Bids and Issuer Bids*[7].

2. Background

In this section, we will first discuss the current Canadian take-over bid regime, focusing on its main objectives. We will then broadly review how NP 62-202 has been interpreted over time. Finally, we will briefly look into the particulars of the take-over bid of Fibrek Inc. ("**Fibrek**") by Resolute Forest Products Inc. ("**Resolute**"), launched in December 2011.

2.1 The Canadian take-over bid regime

The current Canadian take-over bid regime originates from the *Report of the Attorney General's Committee on Securities Legislation in Ontario*[8] ("**Kimber Report**"). The Kimber Report expressed the objectives of take-over provisions as follows:

> "The Committee has concluded that the primary objective of any recommendations for legislation with respect to the take-over bid transaction should be the protection of the bona fide interests of the shareholders of the offeree company. Shareholders should have made available to them, as a matter of law, sufficient up-to-date relevant information to permit them to come to a reasoned decision as to the desirability of accepting a bid for their shares. In arriving at its conclusions, however, the Committee attempted to ensure that its recommendations would not unduly impede potential bidders or put them in a commercially disadvantageous position vis-à-vis an entrenched and possibly hostile board of directors of an offeree company."[9]

[5] L. A. Bebchuk, in an article entitled "The Pressure to Tender: An Analysis and A Proposed Remedy", defined the coercion effect of the take-over bid regime as follows: "In the face of a takeover bid, shareholders' tender decisions are subject to substantial distortions. A target's shareholder might well tender his shares even if he views the offered acquisition price as lower than the value of the independent target. The shareholder might tender out of fear that, if he does not tender, the bidder might still gain control, in which case the shareholder would be left with low value shares in the acquired target. Consequently, a bidder might succeed in gaining control over a target even if the value maximizing course of action for the target's shareholder would be to reject the bid." See L. A. Bebchuk, "The Pressure to Tender: An Analysis and A Proposed Remedy", 12 Del. J. Corp. 911, 1987, p. 911.

[6] L.R.Q., c. V-1.1.

[7] In Québec, *Regulation 62-104 respecting Take-Over Bids and Issuer Bids*, V-1.1, r. 35.

[8] Province of Ontario: *Report of the Attorney General's Committee on Securities Legislation in Ontario*, March 1965.

[9] *Ibid* at 3.10.

The Kimber Report suggested numerous provisions to regulate take-over bids, including the duration of an offer, the withdrawal of securities tendered by a security holder of the target corporation, the take-up and payment of securities deposited and the equal treatment of security holders. Essentially, recommendations were made with a view to enable security holders of a target corporation to have sufficient information and time to make an informed decision.

The recommendations contained in the Kimber Report were introduced in the *Securities Act* (Ontario) and later, with very few amendments, in the securities legislation of British Columbia, Alberta, Saskatchewan and Manitoba, the *Canada Business Corporations Act*, and finally in the QSA.

Over the years, subsequent reports were released without concluding on the need to revisit the underlying principles of the Kimber Report and the resulting take-over bid legislation. Since the Kimber Report recommendations were first implemented in 1966, take-over bid provisions in securities legislation have essentially governed offerors and left boards of target corporations with the task of providing their recommendations on the acceptance or rejection of a bid. Regulatory amendments adopted since have not resulted in any significant changes to these principles.

2.2 NP 62-202 and its interpretation

NP 62-202 was adopted before the first rights plan was implemented in Canada and has in essence remained unchanged. It has served as guidance to Regulators in the exercise of their public interest jurisdiction and has predominantly been applied to cease trade rights plans.

As stated in NP 62-202, the two objectives of the Canadian take-over bid regime are the following:

> "The primary objective of the take-over bid provisions of Canadian securities legislation is the protection of the bona fide interests of the shareholders of the target company. A secondary objective is to provide a regulatory framework within which take-over bids may proceed in an open and even-handed environment. The take-over bid provisions should favour neither the offeror nor the management of the target company, and should leave the shareholders of the target company free to make a fully informed decision. The Canadian securities regulatory authorities are concerned that certain defensive measures taken by management of a target company may have the effect of denying to shareholders the ability to make such a decision and of frustrating an open take-over bid process."[10]

NP 62-202 further states that:

> "In considering the merits of a take-over bid, there is a possibility that the interests of management of the target company will differ from those of its shareholders... Canadian securities regulatory authorities consider that unrestricted auctions produce the most desirable results in take-over bids and they are reluctant to intervene in

[10] *Supra* note 1 at 1.1 (2).

> contested bids. However, they will take appropriate action if they become aware of defensive tactics that will likely result in shareholders being deprived of the ability to respond to a take-over bid or to a competing bid."[11]

In 1987, Stanley M. Beck, then Chairman of the Ontario Securities Commission ("**OSC**"), described the regulatory philosophy embodied in NP 62-202 in six maxims[12]:

- "Takeover bids have an important role in the economy, for both economic and legal reasons"[13];
- "Target management is in a conflict of interest situation when facing a hostile bid"[14];
- "The primary objective of takeover bid legislation is the protection of the *bona fide* interests of target company shareholders. A secondary objective is to provide regulatory neutrality between the offeror and target management"[15];
- "Target company shareholders have the right to make the takeover bid decision. As such, target management has no valid reason to (unilaterally) deny them that right. Target management motivation effectively becomes irrelevant"[16];
- "The appropriate regulatory approach to takeover bids is to encourage unrestricted auctions"[17]; and
- "It is inappropriate to design a specific set of rules regulating target director conduct, other than those imposed by corporate law fiduciary standards. However, even without specific rules, it is possible to develop presumptions as to what may be proper or improper"[18].

Regulators have interpreted this regulatory philosophy by concluding that if a rights plan has the effect of denying security holders the right to respond to a bid or generally frustrates the take-over bid process, it must be cease traded. It is not a matter of *if* the rights plan should go, but *when* it should go.

In *Re Canadian Jorex Ltd.* case[19] ("**Jorex**"), the board of directors of Jorex adopted a tactical rights plan in response to an unsolicited take-over bid made by Mannville Oil & Gas Ltd. ("**Mannville**") without obtaining prior shareholder approval. Shortly after, a competing bid was made by Canadian Trans Arctic & Southern International Corp. which the Jorex board supported. The OSC concluded that the adoption of the rights plan was not likely to result in any enhancement of the Mannville bid nor would it encourage other bidders to join the auction process. As a result, the rights plan was cease traded to enable shareholders to decide in which bid to tender.

[11] *Supra* note 1 at 1.1 (1) and (5).

[12] S. M. Beck and R. Wildeboer "National Policy 38 as a Regulator of Defensive Tactics", in *Meredith Memorial Lectures,* Cowansville, Editions Yvon Blais, 1987.

[13] *Ibid.* at 122.

[14] *Ibid.* at 123.

[15] *Ibid.*

[16] *Ibid.* at 125.

[17] *Ibid.* at 130.

[18] *Ibid.* at 134.

[19] (1992) 15 OSBC 257.

In its decision, the OSC did not take into account a series of ancillary issues, including whether the board of directors acted in the best interests of Jorex or if the board should have taken additional steps in seeking shareholder approval of the plan. The only question to be settled for the OSC was

> "...whether the rights plan had served its purpose in facilitating an auction for Jorex, and ought to be discontinued as against the Mannville bid to let the shareholders decide which bid they preferred (if, indeed, they wished to accept either one)."[20]

The OSC determined the rights plan had served its purpose in inducing a superior offer and could not achieve more. As stated in the decision, "there comes a time when the pill has to go"[21].

Although the majority of case law in Canada on rights plans followed Jorex, decisions rendered by the Alberta Securities Commission ("**ASC**") and the OSC in the last few years have attempted to nuance the Jorex approach. In *Re Pulse Data Inc.*[22] ("**Pulse Data**") and *Re Neo Material Technologies Inc.*[23] ("**Neo**"), the ASC and OSC respectively concluded that rights plans could be maintained in the face of an unsolicited take-over bid when there was evidence of a fully informed shareholder approval.

In Neo, the OSC further stated that:

> "...in finding that so long as the rights plan continues to allow the target's management and board the opportunity to fulfill their fiduciary duties, the plan continues to serve a purpose."[24]

In Pulse Data, the ASC indicated reluctance

> "...to interfere with a decision of the Pulse Board that has a fiduciary duty to act in the best interests of Pulse Shareholders, particularly when that decision had very recently been approved by informed shareholders."[25]

The approach taken by the panels in Neo and Pulse Data was however not followed in subsequent decisions. In *Baffinland Iron Mines Corporation*[26] ("**Baffinland**"), the OSC cease traded the rights plan adopted by the board of directors of Baffinland, even if it had received shareholder approval in the face of the Nunavut Iron Ore Acquisition Inc. unsolicited offer. The OSC considered the shareholders' approval but concluded that this element was not sufficient to maintain the rights plan.

[20] *Ibid.* at 4.
[21] *Ibid.*
[22] (2007) ABASC 895.
[23] (2009), 32 OSCB 6941.
[24] *Ibid.* at 144.
[25] *Supra* note 22 at 101.
[26] (2010), 33 OSCB 10957.

In *Lions Gate Entertainment Corp.*[27] ("**Lions Gate**"), the British Columbia Securities Commission ("**BCSC**") followed the same reasoning when it cease traded the rights plan implemented in response to Icahn Partners' unsolicited offer one week prior to the shareholders meeting called to consider the rights plan.

In the majority reasons for the decision, the BCSC determined that an approval by informed shareholders of a rights plan could not supersede the right of individual shareholders to tender into an unsolicited take-over bid. In the absence of any attempt by the target corporation to increase shareholder value through the enhancement of the bid, a competing bid or an alternative transaction, leaving the rights plan in place would serve no other purpose than denying shareholders the opportunity to accept or reject the bid. The BCSC stated that it was implicit in NP 62-202 that rights plans remain in place only as a temporary measure.

In contrast, the minority reasons for the decision in Lions Gate[28] expressed a more nuanced and fact-specific approach in concluding that provided shareholders have approved a rights plan, a board of directors' decision not to seek alternative transactions should not automatically lead to cease-trading the rights plan. The minority held that Regulators should adopt a broad view of the public interest and consider the long-term interests of shareholders collectively.

Neo, Pulse Data and the reasons expressed by the minority in Lions Gate should pave the way for Regulators to revisit the impact of the majority of decisions following the guidance of NP 62-202 which, in essence, resulted in preventing directors and management from considering measures other than the sale of the target corporation.

2.3 Particulars of the Fibrek case

In December 2011, Resolute launched an unsolicited take-over bid to acquire all the common shares of Fibrek ("**Resolute Offer**"). Resolute entered into irrevocable lock-up agreements with three significant shareholders of Fibrek which held, together with another shareholder publicly supporting the Resolute Offer, approximately 50.7% of the common shares of Fibrek. One of these shareholders, Fairfax Financial Holdings Limited ("**Fairfax**"), was also an insider of Resolute, holding approximately 18% of its common shares.

Fibrek's board recommended that shareholders reject the Resolute Offer and adopted a rights plan. Resolute applied to the *Bureau de décision et de révision* ("**Bureau**") to cease trade the rights plan. The Bureau cease traded the rights plan on February 9, 2012.

On February 10, 2012, Fibrek's board announced it had negotiated with Mercer International Inc. ("**Mercer**") the terms of a superior offer ("**Mercer Offer**") which contemplated the private placement of warrants to Mercer to acquire 32,320,000 common shares of Fibrek ("**Private Placement**"). The Private Placement was necessary to secure the Mercer Offer considering that the number of shares committed to the Resolute Offer under the irrevocable lock-up agreements made it unlikely that the bid would succeed even at a higher bid price. The Mercer Offer represented, as subsequently raised, a premium of 40% over the Resolute Offer.

[27] 2010 BCSECCOM 233 and 2010 BCSECCOM 432.
[28] 2010 BCSECCOM 494.

Resolute subsequently applied to the Bureau to cease trade the Private Placement, and the Bureau issued the cease trade order on February 23, 2012. The Bureau interpreted the guidance provided in NP 62-202 and held that even though the board's role was to maximize value for its shareholders, it was ultimately for the shareholders to decide whether to accept or reject the bid. The Bureau concluded that at the time the warrants were issued in favor of Mercer, the majority of Fibrek shares had been committed to the Resolute Offer. The Bureau declared the Private Placement to be abusive. In its decision, the Bureau gave broad consideration to the interests of the shareholders committed under the irrevocable lock-up agreements. In this respect, some commentators have noted that the Bureau did not take into account the fact that Fairfax was conflicted, being a shareholder of both the target and the bidder.

While directors appeared to have efficiently and without evidence of conflict exercised their fiduciary duty towards the corporation to the benefit of all shareholders, cease-trading the Private Placement ended the auction process and prevented the minority shareholders of Fibrek to decide in which bid to tender and to benefit from a higher offer from Mercer.

The comments that were made on this decision have emphasized the need to re-evaluate without further delay our regulatory framework and address all defensive tactics.

3. Analysis

In this section, we will discuss the reasons why we believe that our take-over bid regime and the guidance in NP 62-202 should be reviewed to better respond to current market realities.

We have three main concerns with the current take-over bid regime and interpretation of NP 62-202. First, we believe that our take-over bid regime has become too bidder friendly, thereby contravening its stated objective of neutrality between bidders and target boards and their management.

Second, the guidance provided in NP 62-202 limits the ability of target boards and management facing an unsolicited take-over bid to contemplate measures other than the sale of the corporation, even if these measures could maximize security holder value in the long-term.

Third, we believe that our take-over bid regime is structurally coercive because security holders are required to act individually. They may feel pressured to tender their securities to a bid they do not support, or sell into the market, to ensure they are not left behind, notably in the event the minimum tender condition is waived to allow the take-up and payment of the deposited securities.

We believe that these concerns warrant a policy review by Regulators as to the appropriate approach to regulate defensive tactics. The current approach, in our view, no longer reflects the legal and economic environment and market practices respecting unsolicited take-over bids.

Protecting the *bona fide* interests of target security holders is a core principle of our take-over bid regime and the foundation of NP 62-202. This policy is meant to address the over-arching concern that the interests of boards and management of targets may not be aligned with those of security holders and that boards and management may implement defensive tactics that deny security holders the right to respond to a bid.

In 1987, Mr. Stanley Beck indicated that

> "[m]anagement's conflict of interest position in a takeover context is...beyond dispute. It is a trite point that jobs and careers are often at stake."[29]

Although this situation is still a legitimate concern for Regulators today, we believe that the result of the current interpretation of NP 62-202 goes beyond ensuring an open and even-handed auction process and in effect virtually mandates the sale of corporations.

In order to restore neutrality between bidders and target boards, we would opt for an approach that alleviates the coercion embedded in our take-over bid regime, as well as give appropriate deference to the exercise by directors of their fiduciary duty.

Such deference would be based on the implementation of measures to manage conflicts of interest and the demonstration of the appropriate degree of competence and skill, including careful and informed deliberation that is expected from directors as part of their duty of care.

3.1 Role of directors

We reviewed the role of directors of corporations under the *Canada Business Corporations Act*[30] ("**CBCA**") and the Québec *Business Corporations Act*[31] ("**QBCA**") in their consideration of fundamental changes like share capital amendments[32], amalgamations[33], continuance[34], sale of all or substantially all the property of a corporation[35] and arrangements[36].

Directors are elected by security holders with the assurance that they will discharge their duty with care and loyalty. While the duty of care commands that directors have the appropriate degree of competence and skill required to carry out their functions, the duty of loyalty commands that they act honestly and in good faith in the best interests of the corporation. Whether directors decide on the daily affairs of the corporation or on fundamental changes to the business, mergers and acquisitions, or friendly or unsolicited take-over bids, their duty remains the same.

Corporate statutes assign primary oversight to the board of directors for fundamental transactions changing the corporation's structure and business, such as mergers or sales of all assets. Some of these transactions are used to achieve a change of control. However, in contrast with a take-over bid, these transactions are only submitted to security holder approval if the board first approves

[29] *Supra* note 12 at 123.
[30] RSC, 1985, c C-44.
[31] RSQ, c S-31.1.
[32] ss. 90 and 91 QBCA and s. 173 CBCA.
[33] s. 276 QBCA and s. 181 CBCA.
[34] ss. 288, 289 and 290 QBCA and s. 187 CBCA.
[35] ss. 271 and 272 QBCA and s. 189 CBCA.
[36] ss. 414 to 420 QBCA and s. 192 CBCA.

them. In take-over bids, the offer is made directly to security holders, and the role of directors is limited to evaluating the terms of the bid, recommending to security holders that they accept or reject the bid and disclosing the reasons for the recommendation.

In our current take-over bid regime and as a result of the interpretation of NP 62-202, directors do not have the necessary tools to act on their recommendation except for the sale of the target through an auction process. In order to restore the stated objective of neutrality between bidders and target boards, we believe that we should reconsider the role that the current regime allows directors to play in take-over bids.

3.2 Deference to decisions of target boards

When target corporations are faced with unsolicited bids, Regulators have generally interpreted NP 62-202 in a manner that encourages unrestricted auctions to benefit security holders. However, the decision by the Supreme Court of Canada in BCE clarified the understanding of director's duties when corporations are put "in play".

The fiduciary duty of directors to a corporation

> "...is a broad, contextual concept. It is not confined to short-term profit or share value. Where the corporation is an ongoing concern, it looks to the long-term interests of the corporation. The content of this duty varies with the situation at hand. At a minimum, it requires the directors to ensure that the corporation meets its statutory obligations. But, depending on the context, there may also be other requirements. In any event, the fiduciary duty owed by directors is mandatory; directors must look to what is in the best interests of the corporation.
>
> ...In considering what is in the best interests of the corporation, directors may look to the interests of, *inter alia*, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions." [37]

In addition, the Court made the following statement:

> "[t]here is no principle that one set of interests — for example the interests of shareholders — should prevail over another set of interests." [38]

As mentioned earlier, Regulators have attempted in recent decisions to challenge the traditional auction paradigm. In Pulse Data, rendered before BCE, the ASC considered the target board's fiduciary duty in its analysis. In Neo, the OSC referred to BCE by invoking the business judgment rule, and determined that there was no evidence that the process undertaken by the board of Neo in adopting the rights plan and deciding not to solicit alternative bids was not in the best interests of the corporation and its shareholders. In Lions Gate, the minority reasons stated that a board of directors' decision not to seek alternative transactions should not automatically lead Regulators to cease trade a rights plan.

[37] *Supra* note 4 at 38 and 40.

[38] *Ibid.* at 84.

The views expressed in these decisions embody the principles reiterated in BCE:

> "Provided that... the directors' decision is found to have been within the range of reasonable choices that they could have made in weighing conflicting interests, the court will not go on to determine whether their decision was the perfect one."[39]

We propose to reconsider the role of directors facing unsolicited take-over bids by giving appropriate deference to their actions and decisions. To give such deference, we would examine the context in which the take-over bid takes place, the process followed by directors and the basis for their recommendation to security holders. When appropriate safeguard measures are effectively implemented and monitored by boards and their independent advisers, this should provide reasonable assurance that directors' decisions are not tainted by conflicts of interest.

3.3 Corporate governance standards and security holders' involvement

Since NP 62-202 was adopted, corporate governance standards have substantially improved, reducing the risk for conflicts of interest of boards and management. Also, security holders have, and increasingly use, the tools available to them under corporate law to efficiently advance their interests and as a result, directors' actions and decisions are scrutinized more than ever before.

3.3.1 Evolution of corporate governance and remedies

The significant improvements in corporate governance standards since 1986 must be acknowledged.

The "Dey Report"[40] released in 1994, which suggested 14 best-practice guidelines for boards of directors, was the first step towards major improvements in corporate governance.

Building on the Dey Report, National Instrument 58-101 *Disclosure of Corporate Governance Practices*[41] and National Policy 58-201 *Corporate Governance Guidelines*[42], adopted in 2005, increased transparency regarding the nature and adequacy of issuers' corporate governance practices. National Instrument 52-110 *Audit Committees*[43] has set, among other things, standards for determining independence of directors on audit committees.

Multilateral Instrument 61-101 *Protection of Minority Security Holders in Special Transactions*[44] ("**MI 61-101**") and its predecessors have institutionalized the role of independent committees in the review of conflicts of interest transactions under securities legislation. MI 61-101 imposes additional procedural requirements such as minority security holder approval and independent director oversight whether it is an insider bid or corporate voting related party transaction.

[39] *Ibid.* at 112.

[40] Committee on Corporate Governance in Canada, Toronto Stock Exchange, *Where Were the Directors* by Peter Dey (Toronto, 1994).

[41] In Québec, *Regulation 58-101 respecting Disclosure of Corporate Governance Standards*, c. V-1.1, r. 32.

[42] In Québec, *Policy Statement 58-201 to Corporate Governance Guidelines*, Decision 2005-PDG-0363, 2005-11-15.

[43] In Québec, *Regulation 52-110 Respecting Audit Committees*, c. V-1.1, r.28.

[44] In Québec, *Regulation 61-101 respecting Protection of Minority Security Holders in Special Transactions*, c. V-1.1, r. 33.

The impact of MI 61-101 on transactional practices has been noticeable. Independent directors, supported by independent legal and financial advisers, are routinely implicated in mergers and acquisitions involving potential conflicts of interests for directors. Target boards also regularly rely on independent or special committees to make an independent assessment of a bid and to ultimately assist target security holders in deciding to accept or reject the bid.

The Toronto Stock Exchange recently amended its Company Manual to require that security holders elect directors annually, on an individual basis, and that listed issuers disclose in their management information circular whether they adopted a majority voting policy for the election of directors or, if they did not, explain their practices or why they did not adopt the policy.

Moreover, a large number of institutional investors have joined forces and formed the Canadian Coalition for Good Governance in 2003 to promote good governance practices in the companies in which they invest. Their actions led to tangible improvements in governance practices. Also, organisations like the Institute of Corporate Directors, the *Collège des administrateurs de sociétés* and other training programs designed almost exclusively for directors now contribute to training and raising the sense of accountability of corporate directors.

In addition, corporate statutes across Canada provide shareholders with effective tools to discipline directors and management. Shareholders who represent a prescribed percentage of the corporation’s voting equity can compel a special shareholders’ meeting for any purpose[45], including the removal of directors from office[46] and the proposal of new directors for an election[47]. Canadian statutes further provide for shareholder recourse under the oppression remedy if directors exercise their powers in an oppressive or unfairly prejudicial manner[48].

Finally, proposals submitted by shareholders over the past years have resulted in important changes in governance practices as some of the most senior Canadian issuers have implemented, for instance, “say-on-pay” policies.

3.3.2 Shareholder activism

Security holders are becoming increasingly knowledgeable of the tools they have to discipline boards and management. They have become more vocal and willing to disagree with boards and management, and proxy contests have become an integral part of the Canadian capital markets. Hedge funds and other institutional investors with sufficient ownership, sophistication and resources are now active participants in the Canadian capital markets.

Over the last five years, it was estimated that, on average, over 20 proxy contests were launched annually in Canada. Security holders increasingly play an active role in imposing discipline on underperforming corporations and, as such, act as motivated representatives to a diversified base of security holders.

[45] s. 208 QBCA and s. 143 CBCA.

[46] s. 144 QBCA and s. 109 CBCA.

[47] s. 198 QBCA and s. 137 CBCA.

[48] s. 450 QBCA and s. 241 CBCA.

The cases of Canadian Pacific Railway Limited ("**CP**") and Magna International Inc. ("**Magna**") are recent demonstrations of effective shareholder intervention.

The campaign led by Bill Ackman against directors of CP through his hedge fund firm Pershing Square Capital Management LP led to concrete results. Five of CP's directors resigned from office before the annual general meeting of shareholders, during which CP shareholders voted in favour of director nominees put forth by Mr. Ackman, supported by both the Ontario Teachers' Pension Plan Board and the Canada Pension Plan Investment Board.

At the 2011 annual meeting of Magna, institutional investors "abstained" from voting for the three directors that formed the independent committee mandated to examine the plan of arrangement that eliminated Magna's multiple voting shares. They further requested that the voting results be made public, including through a lawsuit filed with the Ontario Superior Court. As a result, these three directors did not seek reelection at the 2012 annual meeting.

Finally, it is worth mentioning that two significant shareholders of Rona Inc. ("**Rona**"), *Caisse de dépôt et placement du Québec* and Invesco Canada Ltd., recently forced several changes to the composition of the board of directors, including the appointment of a new Chairman. These changes were brought about following the announcement by Lowe's Companies, Inc. of its intention to acquire control of Rona, which further underscored Rona's underperformance in recent years.

The increasing volume of security holders' activity clearly demonstrates that they have and use available remedies to challenge directors and this trend is likely to continue.

3.4 Ability of hedge funds and other arbitrageurs to exert significant influence on the sale of target corporations

Under our current take-over bid regime, an offeror can subject its bid to a number of conditions, generally to its benefit. The offeror will be bound to take up and pay for the securities tendered to its bid only if these conditions are complied with or waived. At the time the take-over bid is commenced, its outcome is difficult to predict, and the level of unpredictability depends on the nature and number of conditions contained in the bid. The minimum number of securities required to be tendered by target security holders is viewed as one of the key conditions of any bid.

This unpredictability has always had an impact on the security holders of target corporations and in some cases, an effect on their decision to keep their securities until the completion of the take-over bid. Those who decide not to keep their securities will sell them.

The sale and purchase of target securities in the market after the announcement of a take-over bid, and often at a discount to the bid price, is not a new phenomenon. However, over the last decade, it has been amplified by the emergence of hedge funds and other arbitrageurs. Some commentators have noticed that the volume of share transactions of target corporations can increase by as much as 40% within the first 5 days following the announcement of a take-over bid, often irrespective of any preliminary indication of acceptance of the bid by target boards, and before the formal board recommendation.

The unpredictable outcome of a take-over bid is exacerbated by the coercion effect embedded in our take-over bid regime. This coercion gives the offeror in an unsolicited take-over bid a strategic advantage over target security holders who are required to act individually in deciding whether or not to tender their securities to the bid. Target security holders may feel pressured to tender their securities to a bid they do not support, or sell into the market, to ensure that they are not left behind, notably in the event the minimum tender condition is waived to allow the take-up and payment of the deposited securities. This is also relevant in the context of partial bids, where the probability to be left with an insignificant part of the ownership of the corporation is higher.

In the current regulatory environment, hedge funds and other arbitrageurs who acquire target securities in the market position themselves to strongly influence the outcome of bids and ensure that target corporations are either sold to the initial offeror or to a subsequent offeror at a higher consideration. These investors acquire target securities with a short-term investment horizon, giving little consideration to the interests of the corporation in which they invest. They are the ones who will effectively tender their newly acquired securities with the intent of obtaining the highest possible value, or will vote against a tactical rights plan implemented by target boards that could delay or even jeopardize the realization of their profit. It is therefore unlikely that they will support any measure proposed by target directors in the exercise of their fiduciary duty, other than an auction resulting in the sale of the target corporation.

4. Alternative approach under the AMF Proposal

An important principle underlying our take-over bid regime is that it should favor neither the bidder nor target boards and management. However, as indicated earlier, the result of the current interpretation of NP 62-202 leads almost inevitably to the auction of target corporations, making our take-over bid regime too bidder friendly.

The primary objective of the AMF Proposal is to restore regulatory balance between bidders and target boards and update the policy framework of our take-over bid regime to reflect the current legal and economic environment and market practices respecting unsolicited take-over bids. We therefore propose to reconsider the current approach to defensive tactics embedded in NP 62-202 and introduce two significant changes to our take-over bid regime.

4.1 Changes to NP 62-202

The underlying principle of our take-over bid regime is that a take-over bid is an offer made directly to security holders who ultimately decide how they wish to respond to it. In this context, directors cannot adopt defensive measures that will likely result in denying security holders the ability to tender their securities to a bid. As a result, the interpretation of NP 62-202 gives little deference to the exercise by directors of their fiduciary duty when they adopt a defensive tactic.

NP 62-202 states that

> “[i]n considering the merits of a take-over bid, there is a possibility that the interests of management of the target company will differ from those of its shareholders.”

This possibility existed when NP 62-202 was adopted and still exists today. However, we believe that if the concern with conflicts of interest were addressed, appropriate deference should be given to the manner in which boards discharge their fiduciary duty and implement defensive measures that could contribute to maximize the value of corporations and, ultimately, the value for security holders.

We are of the view that unless security holders are deprived from considering a *bona fide* offer because the board has inadequately managed its conflicts of interest or those of management, and absent unusual circumstances that demonstrate an abuse of security holders’ rights or that negatively impact the efficiency of capital markets, Regulators should consider that defensive tactics are not prejudicial to the public interest and limit their intervention accordingly.

We are also of the view that it would be appropriate to consider, among other things, certain facts in assessing the reasonableness of the target corporation board’s actions in proposing or implementing a defensive measure, for instance:

- the establishment of a special committee of independent directors with the mandate to consider and review the bid and make a recommendation to the board;
- the appointment of independent financial and legal advisers to assist the special committee in fulfilling its mandate;
- the conclusion of the special committee and the board that, based on their review of the bid and on the advice of legal and financial advisers, it is in the best interests of the corporation to implement a defensive measure;
- the completeness of the disclosure provided to security holders in the directors’ circular, and any other form of communication used by target directors, on the process followed to provide their recommendation and their reasons in support of the defensive measure.

The guidance to be proposed would complement the appropriate degree of competence and skill, including careful and informed deliberation that directors are expected to demonstrate as part of their duty of care.

Self-dealing and conflicts of interest can be properly addressed through policy making and Regulators, in the exercise of their public interest jurisdiction, can challenge actions of boards that are considered abusive. The decision of the OSC in Magna International Inc.[49] illustrates our opinion and further provides a summary of the case law on point:

> “It is not our principal jurisdiction to assess or determine whether directors have complied with their fiduciary duties in connection with a proposed transaction. The Commission has, however, in a number of decisions, when applying its public interest jurisdiction or other provisions of applicable Ontario securities law,

[49] (2011), 34 OSCB 1290.

> considered the role and process followed by a board of directors or a special committee of independent directors in reviewing and approving a transaction or matter (see, for instance, *Re Standard Trustco Ltd. et al* (1992), 6 B.L.R. (2d) 241, *YBM, supra, Re Sears Canada, supra, Re AiT Advanced Information Technologies Corp.* (2008), 31 OSCB 712, *Re Rowan* (2008), 31 OSCB 6515 and *Re Neo Material Technologies Inc.* (2009), 32 OSCB 6941). In *Re Hudbay Minerals Inc.* (2009), 32 OSCB 1044, we stated that '[t]hese kinds of issues are not solely matters for the courts'."[50]

We are aware that a policy does not constitute a legal requirement and that administrative tribunals are not bound by the *stare decisis* principle. However, in order to provide a level of predictability to market participants and to clarify the context in which policy objectives are applied, we would propose to replace NP 62-202 with a new policy.

The proposed approach of this new policy on defensive tactics would be to give appropriate deference to the manner in which boards discharge their fiduciary duty. To achieve this, the new policy would clearly recognize the directors' fiduciary duty to the corporation in responding to unsolicited take-over bids and would redefine Regulators' intervention on the ground of public interest, within the parameters described above.

4.2 Changes to the take-over bid regime

The current standard form of rights plans contains "permitted bid" provisions that include, among other elements, an irrevocable minimum tender condition and a bid extension following the public announcement that the minimum tender condition has been met. These provisions are meant to address the structural coercion of our take-over bid regime.

However, bidders do not generally comply with these conditions that prevent the triggering of rights plans. Bidders rely on the fact that rights plans will eventually be cease traded by Regulators and their bids will remain open to target security holders.

To compel bidders to comply with these provisions, we suggest adopting them in our take-over bid regime so that they become mandatory for all bids.

An irrevocable minimum tender condition for bids on all securities of a class, and for any partial bids, of more than 50% of the outstanding securities owned by persons other than the offeror and those acting in concert with it would be akin to a collective "voting mechanism". It would serve to mitigate, if not eliminate, the pressure to tender as the bid can only succeed if a majority of "independent" security holders in effect "vote" for the bid, irrespective of how many securities are taken-up at the end of the process.

To complement this "voting mechanism", our take-over bid regime would provide that the bid be extended for an additional 10 days following the public announcement that more than 50% of the

[50] *Ibid.* at 198.

outstanding securities owned by persons other than the offeror and those acting in concert with it have been tendered.

This extension would give less sophisticated or indecisive security holders the opportunity to take into account the tender by security holders who have the resources and expertise to evaluate the terms of a bid. Less sophisticated or indecisive security holders would not be pressured to sell in the market or to the bidder for fear of being left as part of a minority.

We believe the two suggested changes allowing security holders to essentially "vote" on a given offer become an effective substitute to the security holders' approval of a rights plan, or of an amendment to an existing rights plan, under the CSA Proposal. Also, these changes would have the benefit of applying to all bids, not only those triggering a rights plan.

We are of the view that any action to correct gaps in our take-over bid regime should be addressed directly by Regulators. From a policy perspective, the protection of security holders' *bone fide* interests would remain at the core of our take-over bid regime and structural coercion would be mitigated. From a market perspective, bidders may be more inclined to negotiate with target boards or provide greater premiums to security holders to ensure the success of their bid.

Request for comment

We welcome your general comments on the AMF Proposal and its anticipated effects, as well as comments on the following specific questions:

1. If proper safeguard measures to manage conflicts of interest are put in place and there exists no circumstance that demonstrates an abuse of security holders' rights or a negative impact of the efficiency of capital markets, do you agree that Regulators should give appropriate deference to the decision of target boards to implement a defensive measure?

2. Do you think giving appropriate deference to directors in the exercise of their fiduciary duty will negatively impact the ability of target security holders to tender their securities to an unsolicited take-over bid?

3. Should directors, in the exercise of their fiduciary duty, be able to implement a rights plan or any other defensive measure to fend off an unsolicited take-over bid?

4. Is it appropriate for Regulators to provide guidance as to appropriate safeguard measures generally recognized as effective in mitigating the inherent conflicts of interest of directors facing an unsolicited take-over bid? If you agree, are you of the view that these measures should be in a policy or in a rule?

5. Do you have any suggestions of effective measures to manage conflicts of interest of directors?

6. Do you believe that security holders generally have the appropriate tools to discipline directors?

7. Do you agree that our proposed changes to the take-over bid regime to add the irrevocable minimum tender condition and the extension of the bid would contribute to allow target security holders to make a voluntary, undistorted collective decision to sell?

8. Do you believe that the AMF Proposal would enhance investor protection against unfair, improper or fraudulent practices and promote the efficiency of capital markets?

9. Are there other amendments to address gaps in our take-over bid regime that we should contemplate?

Please explain your answers.

How to provide your comments

We are publishing this consultation paper for a 90-day comment period. Please provide your comments in writing to the address that follows by June 12, 2013. Regardless of whether you are sending your comments by email, you should also send or attach your submissions in an electronic file in Microsoft Word.

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We cannot keep submissions confidential because we may publish a summary of the written comments received during the comment period.

Questions

Please refer your questions to any of:

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