DIRECT DIAL : (416) 869-5596
DIRECT FAX : (416) 861-0445
E-MAIL : sromano@stikeman.com

BY TELECOPIER June 9, 2003

Ontario Securities Commission
20 Queen Street West
Suite 1800
Toronto, Ontario M5H 3S8

Attention: Mr. John Stevenson, Secretary

Dear Mr. Stevenson:

Re: Adoption of Proposed Amendment to OSC Rule 61-501

This letter represents my personal comments (and not those of the firm) with respect to the OSC's adoption of proposed amendments to OSC Rule 61-501.

General

1. In originally adopting OSC Rule 61-501 several years ago, the comment process led a majority of commenters to suggest phasing out much of the detailed regulation, particularly of related party transactions. Given the lack of harmony between this facet of the rule and the regulatory requirements in other Canadian jurisdictions and the US, and the complexity of the resulting rule, I would suggest that consideration be given to going back to a public interest-focussed policy statement approach to related party transactions, with the rule itself dealing solely with insider bids, issuer bids and going private transactions. This would likely also be more appropriate from a cost-benefit analysis, given that fiduciary principles already regulate related party transactions.

2. The proposed definition of "collateral benefit" is in my view both conceptually and definitionally seriously flawed. Conceptually, first, it would now appear that pre-existing rights, such as contractual rights, and rights represented by arrangements such as loans, leases, purchase agreements, etc., will all now be found to be collateral benefits. Secondly, by disregarding offsetting costs, the

OSC is ignoring economic reality and its past decisions. See, for example, *Noverco*, where a shareholders agreement containing mutual rights of first refusal, etc. was seen to be normal, and a put and call arrangement was seen to be perfectly "counter-balanced". The existing concept, as will still exist for take-over bids under OSA s. 97(2), requires that a collateral benefit have the "effect…of providing greater value". With the exception of employment arrangements, where OSC staff has previously suggested (although many practitioners disagree absent some "value" effect) that normal commercial employment arrangements should be seen as collateral benefits that require exemptive relief, there has been in my mind no evidence of any abuse that calls for an approach that ignores business and economic reality by pretending that benefits are cost-less. As an example, under this test, a director of a public coffee shop chain with a reward or loyalty card in his or her wallet would, if the reward program would be absorbed into an acquiror`s larger program with enhanced benefits, appear to result in the acquisition transaction becoming a business combination. Ditto for a loan being repaid, or a contract terminated in accordance with previously negotiated and agreed terms, or being offered a directorship with the acquiror. I would strongly suggest sticking with the status quo, coupled with either a more liberal approach to employment arrangements to focus on whether there is really any "value" effect (which I would submit would not be the case where an employee was to be employed on terms either similar to that of equivalent employees of the bidder or on general market terms), or an express exemption for them.

3. Definitionally, in addition to the conceptual comments, the employee exemption language seems flawed. Requiring in (c)(i) that a benefit be reasonably consistent with customary practices will, given the suggestion in the request for comments that the issuer would have to defend its determination if challenged, likely lead to the need for expensive third party advice from compensation consultants, which appears to create unnecessary costs. As an alternative, similarity to the buyer's or merger party`s benefits should be sufficient. Clause (ii) seems inappropriate, since to retain an employee in a merger and bring him into the buyer`s compensation structure will reasonably be conditional on him supporting the transaction. Who would want to hire a new officer who was not supportive?

4. The definition of "business combination" is also seriously flawed, in my view. First, former s. 2.9(1) of former CP 61-501 would now seem to have no application. Thus, an arm's length amalgamation, say between two major Canadian banks none of whom has a 10% or greater shareholder, would seem to be a "business combination", which is inappropriate, if a minor and immaterial collateral benefit were involved, or if warrants, preferred shares or debt securities were involved (as they no doubt would be). New s. 2.5 of CP 61-501 seems to confirm this. Second, former exclusion (c) would cover a forced repurchase in accordance with the constrained share provisions contained in

articles and by-laws as required under many Canadian (and other) ownership statutory regimes, and thus seems important to preserve. Third, employee stock options should presumably be broadened, since they may be held by non-employees, and may be purchase rights, appreciation rights, etc. Fourth, debt securities should not be covered if they are being purchased or repaid. Fifth, what about preferred shares, warrants and other convertible debt securities that would neither be equity securities nor stock options? Their presence, if held by related parties, should not turn an arm's length transaction into a business combination. Sixth, exemption (D) is quite unclear. If there are two classes, and one is non-voting and is proposed to be penalized by 10%, say, compared to the voting shares because that is their historic market price differential (to pay equally is in effect to penalize those who paid more for voting shares and reward those who paid less for non-voting shares), what does "in relation to the voting and financial participating interests" mean?

5. As a final general comment, the addition of series votes to the minority approval requirement even where they are not differentially affected may well be inappropriate, as it will give rise to veto rights and associated opportunities to demand ransom fees. Former s. 8.1(2), which is more consistent with corporate law, should be retained, in my view.

<u>Specific</u>

6. The use of the term "holder", coupled with the footnote, is unclear. In most situations, securityholders are purely beneficial holders, since CDS is the registered holder on their indirect behalf. By suggesting that "holder" is designed to exclude the concept of beneficial ownership, one is left quite confused as to how the rule is intended to affect such securityholders.

7. I do not think that incorporating the ambiguous and extremely complex and lengthy definition of arm's length from s. 251 of the *Income Tax Act* will make the rule user-friendly or helpful. Corporate and securities practitioners (as well as OSC staff) will now need to constantly utilize expensive tax advice in interpreting Rule 61-501, which is inappropriate. In addition, changes in tax interpretations will lead to undesired automatic amendments to the Rule.

8. Including "direct and indirect" in the concept of beneficial ownership leads to much uncertainty, especially after it is layered on top of deemed ownership by subsidiaries. What else is intended here? Also, should s. 1(5) of the Act also be avoided, as it too uses affiliate concepts?

9. The definition of "bona fide lender" should extend to participations as well as assignments, as lenders frequently grant participation interests in a loan without assigning or transferring them.

10. The definition of "connected transactions" should not extend to transactions that are not conditional on each other. Many companies engage in many transactions, and "approximate simultaneity" is a poor test for connection, in my mind, and could easily lead to inappropriate results. In addition, as discussed below, it should be clarified in the rule (not just the policy) that a lock-up agreement is not a connected transaction. The concept of an "indirect party" creates even more uncertainty, and should be dropped, in my view, and at a minimum s. 2.4 of the companion policy should be incorporated into the rule.

11. In the definition of "incentive plan", since they can extend beyond employees, that word should perhaps be removed.

12. In the definition of "interested party", clauses (c) and (d), see para. 4 above. Similar comments apply here. Also, in (d)(i), is an officer or director a "party to the transaction", where his or her rights or position are being terminated (such as where a resignation is required) or amended and continued (such as where an employment agreement or amendment is required)? Why are stock options not referred to in (d)(ii)(B)? Also, in (c)(i), I don`t know what "acquire the issuer" means. Presumably it refers to a majority of the equity securities of the issuer, and perhaps it should say that.

13. In the definition of "related party", the presence of both (a) and (d) seems unnecessary. In my view, (a) alone should suffice. In (f), should receivers, liquidators, etc. also be included here?

14. New (l) in the definition of related party transaction would appear to capture banks and other arm's length lenders who are debt securityholders with substantial control or influence as a result of default, and who agree to amended terms in the context of an insolvent borrower. Thus, amending a loan in such a situation could now be impossible. I am not sure that this is wise.

15. In s. 1.2(b)(iii), as it is not clear given the new approach to competitive marketplaces (see NI 21-101) that such marketplaces will all provide supporting liquidity opinions, the requirement for this supporting opinion should be reconsidered.

16. In s. 1.2(2)(a), for consistency, as with POP issuers (see s. 2.9(3) of NI 44-101), not all 10% holders should be eliminated.

17. In s. 1.3, what about transactions by non-wholly-owned subsidiaries? Also, at then end, you should add "and is deemed not to be a take-over bid in this Rule or in the Act".

18. S. 1.4 seems unnecessary and confusing. "Underlying operating company" is not a defined term, but presumably refers to the subsidiary. Since it is a subsidiary,

why is a special provision required for it and not other public holding companies or entities? Income trust is also not a defined term.

19. Since s. 90 applies to the definition of related party, then an arm's length lock-up to a merger or other transaction could be seen to lead to an otherwise non-related party being seen to be a related party, and thus a transaction becoming a business combination or related party transaction that should not be seen as such. Thus, the joint actor language added also needs to be included in the definition of "beneficial ownership".

20. Sections 2.4(1)3 and 4.4(1)3 are much too complex, in my view (they are 7 dense paras. connected by "and")!

21. In s. 4.1(c)(i), and s. 5.1(1)(c)(i), given the fact that other provinces have not adopted this, other jurisdictions do not have the same rules, and the relative size of Ontario's capital markets in Canada, a 10% or greater threshold would seem more reasonable from a cost-benefit analysis.

22. S. 4.2(3)(h) is often difficult to assess in my experience, given the broad definitions of related party, joint actor, etc. It should start with "to the extent determinable", or something like that. Ditto re s. 5.3.

23. In s. 4.2(4), it should be clarified that it is only changes within the control of the issuer (see s. 98(3)) that warrant this treatment. Query how to comply with s. 4.2(4)(b) if the change occurs just before the meeting. Ditto re s. 5.3. Is an adjournment required?

24. New s. 4.3(1)(b) makes it unclear whether a valuation is required of the business combination or just the connected transaction portions.

25. S. 4.4(1)2 seems to treat foreign small-cap markets (eg NASDAQ SmallCap, etc.) different from Canadian small cap markets, which seems inappropriate, and does not address QTRSs (see NI 21-101). Ditto re s. 5.5(3).

26. S. 4.4(5)b should relate to the time of mailing or proposing, as sometimes closing (i.e. completion) gets delayed for regulatory reasons, etc., and one should not be suddenly pushed off-side at the end for this type of reason.

27. S. 4.4(5)d(i) should not require the strength of "intended". Because things may change (e.g. material adverse changes, changes in the economy, etc.), these types of statements must in practice be qualified, and words such as "currently intends" are often used in practice.

28. In s. 4.6(1)2, presumably a (c)(iii) interested party should count also. Ditto re s. 5.7.

29. In s. 5.5(2), the term "interested parties" should be used, as at present, rather than related parties. Otherwise, the concept of "involving", which has been welcomely deleted elsewhere, will reappear to cause difficulties, and in addition inappropriate parties (e.g. directors and officers) will be counted for 25% purposes.

30. S. 5.5(2)(b), by using the term related party, unlike the current language, suggests that it would apply where a substantial shareholder of a company is combining with the issuer or a subsidiary (i.e. an upstream transaction), whereas today it applies only downstream. In the upstream context, I am not sure that it makes sense.

31. In s. 5.5(2)(c), should para. 1 also be referenced?

32. In s. 5.5(2)(d), there should be no duplication. If I get options to buy shares trading currently at $8 for $10, I should count $8, or perhaps (but I think not) $10, but not $18, which seems to be suggested.

33. In s. 5.5(4)(a), knowledge of the proposed transaction itself should be excluded.

34. The $500,000 exemption should be retained, and increased to perhaps $2.5 million. Even TSX listed issuers can unfortunately shrink and end up doing small transactions that do not warrant the substantial costs of a valuation!

35. In s. 5.7(1)6, the language does not clearly capture the common case of ancillary warrants that would accompany a loan, as it is not the loan that would be convertible in that case.

36. The presence of the current version of s. 6.4(2)(d) has led providers of fairness opinions to say that if a controlling shareholder is offering less than "intrinsic value", without downwards adjustments, the transaction is not "fair". As a result, boards have not been willing to recommend such transactions. When the market price is $5, and the intrinsic value without downwards adjustments is $8, while a valuer may be required to say that, it may nonetheless be very fair to offer $6.50. Minority shareholders will likely never obtain a better price, and the buyer is not acquiring control and thus should not necessarily be expected to pay a control premium. This refusal to allow for downward adjustments does not recognize reality and is likely to prevent certain value-enhancing transactions. Similarly, it seems unfair to allow "effect of transaction" <u>increases</u> but not to allow "effect of transaction" <u>decreases</u>. In effect, minority shareholders can get synergies without cost. If an acquiror is offering its own securities, which are to be subject to downwards adjustments, it will be doubly prejudiced. A preferable route in my view would be to allow for downwards liquidity and minority and "transaction effect" adjustments in the discretion of the valuer, provided that they are explicitly disclosed along with the unadjusted intrinsic value. In

addition, in my view, the companion policy should clarify that value does not necessarily equate to fairness, so that, for example, a transaction may be fair even if it is not equal to the non-downwards adjusted value in these circumstances.

37. As NP 48 has no force of law, as the OSC has confirmed, s. 6.4(3) should probably be moved to the companion policy.

38. Filing formal consents seems to create unnecessary paperwork, and I would not suggest adding it in s. 6.7(a). Also, how does s. 6.7(b) work with s. 6.8, and why is s. 6.7(a) required as well as s. 6.7(b)?

39. Re former s. 8.1(2) and series votes, see para. 5 above.

40. S. 8.2(b)(i) may suggest that a lock-up agreement is a connected transaction. It should be clarified that a lock-up agreement is not a connected transaction in the rule (not just the policy).

41. The inclusion of the “collateral benefit” concept in s. 8.2(b)(ii)(B) will in my view disenfranchise more securityholders inappropriately unless the concept is tightened substantially, as noted above. Also, (C) and (D) should be changed. See para. 4 above.

42. In s. 8.2(d), “completed” should be changed to proposed or filed, as discussed in para. 26 above.

43. In s. 8.2(f), “intended” should be softened, as discussed in para. 27 above.

44. In s. 9.1, exemptions should also be available from the Commission, or a de novo non-deferential appeal expressly provided for, in my view.

45. In the companion policy, the OSC should in my view clarify that collateral benefits will be permitted, subject to discretionary relief and with appropriate adjusted minimum tender requirements to approximate minority approval, in the bid context. Otherwise, form may triumph over substance. In some cases, collateral benefits are essential to complete a beneficial transaction, and yet the street believes, based on past OSC practice, that relief would simply not be available, forcing one into a voting transaction.

46. S. 2.1(5) should clarify that a related party which is acting as a buyer or in concert with a buyer does not have to be treated equally to the seller. In other words, a substantial shareholder can offer to take the company private or can join with another to do so.

47. S. 2.1(5) is too strong, in my view. Where a party has a veto, if with minority approval that party cannot be treated differentially, then it may be that no transaction can occur. The Rule gives vetoes to minority securityholders and

does not punish them for using them to get more value (s. 3.2 of the policy has no teeth and has never been applied). Why then does it threaten to punish a substantial security holder for using his, her or its veto to agree to a transaction that the board considers worthy of doing and minority shareholders get to veto? S. 2.2 also seems in direct contrast to s. 2.1(5).

48. S. 2.7 of the companion policy should in my view be incorporated into the rule.

49. Does s. 2.8(1) of the companion policy mean that if a non-arm's length go-between facilitated negotiations, the exemption would not be available? If so, it should be changed. If the buyer is at arm's length, that should suffice.

50. The last sentence of s. 5.1(4) of the policy should clarify that reasoned discussion is not "influence". Perhaps the word "improper" should be added before influence. Especially in an unsolicited insider bid, the valuator may (to please its client) be pushing the value up, and discussion should be permitted.

Thank you for considering those comments.

Yours truly,

Simon Romano

SAR/he

cc.: Fernand Lavigne – CVMQ
Ralph Shay - OSC