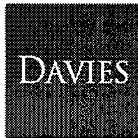

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November 23, 2006

**BY E-MAIL**

Autorité des marchés financiers
Tour de la Bourse
800 Square Victoria
22nd Floor, P.O. Box 246
Montréal, QC H4Z 1G3

Attention: Anne-Marie Beaudoin
Directrice du secrétariat

- and -

Ontario Securities Commission
20 Queen Street West
P.O. Box 55
18th Floor
Toronto, ON M5H 3S8

Attention: Naizam Kanji
Manager – Mergers & Acquisitions

**Request for Comments on Proposed Multilateral Instrument 61-101**

We are writing in response to the request of the Autorité des marchés financiers (the "AMF") and the Ontario Securities Commission (the "OSC", and together with the AMF, the "Commissions") for comments in respect of proposed Multilateral Instrument 61-101 – *Protection of Minority Security Holders in Special Transactions* (the "Instrument") and Companion Policy 61-101CP (the "Companion Policy") as published on August 25, 2006. We strongly support the Commissions' objective of implementing a single harmonized instrument governing insider bids, issuer bids, business combinations and related party transactions.

This letter responds to the specific questions in the Notice and Request for Comments dated August 25, 2006 and identifies certain other aspects of the Instrument that we would request the

Commissions to consider. There have been certain issues with the interpretation and application of Rule 61-501 – *Insider Bids, Issuer Bids, Business Combinations and Related Party Transactions* of the OSC (the "Current Rule") that we have come across in our practice and we would request that the Commissions take the opportunity to consider such issues prior to implementing the Instrument and the Companion Policy.

**Service Agreements with a Related Party**

From a policy perspective, we agree that the provision of services by an issuer to a related party or the payment of valuable consideration by an issuer to a related party for services could raise the conflict of interest and value transfer issues that the related party transaction rules of the Instrument are designed to address. However, we are not sure that the potential risk of abuse justifies the cost of additional regulation through the Instrument.

Service arrangements with related parties are currently regulated through general corporate governance rules. In approving any service arrangements with a related party, directors of public companies are subject to their fiduciary duties and could be subject to oppression actions if they authorize inappropriate arrangements. The framework of the Instrument does not seem appropriate for service arrangements. As recognized in the Instrument, formal valuations of service arrangements are not appropriate as services are not non-cash assets, like shares or real estate, that can be readily valued by an independent valuator. Minority approval for service arrangements with a value that exceeds 25% of market capitalization would be a rare occurrence and it would also be very difficult to ascribe a value to service arrangements for purposes of the 25% of market capitalization exemption. If there is to be additional regulation of related party service arrangements, we would ask the Commissions to consider an appropriate disclosure based approach, such as annual disclosure in the AIF or proxy circular (if required, after considering the existing related party disclosure requirements in financial statements).

We note that the Instrument could apply to typical service arrangements for directors and officers of an issuer. The retention of directors and officers who are already related parties or the promotion of existing officers/directors (or a change to the terms of their retention) could result in the application of the Instrument. If such retention or change is a material change (including, for example, the appointment of a CEO), a material change report with the enhanced disclosure in section 5.2 of the Instrument would be required. We submit that the enhanced disclosure in section 5.2 of the Instrument should not be required in such circumstances. In addition, we submit that minority approval should not be required for the retention of directors and officers. Directors are elected annually by shareholders and executive compensation arrangements are typically reviewed by compensation committees. If service arrangements are to be included in the definition of related party transaction, we submit the provision of services by a related party as a director or officer of the issuer or its subsidiaries should be excluded.

**Independent Directors**

We note that section 7.2(2)(e) of the Current Rule has been modified in section 7.1(2) of the Instrument to create a prohibition on the provision of the specified benefits to independent directors and to explicitly refer to a payment to a director for completion of a transaction. We submit that such modifications are neither necessary nor appropriate. Even without the explicit reference to a success fee, we are of the view that the payment of a success fee to a director is covered by sections 7.1(1) and 7.2(2)(e) of the Current Rule. We understand from footnote 38 of the Notice and Request for Comments that the prohibition is intended to address situations where the intention to make the payment is formed after the transaction closes. We are not aware of any market practice developing for the payment of success fees to directors on independent committees after the closing of a transaction and we do not anticipate that such a practice will develop. Such a practice would jeopardize the utility of independent committees for corporate law purposes. In addition, section 7.2(2)(e) of the Current Rule refers to reasonable expectations of a benefit as a consequence of the transaction – if a standard market practice develops for the payment of success fees to directors on independent committees such that their independence could be compromised, directors would not be viewed as independent to the extent that there is a reasonable expectation of a success fee. Section 7.1 of the Current Rule and the Instrument should be limited to specifying the directors who may serve on an independent committee charged with supervising a formal valuation.

The Current Rule provides in section 7.2(2)(e) that a director will be deemed to be not independent for purposes of the Current Rule where such director would reasonably be expected to receive a benefit as a consequence of the transaction that is not also available on a *pro rata* basis to shareholders. We understand that OSC staff has in the past interpreted the term "benefit" in the definition of "collateral benefit" in connection with share-exchange acquisitions as including the exchange of options of a target company held by directors and officers for options of the acquiror based on the exchange ratio for the transaction. Based on this broad interpretation of the term "benefit", section 7.2(2)(e) of the Current Rule and section 7.1(3) of the Instrument are problematic. The typical exchange of options in a share-exchange acquisition could leave a target board with no independent directors for the purposes of the Instrument. In addition, a broad interpretation of benefit could include the acceleration of stock options in a cash acquisition transaction or the payment of retainers and meeting fees to members of an independent committee that are not contingent on the occurrence of a transaction. We submit that the Instrument or the Companion Policy should clarify these matters.

We note that section 7.1(2)(b) of the Instrument deems a current or former director of an affiliated entity of an interested party to be not independent. A group of companies with a common controlling shareholder may have an individual who is independent of management and the controlling shareholder serving on more than one board in the group (or within 12 months, move from one board in the group to another). If the controlling shareholder proposes a transaction with one company in the group, such a director would be disqualified from serving on the independent committee of such company by virtue of serving as a director on another

board in the group of companies, even though he or she is independent of the controlling shareholder. We submit that such a director should not be disqualified from serving on an independent committee solely as a result of serving as a director of an affiliated entity of the interested party.

**Connected Transactions**

We have had many difficulties with the application of the definition of connected transaction in the Current Rule. As you know, the concept of connected transactions is primarily used in the Current Rule in the definition of business combination and for the purposes of the 25% of market capitalization exemption from the formal valuation and minority approval requirements in the related party transaction rules.

*Definition of Business Combination*

A transaction where the interest of a holder of an equity security may be terminated without the consent of the holder is a business combination under the Instrument and the Current Rule if a related party is party to a connected transaction. We submit that an equity termination transaction should not be subject to the business combination rules of the Instrument solely as a result of a related party being party to a connected transaction. Without reference to connected related party transactions, the definition of business combination already captures the appropriate situations where the business combination protections of the Instrument should be engaged – *i.e.*, where a related party receives consideration that is not identical to that received by other shareholders or where a related party receives a collateral benefit. Related party transactions (whether connected or not to an equity termination transaction) are subject to the related party transaction rules, and we fail to see the benefit of subjecting an equity termination transaction to the business combination rules solely as a result of a connected related party transaction (which is already subject to the related party transaction rules) where a related party does not receive non-identical consideration or a collateral benefit.

The reference to connected related party transactions in the definition of business combination only serves to complicate the application of the Instrument, when the related party rules on their own are sufficient to achieve the policy objectives of the Instrument. One example of the difficulty created by the inclusion of connected related party transactions in the definition of business combination is in the application of the formal valuation requirement to an equity termination transaction that is a business combination solely as a result of a connected related party transaction. Under the related party rules, the non-cash assets involved in the connected transaction will be subject to the formal valuation requirement (unless an exemption is available). However, under section 4.3(1)(b) of the Instrument, if a valuation exemption is not available for the connected related party transaction, the equity termination transaction would be subject to business combination formal valuation requirements (i.e., the "affected securities" appear to be subject to the formal valuation requirement). If a valuation exemption is available for the connected related party transaction, the equity termination transaction would not be subject to the business combination formal valuation requirements. This is an inconsistent and

inappropriate result – the only valuation that should be required in such a situation is for the non-cash assets involved in the related party transaction, unless an exemption from the valuation requirement in the related party transaction rules is available.

Another example of the difficulty created by the inclusion of connected related party transactions in the definition of business combination is in the operation of the 90% exemption from the minority approval requirements. The 90% exemption for business combinations is available only if interested parties within the meaning of subparagraph (c)(i) of the definition of interested party (a related party that is acquiring or combining with the issuer) own 90% or more of the securities of the class. As a result, a transaction that is a business combination solely as a result of a connected related party transaction may not have the 90% exemption available to it under the business combination rules in situations where the 90% exemption in the related party transaction rules would be available for the connected related party transaction.

*25% of Market Capitalization Exemption*

We agree with the principle that a "package" of transactions should not be artificially divided into separate transactions to make use of the 25% of market capitalization exemption for each of the separate transactions. However, the definition of connected transaction is extremely broad and refers to transactions "negotiated or completed at approximately the same time". As a result, transactions which may be independent of each other are required to be aggregated for purposes of the 25% of market capitalization exemption. Rather than casting the net too wide and requiring issuers to seek exemptive relief where transactions are independent, we submit that the Commissions should consider limiting the definition of connected transaction in an appropriate manner. If issuers attempt to abuse the 25% of market capitalization exemption, the Commissions can take appropriate action, as contemplated by section 2.8(1) of the Companion Policy.

**Downstream Transaction Exemption**

The downstream transaction exemption in section 5.1(g) of the Instrument recognizes that the related party transaction rules are not required to protect the shareholders of an issuer where the issuer enters into a transaction with a related party in respect of which such issuer holds a control block, provided no related party of the issuer holds a sufficient interest in the transacting related party (other than through the issuer). If a related party holds a sufficient interest in the transacting related party (other than through the issuer), the related party could have an incentive to cause the issuer to enter into an unfavourable transaction with the transacting related party.

The definition of downstream transaction in the Instrument excludes scenarios where a related party beneficially owns or exercises control or direction over, other than through its interest in the issuer, more than 5% of any class of voting or equity securities of the transacting related party. We submit that this 5% limit is more restrictive than necessary, as it refers to exercising control or direction over securities and is calculated on a class by class basis for voting and equity securities. We submit that the 5% limit should only refer to beneficial ownership and not

the exercise of control or direction over shares – for value transfer purposes, a shareholder would be incentivized by economic ownership of shares and not by shares that are controlled or directed. In addition, the 5% limit should be based on ownership of more than 5% of all outstanding equity securities and not on a separate class basis, as more than 5% of a single class of shares may represent an insignificant equity interest.

**90% Minority Approval Exemption**

The Instrument provides for an exemption from the minority approval requirements in respect of a class of securities for related party transactions and business combinations where the relevant interested parties beneficially own, in the aggregate, 90% or more of the outstanding securities of such class and an appraisal remedy is available. However, if the 90% exemption is not available and minority approval from a class of securityholders is required, the minority approval provisions of the Instrument require that, in addition to securities beneficially owned, securities over which control or direction is exercised by interested parties are to be excluded from the minority. This could result in a scenario where minority approval would be based on a very small proportion of the class of securities due to an interested party owning less than 90% of the class, but controlling or directing additional securities of the class. We submit that the 90% exemption should be available where the relevant interested parties beneficially own or exercise control or direction over 90% or more of the outstanding securities of the class.

We also question the unavailability of the 90% exemptions for business combinations or related party transactions in situations where a related party is an interested party as a result of receiving non-identical consideration or a collateral benefit (this result arises due to the limited categories of interested parties referred to in the 90% exemptions).

**MBOs by Way of Take-over Bid**

The Instrument regulates insider bids, which include take-over bids made by an acquiror acting jointly or in concert with directors or senior officers of the issuer. However, under the take-over bid rules in Part XX of the *Securities Act* (Ontario) and proposed National Instrument 62-104 – *Takeover Bids and Issuer Bids*, the prohibition on collateral benefits may restrict the ability to effect a management buy out by way of take-over bid as arrangements for management to retain equity in the continuing business could be viewed as a collateral benefit.[1] We submit that it is inconsistent to prohibit management buy outs by way of take-over bid in the take-over bid rules, while providing a comprehensive regime for their regulation as insider bids in the Instrument, and request that the Commissions consider allowing management buy outs to proceed by way of insider bid without the need for exemptive relief from the collateral benefit prohibition.

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[1] See: 3932290 Canada Inc., 2002, 24 OSCB 115; and Willbros Group, Inc., 2001, 24 OSCB 5145.

**Valuation Requirements in Other Securities Acts**

Securities legislation in British Columbia, Alberta, Saskatchewan, Manitoba, Nova Scotia and Newfoundland requires that a circular for an insider bid include a summary of a valuation of the offeree issuer. In addition, securities legislation in Manitoba, Nova Scotia and Newfoundland contains valuation requirements in connection with going private transactions. However, such securities legislation does not include analogous exemptions from the valuation requirement as are in the Current Rule. As a result, acquirors have made applications to the relevant securities regulatory authorities for valuation exemptions in situations where an exemption is available under the Current Rule.[2] We request that the Commissions consider an initiative to harmonize the insider bid/going private transaction valuation requirements (including exemptions) in the securities legislation in such other Provinces with those in the Instrument.

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Thank you for the opportunity to comment on the Instrument. Please do not hesitate to contact Vincent Mercier (vmercier@dwpv.com; 416-863-5579) or Peter Hong (phong@dwpv.com; 416-863-5557) if you wish to discuss any of our comments.

Yours very truly,

*(signed)*

Davies Ward Phillips & Vineberg LLP

[2] See: Xstrata Canada Inc., 2006, ABASC 1404; Maple Leaf Heritage Investments Acquisition Corporation et al, 2005 ABASC 997; Nations Energy Company Ltd. et al, 2005 ABASC 538; 3376290 Canada Inc. and Lake Louise LP, 2005 ABASC 164; and Geosam Acquisition Corporation, 2004 ABASC 956.