6.1.3 Notice of Proposed Amendments to Rule 61-501 - Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions and Companion Policy 61-501CP

NOTICE OF PROPOSED AMENDMENTS TO RULE 61-501 - *INSIDER BIDS, ISSUER BIDS, GOING PRIVATE TRANSACTIONS AND RELATED PARTY TRANSACTIONS* AND COMPANION POLICY 61-501CP

Substance and Purpose of Proposed Amendments

The Commission is proposing to amend Rule 61-501 - *Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions* (the "Rule") and Companion Policy 61-501CP (the "Companion Policy"). The Rule provides security holders of issuers involved in specified types of transactions with the benefits of enhanced disclosure requirements and, in certain cases, independent valuations and majority of minority security holder approval.

The amendments are primarily intended to clarify grey areas, reduce the necessity for applications for exemptive relief and generally make the Rule more user-friendly. Some of the proposed changes are also designed to eliminate regulatory burdens of which the costs to issuers and their security holders may not outweigh the benefits, particularly for junior issuers.

Summary of Proposed Amendments

A number of the proposed amendments are drafting changes that do not affect the substance of the Rule or Companion Policy. These and the substantive changes are noted in the footnotes to the draft of the proposed amended versions of the Rule (the "amended Rule") and Companion Policy, copies of which follow this notice. The following are the most significant amendments.

1. Going Private Transaction - Definition

The Commission proposes to substitute the term "business combination" for "going private transaction" throughout the Rule and make other changes to the definition for purposes of clarification.

When the Rule came into effect, it replaced Commission Policy 9.1. One of the fundamental differences between the Rule and Policy 9.1 was in the definition of "going private transaction". In Policy 9.1, the term was defined in the traditional manner, essentially covering plans of arrangement or similar transactions in which security holders could receive cash (or non-participating securities) in exchange for their publicly traded securities without their consent. In the Rule (in subsection 1.1(3)), the definition was narrowed in that it applied only if the transaction was "with or involving a related party of the issuer", and the related party was treated differently from other security holders, subject to certain exceptions. The definition was also broadened in that it no longer excluded transactions in which the security holders received participating securities in substitution for their securities of the issuer.

The changes in the definition that were brought about by the Rule have given rise to some confusion among market participants and their advisers as to the definition's application. One of the reasons for this confusion is that the definition is somewhat counter-intuitive, in that it does not match the normal English meaning of the defined term. As defined in other legislation, including corporate statutes, a "going private transaction" does not entail the substitution of one publicly traded participating security for another. As a result, there have been instances in which issuers have not realized that their transactions were "going private transactions" within the Rule's definition.

Another area of uncertainty in the definition relates to its introductory words, which refer to involvement of a related party, and paragraph (e) of the definition, which essentially removes a transaction from the definition if the related party is only entitled to receive consideration that is identical to the consideration paid to the other security holders. The Commission's commentary that accompanied the requests for comments preceding the enactment of the Rule made it clear that the intention of the definition was to capture conflict of interest situations, which included transactions that were at arm's length as between the main parties but which entailed unequal treatment or a collateral benefit for a related party to the issuer. The definition was also intended to capture the circumstance where a related party was "taking the issuer private", even if no collateral benefit was being provided. Some users of the Rule have suggested that the definition does not apply to one or both of these types of transactions, although the Commission does not share this interpretation. The definition also does not clearly address its application to non-voting and subordinate voting shares, and to payments for non-participating securities held by related parties. The definition has been revised in the amended Rule (and relocated so that it is together with the rest of the amended Rule's definitions in section 1.1) to clarify these areas.

2. Collateral Benefit - Definition

The Commission proposes to add a definition of "collateral benefit" to the Rule.

Collateral benefits in the context of going private transactions are addressed in the current Rule in clause (c)(i)(B) of the definition of "interested party", subparagraph (e)(ii) of the definition of "going private transaction", and the minority approval

requirements in Part 8. Among other things, the concept comes into play in the determination of which security holders are excluded from voting when minority approval is required.

The general wording of the Rule's provisions on collateral benefits has given rise to inconsistencies in the manner in which participants in transactions covered by the Rule and their advisers have interpreted the concept. This is particularly the case regarding arrangements for employees in the context of a going private transaction. Questions of interpretation also have arisen when a related party has proposed to carry out a transaction with an issuer, such as a property acquisition, concurrently with the issuer undergoing a business combination.

One of the policy concerns regarding collateral benefits is that they could unfairly constitute extra consideration paid to some security holders to the exclusion of others for the purpose, in fact or perception, of inducing those security holders to tender to a bid or support a business combination. Even where the motives are above reproach, collateral benefits can cause a transaction to have economic consequences that vary among the security holders that vote on the transaction, which could distort the benefit of a minority vote. These concerns are less likely to arise in the context of employee arrangements if the number of securities held by the employees in question is not sufficiently high to have a likely effect on the outcome of the minority vote.

Accordingly, the Commission is proposing that where the benefits in question relate to employment, and are consistent with customary industry practices, the benefits will not be regarded as "collateral benefits" under the Rule if related parties of the issuer who receive the benefits do not hold, in the aggregate, more than 10% of the outstanding securities of the affected class. If the 10% threshold is not exceeded, it will be up to the issuer to determine whether the benefits are consistent with customary industry practices. The issuer may have to defend this determination subsequently if challenged.

It should be noted that neither the current Rule nor the amended Rule confines the collateral benefit concept to circumstances where the benefit is provided by, or negotiated with, the acquiring party (except in the determination of which securities acquired in a take-over bid can be counted as votes in favour of a subsequent "second step" business combination). Since a fundamental purpose of the Rule is to address conflicts of interest, the Rule's treatment of collateral benefits reflects the Commission's view that minority approval of a price that security holders are offered in a business combination may not be meaningful if a significant component of that approval is represented by security holders who are, in substance, receiving a higher price through collateral benefits. The level of the conflict of interest, or its possible effect on the outcome of a vote of security holders, does not depend on the circumstances under which the conflict arose or when the collateral benefit was negotiated.

The amended Rule would also clarify that if, for example, an amalgamation is carried out in conjunction with a sale of assets of one of the amalgamating issuers to a related party of that issuer, the amalgamation is caught by the amended Rule's definition of "business combination".

3. Downstream Transactions and Business Combinations - Definitions

The Commission proposes to exclude downstream transactions in the definition of "business combination".

A definition of "downstream transaction" has been added to the amended Rule. A downstream transaction for an issuer essentially means a transaction between the issuer and an entity in which the issuer holds a control block, as long as another related party of the issuer does not also hold a significant position in that entity. Although a downstream transaction is carried out among related parties, it does not give rise to the type of conflict of interest, from the standpoint of the party holding the control block, that the Rule was designed to address. The Rule recognizes this for related party transactions by providing valuation and minority approval exemptions in paragraph 10 of section 5.6 and paragraph 3 of section 5.8, respectively, but it does not provide similar exemptions for going private transactions. The proposed revisions would remove this discrepancy.

4. Lock-up and Support Agreements - Definition of "Joint Actors"

The Commission proposes to move the interpretive guidance regarding "acting jointly or in concert" in subsection 2.3(2) of the current Companion Policy to the definition of "joint actors" in the amended Rule. The definition of "joint actors" would replace the definition of "acting jointly or in concert" that is in paragraph 1.2(1)(b) of the current Rule.

Subsection 2.3(2) of the current Companion Policy sets out the Commission's view that a lock-up or support agreement does not, in and of itself, constitute acting jointly or in concert for the purposes of the Rule. The decision of the British Columbia Court of Appeal in *Re Sepp's Gourmet Foods Ltd.* (2002), 211 D.L.R. (4th) 542, in which the court did not apply the interpretation in the Companion Policy in considering the effect of a support agreement on a security holder's right to vote on a going private transaction, illustrates that the interpretation should be in the Rule, rather than the Companion Policy. Pending the coming into force of the amended Rule, the Commission is continuing to interpret the Rule as stated in the current Companion Policy.

5. Insider Bids - Obligations of Independent Committee - Paragraph 2.3(2)(c) of amended Rule

The Commission proposes to add a requirement that the independent committee of the target issuer's board use its best efforts to ensure that the formal valuation for an insider bid is completed and provided to the offeror in a timely manner. This change has been made to address concerns that have been expressed by offerors carrying out unfriendly insider bids.

6. Circumstances where Formal Valuation Required

The Commission proposes to make additions to the existing circumstances in which the Rule does not require the preparation of a formal valuation.

While the formal valuation requirement is a fundamental component of the Rule, the Commission recognizes that the expense of a formal valuation, which often is borne directly or indirectly by the security holders the Rule is designed to protect, may outweigh the benefits. This is reflected in the current version of the Rule, but additional examples have emerged, in the context of applications for exemptive relief, where exceptions to the formal valuation requirement have been considered justified.

There is also a growing recognition among securities regulators that there are circumstances where regulatory accommodations for junior issuers with limited resources may be justified. Examples are in the areas of continuous disclosure and corporate governance, for which new requirements are currently under consideration.

It should be noted that for all the circumstances under which the Commission is proposing to eliminate the formal valuation requirement in the Rule, the minority approval requirement would remain.

(a) **Business Combination with an Unrelated Party:** Under **subsection 4.3(1)** of the amended Rule, a formal valuation will not be required for a transaction that meets the definition of "business combination" solely because a related party is receiving a collateral benefit. If a related party is a party to a substantial transaction, such as a sale of assets, that is connected to the business combination, a formal valuation for the business combination will be required.

(b) **Issuer not Listed on Senior Market:** Formal valuation exemptions for issuers that are not listed on specified markets have been introduced in **paragraph 2 of subsection 4.4(1)** (business combinations) **and paragraph 3 of section 5.5** (related party transactions) of the amended Rule. These exemptions would replace the current exemptions in paragraphs 13 and 17 of section 5.6 of the current Rule for related party transactions smaller than $500,000 and for certain types of transactions by issuers listed on the TSX Venture Exchange, respectively. In order for the exemption to apply, the issuer must have at least one independent director, as defined in the Rule, and at least two-thirds of the independent directors must approve the transaction.

These exemptions recognize that a valuation can impose a significant cost to junior issuers relative to their size and level of development. In addition, the transactions undertaken by these issuers are often of a speculative nature, not lending themselves to traditional valuation techniques.

(c) **Types of Related Party Transactions Requiring Valuations:** Under **subsection 5.4(1), paragraph 4 of section 5.5, and subsection 6.3(2)** of the amended Rule, a formal valuation of most types of financial assets involved in a related party transaction will no longer be required, including securities of a public company if all material information regarding the issuer and its securities has been publicly disclosed. It is reasonable to expect that security holders may prefer issuers not to incur the expense of a formal valuation of these types of assets in the context of a related party transaction, as long as there is proper disclosure and, in appropriate cases, the issuer obtains minority approval.

(d) **Securities Offered in Insider Bids, Issuer Bids and Business Combinations:** Under **subsection 6.3(2)** of the amended Rule, if the consideration in an insider bid, issuer bid or business combination is comprised of securities for which a liquid market exists, a formal valuation of those securities will only be required, subject to certain conditions, if they constitute more than 25% of the outstanding class, up from 10% in the current Rule. The Commission considers the higher threshold to be sufficient given the additional requirement for the valuator to be of the opinion that a valuation of the securities is not required.

7. Connected Related Party Transactions - Section 5.5 subpara. 2(c) of amended Rule

The amended Rule contains a new provision to clarify how the formal valuation and minority approval exemptions for a related party transaction that is not larger than 25 per cent of the issuer's market capitalization applies to multiple transactions. The subject is covered to some extent in section 6.1 of the current Companion Policy, but experience has demonstrated that more precise guidance is needed.

8. Amendments to Securities - Subsection 5.7(2) of amended Rule

The amended Rule contains a new provision to clarify that where a related party transaction is a material amendment to a security, the test for determining the availability of the minority approval exemption for a transaction that is not larger than 25 per cent of the issuer's market capitalization must be applied to the whole transaction as amended, and not just to the amendment. (A formal valuation will not be required in this type of circumstance under the amended Rule.) An amendment to a security can fundamentally change the original transaction.

As an illustration, an issuer with a market capitalization of $10 million may have an insider who holds an "out-of-the-money" $6 million convertible debenture of the issuer. The issuer may propose to lower the conversion price to a price that is "in the money". The amended Rule would clarify that the size test for the minority approval exemption would be applied on the basis of a $6 million transaction, and not on the difference between the number of underlying shares issuable as between the old and new conversion prices. This treatment is justified on the basis that, without the amendment of the conversion price, there may be no share dilution whatsoever to existing shareholders.

9. Downward Adjustments in Formal Valuations - Para. 6.4(2)(d) of amended Rule

Paragraph 6.4(1)(d) of the current Rule provides that a formal valuation of securities must not include a downward adjustment to reflect the liquidity of the securities, the effect of the transaction on the securities or the fact that the securities do not form part of a controlling interest. In the amended Rule, this provision is confined to the valuation of offeree securities and affected securities. A valuation of securities that are to be received by the holders of offeree or affected securities should include adjustments affecting the value of the securities to the intended recipients.

10. Security Holders Excluded from Voting in a Minority Vote - Para. 8.1(2)(c) of amended Rule

Due to the wide net cast by the definition of "related party" in the Rule, some categories of security holders may be disenfranchised in a minority vote, even though the conflict of interest issue the Rule is intended to address is not applicable or significant.

An example is where an issuer proposes to carry out a transaction with its parent company. In this case, all directors and senior officers of affiliates of the issuer, including affiliates that are sister companies and subsidiaries of the issuer, are excluded from voting on the transaction, because those affiliates are related parties to the parent company. The amended Rule will permit the directors and senior officers of the sister companies and subsidiaries to vote if they are not otherwise related to the parent company.

Companion Policy

Several amendments are proposed for the Companion Policy to reflect the proposed changes to the Rule and to provide additional interpretive guidance. Some parts of the Companion Policy that could be construed as being prescriptive have been moved to the amended Rule or eliminated. Explanations for the changes to the Companion Policy are in the footnotes.

Policy Q-27 of the Quebec Securities Commission

The Commission recognizes the desirability of maintaining the existing harmonization of Rule 61-501 with Policy Q-27 of the Quebec Securities Commission and is pursuing this objective in regard to the proposed amendments.

Authority for the Proposed Amendments

The following sections of the Act provide the Commission with the authority to make the amendments to the Rule. Subsection 1(1.1) of the Act provides that "going private transaction", "insider bid" and "related party transactions" may be defined in a Rule. (Section 1.5 of the amended Rule defines "going private transaction", for purposes of the Act, as having the meaning ascribed to the term "business combination" in the amended Rule.) Paragraph 143(1)28 authorizes the Commission to make rules to regulate issuer bids, insider bids, going private transactions and related party transactions, including, in clause v, prescribing requirements for disclosure, valuations, review by independent committees of boards of directors and approval by minority security holders.

Unpublished Materials

In proposing these amendments, the Commission has not relied on any significant unpublished study, report or other materials.

Anticipated Costs and Benefits

The Commission believes that the proposed amendments will enhance efficiency for market participants that are subject to the Rule, as there will be greater clarity regarding the application of the Rule and reduced circumstances requiring valuations and exemptive relief. To the extent that the amendments are substantive in nature, they will have benefits in terms of reduced regulatory burdens, particularly for junior issuers, that will outweigh the costs, if any.

Comments

Interested parties are invited to make written submissions with respect to the proposed amended Rule and Companion Policy. Submissions received by June 9, 2003 will be considered.

Submissions should be made to:

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8
jstevenson@osc.gov.on.ca

A diskette containing the submission in Word format should also be submitted. As the Act requires that a summary of written comments received during the comment period be published, confidentiality of submissions cannot be maintained.

Questions may be referred to:

Ralph Shay
Director, Take-over/Issuer Bids, Mergers & Acquisitions
Ontario Securities Commission
(416) 593-2345

Texts of the Proposed Amended Rule and Companion Policy

The texts of the proposed amended Rule and Companion Policy follow, together with footnotes that are not part of the proposed amended Rule and Companion Policy but have been included to provide both background and explanation.

February 28, 2003.