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

On February 28, 2003, the Commission published proposed amended versions of Rule 61-501 – *Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions* (the "Rule") and Companion Policy 61-501CP (the "Companion Policy") at (2003), 26 OSCB 1822. As stated in the Notice of the proposals, the amendments were 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 were 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.

The Notice and proposed revised versions of the Rule and Companion Policy (the "2003 proposed Rule" and "2003 proposed Companion Policy") were accompanied by a request for comments. A list of commenters, a summary of the comments and the Commission's responses are contained in Appendix A of this Notice. After reviewing the comments and on further consideration, the Commission has made some changes to the 2003 proposals.

Summary of Proposed Changes from 2003 Proposals

The most significant changes from the 2003 proposals are described below. Other changes are discussed in the responses to the comments and in footnotes to the black-lined versions of the proposed amended Rule and Companion Policy that accompany this Notice.

1. Collateral Benefits

The 2003 proposed Rule introduced a definition of "collateral benefit". As stated in the February 2003 Notice, the general wording of the current 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.

Under the proposed definition, a collateral benefit, for a transaction such as an acquisition of a reporting issuer, would include any benefit that a related party of the issuer would receive as a consequence of the transaction (other than pro rata consideration received by the general body of the issuer's equity security holders), subject to exceptions for employment benefits under specified circumstances. As a result of the comments received, some revisions have been made to the exceptions.

Issues relating to collateral benefits arise primarily when a party proposes to acquire all of the outstanding securities of an issuer that it does not already own, either by making a take-over bid followed by a forced acquisition of the securities not tendered to the bid or through one transaction requiring approval of the issuer's security holders. In both cases, security holders who do not wish to sell their securities for the consideration being offered, whether that consideration is cash or securities of the acquiring party, can be forced to do so if enough of the other security holders tender to the bid or vote in favour of the transaction. If a vote of security holders is necessary to complete the acquisition, the Rule may, depending on the circumstances (and in addition to the requirements of corporate law), require that vote to be by way of "minority approval".

In a minority approval vote, the votes of the "interested parties", and certain other security holders that are related to the interested parties, are excluded. Interested parties have actual or reasonably perceived conflicts of interest that could cause them to view the transaction favourably for reasons other than the value of the consideration being offered to the general body of security holders. In view of the fact that a simple majority of the votes cast is required in order to force dissenting security holders to relinquish their securities at a price they may regard as insufficient, it is important, from the standpoint of fairness, for the participants in that vote to be comprised primarily of security holders who are voting on the adequacy of that price, and not on benefits they may receive in addition to that price. (Appraisal rights are normally available, but the time and expense involved makes the process impractical for many security holders.) The 2003 proposed Rule reflected this principle, and the Commission's views on this have not changed.

To accommodate the generally accepted practice for business acquisitions to be accompanied by revised compensation arrangements for employees of the business being acquired, the proposed definition of collateral benefit contained exceptions for certain employee-related benefits, such as participation in a group benefit plan for employees of the successor issuer. For other benefits from employment, such as "golden parachutes" and increased remuneration from the successor issuer, the 2003 proposed Rule contained an exception where the recipients of the benefits did not own, in the aggregate, more than 10% of the outstanding securities of any class of equity securities of the issuer. This exception was proposed on the basis that, at an ownership level not exceeding 10%, the likelihood of the outcome of the vote being determined by the votes of the recipients of

the benefits would not be high enough to justify the disenfranchisement of those recipients. For the exception to apply, the benefit would have had to be reasonably consistent with customary industry practices and not conditional on the recipient supporting the main transaction.

In response to a number of the comments, the definition has been revised to change the 10% ownership exception to a different materiality threshold that takes into account the significance of the benefit in relation to the consideration the related party recipient would receive in the main transaction. Under the revised definition, the exception will apply if the value of the employment-related benefit, net of offsetting costs to the recipient, is less than 5% of the value of the consideration that the recipient will receive in exchange for its equity securities in the main transaction. The determination that the exception is applicable will be the responsibility of an independent committee of the issuer's board of directors, and disclosure of the determination will be required in the information circular (or directors' circular in the case of a take-over bid) sent to the security holders in connection with the transaction. There will also be an exception where the related party receiving a benefit, together with that party's associates, owns less than one per cent of the outstanding securities of each class of equity securities of the issuer.

Due to the concern expressed by some commenters that uncertainty could result from the proposal in the 2003 proposed Rule that, in order for a benefit to fall within the employment-related exceptions, it must be consistent with customary industry practices, that condition has been removed. It has been replaced with the condition that the benefit not be conferred for the purpose of increasing the value of the consideration paid to the recipient for securities relinquished under the main transaction.

Concerns were also expressed regarding the condition that the benefit not be conditional on the recipient supporting the main transaction. However, the Commission regards this condition as important to preserve the integrity of the minority approval vote and prevent the perception that related parties have been "bribed" to vote in favour of the transaction. Words have been added to clarify that the condition refers only to a benefit that, "by its terms", is conditional on the recipient's support of the transaction.

2. Minority Approval Exemption for Certain Junior Company Financings

The 2003 proposed Rule introduced a formal valuation exemption for issuers that were not listed or quoted on specified markets, including the Toronto Stock Exchange and the major U.S. markets. This exemption would replace the current exemptions for related party transactions smaller than $500,000 and for certain types of transactions by issuers listed on the TSX Venture Exchange.

To further relieve junior issuers from regulatory burdens that may outweigh the benefits, a new minority approval exemption has been introduced for related party cash financing transactions of $2.5 million or less, for issuers not listed or quoted on the same markets that are referenced in the formal valuation exemption described in the preceding paragraph. The exemption is in new paragraph 3 of subsection 5.7(1). To qualify for the exemption, the issuer must have one or more directors who are both independent of the transaction and not employees of the issuer, and two-thirds of the directors that meet those criteria must approve the transaction.

3. Definition of Insider Bid

The definition of "insider bid" has been expanded in the new proposals to include a bid where the offeror was an insider of the offeree issuer (or had a similar connection with the offeree issuer, as described in the current definition) within 12 months preceding the bid. This change was made partly to prevent avoidance of the Rule (by, for example, resigning from the board of the offeree issuer shortly before launching a bid). The change is also consistent with the policy behind the formal valuation exemption based on "lack of knowledge and representation", in paragraph 2 of subsection 2.4(1) of the Rule, which applies where the bidder has had a lack of involvement with the offeree issuer within the preceding 12 months.

Policy Q-27 of the Quebec Securities Commission

Commission staff have been working with the staff of the Quebec Securities Commission with a view to maintaining the existing harmonization of the Rule with Policy Q-27 in the context of the proposed amendments.

Authority for the Proposed Amendments

The following provisions 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 proposed amended Rule defines "going private transaction", for purposes of the Act, as having the meaning ascribed to the term "business combination" in the 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 increased fairness to security holders and reduced regulatory burdens that will outweigh the costs.

Comments

Interested parties are invited to make written submissions with respect to the proposed amended Rule and Companion Policy. Submissions received by February 11, 2004 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, black-lined to the 2003 proposed Rule and the 2003 proposed Companion Policy, together with footnotes that are not part of the proposals but have been included to provide both background and explanation.

January 9, 2004.

APPENDIX A

SUMMARY OF WRITTEN COMMENTS RECEIVED AND RESPONSES OF THE COMMISSION

The Commission received submissions on the proposed amendments from the following:

Fasken Martineau DuMoulin LLP
Simon Romano
Robert W. A. Nicholls
Osler, Hoskin & Harcourt LLP
Securities Law Subcommittee, Business Law Section, Ontario Bar Association
Ogilvy Renault
TSX Venture Exchange
Torys LLP

The Commission has considered the submissions and thanks the commenters for taking the time to provide their views.

The following is a summary of the comments received, together with the Commission's responses. Unless otherwise provided, references to section numbers or to the "amended Rule" or "amended Companion Policy" are in reference to the 2003 proposed Rule or the 2003 proposed Companion Policy, as applicable.

Some of the comments pertained to parts of the current version of the Rule and Companion Policy that the Commission had not proposed to change. For the assistance of readers, those comments are preceded by "*Comment(s) Not on Proposed Amendments*" in the discussion below.

A. GENERAL COMMENTS

1. The Rule and Amendments Generally

Comments

Three commenters expressed general support for the proposed amendments. One commenter was of the view that the changes placed a better focus on the underlying policy purpose of the Rule, which is to provide enhanced shareholder protection in certain types of transactions where the interests of minority shareholders have the potential to be in conflict with the interests of insiders. Another commenter supported the Commission's effort to clarify the application of the Rule, reduce the necessity for exemptive relief applications and make the Rule more user friendly.

Comments Not on Proposed Amendments: One commenter suggested that related party transactions be removed from the purview of the Rule, and a public interest-focussed policy statement approach adopted instead. In support of this view, the commenter cited the lack of harmonization with other jurisdictions, the complexity of the Rule and the fiduciary principles that already regulate related party transactions. Another commenter was critical of the complexity resulting from the large number of exemptions in the Rule.

Response

The Commission's experience in the course of its ongoing contact with the various constituents of the investment community is that the subject of conflicts of interest is a highly sensitive one for investors. The Commission considered the question of whether related party transactions should be regulated by rule or policy statement in the late 1990s and was not convinced that a policy statement would provide sufficient protection for minority security holders. The principles and concerns that gave rise to the adoption of the Rule have not diminished with the passage of time.

The Commission believes that the proposed amendments will make the Rule less complex and significantly reduce regulatory burdens for issuers carrying out related party transactions. A further substantial reduction in the ambit of the Rule could unduly compromise investor protection. The elimination of more of the Rule's detailed provisions for the sake of simplicity would likely create an undesirable level of uncertainty for issuers and other market participants. While much of the perceived complexity of the Rule is due to the length of the exemptions, a reduction in the breadth of the exemptions would lead to the need for a greater number of costly and time-consuming applications for exemptive relief.

2. General Drafting Issues

(a) Associated entity - Comment: One commenter suggested that wherever "associated or affiliated entity" appears in the amended Rule, it should be replaced with "associated entity or affiliated entity", because "associated entity" is a defined term.

Response: While this suggestion is consistent with conventional legal drafting practice, the Canadian securities commissions have been moving towards a more "plain language" style of drafting. Among other things, this style calls for the exclusion of words that are not necessary to a proper understanding of a provision. The extra "entity" suggested by the commenter falls into that category. The language has been similarly simplified in other parts of the amended Rule and Companion Policy.

(b) Beneficial holder - Comment: One commenter thought the removal of the word "beneficial" before "holder" in parts of the amended Rule left one confused as to how the Rule affected beneficial, as opposed to registered, security holders.

Response: The term "beneficially owned" is used in a variety of contexts in securities law (e.g. ownership through an intermediary, ownership of securities held by an affiliate, the holding of a right to acquire securities within 60 days). "Beneficial" before "holder" was removed in the parts of the amended Rule where it was not considered necessary and to eliminate possible confusion as to which of its various meanings applies in the particular context. Its removal does not detract from any rights of persons who hold their securities through an intermediary.

(c) Disclosure document - Comment: One commenter noted that some references to a "disclosure document" in the amended Rule are followed by the words "if any", presumably to reflect the Commission's view that the Rule does not itself impose a requirement to publish a disclosure document. The commenter thought in those instances where "if any" was missing, the Rule seemed to be mandating a disclosure document, even for non-material transactions that did not otherwise require a disclosure document. The commenter suggested that "if any" be added to every reference in the Rule to "disclosure document" where it does not already appear in the amended Rule.

Response: "If any" follows "disclosure document" only in the parts of the amended Rule that address related party transactions that do not necessarily require a disclosure document. The words are not necessary in reference to insider bids, issuer bids or business combinations, since those transactions are required to have a disclosure document if they are subject to the Rule.

(d) "Acquire the issuer" - Comment: The amended Rule refers in a number of places to a transaction in which a related party would "acquire the issuer or the business of the issuer, or combine with the issuer, through an amalgamation, arrangement or otherwise, whether alone or with joint actors". One commenter did not understand what "acquire" meant and suggested that it be replaced with a reference to the acquisition of a majority of the equity securities. Another commenter thought the use of "acquire" and "combine" could cause substantial uncertainty because those terms do not have well-understood legal meanings. That commenter suggested that the terms be replaced with a reference to the acquisition of control of the issuer or of all or substantially all of the issuer's assets.

Response: The Commission believes that the alternative wording proposed by the commenters would capture more transactions than are intended. The applicable provisions do not apply to the mere acquisition of a controlling interest, but to the acquisition of the entire issuer or its business, whether with joint actors or otherwise. This is what normally happens in a business combination, for which the terminology is primarily used, and it is unlikely that the words will be misunderstood in that context. In light of the comments, however, section 2.10 has been added to the Companion Policy to confirm the intended meaning.

(e) Special committee - Comment: One commenter noted that the amended Rule has the defined term "independent committee", but also refers to a "special committee" in several places. The commenter suggested that the references to a special committee be changed to conform to the defined term.

Response: The terms "independent committee" and "special committee" do not have identical meanings in the amended Rule. An independent committee is mandated by the Rule in certain circumstances, in which case it must meet the Rule's criteria as to its composition. This is not the case for every special committee.

Comments Not on Proposed Amendments

(f) Time references - Comment: One commenter noted that the Rule uses different references to identify the time at which certain determinations are to be made. In various parts of the Rule, references are made to the time a transaction is agreed to, the time it is proposed or the time it is publicly announced. The commenter suggested that these references be reviewed to ensure clarity and correctness from a policy perspective.

Response: The Commission agrees with the commenter and has made changes to a number of those references. The time a business combination is "proposed" is no longer used as a reference point. Section 2.9 has been added to the Companion Policy to provide an interpretation of when a transaction is "agreed to" for purposes of the Rule.

(g) Disclosure of differing views - Comment: In the parts of the Rule regarding disclosure, there are requirements for disclosure of differing views between the board of directors and an individual board member or the special committee in considering a transaction for approval. One commenter said that an issue has arisen in practice as to whether it is sufficient

simply to refer to the fact, for example, that a director voted against the transaction, or whether the director's expressed reasons for dissenting must be discussed. The commenter suggested that there be clarification of the required level of disclosure.

Response: Wording has been added to the applicable provisions to clarify that the disclosure must contain a discussion of the differing views, not just a statement as to their existence. The appropriate level of detail of the discussion will depend on the particular circumstances, including the extent to which the reasons for the differing views are disclosed to the board of directors.

B. COMMENTS ON SPECIFIC PROVISIONS

Section 1 – Definitions

3. "arm's length"

Comment

One commenter thought incorporating the *Income Tax Act* definition, which the commenter regarded as ambiguous and extremely complex, would not make the Rule more user friendly or helpful. According to the commenter, corporate and securities lawyers, as well as Commission staff, would need to constantly utilize expensive tax advice in interpreting the Rule. In addition, changes in tax interpretations would lead to undesired automatic amendments to the Rule.

Response

The Commission considers the proposed amendment to be an improvement over the present combination of provisions in the Rule and Companion Policy, which are more open to subjective interpretation. In any event, given the contexts in which "arm's length" appears in the Rule, the concept's application to particular fact situations will be obvious in the vast majority of cases.

4. "beneficially owns"

Comments

One commenter thought including the "direct and indirect" concept of beneficial ownership would lead to much uncertainty, especially after being layered on top of deemed ownership by subsidiaries. The commenter questioned what else was intended. The commenter also asked whether the reference to a partial exclusion of subsection 1(6) of the Act should be accompanied by a similar reference to subsection 1(5) of the Act. Both subsections deem entities to beneficially own securities that are beneficially owned by their affiliated entities.

Comment Not on Proposed Amendments: One commenter thought since section 90 of the Act (which, among other things, deems beneficial ownership to include having the right to acquire securities within 60 days) applies to the definition of "related party", the Rule's definition of "beneficially owns" should explicitly exclude lock-ups. Otherwise, lock-ups could cause transactions to fall under the definition of "business combination" or "related party transaction", which should not be the case.

Response

There are several references to direct and indirect beneficial ownership in the present version of the Rule. In the amended Rule, the direct or indirect concept was added to the definition to eliminate the need for those repeated references. The inclusion of the concept reduces the potential for avoidance of the Rule through an overly technical interpretation of what constitutes beneficial ownership. The Commission agrees that the definition should include a reference to subsection 1(5) of the Act and has made this change.

The Commission believes that the subject of lock-ups is adequately addressed in the amended Rule by the exclusion of lock-ups in the definition of "joint actors". Section 90 of the Act has no application to a voting lock-up, which is the normal type of lock-up for a business combination or related party transaction. Even if the lock-up is not a voting lock-up, it will not trigger the definition of business combination or related party transaction if the party in whose favour the lock-up is granted was not a related party of the issuer at the time the main transaction was agreed to.

5. "bona fide lender"

Comment

Comment Not on Proposed Amendments: One commenter thought the definition should extend to a participant in a loan in addition to an assignee or transferee.

Response

The Commission agrees with the commenter and has made the change.

6. "business combination"

Comments

One commenter said that, under the amended definition, current subsection 2.9(1) of the Companion Policy would seem to have no application. For example, an arm's length amalgamation between two major Canadian banks, none of which had a 10% or greater shareholder, would seem to be a "business combination" if a minor and immaterial collateral benefit, or warrants, preferred shares or debt securities, were involved. The commenter did not think this would be appropriate.

Paragraph (c) of the current definition, which is the exception for a compulsory termination of a holder's interest in a security under the terms attached to the class of securities, was removed in the 2003 proposed Rule. One commenter thought it should be preserved because it covers a forced repurchase in accordance with constrained share provisions as required under many Canadian (and other) ownership statutory regimes.

One commenter suggested simplifying the definition by eliminating paragraph (d) in the 2003 proposed Rule (paragraph (e) in the new draft), which contains the exception for transactions where no related party is affected differently from other security holders, and incorporating it in section 4.5 (which contains the minority approval requirement for a business combination).

Under clause (d)(iii)(C) in the 2003 proposed Rule, the exception in paragraph (d) would not apply if, as a consequence of the transaction, a related party would be entitled to receive consideration in exchange for securities of the issuer that were neither equity securities nor employee stock options. One commenter thought employee stock options should be broadened to include options held by non-employees and securities such as purchase rights and appreciation rights. Two commenters did not think a payment for non-equity securities should trigger the definition if, for example, debt securities were being purchased or repaid. One of those commenters said that the receipt of unusual consideration for non-equity securities presumably would be caught as a collateral benefit.

Clause (d)(iii)(D) in the 2003 proposed Rule (clause (e)(iii)(C) in the new draft) applied to issuers with more than one class of equity securities. Under this provision, the exception in paragraph (d) would not apply if, as a consequence of the transaction, a related party was entitled to receive consideration for securities of one class that was greater than the entitlement of the holders of another class in relation to the voting and financial participating interests in the issuer represented by the respective securities. One commenter thought this provision was unclear. The commenter gave as an example non-voting shares trading in the market at a lower price than the voting shares. According to the commenter, paying the two classes equally would, in effect, penalize those who paid more for voting shares and reward those who paid less for non-voting shares, and the commenter asked what "in relation to the voting and financial participating interests" meant.

The comments described in the preceding two paragraphs were also applicable to the definition of "interested party" and paragraph 8.2(b) of the amended Rule regarding which securities can be voted in favour of a second step business combination. See also the comments on the definition of "collateral benefit".

Response

Subsection 2.9(1) of the current Companion Policy would be replaced by section 2.5 of the amended Companion Policy, which more accurately reflects the intent of the definition of "business combination". One of the significant differences between the Rule and former OSC Policy 9.1, which the Rule replaced, was that a "going private transaction" under the Rule includes a transaction in which holders of equity securities could be forced to substitute their securities for different equity securities (and a related party is not treated identically to the other security holders). Whether this forced substitution is accomplished by way of an "amalgamation" or a different method should not affect whether security holders receive the protections provided by the Rule. The fact that amalgamating parties are at arm's length to each other does not necessarily mean that unequal treatment of their security holders, in the form of extra benefits flowing to related parties, should be ignored by the Rule.

The Commission agrees with the comment regarding current paragraph (c) of the definition. The paragraph has been restored in the new draft, but it has been changed to confine its application to constrained securities.

While removing the last paragraph of the definition would simplify the definition itself, it would also introduce the necessity for the reader to review the parts of the Rule regarding disclosure, formal valuations and minority approval to determine how those parts applied to a particular business combination even if all related parties were being treated identically to the other security holders. From a user-friendliness standpoint, the Commission prefers to leave the paragraph in the definition.

Clause (d)(ii)(C) of the definition in the 2003 proposed Rule has been removed, and its subject matter has been incorporated into the definition of "collateral benefit". That definition does not distinguish between employee stock options and other types of non-equity securities that have been issued to employees or directors. In response to the comments regarding consideration that would be paid to a related party for debt or other non-equity securities as a consequence of a business combination, this consideration could cause the related party to favour the business combination for reasons other than the price that would be paid for the equity securities. Since the interests of the related party are not necessarily aligned with those of the general body of holders of equity securities in that circumstance, minority approval would be an appropriate requirement, subject to the applicable materiality tests in the collateral benefit definition.

The application of clause (d)(iii)(D) (now clause (e)(iii)(C)) of the definition in the 2003 proposed Rule is discussed in subsection 2.1(2) of the Companion Policy, with illustrative examples that, in the Commission's view, provide the necessary interpretive guidance for issuers with multiple classes of equity securities. On the substantive issue raised by the commenter, the amended Rule does not prohibit differential treatment among holders of different classes of equity securities in a business combination or related party transaction. The amended Rule recognizes, however, that a related party that is a beneficiary of the preferential treatment may have a conflict of interest that should, for example, preclude its votes from being counted in a vote of holders of the class receiving the lesser consideration.

7. "collateral benefit"

Comments

In the amended Rule, "collateral benefit" is a newly defined term which is used in the definitions of "business combination" and "interested party", and in paragraph 8.2(b) of the amended Rule regarding which securities can be voted in favour of a second step business combination. The main significance of the definition is that the votes of a related party that would receive a collateral benefit as a consequence of a business combination (or as a consequence of a formal bid preceding a business combination) would not be counted in a minority approval vote on the business combination.

One commenter agreed that employment benefits to related parties should be subject to special scrutiny, but thought there should be a general exclusion in the definition for benefits that are not, in the aggregate, material to the related parties receiving them, as determined by the issuer's board acting in good faith. This would replace the proposed exception for transactions where the related parties receiving benefits do not own more than 10% of the outstanding securities. The commenter did not think that owners of more than 10% of the securities should be disenfranchised on an acquisition transaction if their benefits are not material and are in accordance with customary industry practices.

Five commenters did not think that there should be a change to the status quo regarding how collateral benefits are treated under the Rule, and they disagreed with the proposed definition. The objections raised by one or more of those commenters included:

- determining whether a benefit is reasonably consistent with customary industry practices is difficult and would likely require expensive advice from compensation consultants;

- the disregarding of offsetting costs would change the Commission's historic approach of only regulating collateral benefits that provide consideration of greater value than that paid to all security holders;

- if the conferring of a benefit on a related party of the target issuer is conditional on the related party supporting the transaction, this should not cause the related party's votes to be excluded in a minority vote, because having the support of key employees or directors of the target may be important to the acquirer;

- related parties with pre-existing rights, such as "golden parachutes", should not, for that reason, be disenfranchised in a minority vote; they would have provided value for those rights, and the exclusion of their votes would seem unfair from the perspective of the proposed acquirer;

- the proposed exception where recipients of the benefits own less than 10% of the outstanding securities in the aggregate is not appropriate because the issue of whether a benefit is a collateral benefit should depend on the benefit itself, not the security ownership level of the recipient, and extra benefits received by large security holders are unlikely to be significant in comparison to the consideration those holders receive in the main transaction;

- the proposal would create uncertainty and make business combinations more difficult to achieve;

- collateral agreements are often integral commercial components of acquisition transactions; and

- just requiring disclosure of benefits in the information circular would be sufficient or should be considered as an alternative to the proposal.

One of the objecting commenters thought the open-endedness of the definition would result in there being various types of benefits, not currently contemplated, that would not justify a related party's exclusion from the vote and require exemptive relief. The commenter also thought for a large percentage of Canadian public companies, an arm's length acquisition transaction would probably trigger a minority approval vote under the proposed definition solely because directors and senior officers with pre-existing employment arrangements collectively would hold more than 10% of the shares. According to the commenter, prospective acquirers of those companies will be faced with much less deal certainty, since any lock-up agreements negotiated with those directors and officers will be rendered much less meaningful, which will cause lost transaction value.

One of the objecting commenters was of the view that the Commission, in originally establishing the Rule, intended the treatment of collateral benefits for going private transactions to be the same as for take-over bids under the Act, and that there is no reasonable basis for drawing a distinction between the two. The commenter said that in both cases, the Director (in the case of a going private transaction) or the Commission (in the case of a take-over bid) has in the past and should continue to review collateral agreements and grant exemptions from the applicable provisions of the Rule or Act upon being satisfied that the terms of an agreement are commercially reasonable and that the agreement is made for reasons other than to increase the value of the consideration to be paid for securities under the going private transaction or bid. The commenter did not think that going private transactions should be distinguished from take-over bids in this respect just because the consequence of an exemption refusal in the case of a bid would be to prevent the bid from occurring (or the benefit from being provided), whereas in a going private transaction the collateral benefit could still take place with minority approval. The commenter said that whether the concern is called "unequal treatment" under the Act or "conflict of interest" under the Rule, the principles are the same in both and should be applied in the same manner. The commenter pointed out that security holders can be squeezed out following a take-over bid if, for example, an arm's length bidder enters into a collateral agreement with a holder of 90% of the outstanding securities, and that this type of circumstance does not prevent the Commission from granting collateral benefit relief for the bid.

One commenter thought the Companion Policy should clarify that collateral benefits will be permitted in the bid context, subject to the obtaining of discretionary relief and, if appropriate, with adjusted minimum tender requirements to approximate minority approval. Otherwise, according to the commenter, form may triumph over substance. The commenter said that in some cases, collateral benefits are essential to complete a transaction, but the "street" believes, based on past Commission practice, that exemptive relief would not be available, forcing one into a voting transaction.

Response

The Commission has revised the definition in response to a number of these comments. As suggested by the first commenter, the materiality of a benefit to the recipient will now be a factor in determining whether the benefit would fit within the definition, to the extent that the benefit is related to services as an employee or director. However, rather than requiring the board of directors to make a subjective determination of materiality, which could result in inconsistent interpretations by boards of different issuers in similar fact situations, an objective test has been introduced. Under the revised definition, the test will be based on whether the value of the benefit, net of offsetting costs, would be less than 5% of the value of the consideration that the recipient would receive for its equity securities in the main transaction. An independent committee of the issuer would make the determination. The exception in the definition based on aggregate ownership of 10% or less has been replaced by an exception based on less than 1% ownership on an individual basis.

In response to the concerns expressed by some commenters regarding the condition that the benefits be consistent with customary industry practices, that condition has been replaced with a condition that the benefit not be conferred for the purpose of increasing the value of the consideration paid to the recipient for securities relinquished under the main transaction. Regarding the condition that the benefit not be conditional on the recipient supporting the main transaction, words have been added to clarify that this provision does not cause a benefit to be a collateral benefit solely because the recipient supports the main transaction; the provision applies where the conferring of the benefit is, by its terms, conditional on that support. The issue of offsetting costs is addressed in the new 5% exception.

The Commission believes that these changes address a number of the commenters' concerns in a manner that strikes a reasonable balance between the interests of related parties and fairness to other security holders who may be forced to relinquish their securities without their consent. The Commission recognizes that this approach represents a change from historic practice and does not necessarily reflect what the framers of the current version of the Rule had in mind. However, the Commission regards the changes as necessary to support the principle of equal treatment and to adequately address conflict of interest issues.

While disclosure of benefits that are provided to related parties is essential, it is not an adequate substitute for a properly constituted minority vote. Disclosure of material collateral benefits assists security holders in making an informed voting decision but would not prevent the recipients of those benefits from outvoting the other security holders.

To the extent that a collateral benefit, including a pre-existing benefit such as a golden parachute, is significant enough that it could reasonably be expected to influence a related party's decision as to whether to support a transaction, the Commission does not consider it unreasonable for the other security holders to decide whether the transaction is acceptable. This is

particularly the case in light of the fact that in a minority approval vote, a simple majority of votes can force security holders to relinquish their securities at a price that they may consider inadequate. While the approach may provide less certainty for potential acquirers in some cases, this concern is not sufficient, in the Commission's view, to override the fundamental principles of fairness underlying the Rule.

On the comments regarding differential regulatory treatment of collateral benefits as between voting transactions and take-over bids, the Commission agrees that the treatment should be similar to the extent practical. As noted by the commenters, there is a current difference in that the consequence of a collateral benefit being unacceptable in the bid context is that either the bid cannot proceed or the benefit cannot be provided, whereas in the case of a voting transaction the same benefit can be provided if minority approval of the transaction is obtained. The Commission does not regard the proposed amendments as introducing new regulatory discrepancies as between the two types of transactions that outweigh the benefits of the proposals. Regardless of the method of acquisition chosen, in most cases an intended acquisition of all of an issuer's securities will only succeed if holders of a majority of the securities that are not prohibited from voting under the amended Rule are in favour of the transaction. Their support will be demonstrated by their tendering to the bid or their vote in favour of the business combination, which may be a second step transaction following a bid. This will be the case because, if a take-over bid is permitted to proceed despite the existence of a benefit that would be a collateral benefit under the amended Rule, the votes attached to the securities tendered to the bid by the recipient of the benefit would not be counted in a vote on a second step business combination.

As pointed out by one commenter, there may be circumstances in which a potential acquirer of all the issuer's securities would have certainty of succeeding in a take-over bid but, because of the treatment of collateral benefits in the amended Rule, the same certainty would not be available in a voting transaction. For example, a holder of more than 90% of the outstanding equity securities may agree to sell its securities to the acquirer and also receive a collateral benefit that, while meeting the requirements for an exemption in the bid context, would disqualify the votes of that holder in a voting transaction. This scenario would be uncommon in light of the newly proposed 5% materiality exception, but if it does occur, exemptive relief may be sought to allow the securities to be voted.

On the suggested addition of clarification in the Companion Policy regarding the possibility of discretionary relief in the bid context with adjusted minimum tender requirements, it would probably be more appropriate for a provision of this nature to be situated in a regulatory instrument relating to bids generally. The Commission intends to consider the comment in determining whether there should be a review of the manner in which collateral benefits are regulated in the bid context.

8. "connected transactions"

Comments

One commenter did not think that the definition should extend to transactions that are not conditional on each other, since the "approximate simultaneity" test could easily lead to inappropriate results. The commenter also thought the Rule, rather than the Companion Policy, should clarify that a lock-up agreement is not a connected transaction. In addition, the commenter though that the concept of an "indirect party" created uncertainty and should be dropped, and that at a minimum section 2.4 of the amended Companion Policy, which interprets "indirect party", should be in the Rule.

Response

In the circumstances in which the connected transactions concept would arise in the amended Rule, it would be rare for the approximate simultaneity test to have inappropriate results, and exemptive relief would be available in those cases. Without this test, for example, an amalgamation carried out in conjunction with a sale of assets of one of the amalgamating issuers to the controlling shareholder of that issuer would not necessarily be covered by the Rule. Even if the two transactions in this example were not conditional on each other, the amalgamation could reasonably be perceived by minority shareholders to give rise to a conflict of interest.

The discussions of lock-ups and indirect parties in subsection 2.9(3) (subsection 2.8(3) in the new draft) and section 2.4 of the 2003 proposed Companion Policy, respectively, are interpretations of terms used in the Rule and as such are, in the Commission's view, properly situated in the Companion Policy. Inclusion of the "direct or indirect" concept in the definition of "connected transactions" is intended to reduce the potential for technical avoidance of the Rule, and section 2.4 of the 2003 proposed Companion Policy clarifies the application of the concept.

9. "controlled"

Comment

Comment Not on Proposed Amendments: One commenter asked whether the reference in paragraph (b) to 50 per cent of the interests in a partnership or other entity should be to "voting" interests.

Response

The Commission agrees that "voting" should be added and has made the change.

10. "fair market value"

Comment

Comment Not on Proposed Amendments: One commenter suggested that the words "except as provided in paragraph 6.4(2)(d)" be replaced by "subject to paragraph 6.4(2)(d)" or deleted entirely since paragraph 6.4(2)(d) itself contains the modification to the definition.

Response

The Commission agrees with the commenter's first suggestion from the standpoint of technical consistency, but prefers the existing wording as being more user friendly. In regard to the second suggested alternative, it is desirable that there be words to alert readers to the existence of an exception elsewhere in the Rule.

11. "freely tradeable"

Comment

Comment Not on Proposed Amendments: One commenter asked if the first component of the definition should be amended by adding "without satisfaction of any conditions" after "transferable". This was based on the commenter's view that securities of a company with restrictions on transfer (such as where the approval of the shareholders or directors is required for transfers) are arguably still transferable.

Response

The Commission does not regard the additional words as necessary. The term "freely tradeable" is used in the Rule only in reference to publicly traded securities which would not have the restrictions referred to in the comment. In addition, the absolute exclusion of conditions could be interpreted to capture, for example, publicly traded securities that have transfer restrictions for the purpose of maintaining Canadian ownership or qualifying the issuer to carry on a certain type of business.

12. "incentive plan"

Comment

One commenter suggested removal of "employee", since incentive plans can extend beyond employees.

Response

The Commission agrees with the commenter and has made the change.

13. "interested party"

Comments

Under clause (d)(ii)(B) of the definition in the 2003 proposed Rule, an interested party for a related party transaction included a related party that, as a consequence of the transaction, would be entitled to receive a payment or distribution made to holders of non-equity securities. One commenter asked why there was not an exception where the non-equity securities were employee stock options.

Comments Not on Proposed Amendments: Under subparagraph (b)(ii) of the definition in the amended Rule, an interested party for an issuer bid includes a person or company that is expected to be control block holder of the issuer "upon successful completion of the issuer bid." One commenter asked if "and any connected transaction" should be added to the end of this provision. Another commenter, in reference to the definition of interested party for a related party transaction, asked if a "party to the transaction" in subparagraph (d)(i) includes an officer or director whose rights or position are terminated, amended or continued, such as where an employment agreement or amendment is required.

Response

Clause (d)(ii)(B) was intended to cover circumstances that would include a payment or distribution to holders of non-equity securities in conjunction with a rights offering or other distribution of securities to holders of equity securities. An exception for holders of employee stock options was not considered justified in this context. Clause (d)(ii)(B) has been removed in any event because the transactions it was intended to cover would normally be covered by the definition of collateral benefit as well as being related party transactions in their own right.

A reference to connected transactions could be included in the definition as it relates to an issuer bid, but in light of the breadth of the definition of connected transactions, their inclusion could have unintended consequences or add unnecessary complications. The implications of a person or company being an interested party for an issuer bid are primarily disclosure-related, and if an issuer carrying out an issuer bid became aware of a pending transaction that would materially affect its control, disclosure requirements would be triggered in any event.

For a related party transaction, a "party to the transaction" does not include a person whose sole connection with the transaction arises from the fact that his or her employment arrangements will be affected by it.

14. "joint actors"

Comments

One commenter strongly supported the proposal to have in the Rule a definition of joint actors that states explicitly that the definition does not pick up securities that are subject to a lock-up agreement.

Comment Not on Proposed Amendments: One commenter suggested that the definition state explicitly that the recipient of a collateral benefit is not, for that reason alone, a joint actor with an interested party or with a related party of an interested party.

Response

Regarding the second comment, it has not been the Commission's experience that users of the Rule have interpreted persons to be "acting jointly or in concert" solely because they receive collateral benefits. Apart from the exclusion of lock-ups and support agreements, which was added in the amended Rule to address an area of uncertainty, the Commission is reluctant to add to the length of the definition by covering matters that have not given rise to interpretation difficulties. A list of exclusions may give rise to the assumption that non-codified exclusions are caught by the definition, which may not be the case.

15. "minority approval"

Comment

Comment Not on Proposed Amendments: One commenter thought the Rule should allow issuers (particularly emerging issuers) to satisfy the minority approval requirement by obtaining written consents from holders of securities, as an alternative to holding a meeting of security holders, in order to relieve the issuers from the cost burden of holding the meeting. The commenter said that perhaps the nature of this alternative could be a requirement that all beneficial holders of more than 5% of the outstanding securities must approve the transaction.

Response

Section 3.1 of the amended Companion Policy provides for the possibility of a discretionary exemption being granted to permit an issuer to obtain security holder approval in writing. The Commission does not wish to make the exemption automatic, mainly because the Director should be satisfied that the security holders who provide their consent are doing so with adequate disclosure regarding the transaction, and this should be accomplished as part of the exemption application process. On the possibility of requiring approval from holders of more than 5% of the outstanding securities, the Commission would normally consider it appropriate to base the discretionary exemption on consents from holders of a majority of the outstanding securities that would be eligible to be voted if a meeting were held, regardless of the size of each holding.

16. "related party"

Comments

One commenter asked if receivers and liquidators should be added as exclusions in paragraph (f).

Comments Not on Proposed Amendments: One commenter thought the presence of both paragraphs (a) (control block holder) and (d) (holder of securities carrying more than 10 per cent of the votes) seemed unnecessary, and that (a) alone should suffice.

Another commenter thought the definition may be overly broad in that it captures, for example, a purchase of assets of an issuer by a non-top ranking officer of the issuer who is not a director and has a small shareholding in the issuer.

Response

In paragraph (f), "appointed" has been changed to "acting", so that persons who, as a result of either a court appointment under a statute or the operation of a contract, manage an issuer under insolvency law are excluded from being caught by the definition under this paragraph.

Paragraph (d) is necessary to cover large security holders who are not part of a control group. While these insiders may not necessarily be in a position to influence an issuer's actions on their own, they may still reasonably be perceived to have an informational advantage in light of their security holdings. The same holds true for senior officers who are neither directors nor large security holders.

17. "related party transaction"

Comments

For paragraph (j) regarding a credit facility, one commenter suggested that "creates" be changed to "enters into" if it is intended that both the granter and the recipient of a credit facility could be considered to be engaging in a related party transaction. Another commenter was concerned that paragraph (l) (material change to terms of debt or credit facility) appears to capture banks and other arm's length lenders with substantial control or influence as a result of a default, and who agree to amended terms in the context of an insolvent borrower. The commenter thought paragraph (l) could make it impossible to amend a loan in such a situation.

Response

The Commission agrees with the first commenter and has made the change. On the second comment, paragraph (l) is needed to address conflict of interest concerns that could arise in the context of an amendment to a loan from a related party. In the scenario described by the commenter (and assuming that the bank or other lender meets the Rule's definition of "related party"), financial hardship or insolvency exemptions are likely to be available. If they are not, it may be appropriate for the protections of the Rule to come into play, or exemptive relief may be sought.

18. Section 1.2 – Liquid Market

Comment

Comment Not on Proposed Amendments: One commenter thought since it is unclear whether new competitive marketplaces will all provide supporting liquidity opinions, the requirement for an opinion from the published market should be reconsidered. The commenter also thought, for consistency with the POP issuer criteria (subsection 2.9(3) of National Instrument 44-101), securities held by certain institutional investors that are related parties should not be excluded from the market value calculation.

Response

The Commission does not propose to eliminate the requirement to obtain a liquidity opinion from the published market under the circumstances described in the Rule. Given the limited nature of those circumstances (particularly under the amended Rule), the Commission considers the possibility remote that competitive marketplaces will have a material impact in this area, at least for the foreseeable future. While not discounting the legitimacy of the issues raised by both comments, the Commission is reluctant to reduce investor protections or impose additional provisions on users of the Rule to address every conceivable circumstance, no matter how unlikely, that could give rise to a need for exemptive relief at some point in the future.

19. Section 1.3 – Transactions by Wholly-Owned Subsidiary Entity

Comments

One commenter asked why non-wholly-owned subsidiaries were not addressed, and also suggested that the section conclude by deeming a bid by a wholly-owned subsidiary of an issuer for securities of the issuer not to be a take-over bid in the Rule or the Act.

Response

The section is intended to reflect the fact that a wholly-owned subsidiary is essentially an alter ego of its parent issuer, insofar as transactions are concerned, and should be treated as such for the purposes of the Rule. The same cannot necessarily be said

for partially-owned subsidiaries. While the Rule addresses partially-owned subsidiaries through concepts such as beneficial ownership and indirect parties to transactions, a deeming provision that equates transactions of partially-owned subsidiaries with those of their parents would, in the Commission's view, introduce undesirable complications into the Rule. On the second point raised by the commenter, the Commission does not consider the suggested additional deeming provision to fall within the intended subject matter of the Rule, and the issue would arise extremely rarely in any event.

20. Section 1.4 – Transactions by Underlying Operating Entity of Income Trust

Comments

One commenter thought this section was unnecessary and confusing. The commenter asked why a special provision was required for an underlying operating entity, which was presumably a subsidiary, and not for other public holding companies or entities. The commenter also noted that "income trust" was not a defined term.

Response

Given the rapid growth in the number of publicly traded income trusts, the Commission considers it important for the Rule to specifically address transactions involving the assets on which the entire value of the securities of an income trust depends. A definition of income trust has now been added to the amended Rule and includes entities other than trusts. Further requirements to address various other types of holding entities would, in the Commission's view, introduce undesirable complications into the Rule.

21. Section 2.3 – Insider Bids – Formal Valuation – Independent Committee

Comment

Paragraph (d) would require the independent committee, in the case of an insider bid, to use its best efforts to ensure that the formal valuation is completed and provided to the offeror in a timely manner. One commenter, while appreciating the policy reason behind the provision, thought the section as drafted might impose an unduly onerous standard of performance on the special committee. The commenter suggested the following alternate wording: "…use reasonable efforts appropriate in the circumstances to facilitate the provision of the formal valuation in a timely manner."

Response

As the provision is intended primarily to address unfriendly bids, the Commission prefers to emphasize the importance of shareholders receiving a bid in a timely manner by using the stronger language contained in the 2003 proposed Rule. The provision is really a codification of one of the responsibilities reasonably expected of an independent committee in any event.

22. Subsection 2.4(1), Para. 3 and Subsection 4.4(1), Para. 3 – Exemption from Formal Valuation Requirement – Previous Arm's Length Negotiations – Insider Bids and Business Combinations

Comment

Comment Not on Proposed Amendments: One commenter was of the view that this exemption is much too complex.

Response

The Commission considers the exemption to be justified only if all the conditions contained in it are met. Accordingly, none of the conditions could be removed without eliminating the entire exemption. While the conditions may appear complex in the abstract, ascertaining whether the exemption is available in the context of a specific transaction should be fairly simple in most cases, and far less time-consuming than the process of obtaining a discretionary exemption.

23. Paras. 4.1(c) and 5.1(c) – Application – Less than 2% of Security Holders in Ontario – Business Combinations and Related Party Transactions

Comments

One commenter thought requiring the determination to be made at the time the business combination was "proposed", in paragraph 4.1(c), was too vague. The commenter also thought the *de minimis* test should be met if it is satisfied for either registered or beneficial owners, as in the current Rule, rather than having to be satisfied for both registered and beneficial owners.

Comment Not on Proposed Amendments: Two commenters thought the two per cent threshold was too low. One of those commenters was of the view that, given that other provinces have not adopted the Rule, other jurisdictions do not have the same requirements, 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.

Response

The Commission agrees with the comment regarding the use of the word "proposed", which is used in a similar manner in provisions regarding going private transactions in other parts of the current version of the Rule. In the amended Rule, "proposed" has now been changed to "agreed to" in this provision and in those other parts. The change regarding registered and beneficial ownership reflects the fact that a substantial portion of a Canadian issuer's securities may be registered in the name of a depository under an address in a single province, which may not reflect the true location of the issuer's beneficial security holders.

Regarding the two per cent threshold, proposed National Instrument 71-102 – *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers* will contain significantly higher thresholds for most foreign issuers, based on the level of Canadian ownership of the issuer's securities. For Canadian issuers, the Commission regards the benefits of the Rule as outweighing concerns about extra-jurisdictional regulatory reach, except where the security holdings in Ontario are nominal.

24. Sections 4.2 and 5.3 – Meeting and Information Circular

Comments

Paragraph (3)(h) of section 4.2 and 5.3 of the amended Rule would require disclosure in the information circular of the number of votes attached to the securities that, to the knowledge of the issuer after reasonable inquiry, would be excluded in a minority approval vote. One commenter said that this number is often difficult to assess, given the broad definitions of terms such as related party and joint actors. The commenter suggested that the provision begin with words such as "to the extent determinable".

Comments Not on Proposed Amendments: Subsections 4.2(4) and 5.3(4) of the amended Rule (which are substantially identical to subsections 4.2(3) and 5.4(3) of the current Rule, respectively) provide that if a material change occurs between the time of the sending of the information circular and the meeting of security holders to vote on the transaction, the issuer must promptly disseminate disclosure of the change sufficiently in advance of the meeting that security holders will be able to assess the impact of the change. One commenter said that it should be clarified that the provision only applies to changes within the control of the issuer, as is the case for the bidder in a take-over bid under the Act. The commenter also asked how to comply with the requirement if the change occurs just before the meeting, and whether an adjournment is required.

Response

On the first comment, the Commission does not consider the suggested additional words to be strictly necessary in light of the inclusion of the words "to the knowledge of the issuer after reasonable inquiry".

On the other comments, given the importance of security holders being in a position to make an informed decision when voting on a transaction covered by the Rule, the Commission is reluctant to change the Rule in a manner that may reduce the access of security holders to information that could materially affect that decision. If the issuer is unable to give security holders adequate notice of a material change in advance of the scheduled time of the meeting, the issuer may need to adjourn the meeting in order to comply with the Rule.

25. Section 4.3 – Business Combinations – Requirement for Formal Valuation

Comments

Subsection (1) in the amended Rule sets out the circumstances in which a formal valuation for a business combination is required. The criteria are based on the significance of the level of participation of interested parties in the business combination or in a connected transaction. One commenter thought the references to "interested party" should be changed to "related party" to avoid circularity in the use of the former term. The commenter also suggested that paragraph (b) explicitly state that, in determining whether a connected related party transaction will trigger a formal valuation requirement for a business combination, the connected transaction should be considered separately from the business combination for purposes of paragraph 2 of section 5.5 of the amended Rule (the less than 25% of market capitalization exemption).

Another commenter thought paragraph (b) was unclear as to whether it required a valuation for the business combination or just for related party transactions that were connected to the business combination.

Response

The Commission does not regard the use of the term "interested party" as being circular, because the section does not refer to the term in a definitional sense. The Commission also does not consider the proposed explicit reference to the 25% exemption to be necessary. Subparagraph (c) of that exemption in the 2003 proposed Rule, which required aggregation of connected related party transactions for purposes of the 25% calculation, explicitly confined its application to transactions that were subject to Part 5 of the Rule. (A change to this provision in the new draft confines its application further.) Under paragraph 5.1(e) of the amended Rule, business combinations are not subject to Part 5.

The introductory words of the section have been changed to clarify that paragraph (b) requires a valuation for the business combination if the circumstances described in that paragraph apply.

26. Subsection 4.4(1), Para. 2 and Section 5.5, Para. 3 – Formal Valuation Exemption for Issuers Not Listed on Specified Markets – Business Combinations and Related Party Transactions

Comments

Under these paragraphs, issuers not listed or quoted on specified stock markets will be exempt from the requirement to obtain a formal valuation for a business combination or related party transaction. The specified markets in the 2003 proposed Rule were the Toronto Stock Exchange, the New York Stock Exchange, the American Stock Exchange, the NASDAQ National Market, the NASDAQ SmallCap Market and any stock exchange outside of North America.

The TSX Venture Exchange supported these exemptions and believed they would be of considerable benefit to emerging issuers listed on that exchange, providing them with both time and cost savings. Another commenter thought the proposal treated foreign small-cap markets, such as the NASDAQ SmallCap Market, differently from Canadian small-cap markets, which was inappropriate, and that the proposal did not address quotation and trade reporting systems.

Response

On the second comment, this exemption is intended to apply to junior issuers such as those listed on the TSX Venture Exchange. The NASDAQ SmallCap Market has listing requirements significantly higher than those of the TSX Venture Exchange. In regard to other foreign markets, it would be extremely rare for a junior issuer, listed on a stock exchange outside of Canada and the United States, to be a reporting issuer that is subject to the formal valuation requirement in the Rule. Exemptive relief can be sought if this does occur. It is also highly unlikely, at least for the foreseeable future, that there would be a senior reporting issuer that could avoid the formal valuation requirement solely by reason of not being listed or quoted on one of the markets specified in the exemption.

27. Subsection 4.4(1), Para. 5 and Section 8.2 – Second Step Business Combination – Formal Valuation Exemption and Including Votes of Securities Acquired in Bid

Comments

These provisions provide a formal valuation exemption, and allow securities acquired in a formal bid to be voted, for a business combination that is completed within 120 days after the expiry of the bid if certain conditions are met. One of the conditions is that the disclosure document for the formal bid must have disclosed that the offeror, if it acquired securities under the bid, intended to acquire the remainder of the securities under a statutory right of acquisition or under a business combination that would satisfy the conditions of the exemption. One commenter thought "intended" was too strong, because circumstances may change and, in practice, the statement of intention must be qualified with words such as "currently intends".

Comment Not on Proposed Amendments: One commenter thought the 120-day period for completion of the business combination should start at the time of the mailing of the information circular for, or the time of proposing, the business combination. The commenter said that sometimes completion gets delayed for regulatory or other reasons, and one should not be suddenly pushed off-side at the end for this type of reason.

Response

This valuation exemption and the provision that allows securities acquired in a formal bid to be voted are based on the premise that there are certain conditions under which it is fair to security holders for a formal bid and a subsequent business combination to be treated, for regulatory purposes, as though they were a single transaction. This is the case where the two steps are sufficiently linked so that it is reasonable to assume that the interests of the security holders who tendered to the bid are generally aligned with the interests of the security holders who vote on the subsequent business combination. In order for this to be the case, the transactions must be completed within a reasonable time of each other, and the Commission regards 120 days

from the expiry of the bid to be both the appropriate time limit for this purpose as well as a reasonable period in which to complete the business combination. Exemptive relief may be sought in unusual cases.

Similarly, the interests of the two groups of security holders may not be aligned if there is a reasonable possibility that security holders who tender to the bid are motivated by factors other than the bid price. This may be the case if the bidder does not state that it intends subsequently to acquire untendered securities at the bid price in the event that the bid meets its minimum tender condition. In that case, security holders may tender out of a concern that their securities may be less liquid after the bid, and also of less value due to the potential loss of the opportunity to receive a control premium for the securities. In this circumstance, tendering to the bid does not necessarily equate to approval of the bid price. Under the amended Rule, it will still be permissible to qualify the expressed intention in order take into account the possibility of unforeseen events, but the intention must otherwise be firm.

28. Section 4.5 – Minority Approval for Business Combination

Comment

One commenter thought a related party transaction that is connected with a business combination should trigger the minority approval requirement for the business combination only if the related party transaction itself must receive minority approval under the Rule. This would be the same as the approach taken for the formal valuation requirement in paragraph 4.3(1)(b) of the amended Rule.

Response

While the number of circumstances requiring a formal valuation has been reduced in the amended Rule as part of an effort to eliminate regulatory burdens that may not be justified in relation to their costs, identical principles do not necessarily apply to the minority approval requirement. In the case of a business combination, where a majority of security holders can force the minority to relinquish their securities against their will, it is important that this majority be comprised, to the extent possible, of security holders who are voting solely on the merits of the business combination. A related party that stands to benefit from a connected transaction if the business combination proceeds may have an added incentive to vote in favour of the business combination even if the connected transaction is not of sufficient size to be subject to minority approval under the rule.

29. Subsection 4.6, Para. 2 and Subsection 5.7, Para. 7 of 2003 Proposed Rule (para. 8 in new draft) – Minority Approval Exemption Where Interested Parties Own 90%

Comment

One commenter thought the interested parties comprising the 90% holding should include certain types of interested parties that are not actual parties to the business combination or related party transaction, such as persons who are interested parties only because they would receive collateral benefits as a result of the transaction.

Response

The exemption is primarily intended to apply to issuers that are controlled as to 90% or more. The exclusion of interested parties that, for example, only receive collateral benefits is consistent with this intent and also removes the potential for avoidance tactics such as providing security holders with collateral benefits for the purpose of having them included in the 90% calculation.

30. Paragraph 5.1(e) – Application – Related Party Transaction that is Also a Business Combination

Comment

Comment Not on Proposed Amendments: This provision excludes a business combination from the application of Part 5 of the Rule, which contains the requirements for related party transactions. One commenter suggested that the provision also explicitly state that, for greater certainty, a related party transaction that is connected to a business combination is subject to Part 5.

Response

Clarifying language on this subject has been added to subsection 2.8(2) of the Companion Policy.

31. Section 5.5, Para. 2 – Less than 25% of Market Capitalization Exemption

Comments

In the 2003 proposed Rule, the exemption was expressed as being based on the transaction's fair market value, insofar as it involved "related" parties. One commenter thought "related" should be replaced with "interested" to prevent difficulties in interpretation that could cause inappropriate related parties to be included in the 25% calculation.

Subparagraph (b) in the amended Rule provides, in essence, that if the transaction is one in which the issuer combines with a related party, the securities of the related party that are already held by the issuer need not be counted in determining the size of the transaction for the purpose of the 25% exemption. One commenter noted that in the current version of the Rule, this exclusion only applies in the case of a downstream transaction for the issuer. The commenter was not sure that it made sense in the upstream context.

Subparagraph (c) in the amended Rule requires the values of all connected related party transactions to be combined for the purpose of determining whether the 25% exemption is available. There was an exception for those transactions that had one of the other automatic exemptions in section 5.5. One commenter asked whether there should also be an exception for a transaction for which the Director has granted a discretionary exemption.

Subparagraph (d) in the 2003 proposed Rule required warrants, options and similar instruments to be included in the calculation used to determine whether the 25% exemption was available, based on the maximum potential effect of the exercise of the instruments. One commenter thought the amount that the provision required to be included was the sum of the fair market value of the underlying assets and the amount payable on exercise. The commenter disagreed with the duplication that the provision suggested.

Response

The Commission has made the change suggested in the first comment.

In addition to downstream transactions, subparagraph (b) is intended to cover transactions in which, for example, a wholly-owned subsidiary of an issuer amalgamates with a company that is partially owned by a related party of the issuer and partially owned by the issuer. A merger or amalgamation that is an upstream transaction for an issuer will normally be a business combination for that issuer under the amended Rule, in which case the 25% exemption will not be relevant. Even for an upstream transaction that is not a business combination, the subparagraph still should apply to cover the possibility of the issuer already owning securities of the entity with which it is combining.

Subparagraph (c), regarding aggregation of connected transactions, has been amended in the new draft to confine its application to transactions that would require a formal valuation if it were not for this exemption. Therefore, a transaction for which a discretionary exemption is granted will not be subject to aggregation unless the terms of that exemption provide otherwise.

Subparagraph (d) has been redrafted to clarify the amount to be included in the calculation for purposes of the exemption when the transaction includes warrants, options and similar instruments. The amount is the fair market value, as of the time the initial transaction is agreed to, of the maximum number of securities or other consideration that the issuer may be required to issue or pay on exercise.

32. Less than $500,000 Formal Valuation Exemption for Related Party Transactions in Section 5.6, Para. 13 of Current Rule

Comment

One commenter disagreed with the proposed elimination of the current formal valuation exemption for transactions having a fair market value of under $500,000. In the 2003 proposed Rule, this exemption was replaced, in paragraph 3 of section 5.5, with an exemption for all issuers not listed or quoted on a specified senior stock market such as the Toronto Stock Exchange. The commenter thought the current exemption was appropriate for Toronto Stock Exchange issuers that have shrunk in value, and that the threshold for the exemption should be increased to perhaps $2.5 million.

Response

The Toronto Stock Exchange has positioned itself as a market for senior equities. For the purposes of making regulatory accommodations for junior issuers, it is reasonable to differentiate between junior and senior issuers in a manner that coincides with the general perceptions of the investing public. Differentiating on the basis of whether the issuer is traded on a junior or senior market will assist the public in determining which regulatory regime applies to a particular issuer. This is also the

approach that has been taken in proposed National Instrument 51-102 – *Continuous Disclosure Obligations* and proposed Multilateral Instrument 52-110 – *Audit Committees*.

33. Section 5.5, Para. 4 – Formal Valuation Exemption for Distribution of Securities for Cash

Comment

Comment Not on Proposed Amendments: This exemption is conditional on neither the issuer nor, to the knowledge of the issuer after reasonable inquiry, the related party having knowledge of material, undisclosed information regarding the issuer or its securities. One commenter thought the proposed transaction itself should be excluded from this condition.

Response

The condition is applicable at the time the related party transaction is carried out, and since the issuer would need to rely on this exemption only for a highly significant transaction (otherwise the exemption based on the size of the transaction would be available), it is highly likely (and normally desirable) that the transaction would be publicly announced before it is carried out. Therefore, the Commission does not consider it necessary to add extra wording to exclude the transaction itself from the condition.

34. Section 5.5, Para. 9 – Formal Valuation Exemption for Amalgamation or Equivalent Transaction with No Adverse Effect on Minority

Comment

Comment Not on Proposed Amendments: One commenter noted that this paragraph uses various terms to refer to the combined entity, and suggested that "entity resulting from the combination" be used throughout.

Response

The Commission agrees with the commenter and has made the change.

35. Section 5.7, Para. 6 of 2003 Proposed Rule (para. 7 in new draft) – Minority Approval Exemption for Loan to Issuer

Comments

In the 2003 proposed Rule, this exemption was changed so as not to apply to an advance under a credit facility, in order to remove the implication that an advance was regulated as a related party transaction distinct from the creation of the credit facility. An advance would normally be excluded from being regulated as a separate transaction by virtue of subparagraph 5.1(h)(iii) of the amended Rule, which excludes a transaction carried out under the terms of a previous transaction (which in this case would be the creation of the credit facility). A condition in subparagraph 5.1(h)(iii) is that the terms of the previous transaction must have been generally disclosed. One commenter said that the creation of a credit facility may not be material enough to trigger a disclosure obligation under the timely or continuous disclosure requirements of securities law, and that the Rule should not create an additional disclosure requirement. Therefore, the commenter suggested that different wording be used to meet the Commission's objective of ensuring that an advance is not caught by the Rule.

The exemption does not apply where the loan is convertible into equity or voting securities of the issuer and in certain other circumstances. One commenter noted that the list of these circumstances does not capture the common case of ancillary warrants that may accompany a loan.

Response

If the creation of a credit facility with a related party is not sufficiently material to trigger a public disclosure obligation under securities law, advances under that credit facility would normally be expected to have the benefit of the exemption in paragraph 2 for a transaction that is smaller than 25% of the issuer's market capitalization. The Commission is of the view that if none of the exemptions in the amended Rule apply to the advances, the creation of the credit facility is likely material and should be generally disclosed before advances under it are made.

The existence of ancillary warrants is not included as a circumstance that negates the exemption because, given that the exemption only applies if the loan is on reasonable commercial terms, the number of ancillary warrants may not be sufficiently large to justify the loss of the exemption. The issuance of the warrants will generally be subject to minority approval under the Rule if the current value of the securities issuable on exercise of the warrants exceeds 25% of the issuer's current market capitalization.

36. Minority Approval Requirement for Junior Issuers

Comment

The TSX Venture Exchange ("TSX Venture") submitted that the exemption from the formal valuation requirement in the amended Rule for issuers not listed or quoted on a senior stock market should also be a minority approval exemption if the issuer is traded on a market that has security holder approval and disclosure requirements respecting business combinations and related party transactions. TSX Venture, in its submission, has adequate review procedures and safeguards in place to ensure that security holders are not prejudiced by these transactions. Among other things, TSX Venture requires minority approval for a private placement that would cause a related party that was not a control person to become a control person, and TSX Venture does not allow any private placement (whether or not to related parties) to be priced at below the market price less a specified discount. TSX Venture also said that since emerging issuers, by their nature, often rely on financings from related parties, it would be inappropriate for those financings to be subject to minority approval, particularly considering the cost burdens involved. Typically, it was these emerging issuers that were least able to bear these cost burdens, which largely outweighed the benefits of increased financings for the issuers.

Response

The minority approval requirement is a fundamental contributor to fairness and the appearance of fairness in transactions that may give rise to significant conflicts of interest involving an issuer and its related parties. While stock exchanges and quotation systems may have their own systems for regulating related party transactions, these systems may not cover all the concerns the Rule is intended to address. For example, a large private placement that is priced at a discount from the market price (which may be as much as a 25% discount) and made to a person that already controls the issuer could give rise to a reasonable perception of a conflict of interest, but it does not trigger a minority approval requirement under TSX Venture policies, regardless of its size.

However, the Commission agrees that for smaller financings, the minority approval requirement can impose costs, in relation to the amount of money raised, that may outweigh the benefits. Accordingly, a minority approval exemption has been added, in paragraph 3 of subsection 5.7(1), for cash financings of not greater than $2.5 million, for issuers not traded on a senior stock market. The availability of the exemption is subject to the issuer having one or more directors who are both independent of the transaction and not employees of the issuer, and approval of the transaction by two-thirds of the directors that meet those criteria.

37. Section 6.3 – Subject Matter of Formal Valuation

Comment

For a related party transaction, subsection (2) in the amended Rule does not require a formal valuation of securities of a reporting issuer or securities of a class for which there is a public market, subject to certain conditions. One of the conditions is that, in the case of a transaction by the issuer of the securities, neither the issuer nor, to the issuer's knowledge after reasonable inquiry, the related party has knowledge of any undisclosed material information concerning the issuer or its securities. One commenter asked whether it was intended that securities not requiring a valuation would include newly created securities for the purpose of the transaction or whether "for which there is a public market" modified both references to "securities". If the former was intended, the commenter questioned whether, for a transaction by the issuer of the securities, the conditions were sufficient to ensure that the person to whom these securities were offered would have sufficiently detailed knowledge of the value in order to justify no valuation being required.

Response

A minor drafting change has been made to subsection (2) to clarify that, for a related party transaction, a formal valuation of securities of a reporting issuer is not required regardless of whether there is a published market for those securities (subject to the conditions). On the other point, the conditions are intended to eliminate any informational advantage the related party receiving the securities might have, so that security holders who, for example, vote on the transaction will not be deprived of relevant information when making their voting decisions. The conditions are not designed to address the related party's level of knowledge in any other respect.

38. Section 6.4 – Preparation of Formal Valuation

Comments

Paragraph (2)(d) in the current Rule provides that, in determining the fair market value of securities, the valuator must not make 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 paragraph was changed so as to apply only to

offeree securities or affected securities. It would no longer apply, for example, to shares that would be received by the shareholders of a target company in a share exchange insider bid or business combination.

One commenter said that the current version of the Rule has led providers of fairness opinions to say that if a controlling shareholder is offering less than "intrinsic value" (i.e. without downward adjustments), the transaction is not "fair". As a result, boards have not been willing to recommend such transactions. The commenter said that a price that is lower than the intrinsic value may nonetheless be a very fair price to offer shareholders, and if that price is at a significant premium to the market price, minority shareholders will likely never obtain a better price. This refusal to allow for downward adjustments does not reflect reality, according to the commenter, and was likely to prevent certain value-enhancing transactions. The commenter thought there was double prejudice from allowing "effect of transaction" increases, but not decreases, and from the fact that securities being offered by an acquirer are to be subject to downward adjustments. A preferable route, in the commenter's view, would be to allow for downward adjustments in the valuator's discretion, provided that they are explicitly disclosed along with the intrinsic value. In addition, the commenter thought the Companion Policy should clarify that value does not necessarily equate to fairness, so that, for example, a transaction may be fair even if the price offered is not equal to the intrinsic value.

One commenter suggested that subsection (3) in the 2003 proposed Rule regarding the non-application of National Policy 48 should be moved to the Companion Policy.

Response

The disclosure requirements of the Rule are not exhaustive of the information that may be provided to holders of securities in connection with the transactions covered by the Rule. If, for example, a board of directors of an issuer, in consultation with the valuator, decides that it would be useful for shareholders to have the additional benefit of the valuator's views as to the value of the shares on an adjusted basis, this information can be provided. Where this additional disclosure appears, it should be clearly distinguished from the valuation information that has been prepared in accordance with the Rule. On the commenter's suggested inclusion in the Companion Policy of a statement regarding value and fairness, the Commission prefers to let directors and security holders decide for themselves the weight they wish to attach to the results of valuations.

The Commission agrees with the commenter's suggestion regarding subsection (3) and has moved it to the Companion Policy.

39. Section 6.7 – Valuator's Consent

Comment

One commenter thought the requirement to file the valuator's consent with the Commission seemed to create unnecessary paperwork and should be removed. The commenter also asked why this provision was needed in addition to the required statement of the valuator's consent in the disclosure document, and how the latter requirement works with the provisions of section 6.8 on prior valuations.

Response

The Commission agrees that the filing of the valuator's consent with the Commission is not essential, and the requirement has been removed. On the last question, the statement of the valuator's consent relates only to formal valuations that are prepared as required by the Rule for the transaction to which the disclosure document relates. The requirements that apply to prior valuations are independent of those for formal valuations.

40. Section 8.1 – Minority Approval -- Separate Votes for Each Series – Removal of Subsection (2) from the Current Rule

Comments

Subsection (2) in the current Rule, which provides that holders of a series of securities are entitled to vote separately as a series if the transaction would affect that series in a manner different from other securities of the class, was removed in the 2003 proposed Rule. Two reasons for the removal were set out in a footnote. The first was that the provision was unnecessary in light of the Rule's interpretation of "class", which includes a series. The second was that each series should vote separately even if all series receive identical treatment in the transaction, since the different attributes of a series may warrant different treatment. Two commenters thought subsection (2) should be retained. One thought the analysis in the footnote was flawed. The other said that requiring series votes even where the series are not differentially affected may be inappropriate, as it would give rise to veto rights and associated opportunities to demand ransom fees, and that current subsection (2) was more consistent with corporate law.

Response

The minority approval requirement applies only to votes of holders of equity securities, which are very rarely issued in series, and so this issue will seldom arise. If it does arise, however, the Commission does not consider there to be a strong basis for the Rule to treat multiple series differently from multiple classes. Apart from equal priority in the payment of dividends and repayment of capital, corporate statutes generally do not prohibit different series within a class from having substantially different attributes from one another, even if this may be unusual. If an issuer takes the position that holders of a series have an unfair veto power under the particular circumstances, exemptive relief may be sought. A sentence contemplating this type of situation, as well other circumstances where exemptive relief may be appropriate in the context of a dual class structure, has now been added to section 3.3 of the amended Companion Policy.

41. Section 9.1 – Exemption

Comment

Comment Not on Proposed Amendments: One commenter thought exemptions should also be available from the Commission, in addition to the Director, or that the Rule should expressly provide for a de novo non-deferential appeal to the Commission.

Response

For the purposes of regulatory efficiency, the Commission regards it as preferable for exemptions to be granted by the Director, as is the case for other rules. In a hearing and review of the Director's decision, the Commission is not required to be deferential to the Director and, as provided in the Act, may make a decision, different from that of the Director, as the Commission considers proper.

42. Companion Policy – Subsection 2.1(5) – Principle of Equal Treatment in Business Combinations

Comments

This subsection, while acknowledging that there may be circumstances where not all security holders will be treated identically in a business combination, includes a statement that giving a security holder preferential treatment in order to obtain that holder's support of the transaction will not normally be considered justifiable. One commenter thought the subsection should clarify that a related party that is a buyer or acting in concert with a buyer in the business combination does not have to be treated equally to the sellers. The commenter also thought the subsection is too strong. The commenter said that where a party that has a veto in a minority vote cannot be treated differently, it may be that no transaction can occur. Since the Rule gives vetoes to minority security holders and does not punish them for using the vetoes to get more value, the commenter asked why a substantial security holder is threatened with punishment for using its veto to agree to a transaction that the board considers worthy of doing and on which minority security holders get to vote. The commenter also thought this subsection seemed in direct contrast with section 2.2 of the amended Companion Policy, which interprets a "joint actor" in a bid to include a security holder that is provided with an opportunity not offered to all security holders to maintain or acquire an interest in the offeror, the issuer or the issuer's assets.

Response

The first sentence of the subsection excludes the buyer as a security holder to whom the equality principle applies, and this exclusion would apply to multiple buyers by implication. On the second comment, if it is proposed that a security holder will receive preferential treatment in return for its support of the transaction, the unfairness to the other security holders may override concerns about the possibility of the transaction not occurring. If minority security holders use their veto to get more value for the general body of security holders, and are not treated differently themselves, this is not objectionable. On the last comment, section 2.2 primarily addresses circumstances where an insider essentially would be one of the acquirers of the issuer without being the actual bidder. Section 2.1(5) is directed more toward possible unequal treatment among security holders who relinquish their securities in a business combination, although its application will necessarily depend on the particular facts.

43. 2003 Proposed Companion Policy – Section 2.7 – Redeemable Preference Shares

Comment

Comment Not on Proposed Amendments: In this section, the Commission expresses the view that redeemable preference shares that are immediately redeemed for cash after they are issued to security holders in a business combination are equivalent to cash for the purposes of certain provisions of the Rule. One commenter thought this should be incorporated into the Rule.

Response

The Commission agrees with the commenter and has moved the interpretation to the new draft of the amended Rule as section 1.5.

44. 2003 Proposed Companion Policy – Section 2.8 (section 2.7 in new draft) – Previous Arm's Length Negotiations Exemption

Comment

Comment Not on Proposed Amendments: Subsection (1) clarifies that the arm's length relationship must be between the selling security holder and all persons or companies that negotiated with the selling security holder. One commenter asked if this meant that if a non-arm's length go-between facilitated negotiations, the exemption would not be available. If so, the commenter thought the subsection should be changed because if the buyer is at arm's length, that should suffice.

Response

If a go-between is not at arm's length to the seller but negotiates solely on behalf of the seller in an agency or similar capacity, then the go-between's involvement would not negate the exemption. If that go-between performs a different role, it would not normally be appropriate for the exemption to apply.

45. Companion Policy – Section 5.1 – Formal Valuations

Comment

Comment Not on Proposed Amendments: Subsection (4) includes the statement that it is inappropriate for any interested party to exercise or attempt to exercise any influence over a valuator. One commenter thought it should be clarified that reasoned discussion is not "influence", perhaps by adding "improper" before "influence". Especially in an unsolicited insider bid, the valuator may, according to the commenter, be pushing the value up to please its client, and discussion should be permitted.

Response

The Commission is reluctant to make a change that indicates that it is permissible for an interested party to exert influence on the valuator. "Improper" is subjective, and the valuation requirement is intended to provide security holders with information from a perspective that is truly independent from the interested party. If an interested party disagrees with the results of the valuation, the reasons for the disagreement can be provided to the security holders in the disclosure document for the transaction.