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They're Watching: Securities Regulators Announce Increased Scrutiny of Conflict Transactions

Jeffrey P. Roy, Lara Jackson, John M. Picone, Derek Ronde

September 28, 2017

The Canadian Securities Administrators has released important guidance on the role of target boards and special committees, disclosure requirements and fairness opinions in respect of material conflict of interest transactions and advised that such transactions will now be reviewed on a real-time basis to assess compliance with regulatory requirements and identify any potential public interest concerns.

Highlights

- **Active Role for Special Committees.** Staff are of the view that special committees are advisable for *all* material conflict transactions (even though such committees are only strictly mandated for insider bids), and should be formed and engaged early in the process with a broad mandate, independent advisors and an active role including supervision or direct conduct of the negotiations.
- **Fairness Opinions.** Staff acknowledge that fairness opinions are not strictly required for material conflict transactions and will continue to defer to target boards and special committees to determine whether a fairness opinion is necessary. Where a fairness opinion is obtained, Staff expect the target company to disclose (a) the compensation arrangements with the financial advisor, including whether such compensation is on a flat fee or contingent basis, and an explanation of how the compensation arrangement was taken into account in the consideration of the financial advice provided, (b) details of the methodology, information and analysis (including financial metrics) underlying the opinion, and (c) an explanation of the relevance of the fairness opinion to the board or special committee in their determination to recommend the transaction.
- **Enhanced Disclosure.** In addition to enhanced disclosure for fairness opinions, Staff expect the target company to include enhanced background disclosure, including a thorough discussion of the review and approval process, the target board and/or special committee's reasoning and analysis and their views as to the fairness of the transaction, any reasonably available alternatives to the transaction (including the status quo), and the pros and cons of the transaction.
- **"Real Time" Transaction Review.** Staff will actively review material conflict transactions prior to shareholder approval to assess regulatory compliance and to identify and address any public interest concerns. Among other things, Staff will consider the adequacy of the corporate process in protecting minority shareholders and the adequacy of disclosure in ensuring shareholders are able to make an informed decision. Staff may seek additional information from target companies and, in circumstances of non-compliance or potential public interest concerns, may seek corrective

disclosure, appropriate interim orders or take enforcement action.

Summary and Background

On July 27, 2017, Staff of various securities regulatory authorities published guidance on their views and expectations in respect of the role of target boards and/or special committees, disclosure obligations, and financial advice in respect of material conflict of interest transactions under Multilateral Instrument 61-101 *Protection of Minority Security Holders in Special Transactions* (MI 61-101).

This guidance comes on the heels of recent market debate in Canada regarding best practices relating to fairness opinions, corporate process and disclosure standards in M&A transactions following the Yukon Court of Appeal decision denying approval of a proposed US$2.3 billion acquisition of InterOil Corporation by ExxonMobil Corporation. This decision can be found here and is summarized here.[1]

Although much of the commentary in the Notice is reflective of current market practice and existing jurisprudence (in particular, the Ontario Securities Commission's decision in *Re Magna International*), it provides helpful guidance on compliance with the requirements of MI 61-101 and corporate process, financial advice (and fairness opinions) and disclosure relating to such transactions. Staff has further indicated that it will apply a broad and purposive interpretation to the requirements of MI 61-101 that emphasizes its underlying policy rationale, and will consider evolving security holder and market expectations as well as developments in corporate law and market practice in making its determinations regarding the sufficiency of disclosure.

Review Process

Staff has advised that they will review material conflict of interest transactions on a real-time basis (i.e., during the pendency of the transaction) to assess compliance with MI 61-101 and whether the transaction raises public interest concerns. However, Staff will not require issuers to submit their disclosure documents in advance for review. This differs from the approach taken by the U.S. Securities and Exchange Commission, which requires disclosure documents to be submitted in preliminary form for review before they are mailed to shareholders in their definitive form, and may result in circumstances where deficiencies identified by Staff after mailing necessitate corrective disclosure, potentially causing delay and increased transaction costs. Issuers may consider voluntarily submitting their disclosure documents for review to avoid such delays and costs.

< p>The focus of Staff's review will be on (a) compliance with disclosure requirements that enable security holders to make an informed decision, (b) compliance with formal valuation requirements or with the conditions for exemptions from a formal valuation, (c) minority approval requirements, and (d) the substance and disclosure of the process conducted by the target board and special committee in considering the conflict of interest.

Staff may contact issuers or their counsel once issues are identified, and seek additional information and documentation as part of the review. Importantly, Staff has noted that they may apply for temporary orders delaying completion of the transaction where considered necessary in the public interest.

The potential remedies sought by Staff may include (a) timely corrective disclosure or other actions by the issuer, (b) appropriate orders under securities legislation in relation to the transaction, or (c) enforcement action where Staff believes there has been material misleading disclosure or a failure to comply with other securities laws.

Role of Special Committees

Although the formation of a special committee is only mandated under MI 61-101 for insider bids, the Staff notice clearly states that a special committee is advisable for *all* material conflict of interest transactions, which is consistent with current best corporate governance practices.
Staff are of the clear view that such special committees should, among other things, be formed early in the process (i.e., preferably before a transaction is substantially negotiated), have a broad mandate, conduct a robust review of the proposed transaction independently with the assistance of its own advisors, and be insulated from coercion by interested parties.

Enhanced Disclosure

Additional guidance is provided on disclosure standards, including that the disclosure document should contain sufficient detail to enable security holders to make informed decisions on how to vote or whether to tender in respect of a material conflict transaction, and should avoid any misrepresentations.

Specifically, disclosure in the context of a material conflict of interest transaction generally requires a thorough discussion of (a) the review and approval process, (b) the reasoning and analysis of the board of directors and/or special committee, (c) the views of the board and/or special committee on the desirability or fairness of the transaction, (d) reasonable available alternatives to the transaction, and (e) the pros and cons of the transaction.

Fairness Opinions

Securities legislation does not require a fairness opinion as a condition of proceeding with a material conflict of interest transaction. However, Staff notes that if a fairness opinion has been requested and a financial advisor is not able or willing to provide one, the disclosure document should set out the financial advisor’s reasons for not providing the fairness opinion and should explain how the special committee and board took this decision into account.

The Staff notice outlines the need to provide security holders with a meaningful understanding of the

fairness opinion and how it was considered by the board or special committee. Specifically, the disclosure document should (a) disclose the financial advisor's compensation arrangement in respect of the fairness opinion, (b) explain how the board or special committee took into account the compensation arrangement with the financial advisor when considering the advice provided by the advisor, (c) disclose any other relationship between the financial advisor and the issuer or an interested party that could cause a perceived lack of independence, (d) provide a clear summary of the methodology, information and analysis used without overwhelming security holders, and (e) explain the relevance of the fairness opinion in coming to the decision to recommend the transaction.

If you have any questions concerning MI 61-101, CSA Staff Notice 61-302 or on any other matter regarding securities disclosure obligations, please contact Jeffrey Roy, Wendy Berman, Lara Jackson, Derek Ronde, John M. Picone, or any other member of the Cassels Securities and Securities Litigation Groups.

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[1] Cassels Brock acted on behalf of the applicant shareholder in the *InterOil* case.
