Canadian Securities Administrators Provide Guidance on M&A Transactions Involving Material Conflicts of Interest

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Summary

The securities regulatory authorities of Ontario, Québec, Alberta, Manitoba and New Brunswick (the "CSA Members") published a notice (the "Notice") on July 27, 2017 relating to M&A transactions which involve a material conflict of interest, such as insider bids and certain business combinations.[1] The Notice published by staff ("Staff") of the CSA Members addresses the following:

- Staff review and oversight of material conflict of interest transactions;
- Staff views with respect to the role of boards of directors and special committees; and
- Staff views with respect to disclosure obligations in connection with public M&A transactions involving material conflicts of interest, including as they relate to fairness opinions.

The securities regulatory authorities of Ontario (the Ontario Securities Commission ("OSC")) and Québec (the l'Autorité des marchés financiers ("AMF")) previously adopted rules addressing material conflict of interest transactions (see Multilateral Instrument 61-101 — *Protection of Minority Security Holders in Special Transactions* ("MI 61-101")). The Notice confirms that Staff will, as a matter of course, review the disclosure documents (including those provided to security holders) relating to material conflict of interest transactions. In addition, the Notice indicates that the securities regulatory authorities of Alberta, Manitoba and New Brunswick propose to adopt a review approach to conflict of interest transactions consistent with that of the OSC and AMF. The securities regulatory authorities of Alberta, Manitoba and New Brunswick formally adopted MI 61-101 as a rule effective July 31, 2017.

The Notice describes "material conflict of interest transactions" as transactions in respect of reporting issuers which involve related parties and are structured as *insider bids*, *issuer bids*, *business combinations* and *related party transactions*, each as defined in MI 61-101.[2] Accordingly, arm's length transactions not involving related parties are not the focus of the Notice.

As stated in the Notice, "MI 61-101 establishes a securities regulatory framework that mitigates risks to minority security holders when a related party of the issuer, who may have superior access to information or significant influence, is involved in a material conflict of interest transaction".

The Notice provides guidance in respect of a number of the issues involving material conflicts of interest which had been referred to in prior OSC decisions. The Notice also emphasizes that Staff expects market participants to take a purposive interpretation of the requirements of MI 61-101 and "to adopt practices designed to effectively mitigate conflicts in material conflict of interest transactions".

Staff Review of Transactions

The Notice confirms that Staff will "generally initiate a review of a material conflict of interest transaction upon the filing of a disclosure document". Any complaint received by Staff will factor into the review. Staff's review will focus not only on compliance with disclosure requirements, but also on the process employed by the issuer's board of directors in negotiating and reviewing a proposed transaction and whether that process raises concerns that the interests of minority security holders have not been adequately protected.

Staff may ask the relevant parties detailed questions and request supporting documents (including minutes of board and special committee meetings, work product associated with a formal valuation and other relevant materials).

The Notice also sets out the remedial action Staff may seek in the event of non-compliance, including corrective disclosure, orders under securities legislation (*e.g.*, cease trade orders) and enforcement action.

Staff Views on Special Committees and Enhanced Disclosure

The Notice provides guidance with respect to Staff's views of the role of special committees and disclosure to the shareholders in the context of material conflict of interest transactions, including the following:

- timely formation and effectiveness of special committees;
- composition of special committees;
- role and process of special committees;
- mandates of special committees;
- role of special committees in negotiating transactions;
- role of special committees in retaining financial advisors and the use of fairness opinions; and
- the importance of insulating special committees from "coercive conduct" on the part of interested parties.

In the Notice, Staff provides its views on the role of special committees but also notes that the formation of a special committee of independent directors is not the sole governance arrangement that can protect the interests of minority security holders.

The Notice also provides guidance on the expectations of Staff with respect to enhanced disclosure in materials provided to security holders in the context of material conflict of interest transactions, including with respect to the following:

- background to the transaction and process followed by the target;
- desirability or fairness of transaction;
- board of directors and special committee recommendation; and
- fairness opinions.

Staff Views on Fairness Opinions

The guidance provided with respect to fairness opinions addresses some of the issues raised in the context of recent Yukon court decisions in the *InterOil* matter.[3] There the Yukon Court of Appeal had commented on concerns relating to a fairness opinion provided by InterOil's financial advisors, as well as concerns with respect to the process adopted by the board in respect of a proposed plan of arrangement involving an unrelated entity which was not a material conflict of interest transaction as defined in the Notice. See our bulletins dated March 27, 2017 and December 9, 2016.

The Notice reiterates that fairness opinions are not mandated by law and that it is the responsibility of the board of directors and special committee to determine whether a fairness opinion is necessary "to assist in making a recommendation to security holders", and that it is generally the responsibility of the board of directors and the special committee "to determine the terms and financial arrangements for the engagement of a financial advisor". The Notice stops short of commenting on whether compensation arrangements of a financial advisor which include a success fee bring into question the impartiality of a fairness opinion provided by that advisor (as the Yukon Court of Appeal had commented in *InterOil*). Moreover, Staff cautions that a special committee cannot substitute the "results of a fairness opinion for its own judgment" with respect to a transaction. The Notice also comments that if a fairness opinion is requested and not provided, Staff expects the issuer to provide an explanation of the reasons to security holders.

The Notice recommends that when a fairness opinion is obtained for a material conflict of interest transaction, the disclosure document provided to security holders should:

- disclose the financial advisor's compensation arrangements;
- disclose how the board or special committee took into account the compensation arrangement with the financial advisor when considering the advice provided;
- provide a clear summary of the methodology, information and analysis (including, as applicable, financial metrics) underlying the opinion; and
- explain the relevance of the fairness opinion to the board of directors and special committee in coming to the determination to recommend the transaction.

In this respect, Staff also refers to rules of the Investment Industry Regulatory Organization of Canada ("IIROC") which address disclosure requirements relating to fairness opinions provided by IIROC members in the context of “subject transactions” (defined similarly to material conflict of interest transactions generally), as well as standards of The Canadian Institute of Chartered Business Valuators.

Practical Implications for Market Participants

The Notice is a reminder to market participants of the importance of process and comprehensive disclosure in M&A transactions, and in particular in the context of material conflict of interest transactions. As the Canadian disclosure regime does not contemplate pre-clearance of disclosure documents by CSA Members, deficiencies in disclosure documents noted by Staff after mailing may necessitate corrective disclosure (among other regulatory actions) which may impact on the timing of a transaction. The Notice makes it clear that Staff expects that disclosure documents will provide more than the minimum prescribed by the applicable form requirements.

Another point to note in light of the deferential approach of Staff to compensation arrangements of financial advisors, is that market participants will need to continue to be mindful of the judicial approach to expert evidence as it may apply to fairness opinions in the context of court-approved M&A transactions.

Conclusion

The Notice's guidance highlights the sensitivity of CSA Members to M&A transactions involving related parties and formalizes the approach of Staff to the systematic review of disclosure documents and processes. While providing standards with respect to the role of special committees, disclosure obligations and fairness opinions in the context of material conflicts of interest transactions, the Notice leaves to issuers to determine how matters should be dealt with in arm's length M&A transactions.

[1] Multilateral CSA Staff Notice 61-302 — *Staff Review and Commentary on Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions (2017)*, 40 OSCB 6577

[2] The Notice does clarify that business combinations which are subject to MI 61-101 only as a result of employment related collateral benefits would have not generally been included in what Staff considers to be "material conflict of interest transactions".

[3] *InterOil Corporation v. Mulacek*, 2016 YKCA 14; *Re InterOil Corporation*, 2017 YKSC 16

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