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**CORPORATE FINANCE —
RECENT DEVELOPMENTS OF IMPORTANCE**

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by

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RECENT DEVELOPMENTS OF IMPORTANCE

The regulation of the Canadian securities market is changing rapidly as regulators are placing increased focus on aligning continuous disclosure liability with that which presently exists in Canada for misrepresentations in prospectuses, the process of the review of prospectuses, applications for exemptive relief and for registrations is becoming streamlined as Canada begins implementing a virtual national securities commission, and regulators are finding ways to make regulation more responsive to new financial instruments such as asset-backed securities.

In addition to the regulatory developments there has been considerable development of new financing instruments. Some new financial instruments, such as the growth in REITS, are linked to developments in the United States market but have been restructured to address Canadian securities and tax issues; others, such as installment receipt transactions and issues pertaining to the enforcement of nonpayment by holders, raise unique Canadian issues. The proximity of the Canadian and U.S. markets and the significantly different tax regimes have given rise to mergers and acquisitions using exchangeable shares as currency that raise securities law issues.

These developments have occurred in an environment where many of the principal regulators are becoming self-funding and where more resources are being directed to continuous disclosure review and to finding ways to enforce securities laws more effectively.

REGULATORY INITIATIVES

TSE Committee Report on Corporate Disclosure

The Toronto Stock Exchange Committee on Corporate Disclosure (the "TSE Committee") released a report in March 1997 entitled "Responsible Corporate Disclosure: A Search for Balance" (the "Report"). The Report has had a significant impact on public awareness of the issue of statutory liability for continuous disclosure materials similar to liability attaching to prospectuses in Canada and to prospectuses and continuous disclosure material in the United States. In view of the implementation of the multijurisdictional disclosure system between Canada and the United States in 1991 (the "MJDS"), it is somewhat anomalous that such a regime has not been implemented already. The anomaly is that under applicable U.S. legislation, a Canadian issuer can carry out an offering of securities under the MJDS system in the U.S. and Canada simultaneously using substantially the same prospectus and under comparable statutory liability regimes; however, where the investor resells the securities to a third-party, a U.S. third party purchaser has a remedy if there was a misrepresentation in the continuous disclosure documents of the issuer whereas a comparable buyer in Canada currently does not.

The TSE Committee was established with a mandate to review continuous disclosure by public issuers in Canada, assess the adequacy of disclosure, and ascertain whether additional remedies should be made available to aggrieved investors. In establishing the scope for review by the TSE Committee, the TSE recognized that the risks associated with the lack of adequate disclosure directly impact the cost of capital as well as have a significant impact on the credibility of the marketplace. The TSE also recognized the fundamental principle that the capital markets are built on a foundation that assumes full, true, and plain disclosure of all material facts in prospectuses and continuous disclosure materials, and that investor expectations on disclosure are increasing as the marketplace grows more international and investors bring heightened expectations on disclosure based upon practices in other jurisdictions.

In responding to its mandate, the TSE Committee observed that there was a sufficient degree of noncompliance with the continuous disclosure regime to cause concern. The TSE Committee found that remedies at common law were inadequate in that, in addition to other deficiencies, establishing reliance on a misrepresentation was difficult, and remedies were for practical purposes unavailable. Accordingly, the TSE Committee recommended a statutory regime to impose liability for misrepresentations in continuous disclosure documents.

Press coverage of the proposals of the TSE Committee was widespread and supportive of the recommendations. The Canadian Securities Administrators, consisting of representatives of the principal regulators in Canada (the “CSA”), quickly established a task force to develop recommendations responding to the TSE Committee’s conclusions. In late 1997 several members of the CSA submitted to their governments recommendations that legislative amendments responding to the TSE Committee be implemented. The CSA proposed legislative amendments in May 1998 to implement the main recommendations of the TSE Committee.

The CSA proposals are far-reaching and would impact on the level and quality of disclosure in those jurisdictions that adopt the legislation. The proposals mandate that those who trade in securities of any publicly traded issuer would have a statutory claim for damages if they bought or sold during a continuous disclosure violation. A violation period begins when an issuer or someone representing the issuer either releases a document or makes a public oral statement about the issuer that contains a misrepresentation or where an issuer fails to issue and file a news release immediately after a material change in the affairs of the issuer. The liability period would terminate when the issuer publicly corrects the deficient information record.

Documents for which liability may attach will include those filed with securities and governmental authorities and include letters from management to security holders and news releases. Those who could be sued for breach depend on the situation but include the issuer, directors, officers, other insiders, and experts. The CSA has also proposed significant penalties for continuous disclosure violations.

If the legislation is implemented, increased attention by issuers and their directors and legal advisers will be given to continuous disclosure documents and public oral statements may be somewhat curtailed or at least involve greater scrutiny by a larger range of participants before disclosure occurs. Violations may also lead to more class action lawsuits in Canada. The implementation of the regime should further harmonize the disclosure standards of the U.S. and Canada and reduce the anomaly in Canada between statutory liability under prospectuses and the absence of statutory liability in the vastly larger secondary market.

Virtual Securities Commission

Offering of securities in Canada is regulated by 12 provincial and territorial regulators. When a prospectus is filed or an application for relief is requested, in each jurisdiction the submissions are considered by all regulators. Each of the jurisdictions has its own statute to enforce and a staff that may have different approaches. This structure can lead to inconsistent results and can make it difficult to predict outcomes for market participants. Local regulation can be inefficient for any foreign issuers not entitled to use the MJDS or other mechanisms to access the Canadian market.

There have been attempts for decades to establish a Canadian national securities commission but to date jurisdictional disputes have made this goal unattainable. Recognizing this, the CSA has proposed a regulatory framework to implement a “virtual national commission” where market participants could

deal with one regulator acting as the principal regulator for prospectus review, applications for exemptive relief, and registrations.

Early signs of this regulatory trend were implemented several years ago under the “expedited review” system. Under that system, seasoned issuers are entitled in national filings of prospectuses to have one regulator in the chosen principal jurisdiction clear the prospectus on behalf of most of the other authorities. The regulators of the nonprincipal jurisdictions are normally content to rely on the review by the principal jurisdiction. This system has been an effective start to reduce the complexity of the regulatory regime for issuers and to implement an efficient use of regulatory resources in multijurisdictional filings.

A memorandum of understanding and a procedural and substantive framework has been proposed by the CSA to implement the concept of the virtual national commission. The CSA stated in its releases that implementing such a system was designed to facilitate the harmonization of legislative requirements and administrative practices across jurisdictions and to provide consistent treatment for filers. The CSA has indicated that the thrust of the new regime will be that, in exercising jurisdiction under securities regulation, a regulator will be prepared to rely principally on the analysis and review of staff of another securities authority. The mutual reliance system is intended to involve no surrender of jurisdiction by any securities authority and each authority will retain statutory discretion. The system is at a test stage and is a significant step to achieving the logistical benefits of a single regulator without the political and constitutional issues involved in abandoning local regulation.

In the context of a prospectus filing, a principal jurisdiction would be chosen by the issuer based generally on the location of the head office of the issuer. Foreign issuers can choose a principal regulator based on some reasonable connection with the jurisdiction. The principal regulator is responsible for reviewing the prospectus, and the issuer will generally only deal with that regulator in resolving issues. A nonprincipal regulator can elect to opt out of the mutual reliance system if issues arise that concern that regulator.

The system should reduce duplication and be efficient but the time periods for review are not necessarily reduced. With a longform prospectus the principal regulator has up to ten working days from the receipt of materials, and each nonprincipal jurisdiction is required within an additional five working days to advise the principal jurisdiction of any material concerns that if left unaddressed would cause the regulator to opt out of the system. However, it is expected that the time periods should be effectively shortened with the increasing use of “selective review” or “no review” and the presumed willingness of nonprincipal regulators to respond before the expiry of five days. Foreign issuers doing an international offering through a countrywide filing in Canada should find that the periods are not longer than other jurisdictions and that the real advantages come from reducing duplication and the logistical and other efficiencies that should be brought to the review process.

It is still too early to determine how effective the system will be; however, the CSA has indicated that it intends to examine extending the virtual commission concept to continuous disclosure, which would further streamline regulation.

Access to the POP System for Asset-Backed Securities

The asset-backed security market has experienced exponential growth in the U.S. over the last 15 years and has grown rapidly in Canada over the last ten years. Asset types secured include mortgage-backed securities, credit card receivables, trade receivables, fleet vehicle leases, mutual fund fees, and government receivables. The growth of asset-backed securities has been hampered by the fact that the

prospectus regime in Canada is not currently flexible enough to accommodate the unique structure and characteristics of asset-backed securities.

Most securitizations in Canada are done through special-purpose vehicles such as trusts, and to a lesser extent, corporations. Almost all offerings have been sold to institutional investors through private placements. This is quite unlike the U.S. market, where offerings are often done by prospectus and where the retail market is quite developed. The major reason prospectuses have not generally been used is that a special-purpose vehicle is required to do a public offering by way of a long-form prospectus and is not eligible to immediately enter the “POP”(i.e., Prompt Offering Prospectus) system. The POP system permits an issuer who would otherwise be required to file a long-form prospectus to use a short-form prospectus of some 12-15 pages in length, with the continuous disclosure documents of the issuer incorporated by reference into the short-form document. Consequently, where the POP system cannot be used, a securitization offering involves the filing of a long and complicated prospectus for each offering that is subject to a review process that can take several weeks to complete. Most asset-backed securities are interest-rate-sensitive, and an issuer could have a deal aborted before a prospectus is cleared.

Recognizing that asset-backed security vehicles needed a more accommodating system, the CSA has proposed that special-purpose vehicles be permitted into the POP system without being subject to the normal requirements that the issuer have been a reporting issuer for 12 months or meet other criteria. Instead the asset-backed security issuer will only have to meet certain credit rating requirements. The issuer would not have to prepare extensive disclosure on the special-purpose vehicle at the time of filing but would be permitted, by way of an annual information form (similar to a 10-k in the U.S.), to be in place prior to filing the POP prospectus, to be incorporated by reference into the POP prospectus. This disclosure would include all of the structural cash flow and other disclosure unique to asset-backed securities.

One area of disclosure that is difficult for issuers of asset-backed securities is the form requirements of applicable regulation that currently emphasize operational and business-type disclosure that is not relevant to investors making investment decisions with respect to this type of security. The vehicles are largely structural vehicles, and investors' focus on disclosure are on matters such as the protections built into these vehicles for investors, information on the credit history of the assets secured, and disclosure on cash flows. The proposals address these concerns and propose modifying disclosure to reflect the special nature of the asset-backed security entity.

This proposal is a flexible approach to asset-backed securities financings and should enable issuers to access the public markets promptly and efficiently. A companion policy to admit special-purpose vehicles to the shelf prospectus system is also currently being proposed. The combination of these two initiatives should be a catalyst to market participants to access the retail capital markets and result in a deeper asset-backed security market in Canada.

NEW FINANCING INSTRUMENTS

REITS In Canada

One of the faster-growing financing vehicles in recent years has been REITS (Real Estate Investment Trusts). REITS have been offered both by private placement and prospectus. These vehicles have been encouraged largely by institutional and other investors being willing to invest in real estate after the troubling times in the real estate market in Canada in the early 1990s.

REITS have been sold publicly by way of initial public offerings and include diverse investments in shopping centers and office buildings as well as specialized portfolios in hotels and nursing homes. Many of the earlier REITS established are now able to access the public markets through the POP system. The short form allows an issuer to clear a prospectus with regulators normally within five days. The shelf prospectus procedure is also available to short-form issuers so that REITS can establish a base prospectus that is effective for two years and can be used to offer securities in tranches.

REITS are most often structured as trusts (although corporations do exist) that invest in income-producing real estate and mortgages and are designed to be attractive from a tax perspective and offer an attractive yield compared to other investment vehicles. Early evidence indicates that more REITS will be done in Canada, that more specialized REITS will be developed, and that increasingly foreign investors are becoming interested in Canadian REITS. More initial public offerings of REITS in Canada are expected as long as the real estate market continues to be favorable. It is likely that there will also be merger and acquisition transactions involving REITS as acquirors see opportunities to combine existing REITS.

Installment Receipts

Installment receipt transactions have been popular in Canada for many years but the recent downturn in capital markets and the risk of nonpayment may impede the growth of these instruments.

Installment receipt transactions for equity and debt have been offered and are sold normally by prospectus. They require an initial payment on closing and the balance in one or two installments over up to two years. Installment receipts are attractive instruments to an issuer because they allow an issuer that may not be able to sell fully priced securities in the market to nevertheless access the capital market at attractive prices, and they are beneficial to investors since the investors can invest their capital over time while recovering the benefits of the full investment immediately.

Most installment receipts are listed on a stock exchange and trade like the underlying securities. Holders have the same rights as holders of the underlying security, including the right to vote and receive dividends or interest. Holders are liable to pay the balance of the purchase price when due, and mechanics have been established to attempt to make these obligations legally enforceable. The underlying securities are pledged by the underwriters as security for the obligation of the holders to pay the amounts owing on the installments. In almost all cases to date, purchasers have made the final payment or payments when due, but there is at least a theoretical issue as to whether subsequent purchasers of installment receipts are bound by the terms of the installment receipt agreement to which they are not contractually bound.

Recently some installment receipts have traded at prices just before the due date of the installment, that imply a value for the underlying security that is lower than the installment amount. In a few cases holders have defaulted in paying the installment. Offerors have indicated their desire to enforce payment, and there may be cases coming before the courts that will examine the legal obligations of a subsequent holder to make payment for any deficiency between the value of the underlying securities and the installment amount owing. In the meantime, issuers may be reluctant to do installment receipt deals given the risk of price decline and nonpayment.

Exchangeable Shares

Continued interest in exchangeable shares was demonstrated in the recent merger of Merrill Lynch & Co., Inc., and Midland Walwyn Inc., where an exchangeable share structure was utilized to complete a complex merger.

The structures for exchangeable share transactions vary, but the principal element is that a foreign acquiror offers to acquire the shares of a Canadian company in return for exchangeable shares of a special-purpose Canadian company owned by the acquiror. The exchangeable shares have the same economic and legal rights as the shares of the acquiror, such as equivalent voting rights and dividends, and contain the right to exchange the exchangeable shares for the U.S. public company's shares over a period of years.

There are advantages of these securities for both the acquiror and the target shareholder. Because the transaction is a share-for-share transaction, the acquiror may be able to obtain pooling treatment in accounting for the acquisition. This has the advantage of the acquiror not having to amortize goodwill on the transaction against earnings, which would reduce earnings per share for an extended period. The principal attraction to a Canadian resident shareholder is that, because the shares acquired are issued by a Canadian entity, a tax-free rollover is generally available until the exchangeable shares are ultimately exchanged for the acquiror's shares. This rollover is not normally available to Canadian residents if they receive shares directly in a U.S. acquiror.

Securities law issues arise on the various trades that take place while the exchangeable shares are outstanding. Exchangeable shares contain various put and call rights and provide for exchange, in some cases mandatory, and in some cases at the option of the holder, into shares of the U.S. acquiror. Not all of these trades and resales are exempt from prospectus and registration requirements under applicable securities law, and it has been customary for orders to be issued for these types of transactions to permit the issuance and resale of the exchangeable shares. The securities statutes vary from province to province, and coordinating the applications for the exemptions can be time-consuming and complicated.

However, the virtual national commission system can and will be utilized for exchangeable share transactions. The virtual commission approach to exemptive relief will be advantageous because when the system is fully implemented an issuer will only have to apply to the principal jurisdiction for relief and an order likely covering all the jurisdictions where the exchangeable shares are offered will be issued.

As long as a tax deferral is available to Canadian residents and the acquirors can obtain pooling treatment, these types of transactions should continue. With the introduction of a virtual commission concept, exemption relief should be expedited and further encourage cross-border acquisitions through exchangeable share transactions.

THE FUTURE

David Brown, the new Chair of the Ontario Securities Commission, has indicated in recent public appearances a desire to be innovative and to significantly change the direction of the Ontario Securities Commission (the "OSC"). The OSC is the largest, and is widely recognized as the principal, securities regulator in Canada.

Many of the changes contemplated by the Chair are made possible by the OSC recently becoming a self-funded and independent crown corporation. This means that the fees that the OSC

collects will now be retained by the OSC rather than being passed on to the general fund of the Ontario government.

With these new financial resources the Chair has indicated that one of his priorities will be to increase the OSC staffing by an additional 50 percent by the end of 1999. Many of the new staff will work in enforcement and compliance. Consistent with this, the OSC has asked the Ontario government for additional powers of enforcement. The Chair has indicated that the OSC will make increased use of cease-trade orders to deal with violations. With the increased funding and enforcement comes a clear philosophy as well: The Chair has indicated that his approach to regulation will be one of self-compliance, and to protect capital market participants, penalties will be high for those in breach of the legislation.

The Chair seems reconciled to the view that a quest for a national securities commission is probably not useful, and he appears committed to continuing development of the virtual national commission. It appears that his attention will be more focused on the overlap between federal and provincial regulation, as he has observed that there appears to be a considerable amount of duplication of regulation in Canada between the federal government regulating banks and the provincial governments that regulate the securities industry. The thrust of his proposals is that one regulator should be responsible for prudential concerns such as the financial viability of participants, whereas another regulator should focus on the trading and other market activities of all participants.

These recent developments at the OSC, the movement toward liability for continuous disclosure, the development of the virtual national commission, the considerable innovation in the securities marketplace with new financing products, and the increased funding of securities regulators should continue the trend toward making the Canadian markets an efficient, receptive, and innovative market for Canadian and foreign participants.

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Philip Brown practices corporate/commercial law with an emphasis on mergers and acquisitions and corporate finance. Phil acted for Midland Walwyn in its merger with Merrill Lynch and acts for The Toronto-Dominion Bank in the proposed merger with the Canadian Imperial Bank of Commerce. Phil has acted on U.S. and Canadian private and public offerings of securities including for clients such as EdperBrascan, Westcoast Energy, Union Gas, Gordon Capital, Nesbitt Burns, Stanley Technology, Great Lakes Power, Trilon, Inmet Mining, AGF Management and Merrill Lynch Canada. Phil has a particular interest in innovative corporate finance transactions and various forms of structured transactions. From 1990 to 1994, Phil lectured in corporate finance and securities regulation at Osgoode Hall Law School, York University. He was called to the Bar in Ontario in 1986.