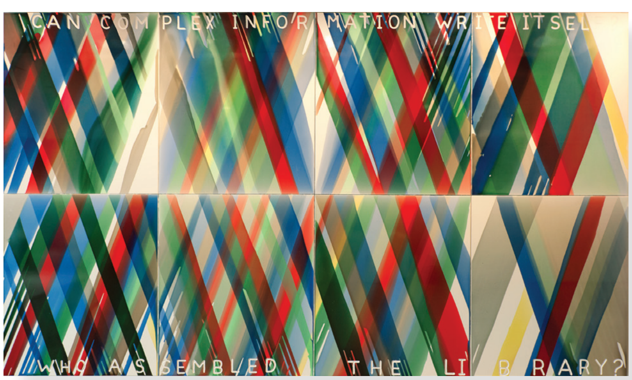
TORYS LLP

Capital Markets 2012 Mid-Year Report



Untitled (Who Assembled the Library?), by Graham Gillmore, 2012.

This painting was commissioned specifically for the reception area in our Calgary office. Gillmore is a Vancouver-born artist who divides his time between his studios in British Columbia and New York.

Cover photo: Untitled, by Graham Gillmore, 2012 (detail).

Contents

Overview

Capital markets in 2012 in North America

If uncertainty in the capital markets is not the new normal, it has at least persisted for several quarters. Many of the themes that clouded the outlook for the markets in mid-2011 remain the same for mid-2012: European stagnation; political debate between austerity and stimulus; concerns about the lack of consumer spending in China; and in Canada, the uncertain future ownership of the TSX. On May 31, 2011, the S&P/TSX Composite closed at 13,802 points; on May 31, 2012, it closed at 11,513 points.

Recent elections in Europe, the pending election in the United States and the likelihood of fiscal and monetary stimulus in China point to a policy shift to emphasize growth at the expense of austerity, later in the year. Equity markets may enjoy a corresponding rebound at that time. In the meantime, as in 2011, Canadian investors have continued to favour issuers with high yield and predictable earnings.

Canadian regulators have sought to address issues of fairness and transparency in the Canadian market. The Ontario Securities Commission's emerging-market review is aimed at enhancing investor confidence, as the TSX continues its efforts to attract listings from across the globe. The Canadian government is taking steps to ease federally regulated financial institutions off their reliance on federal guarantees to support their financing needs. In the United States, the federal government has sought to alleviate some of the expense and complexity of the daunting U.S. IPO process by passing the JOBS Act. The relative simplicity and condensed timing of the Canadian public offering process is demonstrated by the case of an unsolicited bidder accessing the public debt markets within the time frame of a takeover bid. Canadian retail investors' thirst for predictable yield products has been sated, in part, by issuers investing in foreign business or income-producing assets that are excepted from the definition and tax regime associated with SIFT trusts. While capital raising on stock exchanges is relatively slow, capital raising for infrastructure transactions is growing and poised to increase dramatically. For Canadian banks, the implementation of the Basel Committee's requirements on non-viable contingent capital looms on January 1, 2013, but as yet there has been no first mover.

Each of these issues is discussed in detail in this report, and we hope you find this analysis of interest. Torys lawyers – in Toronto, New York and Calgary – would be pleased to discuss any of these topics with you.

June 2012

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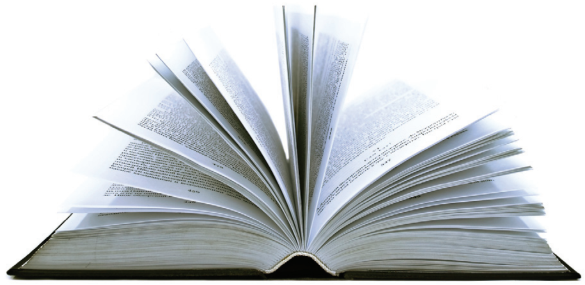

Basel III Revisited

Why has no Canadian bank issued non-viable contingent capital?

Blair Keefe

Almost 18 months ago, the Basel Committee released its new requirement that all non-common capital instruments issued on or after January 1, 2013, must contain provisions that require the instruments to be converted into common shares (so-called non-viable contingent capital, or NVCC) if the relevant regulator determines that the bank is no longer viable. Capital instruments without NVCC features that are outstanding on January 1, 2013 (even those issued in 2012) will no longer qualify as capital and will be phased out in the manner discussed below. Almost 12 months ago, the Office of the Superintendent of Financial Institutions (OSFI) issued its final advisory on NVCC instruments, which customized the Basel rules for the Canadian market. As of October 31, 2011, the largest six banks[1] in Canada had approximately C$73 billion worth of non-common capital (mainly in the form of preferred shares and subordinated debt) outstanding, which will generally[2] be amortized commencing with effect from January 1, 2013. However, to date, no bank has issued any NVCC-compliant instruments. This article discusses some of the possible reasons why no bank has issued any of this capital.

Generous Phase-Out Rules for Existing Capital Instruments

The transition rules fix the base of the nominal amount of all non-NVCC-compliant instruments outstanding on January 1, 2013,[3] and cap their recognition at 90% commencing on January 1, 2013; the cap is reduced by 10 percentage points each subsequent year. However, when a redemption occurs after 2013, the nominal base is not reduced for purposes

[1] According to their annual financial statements prepared as of October 31, 2011, the largest six banks had the following aggregate non-common capital instruments outstanding: TD Bank C$18.353B; RBC C$16.088B; BNS C$14.007B; BMO C$11.713B; CIBC C$9.331B; and NBC C$3.62B.

[2] It is possible in limited circumstances to amend the terms of existing investments to enable them to comply.

[3] The transition rules are applied separately to non-qualifying tier 1 and tier 2 capital instruments. Capital instruments issued after September 12, 2010, that do not meet one or more of the Basel III criteria for regulatory capital (other than the NVCC requirement) will be excluded from regulatory capital effective January 1, 2013.

of the calculation. Therefore, if a bank had, say, $1 billion worth of non-qualifying capital outstanding on January 1, 2013, and redeemed $200 million during 2013, then that $200 million would serve as "amortization shelter" and the bank would be able to treat all $800 million worth of its non-qualifying capital outstanding as eligible until 2015. Given the amount of capital that will be eligible for redemption at par between 2013 and 2015, these transitional rules should permit most, if not all, of the existing outstanding non-qualifying capital to receive full capital credit, especially during the first few years of this transition.

In our view it is unlikely that there will be any issuances of NVCC instruments until at least the fall of this year and possibly not until 2013.

Investor Uncertainty over Future Dilution

In October 2011, the Financial Stability Board (FSB) issued a paper titled "Key Attributes of Effective Resolution Regimes for Financial Institutions." The paper provided that resolution authorities should be able to convert all or part of the unsecured and uninsured creditor claims into equity or other instruments of ownership of the financial institution under resolution in a manner that respected the hierarchy of claims in liquidation. Many observers believe that this requirement could be satisfied with the bridge banking regime that was inserted into the *Canada Deposit Insurance Corporations Act* during the financial crisis. However, the U.K.'s governmental response to the Independent Commission on Banking (the so-called Vickers Report), issued in December 2011, proposed that institutions hold additional "bail-in" debt above the Basel III requirements in the form of uninsured and unsecured debt instruments. The U.K. proposal would have the bail-in senior debt converted to equity in the event that the conversion of the NVCC instruments was insufficient to restore the viability of the institution.

There has been no public comment in Canada regarding whether the bridge banking regime will satisfy the FSB's requirements or whether Canada will be adopting some form of additional bail-in debt requirements. This uncertainty is difficult for potential investors in NVCC instruments because after their instruments are converted into common shares, their position may be significantly diluted further if the bail-in debt trigger is breached.

Cost of Capital Will Increase Significantly

In contrast with other capital innovations over the years, there is no "first mover advantage" for the issuer of NVCC instruments. In fact, it is widely expected that the first issuances of NVCC instruments will require a significantly higher dividend coupon or interest rate to compensate investors for the perceived additional risk over existing instruments. Over time, it is expected that this risk premium will decrease as the market becomes more reassured that the possibility of the trigger event occurring is remote. Therefore, no economic incentive exists for any institution to be the first to spend time and money developing and marketing this new form of capital.

Concern That the United States Will Not Adopt NVCC Requirements

The final NVCC rules released by the Basel Committee on January 13, 2011, provided for a jurisdiction to receive an exemption from the new requirements if the governing legislation applicable to its banks required all non-common tier 1 and tier 2 instruments to be written off if the institution became non-viable or otherwise required those instruments to fully absorb losses before taxpayers were exposed to loss. For the jurisdiction to qualify for the exemption, a peer group comprising other regulators would need to review and confirm that the jurisdiction's laws satisfied the required conditions. It is widely believed that these provisions were inserted at the request of U.S. officials on the basis that the *Dodd-Frank Wall Street Reform and Consumer Protection Act* and other regulatory changes made in that country would satisfy the requirement. To date, however, no peer group appears to have been established to conduct a review and there is not much discussion in the industry about adopting the NVCC requirements in the United States. It is therefore possible that the United States will not obtain peer review confirmation but will still not impose the contractual NVCC requirements on its banks. This would create a significant competitive disadvantage for Canadian banks in relation to their U.S. counterparts.

The Importance of Common Share Equity Under Basel III

Under the new Basel III rules, common share equity has become the predominant form of capital, and non-common capital has become less important. As a result, banks have been stockpiling undistributed earnings, which have driven the banks' total capital significantly above minimum required levels. In addition, subordinated debt will become particularly less important in the capital structure when the asset-to-capital multiple becomes based on total tier 1 capital rather than on total capital under the Basel III rules in 2018.

Implications

In our view it is unlikely that there will be any issuances of NVCC instruments until at least the fall of this year and possibly not until 2013. We also anticipate that, with the generous phase-out provisions for the existing non-conforming capital and the increased focus on common share equity, it will be a long time before the NVCC instruments will come close to matching the amount of non-common capital outstanding today.

Blair Keefe is chair of the firm's Financial Institutions Practice and co-head of the Payments and Cards Practice Group. His practice focuses on corporate and regulatory issues relating to financial institutions, including mergers and acquisitions and corporate finance. He is repeatedly recognized as a leading banking and financial institutions lawyer in Canada.

Cross-Border Income Funds

A panacea for real estate investment trusts?

Simon Knowling, Corrado Cardarelli

In Torys' 2011 *Capital Markets Mid-Year Report*, we wrote about cross-border income funds (CBIFs) – specifically, how the CBIF structure presents an option to entities focused on investing exclusively in foreign businesses or income-producing assets to offer an investment product that delivers yield to investors on a tax-efficient basis.

A CBIF is essentially a Canadian income fund, trust or partnership that would otherwise be a SIFT entity (specified investment flow-through entity, which is subject to corporate tax rates on distributions that are derived from income and gains from non-portfolio properties) except that it owns no non-portfolio properties, primarily because the underlying business and properties are located outside Canada.

"Non-portfolio property" is defined in the *Income Tax Act* (Canada) to be (i) a security in a "subject entity," other than an entity that is a portfolio investment entity; (ii) a *Canadian* real, immovable or resource property; or (iii) a property that the entity uses in the course of carrying on a business in *Canada* (emphasis added). A subject entity is generally a Canadian corporation, trust or partnership. A portfolio investment entity is an entity that does not own any non-portfolio property. Of importance, then, is that a Canadian corporation, trust or partnership that itself owns no non-portfolio property (because it ultimately owns only securities of a non-Canadian entity that carries on business solely outside Canada) will be a portfolio investment entity so that its securities, when owned by a CBIF, would not be non-portfolio property to the CBIF, and the CBIF will therefore not be a SIFT.

In our 2011 report, we mentioned two initial public offerings by CBIFs in the energy sector – Eagle Energy Trust and Parallel Energy Trust. Since then, among other CBIFs, Dundee International REIT completed its initial public offering (in August 2011), Slate U.S. Opportunity (No. 1) Realty Trust completed its initial public offering (in April 2012) and Pure Multi-Family LP recently filed (in May 2012) a preliminary prospectus for its initial public offering.

To recap, in October 2006, the Canadian government introduced rules that provided that most publicly traded trusts and partnerships falling within the definition of a SIFT trust under the *Income Tax Act*

(SIFTs) would be taxed at corporate tax rates with respect to distributions made to unitholders, generally other than distributions that are returns of capital. These so-called SIFT rules essentially eliminated the income fund market as a viable yield investment structure for most entities after the four-year holiday that ended in December 2010.

As part of the SIFT rules, an exception was provided for entities that invested exclusively in specific types of real estate and earned the vast majority of their revenue from those investments (or closely related investments). Generally, to qualify for the "real estate investment trust (REIT) exception" in a particular taxation year, (i) the SIFT must at no time in the taxation year hold non-portfolio property (other than "qualified REIT properties"); (ii) not less than 95% of the SIFT's revenue for the taxation year must be derived from one or more of the following: rent from real or immovable properties, interest, capital gains from the disposition of "real or immovable properties," dividends and royalties; (iii) not less than 75% of the SIFT's revenue for the taxation year must be derived from one or more of the following: rent from real or immovable properties, interest from mortgages, or hypothecs, on real or immovable properties, and capital gains from dispositions of real or immovable properties; and (iv) at no time in the taxation year may the total fair market value of properties comprising real or immovable properties, cash, deposits in a bank or credit union, indebtedness of Canadian corporations represented by banker's acceptances, and debt issued or guaranteed by governments in Canada be less than 75% of the "equity value" of the SIFT at that time.

Under tax proposals released in December 2010 (December 2010 Proposals), which apply for taxation years beginning in 2011 (or for earlier years if elected), the REIT exception will be favourably modified so that under (i) in the previous paragraph, a SIFT may hold some non-portfolio properties that are not qualified REIT properties, provided that at all times in the taxation year at least 90% of the total fair market value of all non-portfolio properties held by the SIFT are qualified REIT properties; under (ii) in the previous paragraph, the test will be reduced from 95% to 90%, and gains from dispositions of certain non-capital property that is "eligible resale property" will be added as qualifying revenues for purposes of that test; and under both (ii) and (iii) in the previous paragraph, the revenues to be measured will be "gross REIT revenues," which will be defined as gross revenue and will include capital gains; and an additional requirement would be added as follows: (v) investments in the SIFT must at any time in the taxation year be listed or traded on a stock exchange or other public market.

Unfortunately, even under the December 2010 Proposals, not all REITs will qualify for the REIT exception.

Under the SIFT rules, "qualified REIT property" of a SIFT means, generally, a property held by the SIFT that is (i) a real or immovable property; (ii) a security of an entity that derives all or substantially all of its revenues from maintaining, improving, leasing or managing real or immovable properties that are capital properties of the SIFT; (iii) a security of an entity that holds no property other than legal title to real or immovable properties of the SIFT and property ancillary to the earning by the SIFT of rents and capital gains from real or immovable property; or (iv) a property ancillary to the earning by the SIFT of rents and capital gains from real or immovable property.

Unfortunately, even under the December 2010 Proposals, not all REITs will qualify for the REIT exception, since many REITs own non-portfolio properties that are not qualified REIT properties or earn more than 10% of their gross revenue from services other than the rental of real property or capital gains from real property. (Examples are REITs that own nursing or retirement homes that provide healthcare or daily living services to residents for a fee, multi-unit residential REITs that have a substantial number of furnished suites and hotel REITs. In those cases, the SIFT owns assets that don't qualify for the REIT exception or too great a portion of the gross revenue earned is not "good" REIT revenue for purposes of the REIT exception.)

As stated in last year's mid-year report, a REIT that owns exclusively non-Canadian real estate could qualify as a CBIF and therefore would be entirely exempt from the application of the SIFT rules; consequently, it would not have to concern itself with the REIT exception. Dundee International was the first REIT established as a CBIF; its stated purpose is to invest in commercial real estate located exclusively outside Canada, with a focus on investments initially in Europe. To date in 2012, Slate U.S. Opportunity (No. 1) Realty Trust, an unlisted, "blind pool" trust formed to acquire, own and lease a portfolio of diversified revenue-producing commercial real estate properties in the United States, with a focus on anchored retail properties, has completed its initial public offering, and Pure Multi-Family has been formed to invest in multi-family real estate properties in the United States.

Of course, establishing a REIT as a CBIF is the relatively easy part – generally, all it needs to do is invest exclusively outside Canada. The hard part is structuring its affairs in the foreign jurisdiction so that it can repatriate its earnings from its foreign holdings in a tax-efficient manner. In addition, in most cases, for REITs structured as CBIFs to be comparable to traditional REITs, we would expect them to list their units and pay distributions in Canadian dollars (though that is not the case with Pure Multi-Family); this would give rise to the need for such CBIFs to hedge their exposure to currency fluctuations. We think these reasons alone help explain why there has been a dearth of CBIFs and, in particular, REIT CBIFs (particularly when compared with the vast number of initial public offerings that were undertaken in the heyday of the pre-2006 income fund market).

In the end, therefore, although we certainly expect there to be more REITs structured as CBIFs in the coming months and years, given the complexities noted above, we aren't expecting a groundswell of transactions. To answer our question, we don't foresee CBIFs as the panacea to the government's Halloween pronouncement in 2006 for real estate investment trusts; however, there is certainly an underutilized opportunity for the right entities to gain access to the Canadian capital markets to feed Canadian retail investors' seemingly insatiable appetite for yield-based investments.

Simon Knowling's practice focuses on commercial law, with an emphasis on securities law, commercial real estate, private mergers and acquisitions (domestic and cross-border) and bank financing. He has extensive experience in all aspects of securities law for real estate companies and REITs, commercial real estate transactions and joint ventures/partnerships. Particular experience includes acting for issuers and underwriting syndicates in public and private equity and debt financings involving real estate companies and REITs (domestic, cross-border and international).

Corrado Cardarelli specializes in corporate, partnership, trust, foreign and general business taxation. His practice largely involves structuring domestic and international business transactions, including mergers and acquisitions, dispositions, financings and reorganizations. He also has extensive experience in structuring collective investment vehicles with domestic, tax-exempt and foreign investors, including REITs and structured products, many of which have involved Canadian and U.S. cross-border aspects.

Emerging-Market Companies

These companies will face increased regulatory scrutiny when accessing Canadian capital markets

Scott R. Cochlan, Janan Paskaran, Michael Pickersgill

In the wake of the allegations of financial irregularities at Sino-Forest Corp. and the earlier collapse of Xingui Haixi Corp. in 2011 following similar irregularities, securities regulators have intensified their focus on Canadian-listed companies with assets in emerging markets. We expect this to be a continuing area of focus over the coming months as regulators and self-regulating organizations consider how to implement the recommendations made by the Ontario Securities Commission in OSC Staff Notice 51-719 Emerging Markets Issuer Review (EMIR Notice), which was released on March 20, 2012.

In this review, staff reviewed 24 emerging-market issuers, which it defined as issuers with mind and management largely outside Canada and whose principal active operations are outside Canada in regions such as Asia, Africa, South America and Eastern Europe. Staff noted that there are approximately 108 issuers listed on Canadian exchanges that meet these criteria, representing a total market capitalization at the time of the EMIR Notice of approximately C$40 billion. Of these, staff reviewed 24 issuers, which represented half of the 48 issuers that meet this definition and for which the OSC is the principal regulator. Issuers with significant foreign assets conducting prospectus offerings during this period received comment letters that included due diligence questions directed at the underwriters, and audit process questions directed at the auditors.

The EMIR Notice highlighted the following four areas of principal concern, making recommendations for each one: (i) the level of governance and disclosure; (ii) the adequacy of the audit function; (iii) the adequacy of due diligence undertaken by underwriters in securities offerings; and (iv) the exchange listing approval process.

For governance and disclosure by emerging-market companies, the OSC recommended, among other things, establishing guidance to improve corporate governance practices generally, clarifying the regulatory expectations of CEOs and CFOs in their annual and quarterly certifications, requiring better disclosure of complex corporate structures and their purpose, ensuring maintenance of books and records in Canada and considering minimum Canadian director residency requirements. Staff focused on issuers with complex structures and the quality of controls in place to manage complex structures. This focus mirrors the attention paid by the U.S. Securities and Exchange Commission (SEC) in 2011 to Chinese VIE (variable interest entity) structures that sought listings on Nasdaq or the New York Stock Exchange. The VIE structure was designed to work around ownership restrictions applicable to Chinese companies, and questions had been raised about the validity of the structure. In a series of offerings in 2011, the SEC required increased disclosure of details of this structure and the legal rights associated with it.

It should not be surprising that as the international operations of Canadian companies expand and access to foreign capital markets increases, the issues relating to emerging-market activities have come into greater focus.

From an auditor's perspective, staff identified several areas of potential concern with respect to the external audit function. In particular, staff noted that some auditors may not have performed sufficient procedures in certain instances to understand and appropriately scrutinize the information provided to them by the companies or local audit firms that are delegated part of the audit function. In February 2012, the Canadian Public Accountability Board (CPAB) released a special report outlining its findings and recommendations following its review of audit files for Canadian reporting issuers that had their primary operations in China. The report revealed similar conclusions. The EMIR Notice recommended working together with the CPAB to resolve these issues.

The EMIR Notice also noted a wide variation in due diligence practices and policies among underwriters, as well as in the thoroughness of due diligence pursued by underwriters in the public offerings reviewed by staff, including in situations in which staff identified "red flags." Among the recommendations for underwriters of emerging-market issuers were establishing a consistent and transparent set of requirements for the conduct of due diligence and developing best practices regarding documentation of all aspects of an underwriter's due diligence. The recommendations included a list of matters that staff would expect the resulting requirements to address. The EMIR Notice indicates that it will look to dealers and their self-regulating authority, the Investment Industry Regulatory Organization of Canada (IIROC), to develop these practices. Generating a formulaic list of due diligence requirements would be a departure from the issue-based, flexible approach to the due diligence imperative imposed by securities laws and prospectus certification requirement. It will be interesting to see what, if any, more formulaic procedure results.

Finally, staff also examined the listing process for emerging-market companies on Canadian exchanges. Staff's principal concerns relate to whether procedures in place for emerging-market issuers are sufficiently robust, whether such companies should be required to maintain a Canadian presence and the lack of disclosure when exchanges waive listing requirements.

The OSC has noted that it wishes to work with IIROC, the CPAB and the exchanges to consider means to implement or address these recommendations. This could mean further regulatory developments in the second half of 2012.

It should not be surprising that as the international operations of Canadian companies expand and access to foreign capital markets increases, the issues relating to emerging-market activities have come into greater focus. While the increased regulatory focus isn't likely to slow the irreversible and welcome trend of globalization, it does suggest that transactions involving Canadian companies in emerging markets will require careful due diligence and governance planning to withstand the higher level of scrutiny expected to be applied by regulators from now on.

Scott R. Cochlan is recognized internationally as a leading Canadian corporate finance lawyer. He has extensive experience representing issuers and underwriters in various complex matters, including domestic and cross-border public/private equity and debt financings, mergers and acquisitions, and other business reorganizations and restructurings.

Janan Paskaran focuses on corporate and securities law, with an emphasis on international transactions. He has extensive experience representing public and private issuers in a wide variety of financing, business combination and mergers and acquisitions transactions, including both private and publicly traded issuers.

Michael Pickersgill focuses on corporate and securities law, with an emphasis on corporate finance and mergers and acquisitions. Michael also advises public issuers and boards in connection with continuous disclosure and stock exchange matters, and shareholder arrangements.

The JOBS Act

Incentives for raising capital in the United States and implications for Canadian issuers

Andrew J. Beck, Mile T. Kurta, Leslie McCallum, Glen R. Johnson

With the goal of reducing the regulatory burdens associated with raising capital in the United States, President Obama recently signed into law the *Jumpstart Our Business Startups Act*. The JOBS Act is meant to encourage capital raising and stimulate job creation by smaller companies, and it significantly increases flexibility for companies accessing the U.S. capital markets. Despite the apparent emphasis on the start-up sector, the public offering reforms under the JOBS Act are applicable to non-public companies with annual revenue of up to US$1 billion, and many of the reforms to the private capital-raising rules will benefit all companies selling securities to qualifying investors.

The JOBS Act is the third major piece of securities law reform legislation to be passed in the United States in the past decade. The *Sarbanes-Oxley Act of 2002* was a response to a crisis in corporate governance, most notably exemplified by the bankruptcies of Enron and WorldCom. The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* was a response to the collapse of financial markets and the subsequent government bailouts of high-profile financial firms. Whereas Sarbanes-Oxley and Dodd-Frank focused on protecting investors and reducing risk in the capital markets through increased regulation, the JOBS Act is entirely deregulatory in nature and actually reverses some of the changes promulgated under Sarbanes-Oxley and Dodd-Frank.

The JOBS Act reforms also highlight differences between the U.S. and Canadian securities regulatory agendas, and the balance that is struck between investor protection and access to capital as regulatory objectives. Whereas the JOBS Act represents a politically driven move toward enhanced capital-raising opportunities in the U.S. market, Canadian politicians have not made a similar push for reforms that would foster issuers' access to capital in the current economic climate. The Canadian securities regulators' recent activity in the areas of permitted marketing activities and prospectus-exempt offerings has suggested a more restrictive approach and a regulatory bias toward investor protection considerations. However, the OSC's recent announcement of an expanded exempt-market review may provide an opening for more flexible regulatory approaches to capital raising in Canada.

New Regime for Emerging Growth Companies

Under the JOBS Act, the so-called on-ramp for IPOs (initial public offerings) and other relaxed public offering rules are available to emerging growth companies (EGCs), which are companies whose annual revenue is less than US$1 billion, provided they have not yet sold equity securities to the public in the United States. For perspective, approximately 75% of the companies that conducted an IPO on the New York Stock Exchange or Nasdaq in the past six months would have qualified as EGCs on the basis of the US$1 billion revenue threshold. In IPOs and other public offerings, EGCs and their dealers now have the freedom to test the market for a potential offering before filing a registration statement with the Securities and Exchange Commission (SEC). Contacting qualified institutional buyers and other institutional accredited investors during the pre-filing period to determine their interest in a potential transaction no longer amounts to illegal gun-jumping. This new rule will help companies avoid the time and expense of preparing a registration statement and will facilitate alternative capital-raising options in cases where there is insufficient investor demand for a public offering. The only other companies that enjoy the freedom to test the market in the United States without gun-jumping liability are very large, seasoned issuers (excluding Canadian issuers making U.S. offerings under the Multijurisdictional Disclosure System, or MJDS). Through supplementary rule making, the SEC is expected to address certain risks associated with testing the market, in particular the risk of misleading or selective disclosure being disseminated to potential investors before a prospectus is available. Canadian securities regulators are also proposing to permit testing the market under certain circumstances; however, in contrast to the JOBS Act, the proposed Canadian rule would permit pre-filing contact with a more limited group of institutional investors, and only ahead of an IPO rather than any public offering.

> The JOBS Act is entirely deregulatory in nature and actually reverses some of the changes promulgated under Sarbanes-Oxley and Dodd-Frank.

The JOBS Act also provides greater freedom for analysts to publish research reports about EGCs, even when their firm is participating in an offering, and permits analysts to attend meetings with underwriters and management of an EGC.

An EGC conducting an IPO is now permitted to file its registration statement with the SEC confidentially, provided that the offering and all prior SEC filings are made public at least 21 days before the related road show. The confidential filing procedure, which had previously been limited to non-U.S. companies with securities either listed or concurrently being listed on a non-U.S. stock exchange, means that complicated disclosure issues can be resolved with the SEC before an offering becomes public; this procedure will thus help reduce the risk of business and reputational harm to the company from cancelling an offering if market conditions deteriorate. To facilitate cross-border financings, Canadian securities regulators will generally allow any IPO issuer, Canadian or foreign, to file a prospectus confidentially if it is undertaking a cross-border offering, and confidential treatment is available under U.S. rules.

In its IPO registration statement, an EGC has the benefit of less burdensome disclosure requirements in respect of financial statements and management's discussion and analysis (MD&A) – it must provide only two years of information rather than three. Following its IPO, an EGC may provide less detailed executive compensation disclosure; it may adopt new accounting standards on the same timetable as private companies; it need not conduct say-on-pay shareholder votes; and, perhaps most significantly, its auditors are not required to provide an attestation of the company's internal controls. Notably, though, EGCs are not compelled to take advantage of all these accommodations. Some may decide, for the benefit of investors or analysts, to provide the same level of disclosure as their non-EGC peers, particularly in respect of financial statement disclosure and the adoption of new accounting standards. Moreover, an EGC undertaking a cross-border offering would have to comply with Canadian securities laws, which generally require three years of financial disclosure and MD&A based on public company GAAP (generally accepted accounting principles) or IFRS (international financial reporting standards), as well as full executive compensation disclosure.

There is a time limit associated with all of the foregoing accommodations for EGCs. Specifically, after a maximum of five years after an IPO, a company can no longer take advantage of EGC status and must revert to complying with the traditional rules governing public offerings and periodic reporting to which non-EGCs are subject. And if an EGC's annual revenue exceeds US$1 billion, its market capitalization exceeds US$700 million or it issues more than US$1 billion worth of non-convertible debt in a three-year period, it will lose its EGC status before reaching the five-year mark. EGCs, along with their advisers, should plan their capital markets activities with a view to ensuring a smooth transition out of EGC status.

The Regulation A+ Alternative

An additional opportunity available under the JOBS Act is the so-called Regulation A+. This provision will permit companies to sell securities to the public without filing a traditional registration statement and without the securities being subject to resale restrictions. There would be a US$50 million cap on the amount of securities sold in any 12-month period (which in practice would limit only the U.S. portion of a cross-border offering by a non-U.S. issuer). Forthcoming SEC rules will establish whether SEC reporting issuers will be permitted to conduct offerings under Regulation A+ as well as set out the disclosure and filing requirements that will apply to these offerings. At a minimum, non-reporting issuers will have to file audited financial statements with the SEC annually. Depending on the SEC's approach to implementation, Regulation A+ may become an alternative way of conducting a U.S. IPO and/or adding a U.S. tranche to a Canadian public offering.

Private Offering Reforms

The JOBS Act dismantled a longstanding element of the U.S. private placement regime by directing the SEC to remove the prohibitions on general solicitation and general advertising in sales to qualified institutional buyers and other accredited investors. Eliminating these prohibitions will expand companies' opportunities to market private offerings and will reduce concerns about regulatory liability; but depending on the SEC's final rule making, increased due diligence may be required to ensure that all participating investors are eligible. In practice, companies have not been subject to comparable Canadian restrictions on general solicitation or advertising, provided that only bona fide prospectus-exempt sales to eligible investors were completed. However, the Canadian securities regulators have increased their focus on issuers' and dealers' compliance with applicable prospectus exemptions, including the due diligence required to confirm investor eligibility.

One anomaly of the JOBS Act is that there is still a prohibition on directed selling efforts in the United States in the context of cross-border transactions made in reliance on Regulation S. As a result, the practical utility of the relaxed marketing rules may depend on the SEC's providing guidance to eliminate confusion for companies combining a U.S. private placement with a public offering in their home jurisdictions, which is a common offering structure for Canadian companies.

One aspect of the JOBS Act attracting significant attention is the crowd-funding provision for private companies. Unlike the other reforms, crowd-funding is available only to U.S. companies, permitting them to make public offerings of up to US$1 million per 12-month period, generally with a limit of US$100,000 per investor. These offerings will have to be made through a registered broker or neutral online funding portal, and certain investor protection measures will be imposed by the SEC. Unlike securities sold under Regulation A+, crowd-funding securities will be subject to resale restrictions for one year. Public statements from Canadian securities regulators to date suggest that changes, such as crowd-funding, that would liberalize the Canadian exempt-market rules are unlikely if they may be seen to compromise investor protection. On the other hand, the Ontario Securities Commission (OSC) is conducting a broad review of the exempt market, which may involve consideration of the merits of the U.S. reforms and their appropriateness in Canada.

SEC Registration by Private Companies

As a corollary to the other JOBS Act reforms, the legislation includes provisions to facilitate the ability of private companies to remain private. Before the JOBS Act was enacted, a company that had 500 or more record shareholders had to register and report with the SEC. Now, companies may privately sell securities to a much larger group of investors without becoming subject to SEC regulation: the limit has been raised to 2,000 shareholders or 500 shareholders who are not accredited investors; shareholders who receive securities under employee compensation plans or in exempt crowd-funding offerings are excluded from the count. Non-U.S. issuers still have the benefit of the existing exemption from SEC regulation if their securities are beneficially owned by fewer than 300 U.S. residents and are not traded on a U.S. national stock exchange or the OTC bulletin board.

The New Landscape of Securities Regulation

Market practices, as well as deal documentation, will certainly evolve in response to the new landscape of SEC regulation brought about by the JOBS Act. The reforms create new opportunities for companies considering conducting an IPO in the United States, and from a cross-border perspective, the benefits of EGC status are available to non-U.S. companies even if they are already public in their home jurisdictions. Moreover, Canadian companies may take advantage of EGC status in combination with the reduced regulatory burdens under the MJDS. Private offerings will be less regulated, and private companies now have greater freedom to raise capital without becoming subject to SEC regulation. These are all positive developments for companies to consider as they plan their capital-raising activities.

Given the similarities between the Canadian and U.S. marketplaces and the linkages between them, Canada has historically adopted many regulatory principles and initiatives from the United States. In that sense, the JOBS Act reforms will inform the Canadian securities regulators' continuing review of offering practices and the exempt market. The fact that the reduced regulatory burdens under the JOBS Act are available to non-U.S. companies regardless of their home jurisdiction is notable in light of the concerns expressed recently by the OSC about compliance with securities and corporate laws by issuers from emerging markets. Furthermore, last year's proposed changes to the Canadian prospectus marketing rules were incremental in nature, and the exempt-market review was initially focused on narrowing prospectus exemptions and increasing eligibility thresholds, which many commentators believed could have a negative effect on access to capital for Canadian issuers. As the OSC launches a broader review of the exempt market – signalling an increased concern for issuers' access to capital and the diversity of the exempt market in Canada – Canadian market participants will continue to look to the United States for regulatory approaches that strike a balance between capital raising and investor protection objectives.

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Extendible Convertible Debentures

Bidders will access public debt markets to finance unsolicited takeover bids

John Emanoilidis, Jamie Becker

One of the competitive advantages that strategic bidders have over financial buyers is the ability to use share consideration as acquisition currency. However, this option became more complicated in 2009 when the Toronto Stock Exchange introduced rules requiring shareholder approval of any issuance of shares for an acquisition that would result in their dilution to existing shareholders of more than 25%. Therefore, a strategic bidder that offers share consideration must make its bid conditional on shareholder approval if the 25% dilution threshold is crossed. This is unappealing, particularly in the context of a hostile takeover, because it adds an element of deal uncertainty and restricts the bidder's flexibility to increase the share consideration (which may be necessary to make its bid more attractive to the target's board and/or its shareholders).

To avoid the TSX's shareholder approval requirement, a strategic bidder will need to structure its bid to offer only cash or a mix of cash and shares. If a bidder makes a cash bid, Canadian takeover bid rules require that the bidder make adequate arrangements before the bid to ensure that it has the necessary funds available to pay for all the securities it has offered to purchase. Conditions in the financing documents are permitted only if the bidder reasonably believes the possibility to be remote that if the bid conditions are satisfied or waived, the bidder will be unable to pay for the securities deposited as a result of a financing condition not being satisfied. Bidders that do not have sufficient cash on hand and that are unable or unwilling to arrange for an acquisition credit facility can raise money for the purchase price in the capital markets. Whereas a concurrent private placement would also be subject to the TSX's shareholder approval requirement, a public offering will not trigger that requirement (regardless of whether it exceeds the 25% dilution threshold).

Hostile bidders that have financed their bids through public offerings have tended to do so on a "bought deal" basis so that the underwriters are committed to purchasing the securities (subject only to the limited termination rights that are typically granted to underwriters in bought deals, such as the "disaster out"). A bidder that funds a hostile bid by raising money in the capital markets faces the possibility that after having raised the money, its bid will not succeed and it will be left with a large amount of capital that it cannot efficiently deploy. Potential investors may be hesitant to invest if they have concerns over the issuer's ability to use the proceeds of the offering if the takeover bid fails.

To address these concerns, bidders in the Canadian market often use subscription receipt offerings to fund their acquisitions. In a subscription receipt offering, the subscriber pays in full for a subscription receipt that is automatically exchanged for an underlying security of the issuer upon closing of the acquisition. The proceeds of the offering are held in trust until the acquisition closes and the subscription receipts are exchanged for the underlying securities. If the acquisition does not close by a specified date, the subscription price is returned to investors, with interest, and the subscription receipts are cancelled.

> WiLAN's hostile bid for MOSAID Technologies was the first time that extendible convertible debentures were offered to finance an unsolicited takeover bid.

Another financing option for strategic bidders is to use extendible convertible debentures, which have features similar to subscription receipts. Debentures of this type have a relatively short initial maturity, often only several months from the issue date. If the acquisition is completed, the maturity date of the debentures automatically extends to what would be a typical maturity date for convertible debentures. If the acquisition does not close, the debentures mature on the initial maturity date, and the principal of the debentures is repaid to investors with interest from the date of issue to the initial maturity date. The debentures are convertible into common shares of the issuer with an implied conversion price set at some level above the market price of the common shares on the date of the offering. As in an offering of subscription receipts, half of the underwriters' fee is typically payable upon the closing of the offering, and the other half is payable upon the closing of the acquisition. If the acquisition never closes, the underwriters' fee is reduced by half and the underwriters do not receive the second half of their fee.

WiLAN's hostile bid for MOSAID Technologies was the first time that extendible convertible debentures were offered to finance an unsolicited takeover bid. On August 23, 2011, WiLAN made an all-cash bid for all the outstanding common shares of MOSAID Technologies. WiLAN proposed to finance C$230 million of the C$480 million purchase price by way of a bought deal public offering of 6% extendible convertible debentures. WiLAN entered into the bought deal letter with the underwriters and filed its preliminary prospectus for the offering on the same day that it publicly announced its intention to make a takeover bid for MOSAID. The offering closed on September 8, 2011, and the takeover bid was initially open for acceptance until September 28, 2011, thereby supplying WiLAN with the funds well in advance of closing. The initial maturity date of the debentures was January 31, 2012, but that date would have been automatically extended to September 30, 2016, if WiLAN had taken up shares under the bid, resulting in WiLAN and its affiliates controlling at least two-thirds of the outstanding MOSAID shares. A unique innovation of the WiLAN debentures was that WiLAN had the option to extend the initial maturity date to March 31, 2012, in its sole discretion. Given the uncertain and potentially protracted timing of hostile takeover bids, which may go through multiple variations and extensions, this feature mitigates the risk that the initial maturity date will arrive before the expiry of the bid and gives bidders flexibility to pursue their bid strategies without the initial maturity date looming as a hard deadline for the takeup of shares. WiLAN's bid for MOSAID was eventually topped by a competing bid from U.S. private equity firm Sterling Partners. WiLAN repaid the extendible convertible debentures with interest on the initial maturity date of January 31, 2012.

Extendible convertible debentures offer the same advantage as subscription receipts in that they allow a bidder to raise funds for its bid with the funds being returned to investors if the bid is unsuccessful. One of the advantages of extendible convertible debentures over equity financing is that dilution is delayed until some future date when the bidder's share price increases beyond the implied conversion price. Debt financing can also be preferable to equity financing for a hostile takeover bid if the bid is being done at a time when the market is depressed or when management believes that the bidder's shares are undervalued. Issuing public debt can avoid this timing problem and the excess dilution that results from the higher number of shares that would have to be issued to attain the required proceeds when the bidder's share price is low.

We expect to see more bidders relying on extendible convertible debentures for this reason. In addition, debt financing is particularly appealing in the current low-interest rate environment in which bidders can get attractive interest rates, especially for convertible debentures, which typically have a lower interest rate than non-convertible debentures due to the conversion feature.

Financing a hostile takeover bid with a public offering of extendible convertible debentures, or any other form of security, presents some challenges. The first is that the timing of the offering is coordinated with the launch of the bid: the bought deal letter is signed when the bid is launched and the prospectus must disclose the takeover bid as the use of proceeds of the offering. This means that the bidder must prepare the bought deal offering documents at the same time as the bid documents.

Another challenge is that securities regulation in Canada requires an issuer that files a prospectus and that is proposing to undertake a "significant probable acquisition" to include historical financial statements of the target and pro forma financial information of the combined business. Securities regulators have taken the position that a significant unsolicited takeover bid constitutes a significant probable acquisition – despite the very real possibility, as seen in the WiLAN bid for MOSAID, that the bid may be unsuccessful. Providing financial statements or other financial information about the target is not a problem in a supported transaction on which the target has agreed to cooperate with the bidder regarding financing matters. However, in a hostile takeover bid, the bidder cannot rely on cooperation from the target or its auditors so compiling the required financial information will be more difficult.

An exemption is available from the requirement to include the target's historical financial statements in a bid circular if the bidder offers its securities directly as consideration for a takeover bid, though pro forma financial information is still required in the circular. However, the prospectus rules that apply when an issuer undertakes a public offering to finance an acquisition have no similar exemption from the requirement to include the target's historical financial statements in the prospectus. In WiLAN's offering of extendible convertible debentures, WiLAN requested and received exemptive relief from the requirement to include MOSAID's historical financial statements in the prospectus; the relief was consistent with the exemption in the takeover bid rules that would have been available if the shares had been offered directly as consideration for the bid. In its prospectus, WiLAN was instead able to refer to MOSAID's publicly filed financial statements, though the prospectus was still required to include pro forma financial information for the combined business. WiLAN prepared the pro forma information on the basis of MOSAID's publicly filed financial statements without the cooperation of MOSAID and its auditors.

Despite these challenges, a public offering of extendible convertible debentures is an attractive financing option for bidders seeking to avoid the uncertainty of a shareholder vote and the dilution of an equity issuance. Given the speed at which funds can be raised through a well-executed bought deal offering, we expect to see strategic bidders increasingly accessing the public markets to finance hostile takeover bids.

John Emanoilidis's practice focuses on corporate/commercial and securities law, with an emphasis on mergers and acquisitions, and corporate finance. John represents domestic and foreign acquirors, targets, special committees, selling shareholders and investment banks in all aspects of M&A, including hostile takeover bids, strategic review processes, proxy contests, going-private transactions and negotiated acquisitions. He has extensive experience in corporate finance transactions representing issuers, underwriters and investors in domestic and international debt and equity public offerings and private placements.

Jamie Becker's practice focuses on corporate and securities law, with an emphasis on mergers and acquisitions and capital markets transactions. Jamie has represented both issuers and underwriters in capital market transactions and both acquirors and targets in a variety of private and public company M&A transactions. Jamie also advises public company clients on ongoing corporate governance and securities law matters.

CMHC Insurance and Covered Bonds

What will happen when the training wheels come off?

Michael Feldman, Jim Hong

Since the financial crisis of 2008, Canadian federally regulated financial institutions (FRFIs) have relied very heavily on the mortgage-backed securities (NHA MBS) program sponsored by Canada Mortgage and Housing Corporation (CMHC) under the *National Housing Act* and on using CMHC-insured mortgages as security for covered bonds in order to meet their funding needs. This now appears likely to change.

Federal legislation prohibits FRFIs from holding mortgages with a loan to value (LTV) greater than 80% unless they are insured. CMHC offers residential mortgage insurance for high LTV mortgages. These insurance policies are paid for by mortgagors who take out high LTV mortgage loans.

CMHC also offers bulk insurance whereby any lender approved by CMHC may submit a pool of conventional low LTV mortgages for insurance. In this case, the approved lender pays the insurance premium. The two main reasons for bulk insurance are capital relief and the ability to use insured mortgages to access the NHA MBS program.

Only insured mortgages can be securitized through CMHC's NHA MBS program. In addition to providing the insurance on the underlying mortgages, CMHC also guarantees the timely payment of principal and interest on the NHA MBS. A total of $134.2 billion of NHA MBS were issued in 2009, $124.6 billion in 2010 and $139.9 billion in 2011.[1]

[1] Compare these amounts with the total amount of term asset-backed securities (ABS), including all ABS and MBS other than NHA MBS or securities backed by NHA MBS, issued in Canada during the same period ($5 billion in 2009, $12.4 billion in 2010 and $10.9 billion in 2011) according to DBRS, Industry Study, "Canadian Structured Finance 2011 Year in Review and 2012 Outlook" (February 2012), online: DBRS <http://www.dbrs.com/research/245480/canadian-structured-finance-2011-year-in-review-and-2012-outlook.pdf> at 7.

This article was written with assistance from Thomas Stevenson, student-at-law.

In addition to issuing NHA MBS, each of the six largest Canadian banks has also issued covered bonds (essentially full recourse bonds secured by pools of financial assets) totalling approximately $60.7 billion outstanding as at April 30, 2012,[2] many of these to foreign investors. A large portion of the assets backing these covered bonds consists of insured mortgages. Because of a general reluctance to allow FRFIs to issue secured debt that would rank ahead of depositors, the Office of the Superintendent of Financial Institutions (OSFI) limits the amount of covered bonds that any FRFI can issue to 4% of the FRFI's assets.[3]

There has always been a statutory limit on the aggregate amount of insurance that CMHC could have outstanding. In March 2008, the limit of $350 billion was raised to $450 billion, which was then raised to $600 billion in March 2009. As at December 31, 2011, CMHC had over $567 billion of outstanding insurance on Canadian residential mortgages (an amount in excess of the entire Canadian federal debt). Finance Minister Jim Flaherty has indicated that the federal government has no current plans to increase CMHC's limit beyond $600 billion. As a result, approved lenders received notice in the first quarter of 2012 that their allocations of CMHC bulk insurance would be drastically reduced (in some cases by up to 80% or 90%).

In another recent development, the federal government introduced the *Jobs, Growth and Long-term Prosperity Act* in April 2012 in order to implement the 2012 federal budget. This statute, which is not yet in force, would prohibit FRFIs from issuing covered bonds outside the legislated framework. It is noteworthy that eligible covered bond collateral would be restricted to uninsured loans made on the security of Canadian residential property (insured mortgage loans would no longer be eligible as collateral for covered bonds).

It is now apparent that the federal government is trying to ease FRFIs off their current reliance on federal guarantees to support their financing needs. It is possible that private mortgage insurers,[4] whose policies have a 90% guarantee by the federal government, could pick up some of the slack, but they too are subject to statutory limits so are unlikely to provide a long-term solution. Unless FRFIs can increase the amount of deposit notes they issue to replace their reliance on NHA MBS and insured mortgage-backed covered bonds, they will have no choice but to develop alternative funding sources. A promising potential funding instrument would be uninsured residential mortgage-backed securities (RMBS). However, we believe that additional steps are needed before a robust uninsured RMBS market can develop in Canada.

It is now apparent that the federal government is trying to ease FRFIs off their current reliance on federal guarantees to support their financing needs.

A key issue to be resolved by issuers of uninsured RMBS is asset quality. There is a concerted international effort among G20 nations to develop best practices in mortgage lending in order to restore investor confidence after the United States' subprime mortgage fiasco. In the United States, proposed rules under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* to require securitizers

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[2] DBRS, Monthly Canadian Covered Bond Report, April 2012, at 6.

[3] Letter from Office of the Superintendent of Financial Institutions Canada to All Deposit Taking Institutions (June 27, 2007) regarding Limited Issuance of "Covered Bonds" by Canadian Institutions, online: Office of the Superintendent of Financial Institutions Canada <http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/notices/osfi/cvbnds_e.pdf>.

[4] Genworth Financial Mortgage Insurance Canada, Canada Guarantee Mortgage Insurance Company and PMI Mortgage Insurance Company Canada.

to retain a level of risk in each of their securitization transactions also propose to exempt securities backed by "qualified residential mortgages" from these risk-retention rules. While the definition of qualified residential mortgage is still being debated, the intention is that qualified residential mortgages will generally reflect best mortgage lending practices.

In Canada, OSFI circulated draft Guideline B-20 – Residential Mortgage Underwriting Practices and Procedures on March 19, 2012. This guideline sets out OSFI's expectation with respect to prudent residential mortgage underwriting practices and procedures. The comment period for this draft guideline has now passed, and the final guideline is expected to be published by the end of June 2012.

In theory, a properly structured RMBS transaction backed only by uninsured mortgages that comply with Guideline B-20 ought to result in attractive RMBS for investors. However, in practice this will likely not happen until there is enough liquidity for such RMBS. Investors will want to know that they will always be able to determine a mark-to-market value, and that there will always be a bid, for their RMBS before they commit to expend the effort required to analyze uninsured RMBS as an investment. Hoping for an uninsured RMBS market to develop without liquidity is like taking the training wheels off a bicycle before the rider has enough confidence to go fast enough without them.

The required liquidity for private RMBS could be provided if the Bank of Canada would agree to accept highly rated RMBS backed by Guideline B-20–compliant mortgages as collateral for overdraft loans to Canadian banks.[5] Providing such liquidity would encourage FRFIs to create and issue uninsured RMBS. Then the interest rates on the RMBS could be used as feedback for the issuing FRFIs to help establish economically sound residential mortgage rates instead of the aggressive pricing encouraged by CMHC-supported (i.e., taxpayer-supported) funding. The Bank of Canada may have very good reasons for not wishing to expand the list of acceptable collateral for overdraft loans at this time. However, if the Bank of Canada could see its way to providing the liquidity that the uninsured RMBS market will require once the CMHC training wheels come off, we could foresee a sustainable, efficient private RMBS market for Guideline B-20–compliant mortgages.

Michael Feldman practises corporate and commercial law, with an emphasis on structured asset-backed financings, securitizations, infrastructure finance, capital markets, secured lending and derivatives.

Jim Hong practises corporate, commercial and securities law, with a focus on public and private managed products, structured asset-backed financings, securitizations and derivatives.

[5] Through its Standing Liquidity Facility, the Bank of Canada provides overdraft loans to certain financial institutions on a secured basis. The list of acceptable collateral was expanded during the financial crisis to include asset-backed commercial paper that met specified criteria but has not been expanded to include any ABS or MBS, other than NHA MBS or securities backed by NHA MBS. See <http://www.bankofcanada.ca/wp-content/uploads/2011/07/boc_balancesheet_sup0611.pdf>.

Infrastructure Transactions

Projects offer an expanding role for capital markets

Mark Bain

Public infrastructure projects require a coordinated effort by government sponsors, engineers, contractors, service providers and advisers. They also require capital investment in staggering amounts: estimates for planned infrastructure investment are in the range of US$40 *trillion* globally by 2050, comprising €2 trillion in the European Union by 2020, £500 billion in the United Kingdom by 2020 and C$200 billion in Canada by 2020. The recent €100 billion rescue of Spanish banks pales in comparison.

There is a clear and growing role for capital markets in the infrastructure field, as governments continue to add capital and stir. That simplified recipe captures the broad theme of the infrastructure finance market. Yet the particular ingredients and proportions vary greatly across projects and throughout the life cycle of these long-term investments.

Capital investment in infrastructure is increasing rapidly, and the infrastructure assets are maturing. The projects themselves are now revolving through different stages and transactions, and the capital markets are increasingly active in that evolving market.

We are in a sustained renaissance period for public infrastructure development and renewal. After several decades of underinvestment, there is a renewed imperative both to catch up on the accumulated infrastructure deficit and to invest in social infrastructure (hospitals, schools and courts) and economic infrastructure (roads, transit systems and ports) for the future.

Not surprisingly, a capital need of this magnitude has generated significant attention, promoting the ascent of infrastructure as a newly recognized asset class for institutional investors and financiers. Public finance alone is unlikely to provide the complete solution. In Canada, for example, the planned rate of infrastructure investment is 6 to 10 times the historical rate. Governments simply cannot meet this need alone – particularly in an era of economic austerity – and are looking to the private sector to help mitigate and distribute the financial burden over the long-term life of the infrastructure assets being financed.

One such approach is to conclude a public-private partnership (PPP) or alternative finance and procurement (AFP) transaction in which a private sector partner will design, build, finance and maintain a public sector infrastructure asset over a period of 20 to 30 years, then hand the asset back to the public sector. A PPP transaction transfers considerable risk to the private partner and contains a performance-based payment mechanism that requires an infrastructure asset to be both built and operational to a specified standard over decades. This approach has repeatedly demonstrated good value for money for the public sector. The PPP approach is not a panacea but has swiftly become a commonly accepted option for public infrastructure transactions, with 170 Canadian projects valued at over C$55 billion completed or underway, most within the last decade.

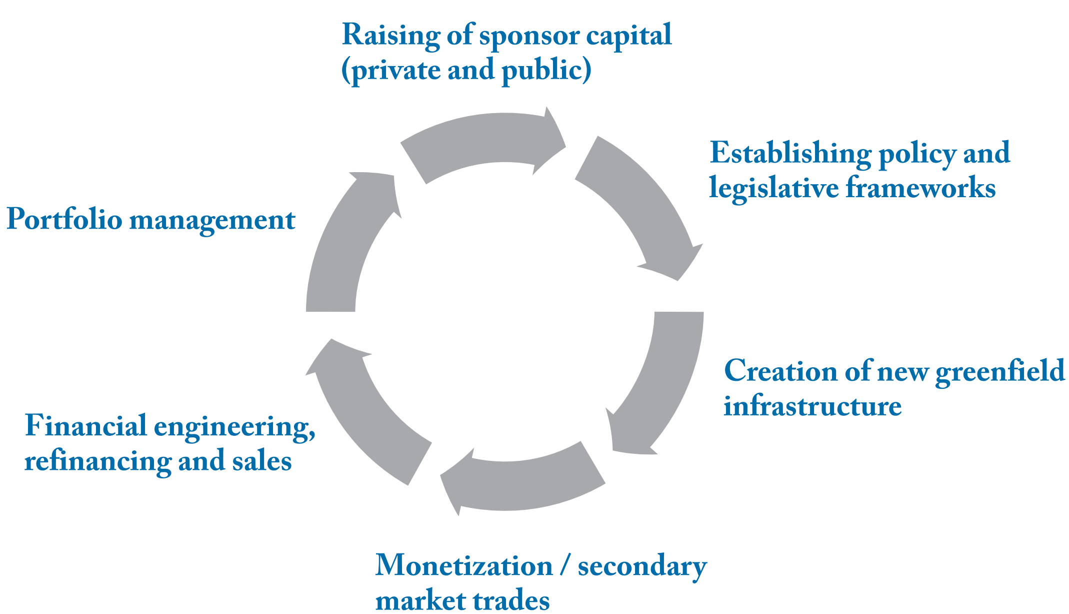
The capital investment in a greenfield asset represents only the beginning of its decades-long life cycle and is followed by a construction stage, an operations and maintenance stage and a hand-back event. Through the life of the infrastructure asset, its financial attributes and risks will change, and the natural and optimal debt and equity financing approaches will evolve in tandem (as shown in this figure).

Capital Raising

The recent surge in infrastructure projects preceded any planned raising of sponsor capital for that dedicated purpose. In the early stages, equity capital was found among construction proponents, redeployment of real estate and private equity allocations from other established funds, and foreign funds already established for more mature PPP markets in other jurisdictions. More recently, we have seen increasing allocations to infrastructure among pension funds, specialty private placement funds in Canada and the U.K., and the initial public offerings of specialty listed infrastructure funds. For example, Bilfinger Berger Global Investments was listed on the LSE in December 2011 and has a current market capitalization of approximately £225 million. It has a focus on operational or near-operational assets that are beyond the greenfield development phase. Part of its seed investment includes an equity interest in three operational Canadian PPP transport projects.

Greenfield Projects

As noted above, there has been a surge in greenfield project development and financing. In the early stages, the Canadian PPP project finance market was dominated by long-term European bank lending



and occasionally by monoline-insured debt, with limited Canadian capital market financing. As the volume and tenor of European bank financing diminished and monoline insurance became unavailable in Canada, the Canadian capital markets moved smartly to fill the gap, first in long-term debt and more recently also in short-term debt.

The short-bank/long-bond hybrid financing structure was one response to the global financial crisis and yielded some significant long-dated capital markets activity. For example:*

- In 2009, Carillion Health Solutions reached financial close on the Centre for Addiction and Mental Health project, in Toronto, with C$12 million in short-term bank loans, combined with C$80 million in long-term bond financing rated A- and issued on a private placement basis.

- In 2010, Groupe immobilier santé McGill reached financial close on the McGill University Health Centre project, in Montreal, with C$380 million in bank debt, C$176 million in government contributions and C$738 million in bond debt issued on a private placement basis.

- In 2011, Hospital Infrastructure Partners reached financial close on the new Oakville Hospital project, in Ontario, with C$511 million in bank debt and C$592 million in bond debt issued on a private placement basis.

- In 2012, Capital City Link GP completed financial close on the northeast leg of Anthony Henday Drive, in Edmonton, with C$535 million in long-term bonds.

The capital markets have been increasingly active also in shorter-dated bonds, for example:

- In 2011, the CHUM Collectif reached financial close on the Centre Hospitalier de l'Université de Montréal hospital project with C$458 million in government contributions and C$1.44 billion of short-term and long-term bonds issued.

- In 2011, Plenary Properties reached financial close on C$167 million in short-term bonds and C$843 million in long-term bonds for the new headquarters for a Canadian federal agency.

- In 2012, 407 East Development Group reached financial close on the Highway 407 East transaction, in Ontario, with C$870 million in short-term and long-term bonds.

Not surprisingly, a capital need of this magnitude has generated significant attention, promoting the ascent of infrastructure as a newly recognized asset class for institutional investors and financiers.

Secondary Market

Following the relatively high-risk construction phase, during the operational phase many infrastructure projects are considered to be de-risked with post-construction revenues that, although performance-based, are relatively predictable – often supported directly or indirectly by government, and at times GDP- or inflation-linked. In short, perfect matches for pension funds and other investors seeking stable long-term cash flows that yield a premium to government direct securities, but with lower risk and volatility than some other private investments. It is often said that the natural "first trading date" for PPP projects is five to seven years after construction once the project has reached this transition stage.

There has been an active secondary market in the international markets, where many projects have

* Financial information is as published in *InfraNews* and *Infrastructure Journal*.

already reached that stage of maturity. For example:

- The Canada Pension Plan Investment Board (CPPIB) recently announced that it has entered into an agreement to acquire significant minority stakes in five major Chilean toll roads from the Atlantia Group. The agreement involves CPPIB acquiring a 49.99% interest in Grupo Costanera. CPPIB will commit an equity investment of 560 billion Chilean pesos, or approximately C$1.14 billion, for this transaction. Grupo Costanera is the largest urban toll road operator in Chile and owns a portfolio of five toll roads that span a 188 km network. Four of the toll roads are located in the Santiago metropolitan region, including two major commuter motorways, Costanera Norte and Vespucio Sur. The fifth toll road is located on the central coast of Chile.

- In 2010, Ontario Teachers' Pension Plan and Borealis Infrastructure Management acquired High Speed 1, a 109 km high-speed rail line linking London with the Channel Tunnel.

There have been fewer such transactions in the Canadian market, largely because our relatively young PPP market has not yet had many projects achieve that state of maturity. It's reasonable to predict that that will change as the projects themselves mature. It is also likely that funds with a low cost of capital (whether tax-exempt funds, listed funds, unlisted funds, strategic investors or otherwise) will emerge as the natural long-term equity investors in those projects.

Refinancing

Tolled projects and other demand-based projects may involve a series of refinancing activities and, with them, opportunities for capital markets activity. However, much of the Canadian PPP market activity has to date avoided demand-based projects and has instead implemented an availability-payment model that does not encourage or reward refinancing activity. To date, therefore, the PPP refinancing market has been relatively quiet in Canada.

The capital structure of infrastructure projects will continue to evolve in tandem with the infrastructure projects themselves. We expect that Canadian capital markets will capture a significant share of this vigorously growing infrastructure and PPP financing market.

Mark Bain is consistently recognized as one of Canada's leading infrastructure and project finance lawyers. He has acted on over 40 major public-private partnership and alternative financing and procurement transactions.

He has recently acted on the new headquarters for a Canadian federal agency, Windsor-Essex Parkway, Women's College Hospital, Niagara Health System, Ottawa LRT and Vancouver SRO projects.

Torys' Corporate and Capital Markets Practice

Torys LLP is entrusted to advise on our clients' most significant transactions. We are known for delivering high-quality capital market services in both Canada and the United States.

We provide a broad range of services to clients in all major industrial sectors, and we are regularly retained by governments and regulatory authorities to provide advice in developing and implementing major policy initiatives. Our longstanding relationships with our clients endure through generations. And with the expansion of our Calgary office, we are now uniquely positioned to provide our clients with valuable insights into several new sectors, including Canada's emerging global oil and gas markets.

The lawyers in our cross-border Corporate and Capital Markets Practice have particular expertise as both lead transaction counsel and strategic advisers in structuring and implementing sophisticated, innovative financing transactions, as well as traditional financing deals, in domestic and international capital markets.

Our practice is highly ranked globally by various sources, including Bloomberg, IFLR, Chambers Global, Mergermarket, Thomson Reuters and Lexpert, particularly for our lawyers' world-leading expertise and our exceptional bench strength.

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