CANADIAN CAPITAL MARKETS REPORT

LOOKING BACK, LOOKING FORWARD

DAVIES

Canadian Capital Markets Report 2014

Looking Back, Looking Forward

Davies Ward Phillips & Vineberg LLP is an integrated firm of approximately 240 lawyers with offices in Toronto, Montréal and New York. The firm is focused on business law and is consistently at the heart of the largest and most complex commercial and financial matters on behalf of its clients, regardless of borders.

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Overview

Following a year of only modest growth, financial markets enter 2014 with a more positive outlook as global economies continue to emerge from fiscal tightening. As always, it is useful to look back on the experience and phenomena of the past year to inform our approach to the year ahead. In 2013, Canadian regulators continued to focus on adapting to market trends while improving the efficiency of the markets. Several key developments took place in 2013, including the initiative of the federal and two provincial finance ministers to create a cooperative capital markets regulator by the summer of 2015 as well as changes proposed and implemented to many existing regulations.

We expect that the developments and trends that evolved in 2013 will continue to shape the Canadian capital markets in 2014. With this in mind, the following key issues and developments are covered in this fourth annual report by Davies on the year that was and the year ahead for Canadian capital markets.

- Following the CSA's 2012 guidance to market participants regarding initial public offerings, the Toronto Stock Exchange introduced proposed new guidelines in 2013 for participants planning to go public. In New TSX Requirements for IPOs, we provide an overview of the TSX's proposed guidelines and the effort to balance investor protection with efficient capital markets for listed issuers.
- 2013 saw a return of the instalment receipt to Canadian capital markets. Offerings of Note: The Return of the Instalment Receipt? describes the instalment receipt mechanism and its place in Canadian capital markets.
- Last summer saw wholesale changes of rules governing marketing activities for Canadian public offerings. This move to a more rules-based regime means issuers, underwriters and their counsel must devote significantly more time and attention to any proposed marketing activities for public offerings. Living with the New Marketing Rules for Public Offerings highlights some of the key elements of the new rules with a focus on areas of potential tension.
- The governments of British Columbia, Ontario and Canada are continuing to negotiate details of their initiative to establish a cooperative capital markets regulatory system by July 1, 2015. Move Towards a Single Canadian Securities Regulator Delayed summarizes the key elements of the proposed cooperative system and associated new federal legislation, and provides an update on the recently announced delay in the project's timelines.
- Corporate governance remains a hot topic in Canada. Headline-grabbing regulatory trends from 2013 such as increasing gender diversity on boards,

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imposing term limits and tenure policies for directors, and the continued rise in shareholder activism are expected to continue in 2014 and we canvass them here in Key Issues and Trends in Corporate Governance.

- The continued phenomenon of shareholder activism and proxy contests has made attracting high-quality board candidates more and more challenging, which has led some activists to implement compensation arrangements for director nominees. These arrangements received heightened attention in Canada last year, particularly as a result of JANA Partners' proxy contest with Agrium. We discuss such arrangements in Shareholder Compensation of Board Nominees: "Golden Leashes" or Valid Incentives?
- Davies published a comprehensive review of Canada's proxy voting infrastructure in 2010 and in response, the CSA has begun an undertaking to determine what changes may be needed to ensure the integrity and reliability of the voting system in Canada. Securities Regulators Ponder New Regulation for Proxy Voting System provides an overview of these recent regulatory developments and initiatives.
- Perception that the current exempt market regime in Canada has not kept pace with other global market participants has prompted the CSA to undertake a review of the current regime and consider introducing a number of new prospectus exemptions to facilitate capital raising, particularly for small to medium-sized issuers. This initiative is canvassed in Trying to Keep Pace: CSA Considers Additional Capital Raising Rules.
- Last year, Davies played an important role in reshaping foreign private placements in Canada for certain securities dealers, paving the way for proposed legislative change to make the exemption available for all similarly situated dealers. We provide an overview of the proposed legislative changes in Updates from the Wrapper World.
- In the aftermath of the financial crisis, the G20 countries agreed to increased regulation of their OTC derivatives markets. In 2013, an important step was taken toward fulfilling Canada's commitments with the adoption of new laws in respect of product determination, trade repositories and derivatives data reporting. Derivatives Regulatory Update: Canada Follows Through on G20 Commitments provides an overview of the new rules as well as other regulatory initiatives in this area.
- Finally, in Recent Developments in U.S. Law Affecting Canadian Issuers, we touch on several highlights from U.S. regulatory developments over the past year, including initiatives to permit general solicitations in certain non-registered offerings.

01
New TSX Requirements for IPOs

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In 2012, the Canadian Securities Administrators (the "CSA") provided guidance to market participants on a number of key concerns for IPOs, including financial statements, dilution and technical report issues. In line with this trend, the Toronto Stock Exchange (the "TSX" or the "Exchange") introduced and proposed new guidelines in 2013 for market participants considering IPOs. These guidelines demonstrate the Exchange's contribution to the continued effort of regulators to balance investor protection with efficient capital markets.

Advancing the Not-So-Advanced Mining Project

Many mining issuers seek to list on the TSX as "exploration and development-stage" companies. These issuers must have at least one property where the continuity of mineralization is demonstrated at economically interesting grades as detailed in a technical report prepared in accordance with National Instrument 43-101. If the TSX geologists reviewing the technical report agree that the property has economically interesting grades, the property will qualify as an "Advanced Property" for purposes of the TSX listing requirements.

In November 2013, staff at the TSX issued a notice providing guidance on the meaning of "economically interesting grades" and the factors considered by the TSX in evaluating whether a property qualifies as an Advanced Property. The staff notice focused primarily on remote bulk commodity projects and the importance of infrastructure to the economic viability of such projects.

Issuers with remote bulk commodity projects must demonstrate to the TSX their plan to develop or obtain access to the infrastructure required to ship commodities to target markets at a reasonable cost. Ideally, the infrastructure requirements and related costs should be outlined in a Preliminary Economic Assessment ("PEA"), Pre-feasibility Study ("PFS") or Feasibility Study ("FS") that has been prepared by or under the supervision of an independent qualified person.

The Exchange also noted that remote or isolated projects, whether or not they are bulk commodity projects, that are also distant from their targeted markets will likely not be considered economical given their lower intrinsic value. This view could present an obstacle for issuers with North American or South American projects targeting markets in Asia or India.

With this staff notice, the TSX is clearly signalling its view, and perhaps the views of many market participants, that remote or isolated bulk commodity projects present additional risk to investors. Although the Exchange's emphasis on a PEA, PFS or FS to address infrastructure-related costs requires issuers to source funding for the preparation of the report before accessing a TSX listing, it also provides investors with additional protection through an independent verification of the viability of the project.

Clamping Down on Backdoor Listings

In late 2013, the TSX proposed changes to the regulation of reverse takeovers, also known as "backdoor listings". In its notice, the TSX questioned whether any special consideration should be given to backdoor listing transactions that result in the listed issuer developing a significant connection to an emerging market jurisdiction. As we reported in our 2013 Capital Markets Report, Canadian securities regulators have been grappling with the regulation of emerging market issuers in light of the number of issuers that have failed to comply with their reporting obligations. Many emerging market issuers accessed the Canadian markets through backdoor listings. In late 2012, the TSX and the TSX Venture Exchange issued a consultation paper seeking input on whether new guidelines should be implemented for the listing of emerging market issuers. The proposed amendments appear, in part, to be addressing concerns raised by and in response to the consultation paper.

The TSX currently requires an entity that obtains a listing as a result of a backdoor listing transaction to meet the Exchange's original listing requirements. A transaction generally constitutes a backdoor listing if (a) following the transaction, existing security holders of the listed issuer will hold less than 50% of the voting securities, and (b) the transaction materially affects control of the listed issuer. The proposed amendments do not provide any bright line tests but expand this list of factors considered to include changes in the business or management (including board members) of the listed issuer, as well as changes in voting power, security ownership, name and capital structure of the issuer and other factors that may be relevant in the particular circumstances.

The proposed amendments also grant the TSX the discretion to consider a transaction a backdoor listing even if it does not otherwise qualify. If maintained, this discretion, together with the expanded list of considerations, will provide the Exchange with the ability to put an issuer through the more rigorous original listing review where the circumstances warrant. Had this tool previously been available to the Exchange, it may have been useful in its evaluation of the suitability of many emerging market issuers.

Pricing of Pre-IPO Options: How Low Can You Go?

Recently, the pricing of securities issued prior to an IPO has come under greater scrutiny by the CSA. As we reported in our 2013 Capital Markets Reports, the CSA introduced escrow guidelines in 2012 for holders of "cheap" shares issued in advance of an issuer's IPO. The guidelines are imposed where an issuer has issued an unusually large number of pre-IPO shares for nominal cash consideration. Consistent with this theme, the TSX is now formally imposing an additional listing requirement related to the pricing of pre-IPO options.

Under the existing TSX rules, stock options issued by a listed issuer cannot have an exercise price that is lower than the market price of the listed securities at the date of grant. In the context of an IPO, the TSX will usually consider the IPO offering price as the market price of an issuer's securities. As a result, issuers seeking to list on the TSX in connection with an IPO will likely have to cancel or reprice options granted within the three months prior to the filing of the IPO preliminary prospectus if such options were granted at an exercise price that is lower than the IPO offering price.

The TSX has indicated however that this requirement will not be strictly applied in all circumstances. For example, the TSX may accept options where the exercise price is equal to the price at which securities were issued to an arm's length party in connection with a material financing. This flexibility allows issuers to grant options to those who have assisted in a successful pre-IPO financing transaction — a useful alternative to paying a cash commission — while ensuring that IPO investors are not immediately and significantly diluted.

02 Offerings of Note: The Return of the Instalment Receipt?

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In 2013, the Canadian capital markets saw the return of the instalment receipt, an instrument that allows the investor to pay for securities on an instalment basis. Instalment receipt prospectus offerings of debt and equity have been used numerous times, although they fell out of favour with the introduction of the subscription receipt. Instalment receipts require an initial payment on closing with the balance of the purchase price to be paid in one or two instalments over a period of up to two years. They allow investors to immediately acquire all the benefits of owning a security despite not having to pay the full purchase price at the outset.

Instalment receipt deals were popular in the nineties when they were used by issuers such as Rio Algom, Sherritt International and Brascan. They returned in a big way in December when Fortis Inc. announced a $1.8-billion offering of 4.00% convertible debentures to help it fund the acquisition of Arizona-based UNS Energy Corp. Approximately $1.6 billion was sold in a bought deal public offering with the balance sold to institutions in a concurrent private placement. The offering closed in January of this year.

For each $1,000 debenture purchased, investors paid $333 on the closing of the offering and committed to pay the balance of $667 upon satisfaction of the acquisition closing conditions. Until the final instalment is paid, the investor's interest in the debenture is represented by an instalment receipt that trades on the Toronto Stock Exchange. The obligation to pay the final instalment is secured by a pledge of the debenture represented by the instalment receipt.

Upon payment of the final instalment, the pledge is released and the investor is entitled to convert the debentures into Fortis common shares at a price of $30.72 per share. Investors are highly incentivized to convert as the interest rate on the debentures drops to 0% on the final instalment payment date for the balance of the 10-year term to maturity. If the acquisition does not close, the instalment receipts are redeemed for the initial instalment amount plus accrued and unpaid interest.

→ The Investor's Perspective

By initially paying only one-third of the purchase price and receiving interest on the entire principal amount of the debenture, investors receive an effective yield of 12% on an investment grade debt security. The balance of the purchase price remains available to be deployed elsewhere until the second instalment is due.

Unlike a conventional subscription receipt where investors are paid a dividend equivalent payment only upon receiving common shares, investors in this structure receive regular quarterly interest payments until they convert their debentures into common shares.

When the debentures are converted on a date up to 18 months after the closing of the offering, investors will acquire Fortis common shares based on their market price on the date of the announcement of the offering. The conversion price in fact represented a modest discount to the market price on the announcement date.

The Issuer's Perspective

Executing a large capital raise upon the announcement of an acquisition provides cost of capital certainty and eliminates potential market risk. Instalment receipts can be marketed to investors who are seeking yield while they wait to convert to common equity.

Unlike subscription receipt proceeds which are initially held by an escrow agent, the issuer receives the proceeds of the initial instalment. These proceeds can be invested or used by the issuer to pay down debt to mitigate the cost of the interest on the outstanding debentures.

In contrast to a common equity offering, an instalment receipt offering results in less dilution to the capital structure and earnings of the issuer during the period prior to the closing of the acquisition. If the acquisition does not close, no dilution occurs.

Looking Forward

Instalment receipts offer issuers an attractive capital markets solution when conventional subscription receipts may not be available. In this case, Fortis had to account for the possibility that the acquisition may not close within the time period of 12 months that the market has traditionally accepted for subscription receipts. Investors in instalment receipts are drawn to the attractive yield, regular interest payments and conversion price. However, we expect that their relative complexity and a lack of market familiarity will ensure that instalment receipts continue to be used in relatively limited circumstances.

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Living with the New Marketing Rules for Public Offerings

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Living with the New Marketing Rules for Public Offerings

Last summer there were wholesale changes to the rules governing marketing activities for Canadian public offerings. A new rules-based regime replaced the old policy and practice-based marketing regime. While many of the new rules simply codify and clarify prior best practices, some can conflict with commercial reality and practice. The new rules also provide a more direct avenue for investors to sue issuers and underwriters for deficient marketing disclosure, and impose a number of new conditions around marketing. As a result of these changes, issuers, underwriters and their counsel must devote significantly more time and attention to any proposed marketing activities.

We highlight below key elements of the new rules, with a focus on some areas of potential tension. For a more detailed summary of the new rules, see our publication of May 31, 2013, "Canadian Securities Administrators Adopt Substantial Amendments to Marketing Rules for Public Offerings".

The Shift to a Rules-Based Marketing Regime

The central tenet of the old marketing regime was that the prospectus should be the only disclosure document for soliciting trades in a public offering. This served a number of policy objectives, including equal access to material information for all investors, investor protection (through liability for any misrepresentations) and deterring insider trading. Prior to the new rules, the general prohibition against marketing with anything but the prospectus was subject to only a few limited exceptions, whose brevity required a principled approach to assessing what marketing activities were permitted.

The new rules change the marketing regime in a few significant ways:

- they impose detailed regulation around written materials permitted for marketing;
- they codify existing practices and add conditions and limitations to the use of the bought deal exemption; and
- they establish a new safe harbour for pre-marketing to assess interest in a potential IPO.

While the rules have changed, the policy objectives have not. In fact, the new rules are intended to address a number of perceived gaps in meeting those objectives. Specifically, they improve investor protection by making issuers and their underwriters liable for deficient disclosure in any marketing materials by requiring that those materials (with some exceptions) form part of the prospectus. They also aim to address lingering equal access concerns by requiring issuers to file marketing materials on the same day they are first used. While any selective disclosure in marketing materials would have been prohibited by virtue of prior existing legislation, this new filing requirement aims to provide further transparency.

New Categories of Permitted Materials for Marketing

The new rules introduce two new categories of written materials: "standard term sheets" and "marketing materials". Dealers may provide these materials to potential investors during the "waiting period" (the time between receiving receipts for the preliminary and final prospectus) provided that they satisfy certain conditions. Each new category serves a separate purpose and different rules govern their use and content. However, they share one key requirement: all of the information included in them must be disclosed in or derived from the filed prospectus (excluding, in the case of marketing materials, "comparables"). The standard term sheet category provides the least cumbersome means to express the terms of a new offering to potential investors. However, in practice, it is rarely used as the content limitations are too restrictive for most offerings.

There are two key conditions to the use of marketing materials: (1) the issuer must publicly file a template version of marketing materials on or prior to the day the materials are first used; and (2) that filed version must form part of the final prospectus. However, any disclosure related to "comparables" (provided it is in a separate section) may be redacted from the filed version (and not form part of the prospectus) if a complete, unredacted template version is delivered on a confidential basis to the applicable securities commissions. Other conditions include the prior approval (by the issuer and lead underwriter) of the template version of the marketing materials and delivery (by the relevant underwriter) of a copy of the filed prospectus together with any marketing materials.

Ground Rules for Road Shows

Road shows are a long-standing, accepted marketing practice. The new marketing rules codify the practice and set out a few administrative ground rules. More noteworthy is that the new rules clearly regulate all written communications used in a road show, including where the investor is shown materials but is not permitted to retain or make copies of them (*e.g.*, a slide show during a road show presented online).

While the new marketing rules cast a broad net around written communications used to market a public offering, they do not regulate oral statements (or, for that matter, marketing materials in respect of private placements). Pre-existing laws in respect of insider trading and selective disclosure regulate oral statements. Generally speaking, oral presentations at road shows should be limited to the information in the prospectus. Exceeding the content of the prospectus could lead to claims of selective disclosure or insufficient prospectus disclosure. Further, misleading or untrue oral statements can attract secondary market civil liability and are generally prohibited under Canadian securities laws.

First Time Regulation of Marketing for Shelf Take-downs

The new rules also regulate marketing activities in connection with a take-down off an effective shelf prospectus. Generally speaking, the new rules governing the use of standard term sheets and marketing materials and the conduct of road shows during the waiting period apply equally in the post-receipt period. This is a significant change from a legal perspective. Prior to the new rules, there was no express regulation of marketing activities during the "post-receipt period" (the period following the waiting period, where a receipt has already been obtained for a final prospectus). The new rules expressly prohibit dealers from providing standard term sheets or marketing materials if they don't satisfy the relevant conditions. While a significant legal change, this new regulation has not substantively altered the content of marketing materials provided in a typical take-down. However, it may significantly limit prior marketing practices with respect to shelf issuers. As a practical matter, dealers won't be able to use marketing materials for any "soft sounding" in respect of a potential debt offering by a shelf issuer as the materials would need to be publicly filed on their first day of use.

More Rules Around Pre-Marketing Under the Bought Deal Exemption

The basic rule under Canadian securities legislation is that one cannot solicit expressions of interest in respect of a potential public offering during the "quiet period" prior to receiving a preliminary receipt. "Bought deals", however, are afforded a limited exception from this prohibition against pre-marketing.

The new rules expand on this bought deal exemption, expressly permitting underwriters to use standard term sheets and marketing materials, and to conduct road shows, in the period between announcing a bought deal and obtaining a preliminary receipt. The new rules also add a number of conditions and limitations to the use of the bought deal exemption. While many of these are largely in line with current market practice (such as the absence of any market-out clause in the "bought deal agreement"), there are also a number of clear limitations that did not previously exist (such as an absolute limit on "upsizing" by more than 100% of the original deal size).

Among the new limitations is a restriction on certain amendments to the terms provided for in the "bought deal agreement" (*i.e.*, the original bid letter as well as the more extended form of underwriting agreement which replaces it). This includes a prohibition on reducing the amount of securities to be purchased, or their price, until on or after the fourth business day after the original bought deal agreement. Even where such a reduction would be advisable from both the issuer's and underwriters' perspective, it likely won't be a commercially viable option in light of this mandated delay.

Testing the Waters

The new rules also expand the range of permissible pre-marketing activities through a new "testing-of-the-waters" exemption for IPOs. This exception allows a dealer to gauge interest in a potential IPO by a private issuer through limited confidential communications with accredited investors. However, there are a number of conditions to the exemption, a few of which may be difficult to satisfy. For example, this exemption permits the dealer to make solicitations on behalf of the issuer; however, it does not exempt equivalent solicitations by the issuer's management. As a result, where a dealer is availing itself of this exemption, it is unclear to what extent management can be involved in the dealer's meetings with potential investors.

Avoiding Potential Pitfalls

Regardless of how well market participants have adapted to date, for most the new rules are not yet second nature. A number of the new requirements are quite technical and, in many cases, are not intuitive. As a result, it is important that issuers and underwriters and their respective counsel are focused on these new requirements in any public offering to avoid any unintentional breach and to identify and address any potential conflicts.

WRITTEN COMMUNICATIONS

Identify at the outset what written communications may be used to market the offering and whether they are "standard term sheets" or "marketing materials". Different rules govern each category of written communication. "Standard term sheets" have substantially fewer conditions; however, in our experience, most term sheets will not constitute a "standard term sheet".

Complying with the conditions governing marketing materials requires steps to be taken prior to their first use. In the case of investor presentations, early preparation is critical to afford the time necessary for review by counsel (and, where applicable, the issuer's auditors and qualified persons) and to assess and prepare the necessary disclosure in respect of any "comparables" information that is to be redacted. In addition, where offering in Québec, a translated version must be filed by the time the marketing materials are incorporated in the prospectus. While the new rules only require that marketing materials be incorporated into the final prospectus, an issuer may choose to incorporate them in the preliminary prospectus to ensure compliance with the requirement that all the information in those materials are included in the preliminary prospectus.

BOUGHT DEAL EXEMPTION

In light of the many express conditions in the new rules, when using the bought deal exemption, it is important to focus on whether these conditions are met. Most dealers have updated their standard bid letter to meet the terms of an acceptable "bought deal agreement" under the new rules; however, if an older bid letter is used there is a risk it will be non-compliant. For example, the bid letter may condition the commitment on further syndication in a manner inconsistent with the new requirements around confirmation clauses. There is also a risk that the underwriting agreement that replaces the bid letter is non-compliant. For example, it may contain a termination right that amounts to a market-out clause or otherwise amend the terms of the original bid letter in an illegal manner. While a market-out has never been appropriate for a bought deal as a commercial matter, a number of bought deal agreements have included them in the past.

Implications of the New Rules

To date, these new rules have not substantively changed the way that dealers market most Canadian public offerings. In many ways, they have simply replaced best practices with express rules — a significant step forward that gives market participants more certainty. However, as is often the case where regulation shifts from principles to prescription, there are a number of elements that are at odds with commercial reality and practice. And there are still a number of ambiguous elements for which a market practice is evolving.

In most cases, the key implication of the new rules will be the additional time and attention devoted to marketing materials, particularly where an investor presentation is used. While it has always been best practice to ensure the information in marketing materials is consistent with the prospectus, the inclusion of these materials in the prospectus raises the stakes. As a result, a closer examination of these materials is now required by all parties involved. More time and attention is also necessary to address additional administrative requirements for the use of marketing materials, including their translation where the offering is made in Québec.

04

Move Towards a Single Canadian Securities Regulator Delayed

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In September 2013, the Ministers of Finance of British Columbia, Ontario and Canada announced their agreement to establish a cooperative capital markets regulatory system. The cooperative system is intended to have a single capital markets regulator (the "CMR") administering provincial and federal legislation and a single set of regulations designed to protect investors, support efficient capital markets and manage systemic risk. The CMR will be responsible for policy development and regulation-making, regulatory operations, enforcement and will have a separate and independent adjudicative tribunal.

Key elements of the cooperative system include:

- A uniform Act adopted by each participating province and territory covering all areas that provincial securities legislation currently addresses.
- A complementary federal Act that will address criminal matters and matters relating to systemic risk in national capital markets and national data collection.
- The CMR will administer both the provincial and federal Acts under authority delegated by each participating jurisdiction.
- A single, simplified fee structure will be designed to allow the self-funding of the CMR and will not impose unnecessary or disproportionate costs on market participants.
- The federal government will provide transitional funding to those provinces and territories that will lose net revenue as a result of transitioning to the cooperative system.
- The CMR will have an executive head office located in Toronto and a regulatory office in every participating province.

The New Federal Legislation

The new federal Act will be "platform" in nature. Rather than containing detailed provisions, the federal legislation will delegate to the CMR authority to:

- make regulations of national application (including in non-participating jurisdictions) related to systemic risk in national capital markets and national data collection;
- make orders regarding practices determined by the CMR to give rise to systemic risk in national capital markets; and
- exercise national emergency powers related to systemic risk in national capital markets and national data collection.

The CMR's regulation-making authority regarding systemic risk would, for example, include the authority to gather information to identify and monitor warning signs of emerging systemic risks to the financial system originating in the national capital markets. The federal legislation would delegate to the CMR national emergency powers in the event of a financial crisis to address an imminent threat to the stability of the national capital markets.

Details of the criminal aspects of the new federal legislation have not yet been disclosed.

Expected Timing Delayed

The implementation of the cooperative system is expected to occur in several phases and the federal and participating provincial governments have agreed to use their best efforts to achieve a number of timelines such that the CMR will be operational by July 1, 2015. Originally, the participating jurisdictions expected to have executed by January 31, 2014, a Memorandum of Agreement setting out the terms and conditions of the cooperative system (to which draft cooperative legislation was to be attached). In January 2014, the Ministers announced a delay in the execution of this agreement to April 2014, stating that the delay would not impact the overall expected timing of the CMR.

The exact cause for the delay has not been publicly announced. The speculation is that the delayed timing may be attributable to the participating jurisdictions continuing to seek support from the other jurisdictions. The participating jurisdictions have stated that active discussions with the other jurisdictions about participating in the CMR have taken place since September 2013. The federal Minister has stated that the change in timing will provide a window of opportunity for broader input in the development and finalization of the draft legislation and the framework agreements relating to the CMR. To date, none of the non-participating jurisdictions has publicly announced its intention to join the initiative.

05
Key Issues and Trends in Corporate Governance

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Key Issues and Trends in Corporate Governance

Corporate governance continues to be a hot topic in Canada with significant implications for the leadership of Canadian issuers. Developments that shaped the corporate governance landscape in 2013 and will continue to attract attention in 2014 include regulatory initiatives to promote gender diversity, debates over term limits and tenure policies, a rise in shareholder activism and the incidence of strategic tools used by issuers to address it, and several regulatory proposals that could affect shareholder voting. It is more important than ever that boards of Canadian companies stay abreast of these trends to ensure effective corporate decision-making and compliance with best practices as they evolve.

Gender Diversity

There have been increased calls to promote gender diversity among the leadership of Canada's public companies over the past year. While the representation of women on boards and in executive positions of Canadian issuers has increased in recent years, progress has been slow. For example, the Ontario Securities Commission (the "OSC") noted that based on responses to its November 2013 survey of approximately 1,000 issuers listed on the Toronto Stock Exchange (the "TSX"), 57% of respondents indicated that they have no female directors, only 3% had a female chair of the board or female lead director and 53% indicated that women held less than 10% of executive positions.

PROPOSED OSC "COMPLY OR EXPLAIN" DISCLOSURE RULES

After publishing a consultation paper and holding public roundtable discussions to solicit feedback on the most effective policies and disclosure practices for increasing the number of women on boards and in executive positions, in January 2014, the OSC published for comment proposed amendments to the existing governance disclosure requirements.

The OSC has proposed a "comply or explain" disclosure model instead of mandatory quotas. If implemented, the proposed amendments would require TSX-listed issuers and other non-venture issuers reporting in Ontario to annually disclose the extent to which women are represented on boards and in executive officer positions, including the number and proportion of women in those roles, any policies regarding the inclusion of women among the issuer's leadership (or an explanation of the absence of such policies), and any targets voluntarily adopted regarding female representation.

KEY ISSUES AND NEXT STEPS

While many are supportive of the OSC's initiative, it has been criticized by some for going too far by incentivizing tokenism resulting in companies not electing the most qualified candidates, while others argue that only fixed quotas, such as those adopted in France and being considered by Britain and the European Commission, will ensure meaningful results.

We expect the OSC's proposed rules will ultimately be adopted in some form and, as such, boards of Canadian issuers should begin to position themselves to provide the contemplated disclosure. They should also start evaluating what, if any, steps and policies they have adopted, or should adopt, in order to foster effective decision-making.

Board Term Limits and Renewal Policies

Director term limits and mandatory retirement policies continue to attract the attention of Canadian regulators, proxy advisory firms and shareholder advocacy groups, like the Canadian Coalition for Good Governance ("CCGG"), that are focused on maximizing board accountability. Based on an analysis of available public disclosure of certain TSX-listed issuers during the 2013 proxy season, approximately

- 33% of S&P/TSX Composite Index (the "Composite Index") issuers had mandatory retirement policies in place (60% of S&P/TSX 60 Index issuers (the "TSX 60", representing Canada's 60 largest issuers by market capitalization) and 23% of S&P/TSX Completion Index companies (the "Completion Index")); and
- 11% of Composite Index companies had term limits in place (32% of TSX 60 and 4% of Completion Index companies).

The number of issuers on the TSX 60 that have disclosed director term limits has jumped in the past two years from nine in 2011 (15%) to 19 in 2013 (32%). Among issuers who disclose that they have term limits, the limit is most commonly 15 years, and less frequently 10, 12 or 17 years.

The OSC's recently proposed amendments to the "comply or explain" disclosure rules include a requirement that TSX issuers disclose whether term limits have been adopted and, if not, to explain why not; however no mandatory requirement for term limits is contemplated. Similarly, the consensus among leading proxy advisory firms like Institutional Shareholder Services ("ISS") and Glass Lewis & Co., LLC ("Glass Lewis"), as well as corporate governance watchdogs like

CCGG, has been not to support shareholder proposals calling for mandatory retirement policies and term limits. For example, ISS's 2014 U.S. proxy voting guidelines state that shareholders should vote against mandatory retirement policies and term limits, provided that boards should be scrutinized to determine independence from management where the average tenure of all directors exceeds 15 years. While ISS's 2014 Canadian proxy voting guidelines are silent on the issue, we expect a similar approach would be adopted in Canada.

Shareholder Activism and Selected Strategic Tools

Shareholder activism continues to rise. Kingsdale Shareholder Services Inc. reports an 84% increase in the number of proxy contests in Canada over the past decade (from five in 2003 to 31 in 2013). Shareholders have become more receptive to activist proposals due to a shift from "corporate raider" agendas to more sophisticated ideas for improving shareholder value, including a focus on corporate strategy, governance and board independence and effectiveness. Shareholder activism has also emerged as a significant "asset class" with investors buying into the potential returns of activist agendas. According to data available through Bloomberg, the value owned by activist investors in TSX-listed companies has been rising steadily over the last two years and grew from $10.8 billion in 2011 to $15.2 billion in 2013. This growth in shareholder engagement has led many issuers to adopt strategic tools like advance notice by-laws and enhanced quorum requirements in an effort to exert more control over activist investors.

ADVANCE NOTICE BY-LAWS

Advance notice provisions in company by-laws or as board policies, requiring a shareholder to provide advance notice to an issuer if it wishes to propose nominees to the board, have gained significant traction in Canada over the past couple of years. If properly constructed and used, advance notice requirements can prevent a shareholder from "ambushing" an issuer by waiting until the annual shareholders meeting to first propose nominee(s) from the floor. Courts have recently condoned the use of such policies on the basis that they foster transparency and informed decision-making by providing shareholders with reasonable notice of, and information concerning, a contested election of directors, indicating that they can be a reasonable measure to prevent a dissident from "hiding in the weeds" and taking advantage of low voter turn-out.

The defence is commonplace in the United States despite some concerns that advance notice by-laws can impose unreasonable hurdles on shareholders wishing to nominate directors and, therefore, may be inconsistent with shareholder democracy. In their 2014 proxy advisory guidelines both ISS and Glass Lewis advise that they will recommend shareholders vote to ratify the adoption of *reasonable* advance notice policies. To be reasonable, ISS and Glass Lewis indicate that the issuer's deadline for requiring notice must not be more than 65 days and not fewer than 30 days before the meeting date. Nevertheless, Canadian issuers should carefully consider the scope of any advance notice by-law they may wish to implement to ensure that the requirements are not prejudicial to shareholder engagement.

ENHANCED QUORUM BY-LAWS

Another measure employed by some issuers has been to amend their by-laws to create an elevated quorum threshold for contested meetings where shareholders seek to replace a majority of the board. If the enhanced quorum threshold is not satisfied, the meeting is typically adjourned for a period of up to 65 days. ISS's 2014 proxy advisory guidelines indicate that shareholders should vote against enhanced quorum by-laws because they are subject to management's predetermination that a contested election is the singularly most important corporate issue. In their view, this conflicts with the notion that all matters for approval should carry equal importance.

Regulators and courts continue to search for an appropriate balance between fostering shareholder engagement while preserving the ability of boards to supervise the management and affairs of their issuers. However, boards of public issuers need to be cognizant of their duties, including the need to ensure accurate, complete and timely disclosure, to minimize the risk of their actions being brought under scrutiny.

Update on Other Corporate Governance Issues

As discussed in detail in Davies' *Governance Insights 2013* report, the following additional issues received heightened attention in 2013 and can be expected to influence governance agendas in 2014:

- **More Say on Pay Votes.** Advisory "say on pay" votes on executive compensation have become the norm in Canada and were put to the shareholders of 80% of TSX 60 issuers in 2013, as compared to just over 50% in 2011. Most Canadian issuers that have adopted say on pay practices are putting forward advisory, non-binding resolutions substantially in the form recommended by CCGG.

- **Review of the Proxy Voting Infrastructure**. The OSC and the Canadian Securities Administrators (the "CSA") have pledged to address perceived flaws in the proxy voting system noted by Davies in our 2010 paper *The Quality of the Shareholder Vote in Canada*. We expect that these proxy voting issues and any potential solutions identified will continue to foster debate and discussion in 2014. **See "Securities Regulators Ponder New Regulation for Proxy Voting System" in this report for further discussion of this topic.**

- **Regulation of Proxy Advisory Firms.** The CSA has undertaken a consultation process concerning the possible regulation of proxy advisory firms such as ISS and Glass Lewis. Similar processes are underway in the United States and Europe. We expect regulators will continue to scrutinize the influence of proxy advisory firms to determine the best means of addressing the perceived influence they have on investors exercising voting rights, while balancing the divergent views expressed by issuers on one hand and investors on the other over whether, and how, to do so.

- **Poison Pill Regulation.** Alternative approaches to regulating shareholder rights plans within Canada's takeover bid and defensive tactics regime have been proposed for comment by the CSA and Québec's Autorité des marchés financiers (the "AMF"). The CSA has proposed a new stand-alone rule based on a shareholder primacy model where the survival of a rights plan would depend upon issuers obtaining shareholder approval within prescribed timelines, while the AMF has proposed changes to existing defensive tactics rules that would give greater deference to target boards provided they follow a reasonable process with appropriate safeguards against directors' decisions being tainted by conflicts of interest. The nature of any regulatory changes to be adopted has not yet been determined.

- **Nominee Compensation Arrangements.** Compensation arrangements entered into between activist shareholders and their board nominees, especially those tying compensation to company performance, were a hot topic in 2013. ISS has left the door open to these types of arrangements, saying it will consider them on a case-by-case basis. We expect the treatment of such arrangements to continue to generate heated debate and scrutiny by many market participants in 2014. **See "Shareholder Compensation of Board Nominees: 'Golden Leashes' or Valid Incentives?" in this report for further discussion of this subject**.

06
Shareholder Compensation of Board Nominees: “Golden Leashes” or Valid Incentives?

06

Shareholder Compensation of Board Nominees: "Golden Leashes" or Valid Incentives?

To address the challenge of attracting good board candidates where proxy contests may become a bit of a battle, some activists have implemented compensation arrangements for director nominees — both for their troubles during the course of a proxy fight and for the value they help create if and when they are successfully elected. Two high-profile proxy contests in 2013 (one in Canada and one in the United States) brought scrutiny of nominee compensation. The debate about the propriety of the practice is still ongoing, with proxy advisory firms starting to weigh in.

In Canada, JANA Partners offered each of its nominees for the board of Agrium a fixed-cash payment of $50,000 plus a profit participation interest in any profit JANA Partners generated from its ownership of Agrium shares over a three-year period. Agrium attacked these compensation arrangements, labelling them "golden leashes" that compromised the nominees' independence. The attack became a main focus of Agrium's campaign to convince shareholders to reject JANA's proposed slate. In particular, Agrium alleged that these arrangements were short-term compensation that incentivized the nominees to pursue actions that would destroy the long-term value of Agrium and would compromise the ability of the board to function. JANA Partners defended the arrangements noting that they did not impose any obligations on the nominees other than to stand for election and that the profit participations were designed to align the interests of the nominees with those of Agrium shareholders.

Agrium was ultimately successful in the proxy contest and some of Agrium's major institutional shareholders who supported Agrium's incumbent board were critical of JANA's compensation arrangements, noting the short time frame of the arrangements (three years or sooner should JANA sell its position) and expressing concerns about whether they would affect the nominees' independence.

At the same time that JANA Partners was waging its contest with Agrium, Elliott Management Corp. was engaged in its own proxy fight with Hess Corp. in the United States. Like JANA Partners, the arrangements for Elliott Management's nominees were intended to provide performance incentives; like Agrium, Hess attacked the arrangements. Just prior to the Hess shareholders meeting, Elliott Management's nominees agreed to waive their compensation arrangement should they be elected to the board, citing the ongoing distraction caused by the compensation issue. On the same day that this concession was announced, Hess and Elliott Management announced a settlement that saw two of the dissident's nominees elected. The timing of the waiver and settlement suggests that compensation arrangements might have presented an obstacle in the settlement discussions.

The Agrium and Hess contests sparked debate among those focused on corporate governance and proxy contests. Critics have included Wachtell Lipton

Rosen and Katz, which recommended that companies adopt a by-law prohibiting compensation arrangements between activist shareholders and their director nominees. Influential proxy advisory firm Institutional Shareholder Services (ISS) has just recently weighed in on the debate. ISS issued a clear statement that it should be up to shareholders and not boards to determine whether individuals should be disqualified for election, noting: "The adoption of restrictive director qualification by-laws without shareholder approval may be considered a material failure of governance". ISS did not comment on whether it agrees with or rejects the criticisms of Agrium and Hess that compensation arrangements compromise the independence of nominees. However compensatory arrangements are among the factors that ISS will consider in evaluating director nominees in contested elections.

The ISS position on by-law amendments that prohibit nominee compensation does not settle the debate sparked by the Agrium and Hess contests. In fact, by asserting that it should be shareholders who decide whether restrictions on compensation arrangements are appropriate, ISS has kept the debate alive. The challenge for activist shareholders will be to craft compensation arrangements that allay concerns about nominee independence and are well-aligned with the long-term interests of shareholders.

07 Securities Regulators Ponder New Regulation for Proxy Voting System

07

Securities Regulators Ponder New Regulation for Proxy Voting System

A recently conducted consultation process by the Ontario Securities Commission (the "OSC") has rekindled attention on the state of Canada's proxy voting infrastructure and raised the prospect of greater regulatory oversight. Problems with the system of shareholder voting have been discussed for a number of years. But while those responsible for the operation of the system claim to have adopted practices aimed at reducing voting irregularities, they have made little headway in gaining the confidence of market participants.

Davies conducted a comprehensive review of Canada's proxy voting infrastructure in our paper, *The Quality of the Shareholder Vote in Canada*, published in 2010. The paper brought extensive attention to an unduly complex and opaque system by which shareholders cast their votes at shareholders meetings and catalogued the myriad of irregularities and inaccuracies that can arise in shareholder votes.

Among the key issues Davies noted in its paper was the need for securities regulators to acknowledge the importance of an effective and reliable proxy voting system and to champion a comprehensive review of the system with a view to the possible regulation of aspects of the system in which securities regulators have not been involved. In August of last year, in response to the Davies paper and the attention it garnered, the Canadian Securities Administrators (the "CSA") published a consultation paper seeking feedback on a proposed approach to improve the integrity and reliability of the proxy voting infrastructure. Following up on this feedback, the OSC hosted a public roundtable on January 29, 2014. Roundtable contributors included representatives from various market participants, including issuers and investors, as well as representatives of firms, such as Broadridge, CDS, transfer agents and custodians, that are responsible for the operation of the proxy voting infrastructure.

The CSA consultation paper and the OSC roundtable brought to light starkly divergent views on the state of Canada's proxy voting system. Broadridge, which handles shareholder mailings and voting instruction compilation for the vast majority of shareholder meetings in Canada, and the Investment Industry Association of Canada contended that the system is not broken and is generally found to be accurate and reliable. Broadridge and others noted their investment in new processes and policies designed to increase transparency and reduce the incidence of voting irregularities such as over-voting. Despite these assurances, numerous market participants, including issuers and investors, reiterated their lack of confidence in the integrity of the system and their experience of frequent voting anomalies. Another common complaint from issuers and shareholders alike is frustration in the lack of transparency into the complex system and the lack of any end-to-end vote confirmation mechanism.

One observation from both the CSA consultation process and the OSC roundtable is how little the debate has evolved since the publication of the Davies paper in 2010. While those responsible for the operation of the system have made efforts to improve the system, the fundamental problems that we canvassed in 2010 are still largely unsolved and doubts about the integrity and accuracy of the system persist.

08

Trying to Keep Pace: CSA Considers Additional Capital Raising Rules

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Trying to Keep Pace: CSA Considers Additional Capital Raising Rules

In response to the widespread perception that the current exempt market regime in Canada has not kept pace with global market developments, such as changes in investor demographics and the use of the Internet and social media, the members of the Canadian Securities Administrators (the "CSA") have collectively and independently undertaken a review of the exempt market to consider introducing new prospectus exemptions to facilitate capital raising.

The Ontario Securities Commission (the "OSC") is exploring the adoption of exemptions that are already available in other jurisdictions, such as an offering memorandum and close family and friends exemption, as well as new exemptions including crowdfunding, and exemptions based on the sophistication of the investor, the receipt of advice from a registrant and sales to existing security holders.

In the fall of 2013, the CSA (without the OSC) published for comment a notice proposing a prospectus exemption that would allow issuers listed on the TSX Venture Exchange (the "TSX-V") to raise capital by distributing securities to their existing security holders. The Autorité des marchés financiers (the "AMF") is supportive of this initiative and, along with the Alberta Securities Commission and the Financial and Consumer Services Commission of New Brunswick, is contemplating adopting the proposed exemption by way of a local rule, making the exemption permanent.

Ontario Harmonizes with the Rest of Canada — Mostly

OFFERING MEMORANDUM

Currently, an offering memorandum exemption is available to issuers selling securities in each province and territory of Canada, other than Ontario. The OSC was initially considering adopting an offering memorandum exemption that would allow Canadian non-investment fund issuers to raise a limited amount of capital within any 12-month period (currently contemplated at $1.5 million) for limited types of securities (such as equity securities or non-convertible debt linked to a fixed or floating interest rate) based on a limited disclosure document that includes basic information about the offering, the issuer and the registrant (if any). Investment by purchasers under the offering memorandum exemption would be limited to $2,500 per single investment, with an aggregate limit on all investments under such exemption of $10,000 each calendar year.

In August 2013, the OSC announced its intention to develop a proposal for an offering memorandum exemption that is substantially harmonized with the existing Alberta model of the offering memorandum exemption. Unlike the British Columbia model which does not restrict the identity of the purchaser nor the investment size, the Alberta model does not allow a purchaser to invest more than $10,000 unless the purchaser is an "eligible investor". The concept of "eligible investor" is based on the net assets or the net income before taxes of an individual, alone or with a spouse. A person who has obtained advice regarding the suitability of the investment from an eligibility adviser would also qualify as an "eligible investor".

In developing the exemption, the OSC will focus on factors such as streamlined disclosure, qualification criteria, limits on types of securities that may be offered and investment limits.

The offering memorandum exemption available in Québec is also based on the Alberta model. In order to render the offering memorandum exemption more readily accessible and less costly to small and medium-sized businesses, the AMF does not require all issuers relying on the exemption to conduct audits and to prepare financial statements following the International Financial Reporting Standards.

FAMILY, FRIENDS AND BUSINESS ASSOCIATES

The OSC had considered adopting an exemption that allows for the issuance of securities to an unlimited number of family members of the directors, executive officers or control persons of an issuer or its affiliates. Although the proposal did not garner significant response, some stakeholders supported adopting a harmonized family, friends and business associates exemption similar to the one available in other CSA jurisdictions.

As a result of market feedback, the OSC is now considering adopting the broader family, friends and business associates exemption, with the objective of substantial harmonization of the exemption across Canada. The OSC will consider whether additional conditions should be added to the "business associates" concept to more clearly define "close personal friend" and "close business associate". Possible conditions could include requiring the relevant executive officers, directors or founders of an issuer to certify the nature of their relationship with the investor and requiring the investor to sign a risk acknowledgment.

Existing Security Holders

Certain CSA members have proposed an exemption that would allow issuers with equity securities listed on the TSX-V to raise money by distributing securities to their existing security holders. To rely on the exemption, the CSA is proposing that only investors that have been security holders for a certain period of time prior to the announcement of the offering can participate. The CSA is seeking input from stakeholders on the appropriate period of time. The CSA is also proposing that the aggregate amount invested by the investor in the 12 months preceding this investment under the proposed exemption not exceed $15,000, unless the investor has obtained advice regarding the suitability of the investment from a registered investment dealer. In addition, it is proposed that each investor be provided with certain rights of action in the event of a misrepresentation in the issuer's continuous disclosure record. Although an offering document is not required, if an issuer voluntarily provides one, investors will have certain rights of action in the event of a misrepresentation contained therein.

Although the OSC has expressed its support for this initiative, it is developing its own existing security holder exemption which it expects to publish for comment in the first quarter of 2014.

Crowdfunding

Crowdfunding is a method of funding a project or venture through small amounts of money raised from a large number of people over the Internet, generally through an Internet portal.

In December 2012, the OSC proposed a crowdfunding exemption to allow Canadian non-investment fund issuers to raise a limited amount of capital within any 12-month period (currently contemplated at $1.5 million) for limited types of securities (such as equity securities or non-convertible debt linked to a fixed or floating interest rate) based on a limited disclosure document that includes basic information about the offering, the issuer, the funding portal and the registrant (if any). Investment by purchasers under the crowdfunding exemption would be limited to $2,500 per single investment, with an aggregate limit on all investments under such exemption of $10,000 each calendar year.

As a result of comments received from stakeholders on the proposal, the OSC announced in August 2013 that it is continuing to work to develop a crowdfunding regulatory framework that will provide investors with adequate protections without imposing excessive regulatory costs on issuers and funding portals. However, the OSC continues to take the view that it should be a condition of any crowdfunding exemption that investments be made through a registered funding portal.

The AMF is currently conducting research in order to determine whether the adoption of a crowdfunding exemption would be desirable and, if so, what registration system would be appropriate. The AMF is also of the opinion that investments made under such an exemption should be done through a funding portal designed for the specific purposes of crowdfunding. The AMF is particularly concerned with the safety of online investors and, as such, commissioned a study to analyze whether a specific instrument to prevent fraud as well as an online fraud prevention centre could successfully reduce potential risks investors face.

Dropped Prospectus Exemptions

The OSC announced in August 2013 that the following prospectus exemptions or amendments which had been proposed in 2012 are no longer being considered at this time: (i) an investor sophistication exemption; (ii) a registrant advice exemption; (iii) changes to the existing private issuer exemption; and (iv) the reintroduction of the closely held issuer exemption. The OSC received limited or mixed support for these exemptions through feedback from the market and it does not consider these proposals to be as important for capital raising as the exemptions it intends to further consider.

Next Steps

It is expected that in 2014 the CSA will continue to focus on adopting capital raising exemptions to provide issuers with easier, cheaper and faster access to capital. The OSC has announced that it intends to publish for comment in the first quarter of 2014 proposals for each of the exemptions discussed above. It is also expected that in 2014 the AMF will issue proposals for additional capital raising exemptions following public consultations held in 2013. These proposals may introduce the reduction of the regulatory burden weighing on start-ups and small and medium-sized businesses.

The challenge for the CSA, as always, is to facilitate capital raising while ensuring investor protection. This struggle is evident in the consultation papers released by the regulators in 2013.

09
Updates From the Wrapper World

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Updates From the Wrapper World

2013 was an important year in the world of foreign private placements in Canada. In the middle of last year, many Canadian, U.S. and other foreign securities dealers obtained exemptive relief from the requirement to prepare a Canadian "wrapper" in connection with private placements of certain eligible foreign securities to sophisticated investors in Canada. Davies assisted several global investment banks in obtaining this relief, which paved the way for legislative changes to make the "wrapper exemption" — as it has become known — available to all similarly situated securities dealers. The exemptive relief orders will expire when these legislative changes take effect.

The Exemptive Relief

In general, the relief orders allow the named dealers to distribute securities of certain foreign issuers to permitted clients in Canada using a foreign offering document that no longer has to be "Canadianized" to include the disclosure customarily provided in a Canadian "wrapper". The relief has its limitations, including a cumbersome "notice and acknowledgement" requirement, enhanced monthly reporting obligations and a requirement that the foreign offering document comply with the disclosure requirements regarding underwriter conflicts of interest applicable to a registered U.S. offering, even if the particular offering is not registered. Overall, however, it was a significant step in the right direction in terms of increasing access to foreign securities for Canadian institutional investors. It was also the impetus for amendments to Canadian securities laws that will make the wrapper exemption permanent.

Proposed Amendments

On April 25, 2013, the Ontario Securities Commission (the "OSC") published for comment proposed amendments to OSC Rule 45-501 *Ontario Prospectus and Registration Exemptions* ("OSC Rule 45-501") and certain Ontario-specific requirements in National Instrument 45-106 *Prospectus and Registration Exemptions*. If adopted, the proposed amendments will give effect to the Ontario-specific elements of the wrapper relief, namely, an exemption from the prohibition on listing representations where all of the purchasers in Ontario are permitted clients and an exemption that would allow dealers to provide the statutory right of action disclosure by alternative means, including by way of one-time "notice and acknowledgement" signed by the permitted client.

In response to the request for comments, several commentators, including Davies, suggested that the requirement to have the permitted client return a signed acknowledgement is unnecessary and unduly onerous. It is unclear if this comment has been accepted.

In order to complete the litany of legislative amendments required to give full effect to the wrapper relief, on November 28, 2013, the Canadian Securities Administrators (the "CSA") published for comment proposed amendments to National Instrument 33-105 *Underwriting Conflicts* ("NI 33-105") and a new proposed Multilateral Instrument 45-107 *Listing Representations and Statutory Rights of Action Disclosure Exemptions* ("MI 45-107"). MI 45-107 will provide in substance the same relief in the rest of Canada as the amendments to OSC Rule 45-501 will provide in Ontario.

The proposed amendments to NI 33-105 regarding underwriter conflict of interest disclosure are generally consistent with the wrapper relief orders. However, there are some technical inconsistencies that would make the proposed amendments more restrictive than the existing relief. We believe some of these inconsistencies were inadvertent and we expect they will be addressed during the comment period.

Notably, while the proposed amendments to NI 33-105 do contain a "notice requirement" (*i.e.*, the dealer relying on the exemption must give notice to prospective purchasers of the exemptions upon which they are relying), they do not include the requirement to obtain a signed acknowledgement from the prospective purchaser. This is a significant improvement from the relief orders. Assuming that this requirement is also eliminated in the amendments to OSC Rule 45-501, it would mean, for example, that foreign dealers could include a boilerplate "Notice to Canadian Investors" section in all foreign offering documents to provide the requisite notice, as opposed to sending out separate notices to each client and tracking which clients returned signed acknowledgements.

Proposed Amendments to Dealer Registration Rules

On December 5, 2013, the CSA published for comment proposed amendments to the dealer registration rules which will impact exempt market dealers and exempt international dealers.

Until now, the prevailing view in Canada was that a dealer registered in a jurisdiction as an exempt market dealer could also rely on the international dealer exemption. This view was supported by guidance issued in a CSA Staff Notice in 2010. In an about-face, the CSA is now proposing to amend the dealer registration rules to provide that the exemptions from the registration requirement, including the international dealer exemption, are not available to a firm that is registered as a dealer in *any* jurisdiction of Canada if the terms of its registration permit the dealer to trade in the relevant security. For example, a firm that is registered as an exempt market dealer in Ontario could not rely on the international dealer exemption in Ontario or in any other province.

The proposed amendments also narrow the scope of activities that exempt market dealers may undertake. Currently, an exempt market dealer may participate in a public offering for which a prospectus has been filed in Canada, provided that the dealer only sells the securities to an exempt market purchaser. The proposed amendments, if adopted, would prohibit an exempt market dealer from trading in securities in the exempt market where a prospectus has been filed anywhere in Canada in respect of that offering.

The proposed amendments would also prohibit an exempt market dealer from participating in the resale of freely tradeable securities which are listed on any domestic or foreign marketplace. For example, an exempt market dealer would not be permitted to facilitate a secondary market trade of the shares of a NYSE-listed issuer unless the trade is a distribution made in reliance on an exemption from the prospectus requirement (*i.e.*, a distribution from the holdings of a control person).

It is not known at this time if and when these proposed amendments will come into effect. However, registered dealers that also rely on the international dealer exemption should monitor the status of these proposals closely to ensure that they are prepared if and when the amendments are enacted.

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Derivatives Regulatory Update: Canada Follows Through on G20 Commitments

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Derivatives Regulatory Update: Canada Follows Through on G20 Commitments

In the aftermath of the financial crisis, the G20 countries agreed to increased regulation of their respective OTC derivatives markets based on common themes, including central clearing, trade reporting and electronic trading, where appropriate. The Canadian government committed at the Pittsburgh and Toronto G20 meetings to reform the Canadian OTC derivatives markets by the end of 2012. In keeping with these "G20 Commitments", in November 2010, the Derivatives Committee of the Canadian Securities Administrators (the "CSA") published a consultation paper that set out high-level proposals for the regulation of OTC derivatives.

Since 2010, the CSA has published a number of additional policy papers that build on the initial high-level proposals. In 2013, the CSA continued this policy initiative with the release in April of a new consultation paper setting out the CSA's recommendations on registration and ongoing compliance of derivatives market participants.

In addition, in December 2013, the CSA published for comment a model provincial rule which would create requirements for central counterparty clearing of OTC derivatives transactions. This is the third model rule that has been published by the CSA and is demonstrative of the rule-making process they have adopted. Generally speaking, these model rules are intended to implement the policy recommendations laid out in the various consultation papers. All model rules are published for a public consultation period, following which appropriate amendments are made. Once this process is complete, each provincial jurisdiction publishes its own rules, with necessary local modifications. However, it is intended that the substance of the final rules will be the same across jurisdictions, and that market participants and derivatives products will receive the same treatment across Canada.

Concurrently with the release of the CSA's model rule relating to central counterparty clearing, the Ontario Securities Commission (the "OSC"), Québec's Autorité des marchés financiers (the "AMF") and the Manitoba Securities Commission (the "MSC") each published for comment proposed local rules setting out requirements for recognition as a clearing agency.

Finally, in late 2013, the OSC, the AMF and the MSC each published revised versions of harmonized derivatives rules in respect of product determination, trade repositories and derivatives data reporting. The revisions to these rules addressed comments received by the regulators on draft versions of the rules that were published earlier in 2013 and were based on model provincial rules that were established by the CSA. The rules came into force in Ontario, Québec and Manitoba on December 31, 2013, with the trade reporting requirements to be phased in over the course of 2014. It is expected that other jurisdictions will adopt similar province-specific rules, based on the CSA's model rules, in the future.

Registration Consultation Paper

On April 18, 2013, the CSA released Consultation Paper 91-407 *Derivatives: Registration* (the "Consultation Paper") which sets out the CSA's recommendations on registration and ongoing compliance of derivatives market participants.

The proposed registration regime includes three categories of registration: the derivatives dealer category for those carrying on the business of trading in derivatives, including intermediating trades, making markets in derivatives, receiving compensation for trading and soliciting derivatives trades; the derivatives adviser category for those carrying on the business of advising others in relation to derivatives; and the large derivative participant ("LDP") category for entities, other than derivatives dealers, that have a substantial derivatives exposure that could subject the Canadian or international financial system to significant systematic risk. Registration would be required for both frontline staff and managers/supervisors and include individuals involved in providing advice and trading services to clients as an intermediary.

The Consultation Paper proposes exemptions from the registration requirement, including for (i) clearing agencies, (ii) persons trading with, on behalf of, or providing advice to, affiliates, (iii) governments and (iv) dealers providing derivatives-related advice incidental to trading services.

A number of registration requirements are proposed that would apply to all registrants. These include: minimum proficiency requirements, financial and solvency requirements (including minimum capital, margin, insurance and reporting requirements), honest dealing obligations and obligations relating to the care of collateral posted by clients or counterparties. Derivatives dealers and advisers would also be required to fulfill certain gatekeeper functions and business conduct requirements including know your client/counterparty obligations, suitability obligations and conflict of interest management.

The CSA is also considering two regulatory alternatives specifically for situations where derivatives dealers trade as principal with non-qualified parties. "Qualified parties" are expected to include sophisticated market participants with the financial ability to absorb losses from derivatives transactions, conceptually similar to "permitted clients" and "accredited investors". Either the non-qualified party will be required to obtain independent advice before trading or the derivatives dealer will be required to instruct the non-qualified party that the derivatives dealer has a conflict of interest and advise the counterparty that it may obtain independent advice. Where a derivatives dealer trades as principal with a non-qualified party that is not independently represented, the derivatives dealer will be subject to additional reporting requirements including pre-trade reports, trade confirmations and account statements.

Market participants required to register as derivatives dealers, derivatives advisers or LDPs who are subject to equivalent regulation by an alternative Canadian regulator, as determined by the applicable securities regulator, would be exempt from redundant regulation. Foreign derivatives dealers, derivatives advisers and LDPs would be exempt from certain regulatory requirements where they can demonstrate that they are subject to substantially equivalent regulatory requirements in their home jurisdiction. However, they would still be required to register in the Canadian jurisdictions where they are carrying on derivatives-related business and would be subject to ongoing reporting requirements.

Also of note in the Consultation Paper is the CSA's recognition of Canada's role in the global derivatives market and its commitment to work with international regulators to develop rules for the Canadian market that ensure that Canadian derivatives market participants "have access to international markets and are regulated in accordance with international principles".

Central Counterparty Clearing Rule

On December 19, 2013, the CSA published for comment CSA Staff Notice 91-303 *Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives* (the "Central Counterparty Clearing Rule") which describes proposed requirements for central counterparty clearing of OTC derivatives transactions. The CSA has indicated that the purpose of the Central Counterparty Clearing Rule is to improve transparency in the derivatives market for regulators and the public, and to enhance the overall mitigation of risks.

The Central Counterparty Clearing Rule is generally divided into two areas, namely (i) the determination of the types of derivatives subject to central counterparty clearing requirements (a "clearable derivative") and (ii) mandatory central counterparty clearing for clearable derivatives.

CLEARABLE DERIVATIVES

The Central Counterparty Clearing Rule contemplates that the applicable local securities regulators will have the power to determine which derivatives or class of derivatives will be considered "clearable derivatives" and as a result be subject to central counterparty clearing requirements. This determination will be made on a product-by-product basis taking into account a variety of factors.

MANDATORY CENTRAL COUNTERPARTY CLEARING

The Central Counterparty Clearing Rule proposes a mandatory central counterparty clearing requirement for clearable derivative transactions involving a local counterparty. This requirement would be subject to certain exemptions, including for end-users that enter into derivatives transactions to hedge commercial risk related to the operation of their business as well as for intragroup transactions between affiliated entities. The CSA has requested specific feedback on the proposed end-user exemption which, as currently proposed, could not be relied on by a financial entity. As a result, small financial institutions would be subject to mandatory central counterparty clearing regardless of whether or not they are in the business of derivatives trading.

Clearing Agency Rule

Concurrently with the release of the Central Counterparty Clearing Rule, the OSC published for comment proposed OSC Rule 24-503 *Clearing Agency Requirements* (the "Clearing Agency Rule") which sets out requirements for recognition as a clearing agency (or exemption from the recognition requirements). Similar proposed local rules were also published by the AMF and the MSC.

The Clearing Agency Rule sets out a number of ongoing compliance requirements that would apply to recognized clearing agencies that act as, or perform the services of, a central counterparty, a central securities depository or a securities settlement system. The requirements are based largely on international standards applicable to financial market infrastructures developed jointly by the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the Board of the International Organization of Securities Commissions (IOSCO).

The standards developed by CPSS-IOSCO are intended to enhance the safety and efficiency in clearing, settlement and recording arrangements and, more broadly, to limit systemic risk and foster transparency and financial stability. The OSC also noted that they consider the implementation of the CPSS-IOSCO standards through the Clearing Agency Rule to be an important part of the CSA's efforts to develop a comprehensive regulatory framework for the trading of derivatives in Canada that is necessary to fulfill Canada's G20 Commitments.

Product Determination Rule

OSC Rule 91-506 *Derivatives: Product Determination* and its related companion policy (the "Scope Rule") provide guidance as to the types of derivatives that will be subject to the new regulatory requirements that are being adopted. Although the Scope Rule is currently only applicable to the trade reporting rule (discussed below), over time as other new rules are enacted (such as the Central Counterparty Clearing Rule discussed above) it is expected that the Scope Rule will apply to those new rules as well.

The Scope Rule effectively narrows the range of products that might otherwise fall within the broad definition of "derivative" under Ontario securities legislation. The Scope Rule also resolves conflicts that may arise when a specific contract or instrument falls under the overlapping definitions of "derivative" and "security" under Ontario securities legislation. Any contract or instrument that is excluded from the definition of "derivative" under the Scope Rule will not be required to be reported to a designated trade repository.

Trade Repositories and Derivatives Data Reporting Rule

OSC Rule 91-507 *Trade Repositories and Derivatives Data Reporting* and its related companion policy (the "TR Rule") generally address two areas: (i) requirements relating to the regulation of trade repositories and (ii) reporting requirements by counterparties to derivatives transactions.

REGULATION OF TRADE REPOSITORIES

The TR Rule establishes detailed requirements for an entity to obtain and maintain a designation as a trade repository. In determining whether or not to designate a trade repository, the OSC will consider various factors, including whether it is in the public interest to do so, whether the applicant is in compliance with securities laws and whether the applicant has established policies that meet standards applicable to trade repositories.

Once designated, a trade repository will be subject to a variety of ongoing compliance requirements relating to, among other things, governance, recordkeeping, data security and confidentiality and risk management.

REPORTING OBLIGATIONS

Pursuant to the TR Rule, all derivatives transactions involving a local counterparty are required to be reported to a designated trade repository or, if none have been designated for the type of transaction, to the OSC. The TR Rule establishes a hierarchy for determining which counterparty to a transaction is required to report. It should be noted that the counterparties to a transaction are free to contract or institute systems and practices to delegate the reporting function to one of them or to a third party to avoid double reporting. However, each counterparty that has a reporting obligation (pursuant to the hierarchy set out in the TR Rule) will remain responsible for ensuring the timely and accurate reporting of a transaction.

CONTENT AND TIMING OF REPORTING

The three main types of data that must be reported under the TR Rule are (i) creation data; (ii) life-cycle event data, which includes any changes to derivatives data previously reported; and (iii) valuation data, which includes the current value of the transaction.

The TR Rule requires that the initial reporting of creation data be completed on a real-time basis and the reporting of life-cycle event data be completed by the end of each business day (in each case provided that it is technologically possible to do so). Valuation data must be reported daily where the reporting counterparty is a derivatives dealer or a recognized or exempt clearing agency. In all other cases, valuation data must be reported quarterly.

EFFECTIVE DATES FOR REPORTING OBLIGATIONS

Although the TR Rule came into force on December 31, 2013, the derivatives trade reporting requirements will not come into force until July 2, 2014 (other than in cases where both counterparties are non-dealers, in which case no reporting will be required until September 30, 2014).

In addition, obligations under the TR Rule that will require the public dissemination of anonymous transaction-level data by designated trade repositories will not come into effect until December 31, 2014. This additional six-month extension was made in response to many comments received by the OSC on the draft rules that the publication of transaction-level data, even with the reporting delays provided for in the TR Rule, could cause harm to the Canadian derivatives market and market participants due to the less liquid nature of the Canadian derivatives market relative to other major trading jurisdictions. It remains to be seen what, if any, changes will be made to the TR Rule to address these concerns.

Next Steps: New Law

The publication of the consultation paper on registration, the proposed model rule on central counterparty clearing and the local rule on clearing agency requirements represent important steps toward fulfilling Canada's G20 Commitments. However, by far the most significant development in Canadian derivatives regulation this past year was the promulgation into law by the provincial governments of Ontario, Québec and Manitoba of new rules in respect of product determination, trade repositories and derivatives data reporting. Although over the past few years the CSA (and the various provincial securities regulators) have released a number of policy papers and proposed rules, until now, no new laws with respect to derivatives regulation had come into force in response to Canada's G20 Commitments. Going forward, we expect 2014 to also be a significant year for derivatives regulation in Canada, as the policy papers and proposed model rules continue to progress through the regulatory process towards becoming new law.

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Recent Developments in U.S. Law Affecting Canadian Issuers

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Recent Developments in U.S. Law Affecting Canadian Issuers

Permitting General Solicitation in Certain Non-Registered Offerings

Rule 506 of Regulation D provides a safe harbor from the registration requirements of the U.S. *Securities Act of 1933*, as amended (the "1933 Act"), for private, *i.e.*, non-registered, offerings of securities in the United States. The safe harbor has been relied on extensively by U.S. and non-U.S. issuers for private placements made generally, although not always exclusively, to "accredited investors". Similarly, Rule 144A under the 1933 Act provides a safe harbor for primary non-registered offerings made to large institutional investors known as "QIBs".

As mandated by the *Jumpstart Our Business Startups Act* (the "JOBS Act"), in July 2013, the U.S. Securities and Exchange Commission (the "SEC") adopted rule amendments that became effective in September 2013, permitting the use of "general advertising" and "general solicitation" (for example, newspaper or magazine ads, television or radio broadcasts and publicly available websites), in offerings of non-registered securities conducted in accordance with Rule 506 or Rule 144A. (We refer to general advertising and general solicitation as "general solicitation" in the remainder of this Report.) This type of activity was for many years prohibited under these rules, and this prohibition was a fundamental aspect of how private offerings were conducted in the United States.

The ability to engage in general solicitation in Rule 506 offerings is subject to compliance with a number of requirements. Under new Rule 506(c), securities may be sold only to persons reasonably believed to be accredited investors, and issuers (or their placement agents) must take "reasonable steps" to verify that all purchasers in a Rule 506(c) offering are accredited investors. This will require going beyond the self-certification by investors previously relied on by issuers to establish the accredited investor status of potential investors, particularly for non-institutional investors.

Whether the steps taken will be "reasonable" is an objective determination, based on the facts and circumstances of each offering. The SEC has suggested that the reasonableness of an issuer's verification efforts will depend on various factors, including the nature of the purchaser, the type of accredited investor the purchaser claims to be, the amount and type of information the issuer has about the purchaser, and the nature and terms of the offering.

Regardless of the steps taken, if an issuer's right to claim the Rule 506(c) exemption is challenged, the issuer will have the burden of proof that it is entitled to the exemption. Consequently, issuers (and any third-party verification service providers retained by issuers) should retain adequate records regarding the steps taken to verify that each purchaser in a Rule 506(c) offering was an accredited investor at the time of the offering.

Private investment companies, such as hedge funds, private equity funds and venture capital funds, are eligible to use the Rule 506(c) exemption. Most of these funds rely on the exclusions from the definition of "investment company" under the U.S. *Investment Company Act of 1940* provided by Sections 3(c)(1) ("100-person funds") and 3(c)(7) ("qualified purchaser funds") of that Act. To qualify for either exclusion, a fund may not make a public offering of its securities. The SEC has confirmed that private funds may engage in general solicitation in a Rule 506(c) offering without losing either of these exclusions.

Issuers that do not wish to engage in general solicitation, or who wish to sell to non-accredited investors, in their Rule 506 offerings may continue to do so under Rule 506(b) provided that sales are made to not more than 35 investors. No additional investor verification efforts are required in Rule 506(b) offerings beyond those already customarily employed by issuers and placement agents.

The amendment to Rule 144A permits the use of general solicitation in Rule 144A offerings provided that sales of securities are made only to QIBs or persons reasonably believed by the issuer or a financial intermediary to be QIBs. The new rule does not make any changes to the ways by which sellers currently determine a potential investor's status. The amendment to Rule 144A is not expected to have a significant effect on the way in which these offerings are conducted.

Of particular interest to non-U.S. issuers is the SEC's guidance that the use of general solicitation in a Rule 506(c) or Rule 144A offering will not cause the U.S. offering to be integrated with an offering being conducted concurrently outside the United States pursuant to Regulation S under the 1933 Act. Issuers will thus be able to conduct unregistered offerings offshore and inside the United States concurrently without fear of losing either exemption.

Proposed Amendments to Regulation D: More Filings and Compliance Required

Concurrently with the elimination of the prohibition against general solicitation in Rule 506 and Rule 144A offerings, the SEC issued proposed amendments to Regulation D, primarily with respect to Rule 506 offerings. The proposals were issued both to enhance the SEC's ability to evaluate the development of market practices in Rule 506 offerings, particularly those involving general solicitation, and to address investor protection concerns that permitting general solicitation in private placements would result in an increase in fraudulent practices, particularly with respect to offerings by smaller, less well-known companies.

Under the proposed rules

- Issuers would have to file an initial Form D in Rule 506(c) offerings at least 15 days before engaging in any general solicitation and an amended Form D within at least 15 days of the first sale in the offering, and a closing Form D after termination of any Rule 506 offering.
- Issuers would have to provide additional information on Form D.
- Written general solicitation materials used in Rule 506(c) offerings would have to include certain legends and other prescribed disclosure.
- On a temporary basis, written general solicitation materials used in Rule 506(c) offerings would have to be submitted to the SEC no later than their first date of use.
- Issuers would be subject to a one-year disqualification from relying on Rule 506 for failing to comply within the past five years with the Form D filing requirements for a Rule 506 offering.

MARKET FEEDBACK

The proposals have elicited numerous comment letters. The proposals requiring the filing of an advance Form D, a one-year disqualification for failing to comply with the Form D filing requirements and the filing of written general solicitation materials with the SEC have elicited a large number of negative comments, as many commenters consider these proposals as being contrary to the JOBS Act's goal of facilitating capital formation by small and emerging growth companies. The comment period for the proposed rules ended on November 4, 2013.

ADVANCE NOTICE

In particular, commenters have noted that the ability of issuers to conduct Rule 506(c) offerings on short notice could be severely constrained if the SEC adopts the 15-day advance notice requirement. Many also noted that issuers may refrain from using general solicitation if advance disclosure would expose them to market or competitive risk. Additionally, the failure to file in advance of an unintended, inadvertent or unauthorized general solicitation could cause an issuer to have to delay an offering, which could result in missing an open market window.

ONE-YEAR DISQUALIFICATION

Perhaps the most controversial aspect of the proposed rules, however, is the proposed amendment to Rule 507 that would automatically disqualify an issuer, with no SEC action required, from using Rule 506(b) or (c) in any new offering for one year if the issuer did not comply within the past five years with the Form D filing requirements in a Rule 506(b) or (c) offering. According to the SEC, this proposal is intended to "...create a significant incentive to file Form D on a timely basis without unduly burdening market participants".

The one-year disqualification period would begin following the filing of all required Form Ds for the subject offering. As proposed, the five-year look-back period would not extend past the effective date of the new rule.

The proposed rules include a 30-day cure period in which to file a late initial or amended Form D that can be used only once for any particular offering, and waivers of non-compliance may be obtained from the SEC upon a showing of "good cause". The Regulation D proposals do not affect the SEC's current position that the failure to file a Form D or filing late for an offering will not cause the loss of the Rule 506 safe harbor for the offering to which it relates or for offers and sales made in connection with other Rule 506 offerings that began before the failure to comply occurred.

Finally, securities sold in subsequent non-Rule 506 offerings during the disqualification period by non-listed companies would not be "covered securities" under U.S. securities laws, and thus would not be automatically exempt from the registration requirements of, and merit review under, applicable state securities ("blue sky") laws. This could require potentially time-consuming and expensive registrations in the states in which such offerings are conducted, which could adversely affect the ability of issuers to raise needed capital.

Commenters have expressed the view that disqualification is a very severe penalty that is disproportionate to the offense for which it would be imposed. Commenters have also noted that a disqualification could result from (i) a non-material failure to timely file that is not or cannot be cured; (ii) failure to file in advance of an unintended or inadvertent general solicitation; or (iii) because the proposal is unclear as to whether it applies to failures to provide all of the information required by Form D, filing a Form D that lacks any required information.

SUBMISSION OF WRITTEN GENERAL SOLICITATION MATERIALS

Included in the Regulation D proposals is a temporary rule (Rule 510T) that would require issuers conducting Rule 506(c) offerings to submit copies of written general solicitation materials to the SEC. The SEC explained in the proposing release that it believes that a review of these materials will provide it with the ability to assess and understand market practices in Rule 506(c) offerings.

As proposed, the temporary rule would be in effect for two years. Written materials would have to be submitted to the SEC no later than their date of first use, but the materials would not be publicly available on the SEC's EDGAR system.

Some commentators have stated that the temporary rule would discourage the use of general solicitation because, among other things, (i) the determination of what constitutes "written general solicitation materials" would be very difficult, particularly in light of the ever-increasing use of social media, and (ii) issuers may be reluctant to provide confidential or proprietary business information to the SEC. Further, it has been noted that the SEC's objectives could be satisfied by requiring an undertaking from the issuer to provide the information upon request rather than requiring that it be submitted to the SEC.

Proposed Regulation A+: Small Company Capital Formation

On December 18, 2013, the SEC proposed rules to amend Regulation A under the 1933 Act to modernize and expand the framework for capital raising by smaller companies. Currently, Regulation A enables eligible U.S. and Canadian issuers that are not SEC reporting companies to raise up to $5 million in any 12-month period in one or more public offerings exempt from registration under the 1933 Act. Regulation A has been used infrequently in recent years principally due to the low offering threshold and the absence of state securities or "blue sky" law exemptions for Regulation A offerings. Title IV of the JOBS Act, "Small Company Capital Formation", directed the SEC to add a new exemption from registration under the 1933 Act for offerings of securities up to $50 million in any 12-month period. The proposed rules, known as Regulation A+, would expand Regulation A to include an exemption from registration for securities offerings of up to $50 million in any 12-month period, including up to $15 million for the account of selling securityholders (a Tier 2 offering).

Existing rules regarding issuer eligibility, communications, qualification and offering process, offering statement disclosure and certain other matters would apply equally to Tier 2 offerings. Tier 2 offerings would also be subject to additional requirements, such as investor purchase limits, the provision of two years of audited financial statements in the offering statement and the issuer becoming subject to ongoing reporting requirements. In light of the additional requirements proposed for Tier 2 offerings, securities offered and sold in a Tier 2 offering would be exempt from registration and qualification under state securities laws.

Regulation A is currently available to any U.S. or Canadian entity that has its principal place of business in the United States or Canada and is not subject to SEC reporting obligations under the U.S. *Securities Exchange Act of 1934* (the "1934 Act"). The types of securities that may be offered under the proposed rules would be limited to equity securities, debt securities and debt securities convertible into or exchangeable into equity securities, including any guarantees of such securities. Asset-backed securities are excluded.

An issuer that seeks to conduct a Regulation A offering must prepare, file and qualify an offering statement before any sales of securities can be completed. The core of the offering statement is the offering circular, a disclosure document much like an abbreviated version of the prospectus in a registered offering. The proposed rules seek to modernize the Regulation A offering process in a manner consistent with regulatory developments in the registered offering process.

Qualification of a Regulation A offering statement would not by itself result in the issuer becoming subject to the reporting requirements of the 1934 Act. Section 12(g) of the 1934 Act, however, requires issuers with total assets exceeding $10 million to register under the 1934 Act any class of equity securities held of record by either 2,000 persons or 500 persons who are not accredited investors. The proposed rules would not exempt securities sold pursuant to Regulation A from the Section 12(g) registration thresholds. Accordingly, an issuer conducting a Regulation A offering would be advised to closely monitor the number of record holders for 1934 Act purposes, especially because securities sold pursuant to Regulation A are not considered "restricted securities" and may be transferred without restriction.

Under the proposed rules, Tier 2 offerings would be subject to a number of additional requirements, which are intended to address certain investor protection concerns. Most notably, Tier 2 offerings would be subject to investment limits — an investor would not be permitted to invest more than 10% of the greater of the investor's annual income and net worth in any one Tier 2 offering and issuers in Tier 2 offerings would be subject to an ongoing reporting regime that is analogous to the regime for U.S. domestic reporting companies under the 1934 Act, but with reduced disclosure requirements.

CAN REGULATION A BE THE "GAME CHANGER" FOR SMALLER GROWING COMPANIES?

Until about a decade ago, IPOs of up to $50 million were common in the United States. However, for a variety of reasons (including significant regulatory changes, expanded disclosure requirements, a lengthy SEC review process, stock exchange governance listing requirements, etc.), the traditional IPO process has become substantially more time-consuming and expensive. Additionally, the uncertainty about being able to complete the lengthy registration process and launch an IPO in favorable market conditions has often discouraged smaller companies from embarking on this path. Despite the accommodations for emerging growth companies provided by the JOBS Act, a traditional IPO may not be a realistic capital raising alternative for smaller companies in the United States.

As a result, smaller private companies have had to rely almost exclusively on exempt offerings, such as Rule 506 and 144A offerings, to raise capital in the United States. While recent changes to Rule 506 and Rule 144A have provided some more flexibility to issuers by lifting the ban on general solicitation, the attractiveness of these offerings is limited due to their eligibility requirements for investors (*e.g.*, accredited investors) and because the securities issued are subject to transfer restrictions. Investors prefer to purchase securities that are not "restricted" and may be freely traded in a secondary market (assuming there is a secondary market). Further, smaller companies may want (or need) to be able to approach any investors. Regulation A does not limit the number of offerees or investors that can participate in an offering, nor does it impose any requirement that investors be accredited or financially sophisticated. The proposed new Tier 2 exemption, if adopted, may finally provide smaller companies with a viable capital raising alternative that is less time-consuming, less costly and more efficient than a traditional IPO and more attractive than a private placement. If successful, the proposed Tier 2 offering and the reduced ongoing reporting regime that follows a completed Tier 2 offering may possibly become the path that smaller growth companies take as a precursor to a subsequent registered IPO or listing on a national securities exchange.

Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings

Effective September 23, 2013, issuers can no longer rely on the safe harbor (from registration) provided by Rule 506 under the 1933 Act for their private offerings in the United States, if the issuer or certain other "covered persons" have been convicted of, or are subject to court or administrative sanction for, securities fraud or violation of other specified laws ("disqualifying events"). This amendment was adopted by the SEC pursuant to the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act").

Under new Rule 506(d), if any of the following persons has experienced a disqualifying event, the issuer is disqualified from relying on Rule 506:

- the issuer, including any of its predecessors, or any affiliated issuer that is issuing securities in the same offering as the issuer;
- the issuer's directors, executive officers and any beneficial owner of 20% or more of the issuer's outstanding voting equity securities;
- any investment manager of an issuer that is a pooled investment fund, any of such investment manager's directors, executive officers, and other officers participating in the offering;
- any promoter connected with the issuer in any capacity at the time of sale; and
- any person that has been or will be paid (directly or indirectly) remuneration for soliciting purchasers in connection with sales of securities in the offering (such as a placement agent), and any of such person's directors, executive officers, and other officers participating in the offering.

The disqualifying events that make Rule 506 unavailable include certain U.S. criminal convictions, U.S. court injunctions relating to the purchase or sale of securities or false filings with the SEC and orders issued by certain state and federal regulatory authorities, including related SEC orders.

Disqualification will not arise as a result of events that occurred before September 23, 2013, provided that a reasonable time before the sale the issuer discloses in writing to each purchaser in the Rule 506 offering those matters that would have resulted in disqualification had they occurred after September 23, 2013.

An issuer that did not know, and in the exercise of reasonable care could not have known, that a covered person was subject to a disqualifying event, will not be disqualified from relying on the Rule 506 exemption. The issuer would have to conduct a factual inquiry to meet the reasonable care standard. The SEC did not prescribe any specific steps for such an inquiry. The steps an issuer should take will vary based on the particular facts and circumstances.

Finally, an issuer can apply to the Director of the SEC's Division of Corporation Finance for a waiver of the Rule 506 disqualification (but not from the obligation to disclose past events that would have been disqualifying but for the fact that they occurred prior to September 23, 2013) if the issuer can show "good cause".

It's important to note that disqualification under Rule 506 does not preclude an issuer from conducting private placements in reliance on Section 4(a)(2) of the 1933 Act. There is, however, one important distinction for Canadian public companies that are not listed on a U.S. national securities exchange.

Disqualification under Rule 506 will generally result in their private placements in the United States being subject to registration or qualification requirements of the securities laws of various states.

Key Contacts

If you are interested in receiving more information, please contact us or visit our website at www.dwpv.com.

The information in this guide should not be relied upon as legal advice. We encourage you to contact us directly with any specific questions.

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