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Boards Beware: Regulators Actively Monitoring Related Party Transactions

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On July 27, 2017, staff of the Ontario, Québec, Alberta, Manitoba and New Brunswick securities regulatory authorities offered guidance on the role of boards and special committees and on their process and disclosure obligations in conflict of interest transactions.[1] The Notice is helpful in that it provides clear and considered guidance on the requirements of MI 61-101 and the role to be played by special committees in such transactions. In summary, the guidance notes that a well-run special committee process will include a robust mandate, the hiring of independent advisors to the special committee, supervision over or direct conduct of negotiations, accurate record-keeping and non-coercive conduct on the part of interested parties. In addition, if a fairness opinion is obtained in a material conflict of interest transaction, it should be accompanied by disclosure regarding the nature of the financial advisor's compensation and the financial metrics supporting the opinion. The guidance is rooted in a long line of securities commission decisions, including *Hollinger* in 2005, Sears in 2006 and Magna in 2011.[2]

What the Guidance Applies To

The Notice applies to a subset of MI 61-101 transactions – namely, MI 61-101 transactions that give rise to *substantive* concerns as to the protection of minority securityholders. The Notice coins the descriptor "material conflict of interest transactions" (here, material conflict transactions). The Notice does not apply to transactions that are caught by MI 61-101 for purely technical reasons. It also does not apply to conflict of interest transactions that are *outside* MI 61-101. Significantly, it does not apply to the type of transaction that was the subject of the Yukon Court of Appeal's highly controversial decision in *InterOil* last year.

Staff Is Watching

Staff is actively reviewing material conflict transactions during the pendency of the transaction. These reviews are not limited to the adequacy of disclosure or the availability of claimed exemptions from valuation and minority approval requirements, but also include consideration of the substance of the process followed by the board and special committee in negotiating and reviewing the transaction. The Notice emphasizes the importance of the process and its substance over form, and the necessity for issuers and boards to treat the minority shareholders fairly by complying with the spirit and intent of MI 61-101 and avoiding tactical or self-serving disclosure.

Issuers are warned that the regulators' review may include the special committee's mandate, minutes of meetings of the special committee and the board, and valuation work product. Staff will assess the substantive steps that boards and special committees take to protect minority shareholders by adopting a broad purposive interpretation of MI 61-101. Non-compliance could result in Staff seeking cease trade orders, corrective disclosure, orders under securities legislation and possible enforcement action.

Role of Special Committees

The formation of a special committee of independent directors is mandated by MI 61-101 only in the context of insider bids. However, Staff are of the view that a special committee is advisable for all material conflict transactions. This view is consistent with current best practice.

The Notice sets out the focus of Staff's scrutiny of material conflict transactions, including the following:

Timely Formation and Effectiveness. Staff call for formation early in the events leading up to a transaction and before a proposed transaction is substantially negotiated. The exact nature of the involvement of the special committee in negotiations will depend on the context of a particular transaction but, in Staff's view, in certain cases the committee should play an active role in negotiating a transaction from the outset, either directly or through advisors by way of supervision. If preliminary negotiations are carried out by interested parties before the special committee assumes control, these should be non-binding on the special committee and subject to a robust review.

Broad Mandates. A narrow mandate may constrain special committees and diminish their effectiveness. In Staff's view, a committee's mandate should provide members with the autonomy to supervise negotiations or negotiate directly; to consider alternatives to the conflicted transaction, including maintaining the status quo; to make a recommendation or provide reasons why a recommendation cannot be made; and to hire its own independent legal and financial advisors. The Notice cautions against mandates merely to review a proposal developed by management in conjunction with a related party or to assess whether a transaction should be put to securityholders for a vote.

Independence. The Notice warns special committees to protect their independence and to properly manage conflicts of interest. For example, while assistance may be obtained from interested board members or subject-matter experts, or advisors with ties or historical relationships, non-independent persons should be excluded from decision-making deliberations. Insiders and interested parties are cautioned against exerting undue influence or engaging in threatening or coercive conduct because this may taint the special committee process.

Reliance on Fairness Opinions. The Notice cautions against overreliance on fairness opinions, reminding special committees that advisors are not a substitute for the committee's own considered judgment of a transaction's merits from a perspective broader than financial fairness. The Notice also reiterates the potential relevance of prior financial work product that could amount to a prior valuation – and trigger separate disclosure obligations under MI 61-101.

Recommendation. The board must consider not only whether a transaction is in the best interests of the corporation, but also whether it is in the best interests of the minority securityholders. Staff believe these interests will generally not be in conflict, but if they are, the board must explain the conflict and how the board addressed it.

Fairness Opinions

Fairness opinions are not mandated by MI 61-101 and Staff have not taken a firm view in the Notice on whether a fairness opinion should be obtained. Staff will continue to defer to boards of directors and special committees to determine whether such an opinion is necessary. In addition, the Notice confirms Staff's view that it is the responsibility of the board of directors or the special committee to determine the terms and financial arrangements for the engagement of the advisor providing the opinion.

In a material conflict transaction, Staff expect issuers to disclose when a fairness opinion was requested but the financial advisor was not able or willing to provide one, including the reasons for not providing the opinion and how this impacted the recommendation made to shareholders in respect of the transaction. Where a fairness opinion is obtained to support a material conflict transaction, Staff expect issuers to provide shareholders with a meaningful understanding of the opinion and how it was considered by the board or the special committee. This disclosure should include the following:

Financial Advisor Compensation. Disclosure of the compensation arrangements with the financial advisor should include whether payments are contingent on successful completion of the transaction or flat-fee based and an explanation of how the compensation arrangement was taken into account in considering the advice provided. It is notable that the requirement to disclose compensation arrangements does not specifically call for the disclosure of compensation quantum.

Independence of Financial Advisor. Any relationship with an interested party that could influence the independence or perceived independence of the advisor delivering the opinion should be addressed and explained.

Methodology and Financial Metrics. Staff expect to see a discussion of the fairness opinion's methodology, including the information and analysis underlying the opinion and financial metrics to supplement the narrative explanation. This requirement is generally satisfied by the disclosure of the formal valuation typically required under MI 61-101 for material conflict transactions. However, this requirement appears to be a change to current practice in situations in which a fairness opinion is being delivered for a material conflict transaction that is exempt from the formal valuation requirements.

Relevance of the Opinion to the Decision to Recommend the Transaction. Staff expect an explanation of the relevance of the fairness opinion in arriving at the determination to recommend the transaction.

What the Notice Does Not Do

What the Notice does not do is address the many M&A transactions that are not subject to MI 61-101 but that nonetheless may give rise to the appearance of conflicts of interest – because of either board or management entrenchment concerns or management incentives to transact (where these conflicts are not adequately addressed by a robust special committee process). Nonetheless, we think two wider lessons can be drawn from the Notice and applied to these situations. First, the Notice should serve as support for the view that no higher standard should be applied to non-MI 61-101 transactions than to material conflict transactions governed by the Notice. In this sense, the Notice implicitly rejects the *InterOil* standards dictating a fixed fee and disclosure of the amount of the financial advisor's compensation. Second, because the principles underlying the guidance would apply equally in the case of a non MI 61 101 transaction in which management conflicts are not adequately addressed, it would be prudent to follow the dictates of the Notice in respect of process, disclosure and fairness opinions.

[1]Multilateral CSA Staff Notice 61-302 (Notice), Staff Review and Commentary on Multilateral Instrument 61-101, Protection of Minority Security Holders in Special Transactions (MI 61-101)

[2]Hollinger Inc. (Re), (2005), 28 OSCB 3309; Sears Canada (Re), (2006), 35 OSCB 8781; Magna Partners Ltd. (Re), (2011), 34 OSCB 8697.

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