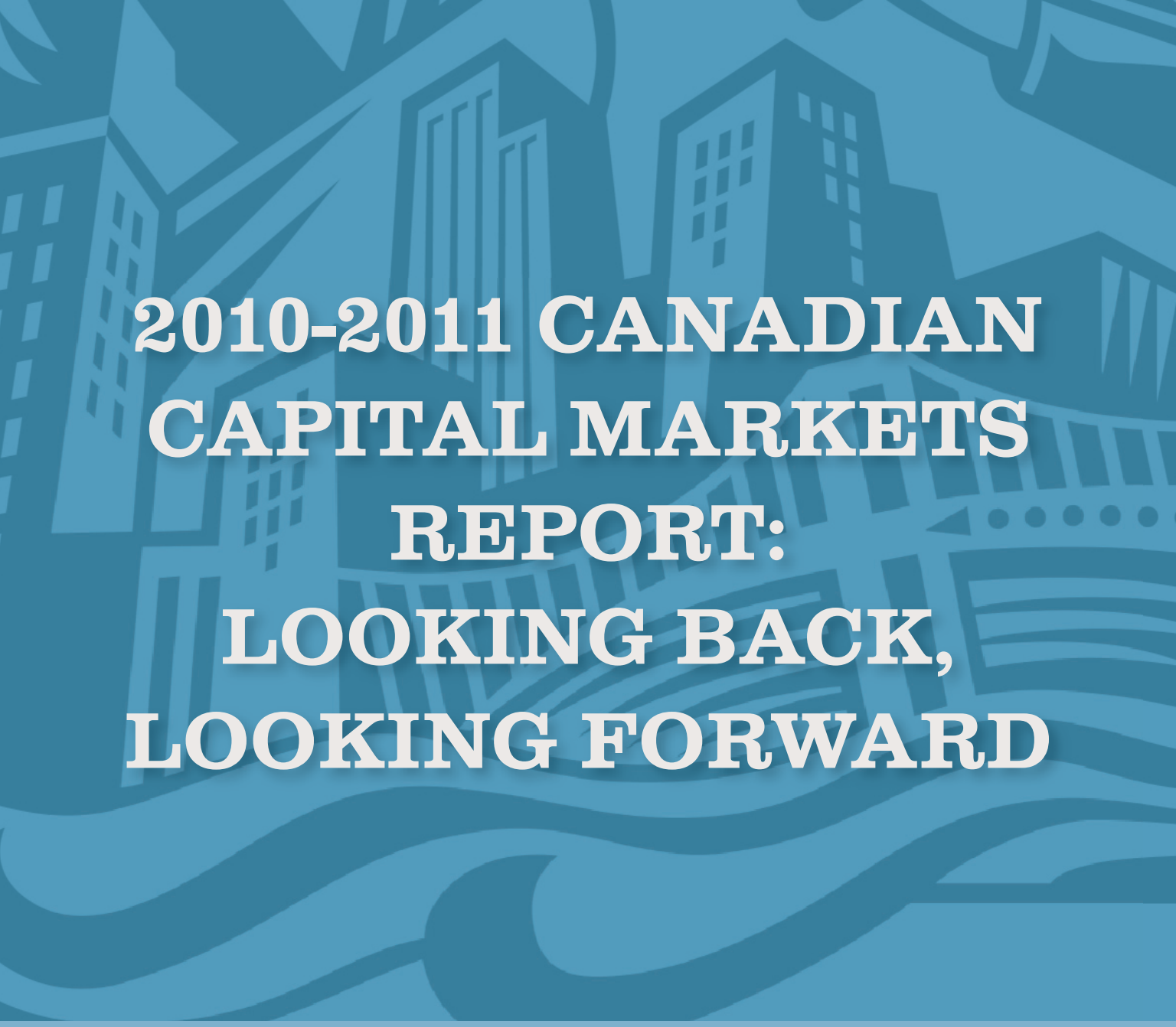

2010-2011 CANADIAN CAPITAL MARKETS REPORT: LOOKING BACK, LOOKING FORWARD

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CONTENTS

TABLE OF CONTENTS

INTRODUCTION

2010 will be remembered as the year the high-yield market came to Canada and the IPO market returned. Davies' Capital Markets group has produced this publication to capture significant developments in the capital markets in 2010 and to identify the trends and developments most deserving of your attention in 2011.

WHAT TO WATCH FOR IN 2011

Bonds - High-yield bonds were the darling of the Canadian capital markets in 2010, with over $3 billion of high-yield notes sold by over a dozen issuers during the year. 2011 may prove to be yet another record year for Canadian high-yield bond deals with a number of new issues already anticipated by market participants.

Pre-marketing - The basic rule under securities legislation in Canada is that underwriters may not solicit expressions of interest in connection with a public distribution of securities until a receipt has been issued for a preliminary prospectus. However, some are asking whether the rules are out of step with practice.

PIPE transactions – Norms are developing around Canadian-style PIPEs. We expect to see more PIPEs in 2011 driven by foreign investment and private equity funds.

IPOs - While many IPOs were successful in 2010, some failed to launch. Companies considering an IPO must be well prepared and able to navigate quickly through the issues.

Governance - As a result of shareholder pressure for a greater voice in corporate affairs, 2011 will see an increased focus on majority voting and Say-on-Pay and a dialogue on the flawed proxy voting system.

U.S. law in Canadian boardrooms – Canadian issuers may find themselves subject to some unusual new laws for which there are no domestic parallels, including the executive compensation clawback and whistleblower incentives provisions under the United States' Dodd-Frank legislation.

Regulatory landscape – A new accounting regime and a new OSC Chair, coupled with announced regulatory initiatives on derivatives and securitized products, shareholder democracy, executive compensation, the exempt market and material contract filings, signal a busy year ahead for capital market participants and their advisors.

HIGH-YIELD BONDS IN CANADA: WHY THEY'RE HERE TO STAY

High-yield bonds were the darling of the Canadian capital markets in 2010, with over $3 billion of high-yield notes sold by over a dozen issuers during the year. Davies has acted as legal counsel on many high-yield bond offerings by Canadian issuers, including the 2010 Canadian dollar offerings by Air Canada, Quebecor Media and Vidéotron. 2011 may prove to be yet another record year for Canadian high-yield bond deals with a number of new issues already anticipated by market participants.

CANADIAN ISSUERS IN THE U.S. MARKET

Historically, there has not been a distinct market for high-yield bonds in Canada. Despite plenty of Canadian companies that have (or could have) issued high-yield bonds, it was widely thought that there was insufficient liquidity in the Canadian capital markets to support the placement of these bonds domestically. So, until 2009, these companies looked south to the U.S. markets in order to raise high-yield debt.

Starting in the summer of 2009, this trend took a dramatic turn. Canadian companies that had previously issued only U.S. high-yield bonds began offering Canadian dollar bonds in Canada. A number of these companies issued tranches of Canadian dollar bonds concurrently with U.S. dollar tranches. This included Air Canada, which issued a $300 million Canadian tranche as part of its total $1.1 billion bond offering. Others, including Vidéotron and Quebecor Media, issued only a Canadian tranche. In addition, there were a number of Canadian companies that issued high-yield bonds for the first time and chose to raise this debt in the Canadian market.

WHY THE MARKET CAME TO CANADA

So, why has a Canadian high-yield market emerged so suddenly? Like all overnight successes, this one was really two decades in the making. Savvy Canadian issuers, like Rogers Communications, saw the opportunity to finance in the U.S. high-yield debt markets almost 20 years ago. Numerous Canadian issuers followed suit and over time small tranches directed at the Canadian private placement market were added, creating familiarity in Canada with the investment product and, ultimately, some specialty buyers in the form of high-yield bond funds. The tipping point came in mid-2009 when prevailing investment and interest rate environments led to overwhelming demand for yield and a corresponding appetite for the associated credit risk. While this insatiable appetite for yield was clearly a global

phenomenon (2010 was also a record-setting year for U.S. high-yield bonds), in Canada this demand was amplified by investors looking to replace their investments in converted income trusts. U.S. investors are also looking northward at Canadian high-yield, driven by the superior performance of many Canadian issuers and the relative strength of the Canadian economy. From a supply perspective, more limited access to debt in the Canadian credit markets - due to more conservative lending practices, fewer available lenders and a general dislocation of these markets – caused more Canadian companies to turn to the public debt markets for capital.

While these Canadian companies could have turned to the United States for the debt capital they needed, many of them found a Canadian bond offering more attractive. For many, a Canadian deal offered better economics by, among other things, avoiding the cost of the currency swaps associated with a U.S. financing. In some cases, a Canadian deal may have improved pricing as a result of Canadian investors' familiarity with the issuer and its Canadian brand or, more generally, the very limited supply of available Canadian high-yield bonds. In addition, pursuing a Canadian offering could save an issuer from significant future costs and other burdens of complying with the U.S. reporting regime. Finally, the Canadian market also demonstrated that it could accommodate smaller deal sizes that would be insufficient for a tranche of U.S. high-yield bonds.

COVENANTS

Generally speaking, the covenants in Canadian high-yield bonds have been similar to those found in U.S. covenant packages; however, some non-standard covenant packages did emerge. We believe these non-standard covenants are largely attributable to the newness of the Canadian market and, in some instances, may have been the result of the issuer having unusual negotiating leverage due to the limited supply of Canadian high-yield bonds. Covenant packages have become more uniform in more recent Canadian offerings, largely following the U.S. standard. We expect this trend to continue as the Canadian high-yield market evolves and as more issuers focus on expanding demand for their Canadian bonds from U.S. and other global investors. Whatever form they take, these covenant packages are complex and the assistance of experienced counsel is essential for issuers of high-yield bonds.

STRUCTURE AND PROCESS

From a structuring standpoint, there is also little to distinguish high-yield bonds issued by Canadian companies from those issued by their U.S. counterparts. In limited circumstances there may be legal limitations in respect of the guarantees or collateral that may be pledged by Canadian issuers or guarantors that could result in structural differences; however, this is true whether the bonds are offered in Canada or the United States. On the other hand, the offering process in Canada is typically more efficient (and therefore less expensive) than in the United States where high-yield bonds are often privately placed in order to get to market quickly and later made freely tradable through a registered exchange offer, requiring clearance from the SEC. In Canada, eligible issuers can quickly qualify a public offering of bonds using a short form prospectus. Where even that speedy option is too slow, they may instead privately place the bonds with accredited investors. Because those privately placed bonds will be freely tradeable in Canada under Canadian resale rules within four months, no further action (or expense) is required on the part of the issuer.

IS THE MARKET HERE TO STAY

While a number of factors could derail the Canadian high-yield bond market, two factors are critical to its continued success: whether there will be a sufficient supply of high-yield issues in the future and whether an active secondary market can be developed and sustained to support new issues. To date, Canadian investment banks have committed significant resources to bring new deals to market and support a liquid secondary market. Earlier commentators questioned whether there were enough Canadian high-yield issuers to achieve critical mass; however, developments over the last two years seem to have countered this concern. Many market participants anticipate that the number of potential Canadian high-yield issuers should continue to grow as the Canadian market broadens to accommodate lesser credits and, in the near-term, as a result of the conversion of income trusts. As a result of this growth in supply, and near term expectations of continuing demand for yield, high-yield bonds may have found a permanent home in the Canadian capital markets.

IPOs: WHAT CAN GO WRONG?

According to a January 2011 report by PriceWaterhouseCoopers LLP, Canadian IPOs more than doubled in 2010 with 73 issues for a total value of $5.5 billion. The report reveals that 25 new issues were offered on the Toronto Stock Exchange in 2010 for a combined value of $5.2 billion (compared to four IPOs worth $1.7 billion in 2009) and the TSX Venture exchange accounted for 42 IPOs worth $347 million in 2010 (compared to 20 IPOs for $69 million in 2009).

For all the IPOs that were completed in 2010, the statistics do not reflect the many IPOs that died before launch. IPOs run aground for a myriad of reasons, but sometimes it is the result of the process getting bogged down by a single issue. Here are some of those issues:

CONSTRUCTING YOUR FINANCIAL PAST

The IPO prospectus must contain three years of annual financial statements. Prior to the switch to International Financial Reporting Standards ("IFRS") in Canada at the beginning of 2011, these statements had to adhere to Canadian Generally Accepted Accounting Principles ("GAAP") (subject to special rules for foreign issuers). However, an IPO prospectus filed in 2011 may include annual financial statements prepared in accordance with Canadian GAAP (for historical fiscal years) and comparative interim financial statements prepared in accordance with IFRS. If the company does not have a three-year history, it is necessary to include the financial statements of predecessor entities that formed the basis of the business of the company. It may also be necessary to include financial statements for businesses acquired in the prior three years if they constitute the primary business of the company. Some companies may wish to exclude financial statements of acquired businesses on the basis that the acquisition occurred too long ago for the statements to be meaningful for investors. Companies may also wish to exclude older financial statements for a cross-border IPO where, under U.S. rules, only two years of financial statements are required. Relief from financial statement disclosure requirements is time consuming and uncertain and can slow down the IPO process.

TECHNICAL REPORTS – DIG IN EARLY

Much of 2010's IPO activity occurred in the energy and mining sectors. Under National Instrument 43-101, a technical report supporting the scientific and technical information in a mining company's

prospectus must be filed at the same time that the preliminary prospectus is filed. Oil & gas companies need to disclose in the prospectus reserves estimates prepared in accordance with the COGE Handbook and National Instrument 51-101 and by an independent qualified reserves evaluator. Preparation of technical information and reports can be time consuming, particularly where the company's properties are located outside of Canada. Being ready with the reports on time requires significant advance planning. If technical information cannot be prepared in time, the company's only financing alternative in Canada is to proceed by way of private placement.

HAVING YOUR CAKE...AND EATING IT

Founders can avoid the dilution of control that normally accompanies an IPO by adopting a dual-class share structure and retaining the superior voting shares. Many significant Canadian public companies have dual-class share structures, including Bombardier, Celestica, Onex, Canadian Tire and the recently IPO'ed SMART Technologies and Skope Energy Inc. Dual-class share structures are attractive to owners looking to maintain control over the company. Although dual-class share structures have a long history in Canada, some Canadian institutional investors will not support a dual-class share structure, arguing that this structure presents corporate governance concerns as voting rights are allocated in a manner that is disproportionate to economic ownership. Several Canadian issuers with dual-class share structures have achieved a balance between maintaining control of the company and providing adequate investor protection by including "sunset provisions" in the share terms, resulting in the ultimate elimination of the superior voting class, and restricting the number and transferability of superior voting shares. Negotiation of the various "coat-tail protections" can be time consuming.

FINDING THE RIGHT DIRECTORS

Companies considering an IPO will need to evaluate their board composition. Often board members with industry and public markets expertise will be added to increase bench strength. Many companies are also faced with the challenge of finding independent directors to satisfy audit committee requirements under Canadian securities laws (minimum of three members and all members must be independent and financially literate). Fortunately, companies that have just completed an IPO may rely on exemptions from the independence requirements allowing them to delay compliance for a period of 90 days, if at least one member of the audit committee is independent, and a period of one year, if a majority of the members of the committee is independent. Companies can take advantage of these grace periods provided that the board has determined that reliance on these exemptions will not adversely affect the committee's ability to act independently.

WASHING MANAGEMENT'S LAUNDRY

Management of a company that is on the doorstep of its IPO may be surprised to learn that the IPO prospectus must contain sensitive personal information. The company must disclose whether a director or executive officer has had a bankruptcy in the past 10 years or has been a director or executive officer of any company that has suffered a bankruptcy in the past 10 years. If the director or executive officer was ever sanctioned by a court relating to securities legislation or by a securities regulatory authority, he or she will have to describe the sanctions imposed and the grounds on which they were imposed. Directors and executive officers must also disclose in the prospectus whether in the prior 10 years they

were subject to a cease trade order, including a management cease trade order, and describe the basis upon which the order was made. In preparing for the IPO, it is best to determine early on whether any of these disclosure issues arise and whether they are sensitive for the individual involved. The only way to avoid airing the laundry in public is to have the individual resign ahead of the IPO.

RECONSIDERING EXECUTIVE COMPENSATION

Over recent years, executive compensation has received increased scrutiny from investors, regulators and the media. Public companies must balance the need to attract, retain and motivate talented people with the pressure to align the interests of executives and shareholders. In addition, Canadian securities regulators continue to adopt more stringent annual executive compensation disclosure requirements. Although companies that have recently completed an IPO are not required to comply with these disclosure requirements for financial years during which the company was not a public company, disclosure of all significant elements of prospective executive compensation must be included in a company's IPO prospectus.

THE CHATTY C.E.O.

New managers of private companies may be unaccustomed to life under a microscope. Even before the IPO becomes a matter of public knowledge, management will find itself suddenly, and often uncomfortably, gagged. During the pre-filing period, management will have to be careful to avoid any communication, written or oral, including on the company's website or through speeches at industry conferences, that might be construed as conduct in furtherance of a distribution of securities under Canadian law. Having a favourable article run in the press or granting a press interview during this period could be considered "conduct in furtherance", depending on the content. At the safe end of the content spectrum is an article or speech about the company's products or operations. At the high-risk end of the spectrum is one that discusses the company's future prospects or promotes the proposed offering. One of the biggest risks is the company's website which must be carefully reviewed and scrubbed at the outset of the IPO process. Securities regulators have been swift to condemn the conduct of company management or investment bankers who have allowed inappropriate disclosure to be made during the pre-filing period.

UNDESIRABLE DISCLOSURE OF MATERIAL CONTRACTS

An often unpleasant realization for management is the requirement for public companies to publicly file their material contracts. There is some limited relief from this requirement for material contracts that have been entered into in the "ordinary course of business". While securities regulators have provided some guidance on what type of material contracts cannot be considered "ordinary course", the list is not exhaustive. Public companies are compelled to disclose contracts with directors and officers, licences for intellectual property and certain financing or credit agreements. While companies are able to redact limited information from material contracts for confidential or competitive purposes, other sensitive information, such as debt covenants and ratios and events of default or termination provisions, cannot be redacted.

CORPORATE GOVERNANCE DEVELOPMENTS IN CANADA

Corporate governance developments in Canada in 2010 have come primarily through investor pressure. As a result of the shareholder pressure for a greater voice in corporate affairs, the 2011 proxy season will see increased focus on two issues: majority voting and Say-on-Pay.

MAJORITY VOTING

Under majority voting, where shareholders vote for individual directors (rather than for a slate of directors), the percentage of votes cast for and withheld from each candidate is publicly disclosed and candidates who do not receive the support of a majority of votes cast offer their resignation. Majority voting has been adopted by approximately 50 percent of all members of the S&P/TSX Composite Index,[1] but institutional investors are growing impatient with the rate at which majority voting is being adopted by other issuers. The Canadian Coalition for Good Governance ("CCGG"), the leading organization representing institutional investors, has indicated that its member organizations are prepared to use the shareholder proposal process to force greater adoption of majority voting. The Ontario Securities Commission ("OSC") has asked for comment about whether it should mandate majority voting.

SAY-ON-PAY

Say-on-Pay is the other issue gaining momentum. The first Say-on-Pay resolutions were put before shareholders of some of Canada's largest issuers in 2010. To date, Canadian issuers have adopted the form of Say-on-Pay resolution recommended by the CCGG and developed in consultation with a number of issuers, including those who were first to put Say-on-Pay on the shareholder agenda.[2] The OSC has also asked for comment about whether it should mandate Say-on-Pay.

PROXY VOTING SYSTEM

Concern about the integrity and reliability of the proxy voting system is growing in the Canadian capital markets, just as it is in the United States. Last year, the U.S. Securities and Exchange Commission ("SEC") issued a concept paper on this topic and received well over 200 detailed comment letters in

1 Canadian Coalition for Good Governance.

2 Canadian Coalition for Good Governance.

response. To date, the OSC is the only Canadian securities regulator that has indicated that a review of the Canadian system could be on the agenda. However, because the Canadian system is very similar to the U.S. system, there will be much to be learned in Canada from the SEC's efforts in this area. Davies has written a discussion paper titled *The Quality of the Shareholder Vote in Canada* which describes the history, mechanics and policy issues relevant to the proxy voting system. It is available at www.shareholdervoting.com.

PROXY ADVISORY FIRMS

Canadian issuers also share with their U.S. counterparts a concern about the influence that proxy advisory firms have on the way in which institutional shareholders vote—and in particular with the quality of the research and analysis that informs their recommendations. Canadians will have to wait to see whether securities regulators follow the lead of the SEC in looking for comment and considering a regulatory response to this issue.

CSA GOVERNANCE AGENDA

Canadian securities regulators have largely fallen silent on the governance agenda. The most recent initiative to update their corporate governance guidelines and disclosure requirements was not well received by the capital markets community and was abandoned late in 2009. Late in 2010, the Canadian Securities Administrators ("CSA") released the results of a compliance review, revealing significant deficiencies with the corporate governance disclosure that is the cornerstone of Canada's "comply or disclose" regime. There is little expectation that the CSA will take any further action until after the Supreme Court of Canada's decision on whether the federal government may establish a national securities regulator. That decision is expected later in 2011. Canadian issuers are in any event fully occupied at the moment with the first full year of implementation of International Financial Reporting Standards ("IFRS").

STOCK EXCHANGE GOVERNANCE AGENDA

Canadian stock exchanges have not engaged in governance issues, other than equity-based compensation and shareholder rights plans, since responsibility for governance guidelines and disclosure was assumed by the securities regulators in 2005. There is, however, an important role for both the TSX and TSX Venture in promoting governance practices among listed issuers that are appropriate for their size and stage of development.

NEGOTIATING PIPE TRANSACTIONS IN CANADA

As credit markets continued to be tight and capital markets remained volatile in 2010, many issuers, particularly in the mining industry, raised capital through Private Investment in Public Equity ("PIPE") transactions. The following is based on a review of PIPE transactions by Canadian issuers listed on the Toronto Stock Exchange (the "TSX") to a single investor (or a small group of investors) ranging in size from approximately $75 million to $1.5 billion. Davies has represented both issuers and investors in connection with PIPE transactions, including Temasek Holdings (Private) Limited in its $500 million PIPE investment in Inmet Mining Corporation that closed in April 2010, and Temasek's US$100 million PIPE investment in Platmin Limited that closed in May 2010.

BENEFITS OF PIPE TRANSACTIONS

For some issuers, a PIPE transaction may be the only economical option to raise capital. For others, a PIPE transaction can provide a cheaper and faster alternative to financing compared to a public offering. In addition, issuers may be able to develop strategic relationships and, depending on bargaining power, may be able to negotiate certain protections such as hold periods and/or standstills.

PIPE transactions can present an attractive opportunity for investors as they are usually offered at a discount to market and typically include some additional rights or protections, such as board seats, pre-emptive rights, registration rights, anti-dilution protection or veto rights.

REGULATORY CONSIDERATIONS

PIPE transactions are private placements and therefore must be made under one of the exemptions from the Canadian prospectus requirements. The issued securities will generally be subject to a four-month hold period unless the investor is a control person, in which case further restrictions apply.

Under Canadian securities laws, if an investor acquires 10 percent or more of the voting securities (or securities convertible into such securities) of a public issuer, the investor will be required to comply with early warning and insider reporting requirements.

The issuance of securities listed on the TSX or securities convertible into such listed securities requires the approval of the TSX. Generally, TSX approval will not be an issue for offerings that are priced within

permitted discounts, do not involve insiders or do not result in dilution to existing shareholders in excess of 25 percent or the creation of a new 20 percent shareholder. If any of these factors is present, the TSX may require shareholder approval as a condition to the issuance of the securities.

Where convertible securities are being issued, relevant rules of the TSX differ from applicable U.S. rules which can affect the way that a U.S. investor approaches its investment. For example, the TSX will consider the underlying common shares to be issued at a discount (and therefore subject to the 25 percent dilution test) unless the conversion price is at least equal to the market price of the common shares at the time of conversion. Further, where a convertible security pays dividends or interest in the form of shares (a pay-in-kind, or PIK security), the TSX has advised that it will treat the PIK as continuing forever with the result that the potential dilution will necessarily exceed 25 percent and thus require shareholder approval.

PIPE transactions involving acquisitions of 20 percent or less of an issuer's voting shares will not be subject to pre-merger notification under the *Competition Act*. Similarly, PIPE transactions involving acquisitions by non-Canadians of less than one-third of an issuer's voting shares will generally not be subject to pre-closing review under the *Investment Canada Act*. PIPE transactions involving acquisitions in excess of these thresholds may be subject to notification or review under the *Competition Act* or the *Investment Canada Act*, provided that certain prescribed financial thresholds are also exceeded.

COMMONLY NEGOTIATED PROVISIONS

The rights and obligations of investors and issuers vary from transaction to transaction based on the needs and negotiating power of the parties. Set out below are some of the more commonly negotiated provisions.

Board Seats. In most of the reviewed transactions, investors were granted a right to nominate at least one individual to the board. This right fell away if the investor owned less than a minimum percentage of the issuer, which generally ranged from 5 percent to 15 percent.

Pre-emptive Rights. In most of the transactions, investors were granted a pre-emptive right that, subject to varying limitations and conditions, enabled the investor to maintain its level of ownership by either participating in, or acquiring securities following the closing of, future offerings.

In recent transactions, the TSX has advised that it will permit issuers to grant pre-emptive rights; however it has cautioned that if the investor is an insider at the time of a future pre-emptive issuance, the TSX would treat such issuance as an issuance to an insider.

Issuers and investors have addressed this point in varying ways. Some issuers have tried to negotiate that they would not have to comply with pre-emptive provisions if doing so would require them to seek shareholder approval. Others have agreed to seek shareholder approval if required, provided that the approval process would not delay the proposed offering and if shareholders voted against the pre-emptive issuance the investor would lose the pre-emptive right for such offering. Finally, some investors have required issuers to delay offerings until shareholder approval is obtained and if not obtained, the issuer is not permitted to complete the proposed offering.

Registration Rights. Notwithstanding that non-control persons are generally able to freely resell securities after a four-month hold period in Canada, some investors that are not control persons still seek registration rights as given the size of their investment relative to the liquidity of the security, it could take months to dispose of the securities through the open market.

The threshold at which the registration right fell away, the number of registration rights, circumstances for postponement rights and who bore the registration costs were some of the points of negotiation that varied among the deals.

Anti-Dilution Protection. Anti-dilution protection is far more common in equity-linked securities than it is in straight equity securities. All of the equity-linked transactions reviewed included fairly standard anti-dilution protection for stock splits, consolidations and issuances of distributions to all shareholders. Far less common is anti-dilution protection in the event that the issuer completes a future offering at a price lower than the market price at the time of the future offering or the then applicable conversion.

When negotiating and drafting anti-dilution provisions, issuers and investors need to be mindful of the rules set out by the TSX in its December 7, 2009 Staff Notice. Among other things, the notice provides that, absent shareholder approval, the TSX will not accept downward adjustments to the conversion price when a listed issuer completes a subsequent offering at a price that is lower than the conversion price if such price would not have been permitted at the time that the convertible security was issued.

Veto Rights. Unless the investor acquires a control position in the target, it is very rare for targets to grant veto rights.

Expense Reimbursement. In some transactions, issuers agreed to reimburse (sometimes subject to caps) the investor for its expenses, including its legal expenses.

Transfer Restrictions/Hold Periods. In many of the reviewed transactions, investors agreed to hold periods beyond the four-month statutory period or to other restrictions on their ability to transfer securities. These restrictions, which were generally subject to certain exceptions such as tendering to a take-over bid, included prohibitions on resales for a set period of time and limitations on the manner in which resales may be made. For example, some investors agreed to resell shares only through broadly marketed distributions whereas others agreed not to sell to competitors, customers or significant shareholders of the issuer.

Standstills. In some of the reviewed transactions, the investor agreed to a standstill. The standstill period was based either on a fixed period of time or for so long as the investor owned a minimum percentage of the issuer's securities.

PRE-MARKETING IN SECURITIES OFFERINGS: LAW VERSUS PRACTICE

The basic rule under securities legislation in Canada is that underwriters may not solicit expressions of interest in connection with a public distribution of securities until a receipt has been issued for a preliminary prospectus. "Bought deals" are the exception. Underwriters are permitted to engage in pre-marketing activities in connection with bought deals.

THE BOUGHT DEAL

Under a bought deal, the underwriters commit to purchase the securities being offered prior to the preliminary prospectus being filed, taking the risk that, barring extraordinary events, the market may deteriorate prior to the closing date. Why are underwriters comfortable bearing this risk? There are two principal reasons: the abbreviated review period for short form prospectuses means deals can close in two to three weeks, and underwriters may solicit expressions of interest immediately upon committing to purchase the securities, provided that certain conditions are met. These include the requirements that: (a) the issuer has entered into an enforceable agreement with underwriters who have agreed to purchase the securities (referred to as a "bought deal letter"); (b) the bought deal letter fixes the terms of the distribution and requires filing and getting a receipt for a preliminary short form prospectus within four business days; and (c) the issuer issues and files a press release announcing the agreement immediately upon entering into the bought deal letter.

TESTING THE MARKET

This pre-marketing regime has served Canadian capital markets very well and the bought deal has for years been the preferred method for Canadian reporting issuers to access the public capital markets. An important aspect of this regime that receives less attention are the rules governing communications between investment dealers and issuers in the period prior to signing up a bought deal. The principal regulatory issue during this period is at what point in the dialogue between a dealer and an issuer does it become sufficiently certain that a public offering will occur and that the dealers must stop "testing the market" with prospective purchasers?

The rule governing dealers in this area is By-law 29.13 of the Investment Industry Regulatory Organization of Canada ("IIROC"). Upon the "commencement of distribution" with respect to a securities offering, a dealer may have no communications with a person or company wherever resident which are designed to have the effect of determining the interest of that person in purchasing the relevant securities. This rule is intended to prevent selective disclosure of an issuer's plan to issue

securities, which could result in buy-side participants being in a position to trade in securities after acquiring knowledge that a public offering is coming but before it is announced.

DISCUSSIONS OF "SUFFICIENT SPECIFICITY"

By-law 29.13 provides that a commencement of distribution occurs at the time that a dealer has had direct discussions with an issuer or selling securityholder, or indirect discussions through another dealer, which are of "sufficient specificity" such that it is reasonable to expect that the dealer will propose an underwriting of securities. There is limited guidance as to what constitutes sufficient specificity. In 1993, IIROC stated in an interpretation bulletin that the discussions must be private – a public statement about financing plans would not generally constitute distribution discussions – and that a significant delay between discussions and a proposal from the dealer would tend to indicate that discussions were not of sufficient specificity or that the dealer determined not to proceed at that time.

The general view is that there must be a *bona fide* intention on the part of both the dealer and the issuer to engage in a public distribution of securities. For instance, a dealer may prepare and provide to a prospective issuer client a term sheet setting out the terms of a proposed bought deal public offering. However, until the issuer provides an indication that it intends to do a public offering, any discussions will not have the requisite mutual intention to rise to the sufficient specificity standard.

COMPLIANCE

The investment dealer community has a strong interest in broad-based compliance with the pre-marketing rules to ensure that dealers are competing for underwriting mandates on a level playing field. On every bought deal public offering the CEO of each underwriter is required to sign and deliver to IIROC a certificate that the dealer has policies and procedures in place designed to ensure compliance with By-law 29.13 and that its provisions have been complied with in respect of the offering.

Complaints have been made to securities regulators alleging that some dealers interpret the rules in an overly aggressive manner to justify communications with buy-side participants at a point when a commencement of distribution has arguably already occurred. However, it remains to be seen whether securities regulators view such complaints as warranting a vigorous response. Enforcement action directed at specific instances of non-compliance would likely have a strong deterrent effect. We understand that the Canadian securities regulators have been urged by some market participants to consider liberalizing the rules on communications around the time of public offerings. Reforms in the United States that created a new class of "well-known seasoned issuers", or WKSIs, and the use of "free writing prospectuses", represent one possible way forward for Canada in this area.

PRE-MARKETING OFF SHELF PROSPECTUS

Of course, Canadian issuers may enjoy the benefits of a more liberalized pre-marketing regime by using a shelf prospectus. Under National Instrument 44-102 *Shelf Distributions*, a short form eligible issuer may qualify an aggregate dollar amount of securities under a base shelf prospectus for up to 25 months. At the time of sale, a relatively brief prospectus supplement is filed that is not subject to review by securities regulators. Dealers are free to solicit expressions of interest during the period up to and after the filing of a prospectus supplement, subject only to the rule that an issuer or selling securityholder must issue a press release upon forming a reasonable expectation that a distribution of equity securities will proceed under an unallocated shelf prospectus (*i.e.*, a shelf prospectus not reserved for equity securities only).

DODD-FRANK FOR CANADIANS: WHY YOU NEED TO CARE

Canadian public companies with their securities registered or listed in the United States will be subject to certain provisions of the recently enacted *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank"). Some provisions of Dodd-Frank, or the rules of the U.S. Securities and Exchange Commission (the "SEC") implementing them, are already effective. The SEC is currently in the process of proposing and adopting other rules that will implement other provisions of Dodd-Frank. It is expected that the SEC will have adopted most of its Dodd-Frank rules by the end of 2011. Discussed below are the key provisions of interest to Canadian companies.

EXECUTIVE COMPENSATION CLAWBACK

Dodd-Frank directs the SEC and the U.S. stock exchanges to adopt rules requiring "clawback" of certain executive compensation by issuers that restate their financial statements. Although the clawback provisions of Dodd-Frank do not exclude foreign private issuers ("FPIs"), the SEC and the stock exchanges may elect to create an express exemption for FPIs. Dodd-Frank directs the SEC to require that issuers of all listed securities include in their compensation policies a mandatory clawback of incentive-based compensation tied to reported financial information, and that these policies be disclosed. The clawback will be triggered automatically by a restatement of financial statements due to material noncompliance with financial reporting requirements under U.S. securities laws. Under the rules, the issuer will recover, based on the corrections to the misstated financial statements, any overpayment of incentive-based compensation to an executive officer during the three-year period prior to the date on which the issuer was required to prepare the restatement that triggered the clawback. The Dodd-Frank clawback provisions are more expansive than the clawback rule contained in the *Sarbanes-Oxley Act of 2002* ("Sarbanes-Oxley") in that they apply to all present and former executive officers (not just the CEO and CFO associated with the noncompliant filing) and they apply retroactively to all incentive-based compensation paid over a three-year period. Moreover, unlike Sarbanes-Oxley, Dodd-Frank does not require any misconduct to trigger the clawback. A mere accounting error, if found to be materially non-compliant, will be sufficient to trigger the clawback remedy under Dodd-Frank. The SEC's current timeline projects that clawback rules will be proposed between August and December of 2011, but does not provide a date for the rules' subsequent adoption.

WHISTLEBLOWER INCENTIVES AND PROTECTIONS

As part of its efforts to strengthen enforcement measures, the Act creates a whistleblower "bounty fund". Persons who voluntarily provide original, independently derived information to the SEC relating to U.S. securities law violations that result in penalties of greater than $1 million will be entitled to receive between 10 and 30 percent of the amount of those penalties, as determined by the SEC. Whistleblowers are also granted enhanced protections against retaliation, including a private right of action and, under certain circumstances, extended limitations periods and provisions for jury trials. In addition, Dodd-Frank reinforces the SEC's rules prohibiting the disclosure of any information regarding the whistleblower's identity until the start of enforcement proceedings. Both U.S. and non-U.S. affiliates and their employees are expected to be included in these whistleblower protections. In addition, based on the SEC's proposed rules, FPIs will be subject to the whistleblower rules, at least with regard to U.S. securities law violations. The SEC currently plans to adopt the final whistleblower protection rules no later than March 2011, ahead of the April 18, 2011 deadline provided by Dodd-Frank.

EXEMPTIONS FROM AUDITOR ATTESTATION REPORTS FOR SMALLER COMPANIES

Under Dodd-Frank, smaller companies (generally, those with worldwide market capitalization of less than US$75 million), including FPIs, are permanently exempted by Dodd-Frank from the requirement to provide an auditor attestation report on internal controls pursuant to Section 404(b) of Sarbanes-Oxley. The SEC has already amended its rules to effect this exemption.

EXTRATERRITORIAL ENFORCEMENT OF ANTI-FRAUD PROVISIONS

Dodd-Frank purports to expand the jurisdiction of the SEC and the U.S. Department of Justice in actions alleging violations of the U.S. Federal securities laws where the impugned conduct (i) takes place within the United States and constitutes "significant steps in furtherance of the violation," even if the securities transaction itself occurs outside the United States and involves only foreign investors, or (ii) occurs outside the United States but has "a foreseeable substantial effect" within the Unites States. Because the provision applies only to actions brought by governmental agencies, it does not affect the U.S. Supreme Court's recent decision in *Morrison v. National Australia Bank, Ltd.*, in which the Court ruled that private party fraud claims could be brought under U.S. securities laws only where the transaction either occurred in the United States or involved the purchase or sale of a security listed on a U.S. stock exchange. However, Dodd-Frank does require the SEC to provide Congress with a study examining whether extraterritorial private rights of action should be added to U.S. securities enforcement provisions. The SEC plans to deliver its report in January 2012.

PROPOSED ELIMINATION OF MJDS FORM F-9 FOR OFFERINGS OF INVESTMENT GRADE SECURITIES

Dodd-Frank directs the SEC to remove references to credit ratings in the SEC's rules and forms and replace them with other appropriate criteria. The SEC has proposed rules that would rescind Form F-9, the primary MJDS form for registered offerings of non-convertible debt and preferred stock. Currently, Form F-9 requires that the debt or preferred securities to be registered be investment grade rated. Use

of Form F-9 (rather than Form F-10, the general purpose MJDS registration statement form) is often preferred because it does not (as does Form F-10) require reconciliation of the issuer's financial statements to U.S. GAAP. Because, however, Canadian public companies are now generally required to prepare their financial statements in accordance with IFRS, the SEC is of the view that Form F-9 is dispensable. Form F-10, however, requires that either the issuer of the registered securities have a public equity float of $75 million or that any debt securities or preferred securities of a majority-owned subsidiary being registered be fully and unconditionally guaranteed by the parent company, which itself must meet all of the F-10 requirements. The proposed rules would also require issuers that have a current reporting obligation under the *Securities Exchange Act of 1934* resulting solely from an F-9 registration statement covering investment grade securities to file annual reports on Form 20-F rather than being permitted, as is currently the case, to file on MJDS Form 40-F. Public comments on the proposed rules are due by late March 2011.

MINING INDUSTRY DISCLOSURE

Dodd-Frank will require mining companies that are reporting issuers in the United States to include additional disclosure regarding mine safety issues for mines located in the United States (including disclosure of accidents and receipt of notices of imminent danger by U.S. regulators) and the making of payments (including all taxes, royalties, fees and other material benefits, beyond *de minimis* amounts) paid or given by the issuer to any government, including the U.S. government, for the purpose of commercial development of oil, natural gas or minerals. In addition, the Act requires the SEC to issue rules mandating additional disclosure requirements for all reporting companies that manufacture a product whose functionality or production depends on "conflict minerals" (which are defined as coltan, cassiterite, gold, wolframite or any other minerals or mineral derivatives whose trade is deemed by the U.S. Secretary of State to be funding the conflict in the Democratic Republic of the Congo). The SEC has proposed rules implementing these provisions of the Act, and those rules are currently in the comment review process.

REGULATORY DEVELOPMENTS: 2010 AND BEYOND

ADOPTION OF IFRS

2010 saw the end of Canadian Generally Accepted Accounting Principles ("GAAP"). The change to International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board, which takes effect for issuers with financial years beginning on or after January 1, 2011, was effected by adoption of IFRS as Canadian GAAP for publicly accountable enterprises in the CICA Handbook. Canadian securities regulators have now amended the continuous disclosure, prospectus, certification and ancillary rules necessary for the transition to IFRS, including providing a 30-day extension to the filing deadline for the first IFRS interim report.

NEW INSIDER REPORTING RULE

On April 30, 2010, new National Instrument 55-104 *Insider Reporting Requirements and Exemptions* ("NI 55-104") came into force. The changes include reducing the number of insiders that are required to file insider reports solely because of the office they hold. Filing requirements now extend to a narrower core group of insiders based on office (CEO, CFO, COO, directors and major shareholders) plus those insiders (i) who in the ordinary course receive or have access to material undisclosed information concerning the reporting issuer, and (ii) who directly or indirectly exercise or have the ability to exercise significant power or influence over the business, operations, capital or development of the reporting issuer. NI 55-104 also accelerates the reporting deadline from 10 calendar days to five calendar days for insider reports disclosing changes in previously reported holdings.

NEW DISCLOSURE INITIATIVES

Mining: The Canadian Securities Administrators ("CSA") published for comment proposed amendments to National Instrument 43-101 *Standards of Disclosure for Mineral Projects*. While the proposed amendments set out in the request for comments relate to matters such as streamlining of the certification and consent requirements and modifying the technical report disclosure requirements to address the stage of development of the property, the CSA has also requested specific feedback on whether to keep, modify or eliminate the existing requirement to file a technical report with a short form prospectus. The comment period on the proposed amendments closed in July 2010 and the CSA

expects that a final rule will come into force in the summer of 2011. Davies submitted a comment letter on July 30, 2010, which you can find at *http://osc.gov.on.ca/documents/en/Securities-Category4-Comments/com_20100730_43-101_damianil_murphyr.pdf*.

Executive Compensation: On November 19, 2010, the CSA requested comments on proposed amendments to Form 51-102F6 *Statement of Executive Compensation*. The proposed amendments would require reporting issuers to disclose in their compensation discussion and analysis whether the board of directors has considered the risks associated with the company's compensation policies and practices (such as whether the short-term incentives created by the compensation policies are misaligned with the issuer's long-term objectives). If risks arising from compensation policies or practices are reasonably likely to have a material effect on the issuer, then the issuer must discuss and analyse its broader compensation policies and practices. This discussion must include disclosure of (i) the nature and extent of the board's role in the risk oversight of compensation policies and practices, (ii) the practices used to identify and mitigate compensation policies and practices that could potentially encourage taking inappropriate or excessive risks, and (iii) the identified risks arising from the policies and practices that are reasonably likely to have a material adverse effect on the issuer. Issuers will also be required to disclose whether named executive officers or directors are permitted to purchase financial instruments that are designed to hedge or offset a decrease in the market value of equity securities granted as compensation or held, directly or indirectly, by the officer or director. In addition, enhanced disclosure regarding compensation advisors, including a description of their mandate and any other work performed by the company with a breakdown of fees paid for each service provided. The comment period on the proposed amendments closed on February 17, 2011 and final amendments are not expected to come into force until next year's proxy season.

Environment: The CSA issued Staff Notice 51-333 *Environmental Reporting Guidance* on October 27, 2010 which provides additional guidance on existing continuous disclosure requirements relating to environmental matters under securities legislation. The guidance is intended to provide issuers with assistance in determining what information about environmental matters needs to be disclosed and enhancing or supplementing disclosure regarding environmental matters as necessary.

WHAT TO EXPECT IN 2011

Continuous Disclosure Reviews: The OSC indicated in Staff Notice 51-706 *Corporate Finance Branch Report Fiscal 2010* that it planned to conduct issue-oriented reviews in four areas. First, disclosure regarding risk and risk management practices will be reviewed for compliance with the relevant continuous disclosure or prospectus rule. Second, corporate governance disclosure will be reviewed to assess compliance of reporting issuers and, if necessary, additional guidance will be provided. Third, the OSC will undertake a follow-up review of certification compliance in light of the high non-compliance rate with the requirements revealed by the 2009 review of certification compliance (approximately 62 percent). Finally, reporting issuers' disclosure records will be reviewed to ensure that they have filed all material contracts, interpreted the exemption for contracts entered into in the "ordinary course of business" correctly and complied with provisions allowing for the omission and redaction of information from material contracts.

Derivatives and Securitized Products: In 2010, securities regulators continued their examination of the proper regulatory response to developments in the market for derivatives and securitized products. In November 2010, the CSA released Consultation Paper 91-401 on Over-the-Counter Derivatives

Regulation in Canada. The consultation paper addresses issues such as mandatory central clearing for certain OTC derivatives, mandatory reporting of trades to a central repository, requiring electronic trading of certain OTC derivative products and implementing risk-based capital and collateral requirements. The comment period on the consultation paper expired on January 14, 2011. In addition, in early 2011, the CSA is expected to publish supplementary disclosure requirements for asset backed securities and other securitized products that will be applicable in both the prospectus and continuous disclosure contexts.

Shareholder Democracy: On January 10, 2011, the OSC released Staff Notice 54-701 *Regulatory Developments Regarding Shareholder Democracy Issues*. The staff notice sets out that the OSC will consider issues relating to (i) whether to require majority voting for directors, (ii) whether it should mandate Say-on-Pay for both executive compensation and "golden parachute" payments, and (iii) whether there is need for reform of the proxy voting system. The OSC has indicated that it intends to coordinate its review and the development of regulatory proposals with other members of the CSA. The OSC has requested comments on whether staff should develop proposals in these areas and, if so, the appropriate scope of such proposals. The comment period on the staff notice runs until March 31, 2011.

Exempt Market Regime: In fiscal 2011 the OSC plans to undertake a review of how securities in the exempt market are sold to investors, in particular whether the accredited investor and $150,000 minimum amount prospectus exemptions remain appropriate or whether amendments are necessary.

New OSC Chair: In 2010, Howard Wetston was appointed as Chair of the OSC. Mr. Wetston brings a combination of regulatory, adjudicative and enforcement experience to the OSC having previously served as head of the Competition Bureau, Federal Court Judge, Vice-Chair of the OSC and, for the past seven years, as Chair of the Ontario Energy Board. Mr. Wetston has indicated that the OSC will continue to support the national securities commission initiative. In addition, Mr. Wetston has outlined three priorities for his term as OSC Chair: strengthening the enforcement regime, protecting the interests of investors and responding to regulatory challenges in a proactive, risk-oriented manner.

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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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