CSA Issues Proposed Amendments to Early Warning System

Introduction

In response to increased shareholder activism and the need (and demand by many public companies) for more transparency, the Canadian Securities Administrators (the "CSA") have proposed amendments[1] to the so-called "early warning system." The proposals would, among other things:

- lower the threshold for public disclosure of ownership of voting or equity securities of public companies from 10% to 5%;
- require that, in calculating such holdings, voting or equity securities in respect of which a person has an economic interest be included regardless of whether such person beneficially owns the securities;
- prevent eligible institutions from using the alternative monthly reporting system if they solicit or intend to solicit proxies on matters relating to the election of directors or major corporate transactions; and
- require more detailed disclosure on the purpose of reported acquisitions.

A summary of the proposed amendments is set out below.

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[1] *CSA Notice and Request for Comment - Proposed Amendments to Multilateral Instrument 62-104 Take-over Bids and Issuer Bids and National Policy 62-203 Take-Over Bids and Issuer Bids and National Policy 62-103 Early Warning System and Related Take-Over Bid and Insider Reporting Issues*, CSA Notice, (13 March 2013).

Summary of Proposed Amendments

Reporting Threshold

Under the current rules, a person who acquires beneficial ownership of, or control or direction over, voting or equity securities that constitute 10% or more of the outstanding securities of any class of a reporting issuer must file an early warning report. Under the proposed rules, the threshold for reporting would be cut in half, to 5%. This change would apply to both the regular early warning requirements and the alternative monthly reporting regime ("AMR") for eligible institutional investors ("EIIs"), which is discussed in more detail below.

As a result of the lower threshold, the CSA is proposing to remove the current requirement to report beneficial ownership of, or control or direction over, voting or equity securities that constitute 5% or more of the outstanding securities of a class in a situation where there is a formal take-over bid being made for the securities, as such provision would become redundant.

Currently, there are additional reporting requirements when a person acquires an additional 2% or more of the outstanding securities of the class of securities that was subject to the initial reporting requirement, or where there is a change in a material fact in an earlier report. Under the proposals, additional disclosure would also be required where there is a decrease in ownership[2] of 2% or more. Furthermore, disclosure would also be required where the ownership percentage falls below 5%.[3]

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[2] Note that EIIs reporting under the current AMR are subject to reporting requirements for decreases or increases of 2.5% in ownership – this would not change.

[3] Note that EIIs reporting under the AMR are currently required to file a report if the ownership percentage falls below 10%.

Reporting Trigger

Reporting requirements are currently based on beneficial ownership of, or control or direction over, voting or equity securities. It is therefore possible to accumulate an economic interest through equity swaps, or hold voting rights through derivatives, without public disclosure under the early warning requirements. It is of interest to note that the CSA is of the view that the current early warning regime applies to borrowers and lenders in circumstances where securities are "lent to" or "borrowed" by a securityholder under a securities lending arrangement.

To calculate whether the reporting threshold has been met under the proposed new requirements, the acquiror would be required to include "equity equivalent derivatives." These are derivatives which provide the holder with an economic interest substantially equivalent to beneficial ownership of the security. This is meant to include total return swaps and contracts for differences.[4] Lenders under securities lending arrangements, pursuant to which they have the right to recall securities prior to a record date or where they require the borrower to vote in accordance with their instructions, would be exempt from having to report the disposition of such securities. However, borrowers would not be exempt. These changes would apply to both the regular early warning requirements and the AMR.

Timing

When an acquiror meets the reporting threshold, under the current rules, a news release must be promptly filed and a report must be filed within two business days.

If the proposals are adopted, when an acquiror meets the reporting threshold, a news release would be required to be filed promptly, but no later than the opening of trading on the business day following

[4] The proposed amendments to National Policy 62-203 provide that an equity equivalent derivative is not meant to include partial-exposure derivatives, including cash-settled call options which only have upside exposure.

the acquisition. The timing for the filing of the report would not change in substance,[5] and the timing under the AMR would not change.

Enhanced Disclosure

Enhanced disclosure would be required for reports filed under both the regular early warning requirements and the AMR.

Currently, reports must include information such as the number of securities, the value of the consideration, the purpose of the acquisition, any joint actors, and the nature and material terms of any agreement, other than lending agreements, entered into in connection with the transaction.

The amendments would require more detailed disclosure of any plans or future intentions of the acquiror, including in respect of any plans for a merger, reorganization or liquidation, a sale or transfer of a material amount of assets, any changes to the present board or management, actions which may impede the acquisition of control of the reporting issuer, or any intention to solicit proxies. If the transaction involved a securities lending arrangement, that fact would have to be disclosed in addition to the material terms of the agreement. The report would also have to be certified and signed.

Alternative Monthly Reporting Qualification

The AMR is unavailable to an EII who makes, or intends to make, a take-over bid for securities of the reporting issuer, or proposes, or intends to propose, a business combination with a reporting issuer if the EII would obtain a controlling interest in the reporting issuer.

Under the proposals, the AMR will also not be available to an EII who solicits, or intends to solicit, proxies from the security holders of a reporting issuer on matters relating to the election of directors, a

[5] Under the current rules, the report must be filed within two business days and, under the proposed amendments, it must be filed promptly, but no later than two business days.

reorganization, an amalgamation, a merger, an arrangement or similar corporate action.

Observations

In general, we expect that public companies will applaud the thrust and goals of the proposed amendments while institutional shareholders may have certain concerns. We believe that the following issues may engender the most debate:

- The current restriction (or moratorium) on acquiring shares between the time of reaching the threshold and one business day following disclosure would apply at the 5% threshold. Under the United States disclosure system, a shareholder has 10 days to disclose its 5% holdings and is not restricted from acquiring additional securities prior to disclosing its holdings.[6] We suspect that a fair balance may be to not impose the moratorium until the 10% threshold is acquired.
- The inability of an EII to utilize the AMR if it "solicits or intends to solicit proxies" in connection with the election of directors or significant corporate transactions may be problematic because of the fact that the word "solicit" can be interpreted quite broadly and therefore may create significant uncertainty. Additionally, the composition of a board could be changed without the solicitation of proxies. It is interesting to note that in the U.S., investors are prohibited from using the alterative reporting system on Schedule 13G if they hold 20% or more of the shares of an issuer or if they acquired shares for the purpose or with the effect of changing or influencing "control" of the issuer.

[6] Under sections 13(d) and 13(g) of the *Securities Exchange Act of 1934*, as amended, any person or group who directly or indirectly acquires or has beneficial ownership of more than 5% of any issuer's outstanding securities is required to report such beneficial ownership on Schedule 13D or Schedule 13G, as appropriate. Schedule 13G provides for an alternative delayed reporting system and may only be used by certain defined persons, including certain institutional shareholders.

- We would also expect some discussion related to the application of the early warning regime to derivatives; and the failure to exempt borrowers in securities lending arrangements when the lender on the other side of the transaction is exempted.

The CSA has requested comments in writing by June 12, 2013, and we would encourage clients who wish to comment to contact one of the writers of this bulletin or any other member of the firm's Capital Markets and M&A group.

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