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Canada Proposes Improvements in Early Warning Disclosure, Rights Plans

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Editor's Note: Theodore N. Mirvis is a partner in the Litigation Department at Wachtell, Lipton, Rosen & Katz. The following post is based on a Wachtell Lipton memorandum by Mr. Mirvis, Eric S. Robinson, Adam O. Emmerich, William Savitt and Adam M. Gogolak. Posts regarding the Wachtell Lipton rule-making petition referred to in the post, and Wachtell Lipton's forthcoming Harvard Business Law Review article on the subject, are available here and here. A post by Lucian Bebchuk and Robert Jackson regarding an article to which the Harvard Business Law Review article responds is available here. Other posts about blockholder disclosure and Schedule 13D are available here.

The Canadian Securities Administrators (CSA) recently proposed changes to Canada's early warning regime for the disclosure of substantial blockholdings, including to lower the initial reporting trigger to 5% from 10%, to require disclosure no later than the opening of trading on the next business day, and to include equity equivalent derivatives and securities lending arrangements in the ownership calculation. Separately, the CSA proposed a new policy of greater flexibility as to rights plans, including in connection with unsolicited takeover bids. These proposals reflect sensible and necessary improvements to Canadian market regulation, to protect shareholders from the sorts of activist and takeover techniques and abuses that militate for changes in the U.S.'s Section 13(d) rules, and which, in the context of unsolicited takeover bids, the U.S. acceptance of rights plans have largely banished from the U.S.

Early Warning Disclosure. The CSA proposes lowering the initial disclosure threshold from 10% to 5% – which would bring Canada's blockholder disclosure regime more in line with that of the U.S. and other leading jurisdictions – and requiring enhanced disclosure once disclosure is required. The proposal recognizes the change in the nature and intensity of activism to which public companies are today subjected and that accumulations of even 5% can be critically important to investor decision making, corporate policy, proxy contests, and market transparency. Importantly, the CSA also proposes to include certain equity derivatives and securities lending arrangements – such as total return swaps and other derivatives that provide an acquiror with a notional "long" position – within the early warning ownership calculation, to address the

widespread use of derivatives and other financial instruments to surreptitiously accumulate large economic interests without disclosure (so called “hidden ownership”) or to accumulate voting rights without a corresponding economic interest (so called “empty voting”). As the CSA notes, the “disclosure of these arrangements would be helpful in maintaining transparency and market integrity.” The CSA proposes that disclosure be made promptly but no later than the opening of trading on the next business day, recognizing that in today’s digitized and connected world, there is no excuse for longer timeframes. Finally, the existing rule imposing a moratorium on additional acquisitions until the end of the first business day after the required disclosure would apply from the time of acquiring 5%, and would include acquisitions of equity derivatives.

Rights Plans. The CSA has also proposed a comprehensive new regulatory framework for rights plans, which would provide target boards and shareholders with greater discretion over their use, and reduce the circumstances in which regulators would intervene to force an issuer to remove a plan. As noted by the CSA, the current Canadian approach has been “that a Rights Plan ‘must go’ once it has accomplished its ‘legitimate’ purpose of maximizing shareholder choice and value by encouraging competing bids or transactions.” Under this approach, regulators often cease trade a rights plan within 45-55 days of a takeover bid. Under the proposed regime, in most circumstances a board would be able to keep a rights plan in place indefinitely, subject to shareholder approval within 90 days of the plan being implemented (or if adopted in response to a takeover, within 90 days of the commencement of the takeover), and annual shareholder approval.

The Quebec *Autorité des marchés financiers* (AMF) has separately made an alternative proposal on the topic of rights plans and defensive tactics more generally. The AMF suggests that under most circumstances regulators should defer to the judgment of directors of the target corporation in the exercise of their fiduciary duty in responding to unsolicited bids. The AMF also proposes to impose a minimum acceptance condition on all takeover bids of 50% of unaffiliated shareholders, which would provide a target’s shareholders with a “collective ‘voting mechanism’” to approve such bids. Similar improper pressure on target shareholders, through the manipulative practice of partial, front-end-loaded or two-tier bids in the 1980s was one of the principal motivating factors in the creation of the rights plan in the U.S. Such practices have been virtually entirely eliminated in the U.S. as a result of the widespread adoption of rights plans, today most often in the context of an actual bid.

Both the CSA and AMF proposals address criticism that Canada’s current rights plan regime favors bidders over target companies and their shareholders, inappropriately limits directors’ ability to take action in the best interest of a company and all of its shareholders and does not sufficiently protect shareholders from coercive takeover bids. The AMF’s proposal also explicitly

recognizes the increased influence of activist investors – who often have short-term investment horizons and who may give little consideration to the long-term interests of a company and its shareholders – on takeover bids, and the need to give companies and shareholders the tools to defend against the opportunistic and abusive tactics of such activists.

Very much echoing Delaware's long-established *Unocal* doctrine, the AMF said that "We are of the view that unless security holders are deprived from considering a *bona fide* offer because the board has inadequately managed its conflicts of interest or those of management, and absent unusual circumstances that demonstrate an abuse of security holders' rights or that negatively impact the efficiency of capital markets, regulators should consider that defensive tactics are not prejudicial to the public interest and limit their intervention accordingly."

These Canadian proposals on rights plans – especially that of the AMF – would bring Canada more into line with the well-established rules and practices concerning directors' responses to unsolicited bids that the Delaware courts have carefully developed over the last thirty years, properly recognizing the primacy and unique fiduciary responsibilities of a corporation's board of directors, and that a corporation is not to be run by plebiscite, even as the shareholders retain ultimate authority to select the corporation's board of directors.

On the reporting side, these proposed policy changes would catapult Canada substantially ahead of the U.S. and into alignment with reporting regimes in most other developed markets. The wave of reform in reporting regimes of the last several years highlights that regulators can and should adapt such regimes to changes in market dynamics and investor behavior – including the massively increased trading volumes and liquidity of markets today, the control of many of our largest publicly traded companies by institutional shareholders, and the widespread use of derivatives and other stealth accumulation and activist tactics – to ensure that they continue to serve the ends for which they were established. Indeed, as we have noted previously, changing market conditions and practices have rendered the current U.S. blockholder disclosure rules obsolete, particularly Sections 13(d) and 13(f) of the Securities Exchange Act of 1934 (see our memos of March 7, 2011 [available on the Forum here], April 15, 2011 [available on the Forum here], March 3, 2008, February 7, 2013 [available on the Forum here], and our forthcoming paper in the Harvard Business Law Review). The CSA's proposed approach on timing of blockholder disclosure, inclusion of derivatives and moratorium on additional purchases parallel the recommended changes to the U.S. blockholder disclosure regime in our rule-making petition to the SEC two years ago. We continue to urge the SEC to take similar steps to bring the Section 13(d) disclosure regime in line with modern market and investor dynamics and to ensure transparency and fairness – the bedrocks on which our markets and investors have prospered – in U.S. markets.