Early Warning Reporting for Pledgees Under Section 102.1 of National Instrument 62-103

AIRD & BERLIS LLP
Barristers and Solicitors

By Jeffrey Merk, Andrew Magnus and Matthew Liberatore **June 2013**

The Canadian securities regulatory regime has put in place various mechanisms to allow the "market" to be aware of whom has dispositive control of blocks of securities of reporting issuers. The disclosure system applies to every person holding the securities but allows some exceptions for lenders acting in the ordinary course of their business until the lenders actually have dispositive rights, whether exercised or not. There is a paucity of filings being made by lenders — which leads one to conclude that significant blocks of shares are never subject to realization by lenders. This article will examine some of the legal requirements that would apply when blocks of shares are pledged and financial remedies are to be exercised.

The basic requirements of the early warning reporting regime are set out in sections 102 and 102.1 of the *Securities Act* (Ontario)' and Part 7 of OSC Rule 62-504 *Take-Over Bids and Issuer Bids*. Under the Act, every acquiror who acquires beneficial ownership of, or the power to exercise control or direction over, voting or equity securities of any class of a reporting issuer (or securities convertible into voting or equity security of any class of a reporting issuer) that would constitute 10% or more of the outstanding securities of that class, shall disclose the acquisition in the manner and form prescribed by regulation.' The regulations prescribed in Part 7 of OSC Rule 62-504 Take-Over Bids and Issuer Bids require that an acquiror under subsections 102.1(1) or (2) of the Act promptly issue and file a news release and report containing prescribed information[3] within two business days from the date of acquisition.

Additionally, under National Instrument 62-103 *Early Warning System and Related Take-Over Bid and Insider Reporting Issues* ("NI 62-103"), persons or companies who make acquisitions in the capital of a reporting issuer, which exceed prescribed thresholds are deemed to have made a significant acquisition and are required to provide prompt public disclosure. Furthermore, Part 3 of NI 62-103 outlines the prescribed information to be included in both the report and news release thereby informing the market of the ownership and/or control position with respect to a particular reporting issuer. Except in certain limited circumstances, following the initial report, the person or company (the acquiror) would be required to issue and file a further news release and report whenever its ownership or control position increases by 2% or more of the outstanding shares of the class.[4]

The foregoing disclosure obligations are aimed at facilitating transparency for current and future stakeholders of the reporting issuer and other market participants by advising those persons of accumulations of significant segments of a reporting issuer's securities which may affect control and liquidity of the reporting issuer. The securities of reporting issuers, when acquired, are accompanied by both voting and disposition rights, hence the accumulation of large segments thereof may affect investment and other decisions with respect to the reporting issuer. The ability to vote significant segments of securities can also affect the constitution of a reporting issuer's board of directors as well as approvals for significant transactions and business proposals.

While NI 62-103 provides exemptions from the early warning requirements, namely, for "eligible institutional investors" (which are not discussed here), a less mentioned form of relief is granted in Part 8 of NI 62-103 (the "Pledge Exemption"). Section 8.1 of NI 62-103 provides an exemption from the early warning requirements for pledgees controlling the securities of a person or company that have been pledged, to the pledgee, as collateral for a debt under a written pledge agreement. In other words, the Pledge Exemption arises where securities of a pledgor have been pledged, mortgaged or otherwise encumbered as collateral for a debt under a written pledge agreement.'

1 R.S.O. 1990, Chapter S.5 [the "Act"].

2 Sections 102 and 102.1 of the Act.
3 See NI 62-103, Part 3.
4 Section 102.1 of the Act.

In such an instance, the early warning disclosure (i.e., news release and report) is not required by the pledgee. Additionally, in the event that the Pledge Exemption applies, section 8.3 of NI 62-103 also provides a pledgee relief from the insider reporting regulations required by the Act as well as National Instrument 55-102 *System for Electronic Disclosure by Insiders* ("SEDI"). Under the Act,[6] a person or company who is or becomes an "insider"[7] of a reporting issuer is obliged to report each change in its holdings of securities of that reporting issuer. Thus, whenever a person or company becomes an "insider" of a reporting issuer, they would be required to disclose their interest through the electronic filing of insider reports on SEDI. The requirements, definitions and parameters of the SEDI reporting regime are beyond the scope of this article and will thus not be discussed here in further detail. Nevertheless, it is precisely this "insider" reporting that section 8.3 of NI 62-103 extends to pledgees.

While the relief provided to pledgees, in Appendix E of NI 62-103, is seemingly straightforward, the mechanics of the Pledge Exemption become far less clear upon closer inspection. In particular, subsection 8.1(2) of NI 62-103 provides that the Pledge Exemption does not apply at any time that a person or company becomes "legally entitled to dispose" of the securities as pledgee for the purpose of applying the proceeds of realization in repayment of the secured debts Consideration must also be had to whether a change in the rights of pledgees under a pledge agreement constitute a "change in any material fact") which, like an increase by 2% or more of the outstanding shares of the class, requires the pledgee to issue and file a news release.

As such, it can be extraordinarily challenging to specifically identify the time (or times) at which the loss of the Pledge Exemption is triggered, thus requiring the pledgee to provide early warning disclosure. More specifically, what legal entitlements are contemplated by subsection 8.1(2) of NI 62-103 and how can one be certain of their attainment? Must all formal steps be taken to realize on the pledge or is simply the right to realize on the pledge sufficient? Could a pledgee who is entitled to realize on a pledge estop themselves from realizing on a pledge through words or actions? What level of information must be included in the required disclosure documentation in relation to the realization of the pledge and could such disclosure conflict with any other laws? Furthermore, how have these issues been dealt with in the United States and the proposed amendments to NI 62-103?

What Is Meant by "Legally Entitled to Dispose"

The standard early warning reporting notification requirement under subsection 102.1(1) of the Act is inherently quantitative inasmuch as the test for an acquirer to file a report under subsection 102.1(1) is triggered by the acquisition of beneficial ownership, or power to exercise control or direction over voting or equity securities of any class or securities convertible into voting or equity securities of a class that would constitute 10% or more of the outstanding securities of a class of securities.

As described above, the relief from the reporting requirement for pledgees set out in subsection 8.1(1) of NI 62-103, Part 8 does not apply at any time that the pledgee is "legally entitled to dispose of the securities as pledgee" for the purpose of realizing on its security, which introduces a qualitative test as the trigger, once the quantitative condition has already been satisfied.

Guidance on the interpretation of "legally entitled to dispose of the securities" can be found in the Notice of NI 62-103, dated September 4, 1998 (the "Notice"), where the Canadian Securities Administrators (the "CSA") set out the substance and purpose of the proposed NI 62-103. The Notice states that the phrase "legally entitled to dispose" means that the pledgee has satisfied all requirements, under both the pledge agreement and the statute, to permit it to sell.

Although this guidance provides context, there is still ambiguity about when the obligation is triggered, given the potential variation in the terms of the pledge agreement, what constitutes reasonable notice from pledgee to pledgor of an enforcement event after an event of default, which is based not just on contract but also common law, the ability under laws related to the realization on security to have a pledgee stop themselves from taking action under a pledge agreement and the existence of the pledgor's ability to repay amounts secured by the pledge through the equity of redemption. In the context of the appointment of a public receiver, the approval of a court might offer a bright-line test, though the line is less clear in the context of a private receiver appointed by the pledgor to enforce the pledge or in any other private enforcement scenario.

What to Say in the Report

The required disclosure in a news release filed under early warning requirements, as set out in Appendix E to NI 62-103, is straightforward, though there are potential

5 Part 8 of NI 62-103, subsection 8.1(1).
6 Section 107 of the Act.
7 See definition of "insider" at section 1(1) of the Act.
8 Part 8 ofNI 62-103, subsection 8.1(2). '
9 Section 102.1 of the Act.
10 S.C. 1991, c. 46.

pitfalls in the context of a pledgee enforcing where securities are the form of security provided. Subsection 1(a) of Appendix E calls for disclosure of the name and address of the offeror, and subsection 1(f) also calls for, in part, the name of any joint actors effecting the transaction or occurrence that gave rise to the news release. In the context of a pledge, the "offeror" would be the pledgee, which in a traditional loan context could be a bank or a related financial institution. The purpose of this disclosure speaks to the underlying purpose of the early warning system in terms of disseminating to the market the identity of market participants who hold significant interests in a threshold amount of securities. Although the form may require this disclosure, practitioners should be aware of the prohibition in subsection 983(1) of the *Bank Act*,'[10] regarding use of the name of a bank in certain contexts:

> every person who uses the name of a bank or of a bank holding company in a prospectus, offering memorandum, takeover bid circular, advertisement for a transaction related to securities or in any other document in connection with a transaction related to securities is guilty of an offence.

Given that the intention of the pledgee when realizing on its security is often to dispose of collateral in order to satisfy the obligation, such an early warning report could be considered a document "in connection with a transaction related to securities." In the absence of guidance regarding how to resolve the conflict between the obligation in NI 62-103 and prohibition under a federal statute, practitioners may consider the doctrine of paramountcy when deciding on how to proceed.

Guidance From the United States

In the United States, by virtue of the *Securities Exchange Act of 1934"* — Rule 13D Beneficial Ownership Reporting, the beneficial ownership reporting regime is similar to the requirements within NI 62-103 save for the thresholds triggering disclosure. Generally speaking, under Rule 13D, securityholders must report their beneficial ownership of more than 5% of the voting securities of a class of such securities of an issuer within 10 days of acquiring the securities. Thereafter, generally speaking, the securityholder is required to amend its report whenever there is a material change in the securityholder's beneficial ownership of an issuer's securities, including an increase or decrease of 1% or more.

The United States thresholds are therefore lower than those in Ontario. However, in greater alignment with the United States thresholds, are the proposed amendments to NI 62-103 issued by the CSA in a notice dated March 13, 2013 (the "Amendments").

Under the proposed terms of the Amendments, the early warning reporting thresholds would be lowered from 10% to 5%, requiring disclosure of both increases and decreases in ownership of 2%. While these proposed amendments will ultimately affect the thresholds pertaining to pledgees and offerors alike, they do not deal with the Pledge Exemption.

The question remains open as to the precise point at which a person or company becomes legally entitled to dispose of the pledged securities. The United States Securi-ties and Exchange Commission (the "SEC") in one of its compliance and disclosure inter-pretation documents (the "CD&I") has shed some light on the mechanics of the beneficial ownership reporting requirements in relation to pledgees.

One of the questions asked of the SEC was whether upon default by the pledgor, the pledgee should immediately examine whether it is required to file a beneficial ownership report or whether it may wait until it takes all formal steps necessary to declare a default? Section 105 of the CD&I responds to this question by explaining that should a default by the pledgor occur, the pledgee should reexamine the pledge agreement to determine whether the pledgee has been granted voting or investment power irrespective of whether it has taken all formal steps necessary to declare a default or perfect its rights.' [12]

Therefore to the extent that, upon default, the pledge agreement grants the pledgee voting or investment power over greater than 5% of the class of outstanding securities, the pledgee will be deemed to have acquired beneficial ownership of the pledged securities on the date of default and must therefore report. This is in contrast to Part 8 of NI 62-103, which requires that the pledgee actually become legally entitled to dispose of the pledged shares for the purposes of realizing on the pledged securities.

Unfortunately, there has been no clear direction from the regulations clarifying whether the triggering point requiring the pledgee to file a news release and early warning report occurs at the time of execution of all necessary and formal steps for the purposes of realizing on the pledge. Pledge agreements may also include a variety of milestones, extensions and conditions further confusing the moment when the Pledge Exemption has been lost triggering a pledgee to commence making the required early warning disclosure.

11 Securities Exchange Act of 1934, Regulation 13D.

12 CD&I of November 16, 2009 retrieved from www. sec.govidi-visions/corpfiniguidance/reg13d-interp.htm on April 4, 2013.