Co-Counsel

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While global economic and financial market turmoil continues, albeit at an abated pace, we are publishing our latest edition with articles on a variety of topics that have arisen during this period of tumultuous activity.

In this issue, we report on the continued efforts of the Canadian government to create a federal securities regulatory regime with the establishment of a transition office. We also report on the Canadian Securities Administrators' (CSA) extensive overhaul of the uniform rules and processes for registration of firms and individuals that deal in securities, provide investment advice, or manage investment funds. We include a note on some departures from the CSA approach taken by the Ontario Securities Commission, which earlier elected not to participate fully in the passport system in anticipation of the creation of a federal system. And we report on shareholder governance initiatives in the United States and their implications for Canada, on continuing guidance from the CSA for the process of the changeover from Canadian GAAP to IFRS for Canadian publicly accountable entities by January 1, 2011, and on improved sale disclosure for mutual fund investors.

We also include additional reports on recent changes to Canadian competition laws and foreign investment laws and we include an article reporting on Canadian rules for ownership and control of certain industries.

On the securities regulatory enforcement front, we report on a recent decision of the Ontario Securities Commission refusing to cease trade a poison pill.

There is a guide to the creation of indemnification agreements for directors and officers of public companies. We report on the recent Supreme Court of Canada ruling on how employers may deal with surpluses in a defined benefit pension plan.

Three articles are included relating to the creation of cap-and-trade systems for greenhouse gases, including reports on legislative initiatives by the Province of Ontario and by the Province of Québec as well as a report on a federal government proposal describing a carbon pricing system and recommending, among other things, the unification of existing provincial efforts into a national scheme in order to realize necessary economic efficiencies and reinforce Canada's engagement in international markets. These articles were recently published in the *McCarthy Tétrault Co-Counsel: Technology Law Quarterly*.

You will find these and other topics of interest in this issue of our quarterly. As always, we welcome your questions and comments. If you are not a subscriber to *McCarthy Tétrault Co-Counsel: Business Law Quarterly*, simply contact us to have your name added to our mailing list.

Yours truly,

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August 2009

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Securities

REGULATION

Canadian Securities Regulator Transition Office Opens for Business

The minority federal Conservative government has established the Canadian Securities Regulator Transition Office as the next step in the transition to a Canadian securities regulator.

As we previously reported, the Expert Panel on Securities Regulation in Canada, in its final report published on January 12, 2009, recommended the creation of a single Canadian federal securities regulator and called for the creation of a transition and planning team as the first phase of the transition path to a federal securities regime.

The establishment of the Transition Office was announced by the Minister of Finance on June 22, 2009, and Orders-in-Council appointing Douglas M. Hyndman of Vancouver, British Columbia and Bryan P. Davies of Toronto, Ontario as Co-President and part-time Co-President, respectively, of the Transition Office became effective on July 13, 2009. The Transition Office was created by the *Canadian Securities Regulation Regime Transition Office Act* (Transition Office Act), embedded as Section 297 of the *Budget Implementation Act*, 2009 (Budget Act). The Budget Act was enacted on March 12, 2009, and Section 297 was proclaimed in force on July 13, 2009.

Mr. Hyndman was Chairman of the British Columbia Securities Commission from 1987 until his appointment to the Transition Office. In 2003, Mr. Hyndman stated in a speech that the chances of the provinces agreeing on a national securities regulator "any time soon" were about as good as those of the Vancouver Canucks hockey team winning the Stanley Cup in the 2003-2004 hockey season. In January 2009, immediately following the release of the Expert Panel's final report, the British Columbia government announced its support for a single Canadian securities regulator. The Canucks were eliminated in the quarter-finals of the 2009 Stanley Cup playoffs. Mr. Davies is the Chairman of the Canada Deposit Insurance Corporation.

The staffing of the Transition Office was further enhanced by the addition of OSC Vice-Chair Lawrence Ritchie as Executive Vice President and Senior Policy Advisor, on secondment from the OSC until September 2010.

The Transition Office, which has a statutory life of three years, is expected to deliver a plan for the transition to a Canadian securities regulator within one year. It will be advised by an Advisory Committee whose members had not yet been named at the time this article was written.

The Transition Office Act (subsection 14(1)) authorizes the Minister of Finance to make payments in an amount of up to $33 million to the Transition Office. Certain provisions of the *Budget Implementation Act* (Sections 295 and 296), which came into force on March 12, 2009, authorize the Minister of Finance to make further payments in an amount of up to $150 million to

provinces and territories for matters relating to the establishment of the Canadian securities regulation regime and a Canadian regulatory authority. It is expected that these amounts will be used to purchase assets of provincial regulators and to make payments to compensate for the loss of revenues derived from securities regulation.

As we previously reported, while the Provinces of Ontario and British Columbia have expressed support, the Provinces of Alberta, Québec and Manitoba oppose the establishment of a Canadian securities commission. The Expert Panel, in its final report, referred to assurances it had received from its constitutional advisor as to the constitutional authority of Parliament and stated that as an ultimate measure, federal securities legislation might fully occupy the field.

Both the current Conservative federal government and the previous Liberal federal government expressed support for a Canadian securities commission, and Conservative and Liberal members voted to approve the Budget Act earlier this year. However, in reply to a motion made by the Bloc Québécois in Parliament in mid-June 2009, calling for confirmation that securities regulation falls under the exclusive jurisdiction of the provinces, Liberal members of Parliament stated that the current policy of their party is that a future Liberal government would refer the constitutional jurisdiction question to the Supreme Court of Canada. The Bloc Québécois motion was defeated by a vote from which Liberal members abstained.

The constitutional challenge will continue, as the government of the Province of Québec announced on July 7, 2009 that it will launch a constitutional reference in the Québec Court of Appeal for an opinion with respect to the decision of the federal government to proceed with the creation of a Canadian securities regulator.

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Canadian residency requirements for all registrants in all provinces and territories are to be eliminated.

In Québec, the Autorité des marchés financiers (AMF) has undertaken a major overhaul of the regulatory framework for mutual fund dealers and scholarship plan dealers.

In all jurisdictions other than Ontario, NI 31-103 becomes effective on September 28, 2009. In Ontario, it becomes effective on a date to be announced by the Ontario government. A number of requirements will not take effect immediately, but will be subject to transition periods to give market participants time to comply with the new requirements once they become effective. Transition timelines are available to registered firms to afford them an opportunity to comply with a number of new requirements.

For a detailed discussion of these changes, please see our August 2009 Legal Update.

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Ontario Prospectus and Registration Exemptions — Amendments to National Instrument 45-106 and OSC Rule 45-501 arising from Ontario Budget Bill 162: Other Changes to National Instrument 45-106

OSC Notice

In its May 22, 2009 Notice (Notice), the Ontario Securities Commission published for comment proposed changes (Proposed Modifications) to proposed amendments to National Instrument 45-106 *Prospectus and Registration Exemptions* (NI 45-106), National Instrument 45-102 *Resale of Securities* (NI 45-102) and OSC Rule 45-501 *Ontario Prospectus and Registration Exemptions* (OSC Rule 45-501) that were originally published for comment on February 29, 2008 (Proposed Rule Amendments). The Proposed Rule Amendments, in turn, are related to proposed changes to National Instrument 31-103 *Registration Requirements* (NI 31-103) and to the registration reform initiative of the Canadian Securities Administrators (CSA), first published on February 23, 2007. Following a comment period, NI 31-103 was republished on July 17, 2009 and will come into force on September 28, 2009. We are also reporting on changed NI 31-103 in this issue of the *Business Law Quarterly*.

The Proposed Rule Amendments affect prospectus and registration exemptions, and resale provisions for securities distributed under the prospectus exemptions, while the Proposed Modifications address the application in Ontario of certain of those provisions.

Ontario Budget Bill 162

The Notice was published as a result of the Ontario budget bill, the *Budget Measures Act, 2009*, (Bill 162) that was introduced on March 26, 2009. Bill 162 includes amendments to the *Securities Act* (Ontario) (OSA), found in Schedule 26 to Bill 162 (Proposed OSA Amendments). Schedule 26 received Royal Assent on June 5, 2009 but most of its provisions will come into force by proclamation at a later date. The Proposed OSA Amendments amend statutory provisions for registration requirements for dealers, advisors and others, for exemptions from the registration requirements and from the prospectus requirements, and for the resale of securities previously distributed under an exemption from the prospectus requirement. A consultative draft of the proposed amendments to the registration requirements and registration exemptions (Consultative Draft) was published by the Ontario Ministry of Finance on April 24, 2008. The Proposed OSA Amendments will require amendments to NI 31-103 in order to reflect the fact that the Ontario government proposes to maintain in the OSA, rather than in NI 31-103, certain of the registration requirements, and certain of the registration exemptions.

Ontario — Stage 1 OSA Amendments

The Proposed Modifications published by the OSC with its Notice relate only to certain of the Proposed OSA Amendments, namely, the Stage 1 OSA Prospectus Exemption Amendments, such that prospectus exemptions for which there is a corresponding registration exemption in the OSA, rather than in a rule, will be maintained in the OSA and not in a rule. The OSC notes that it is intended that the Proposed Modifications will come into effect when the changed NI 31-303 becomes effective.

Ontario — Stage 2 OSA Amendments

The OSC has advised that if certain additional second stage Proposed OSA Amendments in Bill 162 come into force at a date later than the date when the changed NI 31-103 and the Stage 1 OSA Prospectus Exemption Amendments come into force, further modifications will be required to NI 45-106 and OSC Rule 45-501. The Stage 2 OSA Prospectus Exemption Amendments would maintain in the OSA, rather than in a rule, an additional limited number of prospectus exemptions including the "accredited investor" exemption, the "private issuer" exemption, and the "government incentive security" exemption. These amendments to the prospectus exemption provisions were not included in the Consultative Draft. The language of these statutory prospectus exemptions in Bill 162 does not faithfully track the corresponding language in NI 45-106.

The Unique Ontario Approach

Bill 162 reflects an approach by the Ontario government that is similar to the approach it took in connection with changes adopted by the CSA to the takeover bid and issuer bid rules, which came into force on February 1, 2008. These rules were created so that there would be a harmonized set of rules applicable in all Canadian jurisdictions. At that time, Ontario elected to keep certain takeover bid and issuer bid provisions in the OSA while all other Canadian jurisdictions moved them to the rules. As a result, and as reported by us earlier, the takeover bid and issuer bid rules are now found in Multilateral Instrument 62-104 *Takeover Bids and Issuer Bids* for jurisdictions

other than Ontario and in Part XX of the OSA and OSC Rule 62-504 *Takeover Bids and Issuer Bids* for Ontario. In that case, Ontario used its March 2007 budget bill to introduce the amendments to the OSA.

In the case of the rules for prospectus and registration exemptions, Ontario earlier adopted both NI 45-106 and OSC Rule 45-501, so it has an instrument, apart from the OSA, in which to embed the Ontario-only rules that may flow from Bill 162.

Other Changes to NI 45-106

In an initiative unrelated to Bill 162, the CSA announced on July 17, 2009, following a comment period, that it has approved amendments and a restatement of NI 45-106 and amendments to National Instrument 45-102 *Resale of Securities* (NI 45 102) and their related Forms and Companion Policies and that these restated and amended instruments and policies are expected to come into effect on September 28, 2009, being the same date on which the changed NI 31-103 is expected to come into force.

The restated NI 45-106 reflects substantive changes designed to improve its effectiveness, including:

- clarification of certain provisions of the NI 45-106 and its companion policy;
- changes that reflect policy decisions the CSA has made in the course of granting exemptive relief;
- provision of additional guidance to market participants on the applicability of the exemptions contained in NI 45-106; and
- harmonization of exemptions previously found in local instruments.

In addition, NI 45-106 has been restructured to support the implementation of the changed NI 31 -103 by setting out the registration exemptions in separate parts, with the part containing the registration exemptions to be phased out six months after the coming into force of the changed NI 31-103.

The amendments to NI 45-102 and its companion policy are designed to:

- clarify certain of their provisions; and
- update the legending requirements where an electronic book-entry system is used, or where the purchasers of securities do not receive a paper certificate from the issuer.

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MUTUAL FUNDS

Implementation of Point of Sale Disclosure for Mutual Funds

On June 19, 2009, the Canadian Securities Administrators (CSA) published proposed amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure* (Proposed Rule), Forms 81-101F1 *Contents of Simplified Prospectus* and 81-101F2 *Contents of Annual Information Form* and Companion Policy 81-101CP *Mutual Fund Prospectus Disclosure* (the Companion Policy). New Form 81-101F3 *Contents of Fund Facts Document* is part of the Proposed Rule. The Proposed Rule and Companion Policy together are referred to as the Instrument.

The Instrument, along with related amendments, comprises the first phase of the CSA's proposed approach to implement the shared vision of securities and insurance regulators to provide investors with more meaningful and effective disclosure of mutual funds and segregated funds, as described in Framework 81-406 *Point of sale disclosure for mutual funds and segregated funds* (Framework), which was published by the Joint Forum of Financial Market Regulators (Joint Forum) on October 24, 2008.

We discussed in a previous article the features of an initial proposal for the Framework, i.e., a point of sale disclosure regime, including a new fund summary document called 'Fund Facts,' delivery options, cancellation rights, and the regulatory requirements for preparing, filing and delivering the Fund Facts document. Under the initial Framework, the Fund Facts document was required to be delivered before the investor made the decision to buy any mutual fund.

Following a comment and consultation period, the Joint Forum published the Framework, which reflected modifications in certain respects of the initial Framework, including modifications in response to industry concerns about the potential preparation and delivery costs and disruptions to the sales process.

The Fund Facts document is central to the Instrument and to the Framework. The delivery requirements have been modified slightly from the initial Framework, but still provide for delivery at a time and in a way that allows investors to easily link the information they receive about a mutual fund to the purchase they are considering.

As under the Framework, the Instrument requires the Fund Facts document to be filed concurrently with the mutual fund's simplified prospectus and annual information form. The certificate for the mutual fund applies to the Fund Facts, just as it applies to all documents incorporated by reference into the simplified prospectus.

The existing statutory rights of investors that apply for misrepresentations in a prospectus will apply to misrepresentations in the Fund Facts. As under the Framework, the Instrument contemplates replacing the current withdrawal and rescission rights under securities legislation with a single, harmonized two-day cancellation right for investors that applies to all mutual fund purchases. The purpose of the right is to give

investors the reasonable opportunity to change their minds if they have been sold a mutual fund they do not really want. It is not intended to protect investors from a short-term decline in market value.

The Instrument contemplates a staged implementation, with the requirement to prepare and file the Fund Facts document becoming effective earlier than the new delivery requirements. The CSA currently propose a two-year transition period for delivery of the Fund Facts following the effective date of the Instrument. During this period, the Fund Facts document would not be required to be delivered to the investor, but would be required to be prepared, filed concurrently with the mutual fund's next filed simplified prospectus and annual information form, and posted on the website of the mutual fund, mutual fund family or the manager.

The CSA have invited comments on the Instrument and related amendments by October 17, 2009.

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STRUCTURED PRODUCTS

Regulation of Derivatives — An Update

In our previous articles on the Regulation of Credit Default Swaps, published on September 26, 2008 and November 28, 2008, we described how regulators in the United States and Canada were addressing the issues of systemic risk and the instability of the financial system attributed to credit default swaps in the aftermath of the financial credit crisis that started in the summer of 2007. While there are many areas in which regulation is seen to be necessary, the largely unregulated, privately negotiated, over-the-counter (OTC) derivatives market, which includes credit default swaps, is receiving the most attention.

On May 13, 2009, Secretary of the US Treasury Timothy F. Geithner sent a letter to US congressional leaders outlining proposed amendments to the *Commodity Exchange Act*, securities laws and other relevant laws that Secretary Geithner believes are needed to enable the US government to effectively regulate the OTC derivatives markets. In June, the US Treasury Department detailed these plans more fully when it rolled out its proposal for overall financial regulatory reform. On July 10, 2009, Secretary Geithner testified at a joint hearing of the House Agriculture Committee and the House Financial Services Committee on the US federal administration's proposal for a comprehensive regulatory framework for the OTC derivatives markets. He indicated that the forthcoming legislation would not be overly specific and would leave many of the details to the actual regulators.

The US Treasury Department has outlined four main public policy objectives to be achieved by government regulation of the OTC derivatives markets: (1) preventing activities in OTC derivatives markets from posing risk to the financial system; (2) promoting the efficiency and transparency of the OTC derivatives markets; (3) preventing market manipulation, fraud and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties. Some of the specific steps proposed to achieve these objectives include (a) imposing record-keeping and timely reporting requirements on all OTC derivatives; (b) requiring all standardized OTC derivative transactions to be executed in regulated and transparent venues, and cleared through regulated central counterparties; and (c) harmonizing the laws that govern the regulation of futures, derivatives and securities, as well as both the Commodities Futures Trading Commission and the Securities and Exchange Commission, so as to allow these bodies to police fraud and effectively regulate the derivatives market, among others.

As discussed in our previous two articles, Alberta, British Columbia and Québec have adopted rules and legislation regulating OTC derivatives. Ontario is still considering its proposed Rule 91-504 dealing with OTC derivatives. However, none of the Canadian provinces have rules in place, nor has any province publicly announced that it is considering rules that require centralized clearing of OTC derivatives. Furthermore, the rules and legislation that have been adopted do not deal with the excessive recordkeeping and reporting requirements proposed by the US Treasury Department.

Many commentators point to the largely unregulated OTC derivatives market, in particular, credit default swaps, as being the catalyst for the current global credit problems. Whether one agrees with that view or not, it appears that all interested parties welcome the regulation of OTC derivatives at some level. Although US politicians appear to be moving toward establishing a framework for regulation of OTC derivatives, there are still many unanswered questions, such as how a "standardized" OTC derivative will be defined and who will make that determination.

On August 11, 2009, the US Treasury Department delivered draft legislation (*Over-the-Counter Derivatives Markets Act of 2009*) to Congress. It will work with Congress with a view to passing legislation by the end of the year.

For a detailed discussion of these issues, please see our June 2009 Legal Update.

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Public Company Disclosure & Corporate Governance

SHAREHOLDER GOVERNANCE

Recent Shareholder Governance Initiatives in the United States and Implications for Canada

A number of recent legislative and regulatory initiatives in the United States will likely result in corresponding changes in Canada in the area of shareholder governance of companies.

Those changes include the following:

- Mandatory 'Say-on-Pay' Vote — A requirement was introduced under the US *Emergency Economic Stabilization Act of 2008* for a shareholder advisory 'say-on-pay' vote on executive compensation for public companies receiving money from the Troubled Asset Relief Program (TARP). On July 1, 2009, the Securities and Exchange Commission (SEC) proposed changes to its rules that would require public companies that are TARP recipients to provide 'say-on-pay' votes. Shareholder advisory votes on executive compensation have become more common both in the United States and Canada, however this is the first instance of a mandated shareholder advisory vote in the United States or Canada. In addition, bills have been introduced in both the US Senate (the *Shareholder Bill of Rights Act of 2009*) and the US House of Representatives (the *Shareholder Empowerment Act of 2009*) to make 'say-on-pay' votes mandatory for all US public companies, and the US Treasury Secretary has announced that the US Treasury supports these legislative initiatives.

- Shareholder Nomination of Directors — A proposed rule was published by the SEC on June 10, 2009 that would entitle eligible shareholders to have access to a company's proxy materials in order to facilitate the election of directors nominated by those shareholders — by requiring inclusion in the Company's proxy materials of a shareholder's nominees for up to 25 per cent of the board if the shareholder has held for at least one year a significant interest in the company's voting securities (one per cent for large accelerated filers, three per cent for accelerated filers and five per cent for non-accelerated filers). The shareholders would be required to sign a statement declaring their intent to continue to own their shares through the annual meeting at which directors are elected and would be required to certify that they are not holding their shares for the purpose of changing control of the company, or to gain more than minority representation on the board of directors. In Canada, shareholders continue to avail themselves of the provisions of corporate and securities legislation to use a dissident proxy

circular prepared and distributed at their expense to promote the election of their nominees for election. Recent examples of Canadian companies where proxy contests for the election of directors have been waged include Biovail Corporation, PetValu Canada Inc., Zarlink Semiconductor Inc., and Genco Resources Ltd.

- Broker Discretionary Voting of Street Name Securities — The SEC recently approved an amendment to Rule 452 of the New York Stock Exchange (NYSE) eliminating the right of brokers to vote uninstructed shares in director elections at shareholder meetings held on or after January 1, 2010. Under current NYSE Rule 452, brokers are allowed to vote on routine proposals, including ratification of auditors and uncontested director elections, if the beneficial owner customer has not provided voting instructions to the customer's broker prior to the scheduled meeting of shareholders. The current practice of most brokers is to vote uninstructed shares in accordance with the recommendations of a company's management. In Canada, National Instrument 54-101 *Communication with Beneficial Owners of Securities of a Reporting Issuer* (NI 54-101) prohibits brokers from voting securities of Canadian reporting issuers in street name without specific voting instructions from the beneficial owner of the securities.

These changes follow an earlier change in both Canada and the United States in which many public companies, without being required to do so by law or stock exchange rule, have implemented a majority-voting-for-directors' policy. The policy, which is frequently set forth in amended bylaw provisions of a company, requires the company to determine whether a director receives at a shareholders' meeting fewer votes for his or her election than the number of votes withheld from voting for that director. If so, the board must then consider whether to accept the resignation of that director, which is required to be delivered in such circumstances pursuant to the policy.

As always, Canadian securities industry participants will need to keep an eye on US developments as they often migrate to Canada.

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EXECUTIVE COMPENSATION

CCGG Advances 'Say-on-Pay' Policy and Executive Compensation Principles

The views of the Canadian Coalition for Good Governance (CCGG) on executive compensation have evolved and advanced with the release in April 2009 of the CCGG's *Shareholder Engagement and 'Say-on-Pay' Policy* and in June 2009 of the CCGG's *Executive Compensation Principles*.

In the Policy, the CCGG states its belief that institutional shareholders should have regular, constructive engagement with the boards and board compensation committees of public companies on governance, compensation and disclosure practices, and that 'Say-on-Pay' shareholder advisory resolutions are an important part of this ongoing engagement process. The CCGG recommends that all boards follow the practice of voluntarily adding to each annual meeting agenda an advisory shareholder resolution on the report of their human resources or similar committee, their compensation plan, and the prior year's awards. Further, the CCGG states that it intends to publish a model form of board 'Say-on-Pay' policy and shareholder resolution for boards to consider using for their next annual meetings.

The *Executive Compensation Principles* replace the *Good Governance Guidelines for Principled Executive Compensation*, which had been issued by the CCGG in 2005. The Principles are intended to provide guidance to compensation committees in developing executive remuneration packages that create a linkage between pay and performance and directly link risk management with the compensation program structure.

The six principles of compensation developed and enunciated by the CCGG are as follows:

1. Pay for performance should be a large component of executive compensation.
2. Performance should be based on measurable risk adjusted criteria, matched to the time horizon needed to ensure the criteria have been met.
3. Compensation should be simplified to focus on key measures of corporate performance.
4. Executives should build equity in their company to align their interests with shareholders.
5. Companies should limit pensions, benefits, and severance and change of control entitlements.
6. Effective succession planning reduces paying for retention.

McCarthy Tétrault Notes:

The thoughtful development and evolution of the Policy and the Principles reflects a workable approach that will be helpful to Canadian reporting issuers as they develop practices that are suitable to their respective circumstances.

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DIRECTORS & OFFICERS

Director and Officer Indemnification Agreements

In the ongoing effort to attract highly qualified individuals to act as directors and officers, indemnification agreements have increasingly become a common way for Canadian public companies to supplement the protections typically afforded to their directors and officers by director and officer liability insurance (D&O insurance) and bylaw indemnification rights. Generally, indemnification agreements provide the director or officer with a stand-alone, contractual indemnity against liabilities incurred as a result of serving in that capacity, together with expense advancement and certain other rights.

Indemnification agreements offer several advantages over simply including indemnification provisions in the company's bylaws or other organizational documents. Unlike a company's bylaws, which may be unilaterally amended by the directors (subject to confirmation by the company's shareholders at a later date), an indemnification agreement is a bilateral agreement between the director/officer and the company that cannot be amended to remove the indemnification protections without the consent of the director or officer. This right can take on added importance in the event of a change of control of the company, following which the company's new owners may choose to amend the bylaws to alter or remove the indemnification rights. In addition, an agreement enables the parties to set out in greater detail the terms and conditions upon which indemnification, expense

advancement, and other protections afforded to the director or officer are to be administered. This is typically not the case where indemnification rights are contained in a company's bylaws.

Care must be taken in drafting indemnification agreements to ensure that the agreement strikes an appropriate balance between the interests of the individual director or officer, the interests of the company, and the statutory limitations imposed by the company's governing statute (such as the *Canada Business Corporations Act* and similar provincial corporate statutes). Set out below is a summary of several issues to keep in mind when preparing a director and officer indemnification agreement:

- *Expense Advancement Rights*. Most Canadian corporate statutes now permit a company to make advances to directors or officers for expenses incurred by them as a result of being involved in legal proceedings related to their role as a director or officer. Typically, the company's governing statute will stipulate that an individual who receives those types of expense advances must repay the money if the individual has not acted honestly and in good faith with a view to the best interests of the company for which he or she acted as a director or officer or in a similar capacity. Accordingly, the indemnification agreement should require the director or officer to provide a written undertaking that he or she will repay any expense advances made by the company if it is determined that the director or officer did not meet those standards of conduct. This undertaking is usually unsecured.
- *Consistency with Insurance Policies & Bylaws*. It is important to ensure that a company's D&O insurance policy — which is intended to help protect the company's balance sheet in the event of litigation involving its directors and officers — properly interacts with the terms of the indemnification agreement. Indemnification agreements are often drafted in a manner that puts an onus on the company to obtain and maintain D&O insurance. This type of boilerplate language should be avoided, as it is not possible to contractually ensure that a company will obtain and maintain insurance policies that cover all risks. This is because such coverage will likely not be available; insurance policies contain standard exclusions (for types of conduct and claims), including, for example, payment of fines and penalties. Any conflicts such as this must be addressed in the indemnification agreement, and properly worded to ensure the indemnity that is negotiated is, in fact, the indemnity that will be capable of being provided by the company to the directors or officers. Further, the indemnity provided should be consistent with any indemnification provisions of the company's bylaws and applicable corporate law.
- *Establishing a Trust*. As a result of the recent economic uncertainty, indemnification agreements sometimes require or permit the company to hold funds to be used to maintain the D&O insurance or satisfy indemnification claims or expense advances in the event the company undergoes a change of control or faces insolvency. It remains unclear whether such trusts, if contested by a third party,

would withstand the scrutiny of a bankruptcy court.

- *Entity-Specific Considerations*. Different types of corporate entities should be attuned to specific considerations in negotiating contractual indemnities with their directors and officers. For example, often a private equity fund requests its directors to serve on the boards of the fund's portfolio companies. It should be determined whether the private equity fund will be responsible for the director's conduct while on the board of the portfolio company or whether a separate indemnification agreement should be entered into with the portfolio company. If a separate indemnification agreement is entered into with the portfolio company, consideration should be given to whether the private equity fund's obligations under the indemnification agreement are secondary or concurrent with those of the portfolio company.

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IFRS

Issues Relating to Changeover to IFRS — More from CSA Staff

In our June 2008 issue, we reported on the push in Canada for the transition from the use of Canadian generally accepted accounting principles (GAAP) to the use of International Financial Reporting Standards (IFRS), and we discussed the Canadian Securities Administrators' (CSA) Concept Paper 52-402 *Possible Changes to Securities Rules Relating to International Financial Reporting Standards* and CSA Staff Notice 52-320 *Disclosure of Expected Changes in Accounting Policies Relating to Changeover to International Financial Reporting Standards*.

In our May 2009 issue, we reported on CSA Staff Notice 52-321 *Early adoption of International Financial Reporting Standards, use of US GAAP and reference to IFRS-IASB* and we discussed exemptive relief applications to permit early adoption of IFRS.

On May 21, 2009, the CSA issued CSA Staff Notice 52-324 *Issues relating to changeover to International Financial Reporting Standards*, which provided an update on several issues related to the changeover to IFRS in Canada, including:

- more on the use of IFRS by a domestic issuer for periods beginning prior to January 1, 2011;
- requirements for interim financial statements in the year of IFRS adoption; and
- reference to IFRS and Canadian GAAP.

In CSA Staff Notice 52-324, the CSA said that it expected to publish, later in 2009, details of the proposals discussed in the Notice. Some of these proposals are described briefly in this article.

Exemptive Relief for Early Adoption of IFRS

In CSA Staff Notice 52-321, the CSA had indicated that CSA staff were prepared to recommend exemptive relief to permit a domestic issuer to prepare its financial statements in accordance with IFRS for periods beginning prior to January 1, 2011. In CSA Staff Notice 52-324, the CSA reports that several exemption orders have been issued with the condition that the issuer file revised interim financial statements prepared in accordance with IFRS, revised interim management discussion and analysis, and new interim certificates.

CSA Staff Notice 52-324 also describes the Accounting Standards Board (AcSB) publication *Adopting IFRSs in Canada, II*, which disclosed the expectation that IFRS for publicly accountable enterprises will be incorporated into Part I of the *CICA Accounting Handbook* in the second half of 2009 and the standards constituting Canadian GAAP before the mandatory effective date of January 1, 2011 will be contained in Part IV of the *Handbook*. Because securities legislation refers to Canadian GAAP as applicable to public enterprises, and defines Canadian GAAP as generally accepted accounting principles determined with reference to the *Handbook*, CSA staff consider the standards in Part IV to be Canadian GAAP as applicable under securities legislation until January 1, 2011, so the use of IFRS in Part I prior to that date will continue to require exemptive relief. Part IV will eventually be removed from the *Handbook*.

Interim Financial Statements in the Year of IFRS Adoption

CSA Staff Notice 52-324 proposes that the CSA require the issuer to disclose compliance with International Accounting Standard 34 *Interim Financial Reporting* in its interim financial statements, commencing with the first interim financial statement in the financial year in which it adopts IFRS. The CSA also proposes to require a domestic issuer to include a balance sheet that complies with IFRS as at the issuer's "transition date" in its first interim financial statements in the first financial year that the issuer adopts IFRS. An issuer's transition date is the beginning of the earliest comparative period presented in the financial statements. So, an issuer that has a calendar year-end and that elects not to "early adopt" IFRS will be required to include, along with its quarterly financial statements for the period ended March 31, 2011, a balance sheet that complies with IFRS as at January 1, 2010. If the interim financial statements for the period ending March 31, 2011 have not been the subject of auditor review, those statements must be accompanied by a notice indicating that fact. The issuer's audited financial statements for the year ended December 31, 2011 will be required to be presented with an auditor's report for the balance sheet dated January 1, 2010.

Reference to IFRS in Canadian GAAP

In CSA Staff Notice 52-321, the CSA had stated that it preferred that reference be made to IFRS issued by the IASB, rather than to Canadian

GAAP, in financial statements and audit reports for domestic issuers after the mandatory effective date. Based on input from stakeholders and the Canadian Accounting Standards Board, the CSA now proposes to allow an issuer to choose between referring:

- only to IFRS in the notes to the financial statements and in the auditor's report; or
- to both IFRS and Canadian GAAP in the notes to the financial statements and in the auditor's report.

The CSA now proposes that these two options be implemented by requiring domestic issuers to prepare annual and interim financial statements for the financial years beginning on and after January 1, 2011 as follows:

- the annual and interim financial statements must be prepared in accordance with Canadian GAAP for publicly accountable enterprises;
- an explicit and unreserved statement of compliance with IFRS (as issued by the IASB) must be made in the notes to the financial statements and disclosure of compliance with International Accounting Standards 34 be made in the interim financial statements; and
- the auditor's report must refer to IFRS and be in the form specified by Canadian generally accepted auditing standards for financial statements prepared in accordance with a fair presentation framework.

This will enable issuers to continue to refer to Canadian GAAP to satisfy existing contractual obligations, such as definitions in credit agreements, and to comply with other laws, rules and regulations that require Canadian GAAP.

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Mergers & Acquisitions

OSC Refuses to Cease Trade Poison Pill: Shareholder Rights Plan Maintained in the Face of a Hostile Partial Bid

In the Matter of Neo Material Technologies Inc. et al is a recent decision of the Ontario Securities Commission dismissing an application by a hostile bidder seeking to cease trade a target's tactical shareholder rights plan that had been adopted in the face of an unsolicited partial bid. This decision is of significant interest to boards of directors of potential targets because it represents a departure from earlier decisions where securities commissions have primarily focused on whether the time had come in the circumstances to set aside a shareholder rights plan. The OSC released this decision on May 11, 2009, noting that full reasons will follow in due course.

Neo Material Technologies Inc. (Neo) is a Canadian public corporation carrying on business in the mining and resources sector. Pala Investments Holdings Limited (Pala), an investment company, held approximately 20 per cent of Neo's outstanding common shares and had been an investor in Neo since July 2007. On February 9, 2009, Pala announced its intention to commence a partial bid to acquire up to an additional 20 per cent of Neo's outstanding common shares at a price of $1.40 per share (the offer was subsequently varied by Pala to increase the offer price, reduce the number of shares subject to the offer, and extend the expiry time).

Neo had two shareholder rights plans in effect. The first shareholder rights plan was approved by Neo's shareholders in June 2004 and subsequently reconfirmed in April 2007. Pala's offer was structured to comply with the "permitted bid" provisions of the first shareholder rights plan, which included a minimum tender condition, so as not to trigger the issuance of rights under the plan. The second shareholder rights plan was adopted by Neo's board of directors on February 12, 2009 in response to Pala's offer, and was subsequently approved by Neo's independent shareholders at a meeting held on April 24, 2009. This second shareholder rights plan was substantially similar to the first shareholder rights plan except that it prohibited partial bids.

In dismissing Pala's application and refusing to cease trade Neo's second shareholder rights plan, the OSC noted that it was influenced by the following considerations:

- the second shareholder rights plan was adopted by Neo's board in the context of, and in response to, Pala's offer;
- there was no evidence that the process undertaken by Neo's board to evaluate and respond to Pala's offer was not carried out in what the board determined to be in the best interests of Neo and its shareholders, as a whole;
- an overwhelming majority of Neo's shareholders approved the second

shareholder rights plan while Pala's offer remained outstanding;

- Neo's shareholders were sufficiently informed about the second shareholder rights plan prior to casting their votes; and
- there was no evidence that Neo's management or board of directors coerced or unduly pressured Neo's shareholders to approve the second shareholder rights plan.

> **McCarthy Tétrault Notes:**
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> While the reasons for decision have not yet been released, it remains to be seen how key the overwhelming support of the rights plan by sufficiently informed shareholders of Neo was in the OSC's decision to dismiss Pala's application and permit Neo's second shareholder rights plan to stand. Overwhelming shareholder support was also cited as a principal factor that led the Alberta Securities Commission to reach a similar conclusion in its 2007 decision to let a shareholder rights plan stand in *Re Pulse Data Inc.* In the meantime, boards of directors should be mindful of the positive impact that the approval of a tactical shareholder rights plan by sufficiently informed shareholders could have on mounting a successful takeover defence.

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Updates

COMPETITION LAW UPDATE

Government Enacts Significant Changes to Canada's Competition Laws

Bill C-10, the *Budget Implementation Act*, 2009 received Royal Assent on March 12, 2009. The bill introduced significant changes to the *Competition Act* (Act), most notably in the area of competitor conduct. While the majority of changes came into force upon Royal Assent, some of the most significant amendments will come into force in March 2010.

In the last issue of the *McCarthy Tétrault Co-Counsel: Business Law Quarterly* we discussed the changes to the merger review provisions of the Act. In this issue, we discuss other changes to the Act that have been made under the bill and that will be of interest to our business clients.

A. Reform of Criminal Provisions

- ***Per se* Conspiracy Offence and a Dual-Track Approach** — Under the current Section 45, the Crown must demonstrate beyond a reasonable doubt that agreements among competitors "unduly" lessen competition. When the amendments to the conspiracy provisions come into force on March 12, 2010, that burden will be removed for so-called "hard-core" cartels (i.e., agreements among competitors to fix prices, allocate markets or restrict supply), making it easier for the Crown (and civil plaintiffs) to prove price-fixing conspiracies. Parties to an agreement may defend a charge under the amended provision if they can prove the arrangement is ancillary and necessary to a broader agreement that is not within an impugned hard-core category. However, this defence may not alleviate all risk that arrangements between competitors, such as co-marketing agreements or other joint ventures, could be captured by the new provisions.

Agreements or arrangements between competitors other than hard-core cartels that substantially prevent or lessen competition will be civilly reviewable. The Commissioner of Competition may bring an application to the Competition Tribunal for an order prohibiting any person from doing anything under the agreement, but the conduct would not be subject to monetary penalties or criminal sanction.

The Competition Bureau has issued draft *Competitor Collaboration Guidelines* that describe the approach it will take in applying the dual-track regime to collaborations between competitors. Although still out for public consultation, the guidelines clarify some potential areas of

uncertainty — suggesting, for example, that vertical agreements between suppliers and customers, as well as dual-distribution agreements between a single supplier and distributor, will be assessed under the civil, rather than criminal, provisions. Bill C-10 also provides that parties may apply prior to March 12, 2010 for an advisory opinion on how the new laws will apply to existing agreements without having to pay the standard service fee.

- **Higher Penalties** — When the amendments to the conspiracy provisions come into effect on March 12, 2010, the maximum fine for conspiracy will increase from $10 million to $25 million, and the maximum prison term will increase from five years to 14 years.

  Penalties for obstructing an investigation and bid-rigging also increased on Royal Assent: a new indictable category of obstruction offence was added with a maximum sentence of an unlimited fine and/or 10 years in prison. The maximum prison sentence for bid-rigging increased from five to 14 years, while the maximum unlimited fine was maintained.

- **No Criminal Sanction for Price Maintenance, Predatory Pricing or Price Discrimination** — The provisions for criminal sanction for predatory pricing, price discrimination and price maintenance have been repealed, and a new provision added to the civil enforcement track for price maintenance. Moving price maintenance to the civil enforcement track removes the prospect of criminal sanction and civil actions for damages, but allows private parties to seek leave from the Tribunal to bring applications to regain supply on usual trade terms or other remedial orders. However, predatory pricing — and, potentially, price discrimination — will continue to present risks for those who possess market power, since the Commissioner of Competition will be able to seek administrative monetary penalties (AMPs) under the Act's abuse of dominant position provisions (as discussed below).

- **Effect on Civil Actions** — Section 36 of the Act permits parties to sue for loss or damages suffered as a result of conduct that is contrary to the criminal provisions of the Act. Bill C-10 may make it easier for private plaintiffs to prove violation of the new conspiracy provision as the "unduly" element will be removed, but price discrimination, predatory pricing, and price maintenance are no longer subject to civil damage claims under the Act.

B. Changes to Reviewable Conduct Provisions

- **$10- to $15-Million Fines for Abuse of Dominant Position and Deceptive Marketing Practices** — Those found by the Tribunal to have abused their dominant position (other than airlines) were previously not subject to monetary penalties, though the Tribunal was able

to order a party to cease an offending practice and/or impose other potentially broad remedial orders. Corporations found to have engaged in civil deceptive marketing practices were subject to orders to cease the offending conduct, publish a notice, and pay an AMP of up to $100,000 for the first order and up to $200,000 thereafter.

Effective immediately, AMPs of up to $10 million are available for a first finding of abuse of dominant position or deceptive marketing practices and AMPs of up to $15 million are available for each subsequent finding.

- **Other Changes** — Other changes to the civil provisions of the Act include: interim injunctions for misleading representations, repeal of the consignment selling provisions, private applications for price maintenance (with leave of the Tribunal), and repeal of airline-specific provisions.

The amendments to the Act present significant risks for businesses but may also create some opportunities, particularly in the area of pricing. Companies should review their competition law compliance programs to ensure that their business practices do not run afoul of the new laws, as well as to ensure that they identify new opportunities to improve their business.

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ENVIRONMENTAL LAW UPDATE

Québec Cap-and-Trade System

By Julie Elmlinger and Anne-Marie Sheahan

The Québec government recently adopted Bill 42, An *Act to amend the Environment Quality Act and other legislative provisions in relation to climate change* (the Act), which puts in place a structure for a provincial greenhouse gas (GHG) cap-and-trade system. When considered in the broader North American context, the Act presents business opportunities for clean technologies. Some of its provisions are not yet in force.

North American Context for Québec Regime

The Act enables Québec to meet its commitments as a member of the Western Climate Initiative (WCI), a group of seven US states and four Canadian provinces (British Columbia, Manitoba, Ontario and Québec) that have committed to common GHG emission-reduction targets and to implementing a regional cap-and-trade system.

British Columbia's *Greenhouse Gas Reduction Act* received Royal Assent last year and will come into force by regulation. This year, Ontario introduced the *Environmental Protection Amendment Act (Greenhouse Gas Emissions Trading), 2009* (Bill 185). Manitoba is expected to introduce proposed legislation shortly. The Act also aligns with a June 2008 memorandum of understanding between Québec and Ontario.

These provincial regimes differ significantly from Alberta's *Climate Change and Emissions Management Act* and from federal policy set out in the Government of Canada's "Turning the Corner" plan. They also differ in many ways from the system proposed in the American *Clean Energy and Security Act of 2009* (Waxman-Markey Bill).

Key Features of the Act

Reduction targets are based on 1990 emissions and may be broken down into sector-specific targets. The proposed GHG emission-reduction objective is 10 million metric tonnes (Mt CO_2 eq.) per annum.

No specified threshold for emitter eligibility has yet been set. Emitters that are subject to the new regime will have to counter actual GHG emissions with an equivalent number of emission units. These include: (i) free allowances granted by the Minister; (ii) allowances sold at auction or by agreement; (iii) early-action credits; and (iv) offsets. Finally, the Minister may grant any other type of emission-reduction units determined by future regulation.

These units will be fungible and emitters will be able to trade them. Emitters will be entitled to bank them for use or trade during a later period. The Minister will maintain a public register of emission allowances to ensure proper accounting and tracking. Furthermore, the Minister has the power to enter into agreements with governments or international organizations for the harmonization and integration of cap-and-trade systems.

Failure to comply with the targets will result in penalties. All sums collected through auctions and penalties will be paid into the Green Fund, which will be used to finance measures to address climate change.

Comparison with Other Initiatives

The WCI provides for emission reductions of 15 per cent below 2005 levels by 2020, while the Waxman-Markey Bill provides for three per cent reductions below 2005 levels by 2012 and reductions of seven per cent by 2020, 42 per cent by 2030 and 83 per cent by 2050. The Canadian federal plan proposes intensity-based reductions rather than fixed emission caps. All covered industrial sectors will be required to reduce their emissions intensity from 2006 levels by 18 per cent by 2010, with two per cent continuous improvement every year after that. The federal government also indicated its intention to move from emission-intensity targets to fixed emission caps in the 2020-2025 period.

The WCI provides that early-action credits may be issued for reductions that occurred between January 1, 2008 and January 1, 2012. The Canadian federal plan proposes a very limited amount of early-action credits for reductions that occurred between 1992 and 2006. The Waxman-Markey Bill does not allow for issuance of early-action credits.

Both the WCI and the Waxman-Markey Bill allow for offsets, but propose limiting their availability for use by regulated emitters. While the WCI limits offsets to 49 per cent of total emission reductions from 2012 to 2020, the Waxman-Markey Bill proposes an upper limit of two billion tons of offset allowances, as well as variable limits on use for regulatory compliance. In the recent report by the National Round Table on Environment and Energy (NRTEE), it proposes that the availability of offsets be phased out by 2015.

McCarthy Tétrault Notes:

The Act, particularly when taken in the broader North American context, presents business opportunities for clean technologies. Emission-reduction incentives include funding of research and development for clean technologies. Non-regulated companies may be able to leverage the economic value of reductions achieved through their technology to finance projects. Regulated GHG emitters will create demand for clean technologies and resulting offsets.

The Act rewards early emission reductions. Forthcoming regulation should be monitored to maximize benefits from early-reduction credits. For example, as mentioned above, according to the WCI, 49 per cent of total emission reductions could be satisfied by offsets.

Emission-reduction units will also present trade opportunities. The NRTEE is predicting carbon prices as high as $200 to $300 per tonne, if provincial cap-and-trade systems are not integrated and if the Canadian system is not linked internationally.

A version of this article previously appeared in *McCarthy Tétrault Co-Counsel: Technology Law Quarterly*.

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Ontario Introduces Legislative Changes to Facilitate a Cap-and-Trade System for Greenhouse Gases

The Ontario government recently introduced Bill 185, the *Environmental Protection Amendment Act (Greenhouse Gas Emissions Trading), 2009*. This new legislation proposes amendments to the Ontario *Environmental Protection Act* that would provide the regulatory authority to set up a greenhouse gas cap-and-trade system in Ontario. The changes would permit the creation of regulations that would set rules around various aspects of a cap-and-trade system, such as the granting and/or auctioning of allowances, linking to other trading systems, credit for early action, the use of offsets, and verification and reporting provisions.

The government also released a discussion paper, *Moving Forward: A Greenhouse Cap-and-Trade System for Ontario*, which outlines the elements of a cap-and-trade system, gives a background and overview of previous stakeholder comments on each element, and outlines design issues and policy options for each element. Government news releases indicate that stakeholder discussions on the details of a cap-and-trade system will continue over the summer and fall of 2009. Our information is that, at this point, the preferred model inside the government resembles the nitrogen oxides and sulphur dioxides Regulation 194/05, albeit with a possible auction component as well as provisions for offsets.

The details of the cap-and-trade system that is finally adopted in Ontario, such as the extent of credit that will be given for early action and the mechanism chosen to allocate allowances (whether by auction or gratis), will have broad implications for regulated emitters.

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The New Currency of Carbon Tonnes in Canada: Hints at $100+

The National Round Table on the Environment and the Economy (NRTEE), a federal Crown corporation, recently released a report entitled, *Achieving 2050: A Carbon Pricing Guide for Canada*, concluding that "Canada must act decisively now if we are to achieve our 2050 emission-reduction targets." The NRTEE recommends carbon prices, representing the cost of purchasing permits, allowances or offsets for emitting greenhouse gases (GHGs), in the $100 to $200 per tonne range. The NRTEE characterizes such prices as "the least economic cost" by which the federal GHGs targets of 20 per cent below 2006 levels by 2020, and 65 per cent below 2006 levels by 2050 can be met. Without complementary regulations and other measures recommended in the report, the NRTEE estimates that national carbon prices upwards of $300 per tonne would be required post-2025.

Achieving 2050 emphasizes absolute rather than intensity-based targets, and recommends the development of a uniform, national, economy-wide cap-and-trade system no later than 2015. Under a cap-and-trade system, the government would set limits on the amount of GHGs that regulated facilities can emit. Emitters that are able to reduce their emissions below the limits would receive credits for the surplus, which they in turn could sell to other emitters or use to offset future emissions.

The NRTEE recommends transitioning from initial allocations of emission permits to a full auction by 2015 (with the exception of the electricity sector where a full auction is recommended immediately because permit costs can be passed through to customers). A hard cap is recommended by 2015, a full auction by 2020, and full carbon market trading beyond 2020. The NRTEE recommends that an auction initially be phased in and output-based allocations limited, but suggests that sectors particularly exposed to trade and cost challenges be able to obtain output-based allocations.

According to the NRTEE, the sort of hybrid cap-tax system recommended should include carbon taxation elements for price certainty and cap-and-trade elements for reduction certainty.

National Regime: All Jurisdictions, All Emissions

The NRTEE recommends unifying existing provincial efforts into a national scheme covering all jurisdictions and all emissions as soon as possible in order to realize necessary economic efficiencies and reinforce Canada's engagement in international markets. Regional and sector-specific disproportionate impacts are recommended to be targeted through "income support" rather than a fundamental dilution of the carbon price.

The NRTEE recommends that a national cap apply to large final emitters (including fugitive and process emissions) as well as to buildings, households, transportation, and light manufacturing sectors, which for certain sectors should include regulations or taxation based on the carbon content of the fuel purchased by such users.

Achieving 2050 suggested that domestic offsets created from sectors not covered by the cap-and-trade regime should initially be allowed, but phased out "rapidly" within the first few years.

International Linkages

The NRTEE recommends that Canadian participation in international frameworks be increased and that Canadian businesses be permitted to seek real and verifiable reductions outside Canada for domestic compliance purposes. Even at $100 to $200 per tonne, NRTEE modelling suggests that sufficient reductions will not be achieved within Canada, and that affordable, credible, and sustainable foreign opportunities must be included.

According to the report, without international trading, domestic prices could rise to $300 per tonne by 2030. With 30 per cent international credits allowed, however, prices could remain below $200 over the same period. International linkages could be through U.N. frameworks or directly to US or European schemes and should move towards a unified global carbon price.

Complementary Regulations

Along with the cap-and-trade regime, the NRTEE also recommends complementary regulations, particularly in the upstream oil and gas, pipelines, transportation, buildings, landfills, and agricultural sectors, which could mandate changes to certain practices, vehicle standards, public transportation programs, building codes, or fuel content, for example. The NRTEE estimates that complementary regulations could contribute almost half of the necessary reductions by 2020 and almost a fifth by 2050, and would effectively reduce the highest costs of abatement and help reduce the national carbon price.

Overall, *Achieving 2050* strongly recommends that there be no further delay in federal policy development and indicates that "fast and deep" reductions are needed prior to 2015 to avoid more expensive reduction costs in future years. The NRTEE recommends that early auction revenues be invested in technology and economic impact mitigation. Overall, the NRTEE sees three key policy wedges necessary for Canada to achieve its targets:

(i) a national cap-and-trade system;

(ii) complementary regulations and technology policies specifically directed at hard-to-reach emissions; and

(iii) international carbon-abatement opportunities to help align domestic prices with those of our major trading partners.

Achieving 2050 estimates annual compliance costs of $3.4 billion by 2020, and indicates that 2020 auction revenues for the 570 mega-tonnes (Mt) available may approach $18 billion. Distribution of this value will be important and auction design will require careful consideration. In terms of macro-economic impacts, *Achieving 2050* assumes that under a "business-as-usual" scenario, Canada's economy would grow in the order of 40 per cent by 2020 and 150 per cent by 2050, and implementation of the recommended carbon policy would shrink such national economy by one to three per cent in 2020 and three to five per cent in 2050.

A more detailed description of the NRTEE report is available on our website.

> **McCarthy Tétrault Notes:**
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> After the NRTEE report came out, the federal government announced "Canada's Offset System for Greenhouse Gases" and published a revised overview of the proposed offset system, describing the principles underlying the system's design, setting out the requirements for offset credits, and outlining the intended use of the credits in a carbon market.
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> Under the system, companies will be able to apply to the federal Minister of the Environment to register domestic offset projects that will result in "real, incremental, quantifiable, verifiable and unique" GHG reduction or removals. Once the GHG reductions are verified, offset credits may be issued and may thereafter be banked, traded or used for compliance purposes.
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> As part of this initiative, the federal government also released two draft guides for public comment: *Program Rules and Guidance for Project Proponents and Program Rules for Verification and Guidance for Verification Bodies*. These documents set out the rules and guidance on the requirements and processes to create offset credits and verify a registered project's GHG reductions or removals. The government expects final versions of the guides to be published in the fall of 2009.

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FOREIGN INVESTMENT LAW UPDATE

Canadian Ownership and Control Rules: What Every Eager Foreign Investor Should Know

Although Canadian legislation requires that Canadians substantially own and control certain targeted industries (telecommunications operators, broadcasting licensees, domestic airlines and a number of cultural industries such as certain book publishing and retailing businesses), a few determined foreign investors have found investment opportunities by carefully navigating through these rules.

To be clear, the Canadian ownership and control rules do not forbid all foreign investment in the targeted industries. But the rules are complex, and they do make it difficult for an investor seeking to make a sizeable investment, or to consummate a trans-border merger. Still, in a number of prominent cases, non-Canadians have achieved their investment objectives. For example, despite Canadian ownership and control rules, American Airlines was able to buy a majority interest in a Canadian airline and operate much of its back-office activities; Goldman Sachs was able to buy a majority interest in the Canadian broadcasting business of Alliance Atlantis; US-based Loral was able to buy a majority interest in Telesat, Canada's largest communications satellite operator; and non-Canadian private equity firms were able to acquire a large majority of the equity in Air Canada.

The Canadian ownership and control rules are structured in a similar manner. They establish formal limits on measurable factors, such as the percentage of voting shares that non-Canadians can hold or the percentage of the board of directors that must be Canadian. These are usually straightforward to understand and apply. A key point is that no specific limits are imposed on non-voting shares or other forms of equity participation. A foreign investor can therefore obtain a greater equity participation in a Canadian target than the ownership tests would suggest. Indeed, this is commonly done.

The rules also include a requirement that Canadians exercise "control in fact" over the enterprise — a concept that is anything but straightforward. In making a control-in-fact determination, the regulators undertake a multi-faceted review of all points of influence by non-Canadian and Canadian investors. This is done by looking at shareholders' agreements and other agreements or arrangements that can bear on governance, composition of the board or strategic decision-making by the company.

Although the rules do not stipulate a numeric limit on non-voting equity, when examining who exercises control in fact, regulators become concerned if the overall equity stake held by non-Canadians becomes too large. Where Canadians have too small an economic stake in an entity, and non-Canadians too large a stake, regulators simply do not believe that Canadians will be in control.

Although a non-Canadian equity participation level of up to 65 per cent does not seem to

generate concerns, it is not a simple matter to predict how high foreign equity participation can go before regulatory resistance becomes significant. Much will depend on the individual facts. For example, a single non-Canadian investor is probably more troublesome than a large number of unrelated foreign investors, given the difficulty likely to be encountered by multiple investors in concentrating their individual influence into control.

The rules are enforced by several federal regulators, depending on the industry involved. Although enforcement, in theory, can occur anytime, a foreign investor is most concerned at the time of a business acquisition, when regulatory scrutiny is most intense. The anticipated regulatory reaction under the Canadian ownership and control rules thus becomes a key input on whether to make an offer, and how to properly structure it.

For a more detailed analysis of these ownership and control rules, please see our Legal Update.

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Canada's New Foreign Investment Screening Rules: What Every Eager Foreign Investor Should Know

In March 2009, the Canadian Parliament amended several laws that impact foreign investment in Canada. It both reduced and clarified some important foreign investment restrictions, while also imposing what could be significant new burdens on investors.

The *Investment Canada Act* authorizes the Canadian government to screen foreign investment to determine if it is likely to be of "net benefit" to Canada. Foreign direct acquisitions of Canadian businesses with assets that exceed $312 million, for most industries, and $5 million, for certain sensitive sectors of the economy, must endure a "review" by one of the two government departments that deal with such matters. Often the review will lead to the foreign investor giving undertakings relating to employment, future investment and other commitments considered beneficial to Canada.

The March 2009 amendments to the *Investment Canada Act* are intended to make it easier for foreign investors seeking to acquire Canadian companies, as fewer acquisitions will have to endure the Investment Canada review process. The list of sensitive sectors has been narrowed to only include certain cultural industries. Thus, acquisitions in the uranium mining, financial services, and transportation services sectors will no longer be subject to the low $5-million review threshold.

As well, the formula for calculating the higher review threshold will be changed and the threshold number will increase. The threshold moves from a test based on the book value of the assets of the target company to a test based on its "enterprise value." The definition of this term has been set out in proposed regulations published for comment on July 11, 2009. For a publicly listed company, enterprise value means market capitalization plus debt less cash. For

non-publicly traded companies, or for asset sales, enterprise value will be calculated using the value-of-assets formula currently applied. The new enterprise value threshold will be set at $600 million initially and will increase in stages to $1 billion in four years' time.

An important addition to the *Investment Canada Act* is the new power given to the federal government to vet investments by non-Canadians on national security grounds. Canada joins the United States, Australia, and most recently, Germany, with explicit procedures to review, adjust, and if necessary, reject, foreign investments that are perceived to be injurious to national security.

The scope of the review is potentially very broad. There is no minimum investment threshold. A review can be undertaken for a takeover of an existing business or the start-up of a new business. To date, there is no list of sensitive sectors, where a review is more likely; nor is there a procedure to voluntarily pre-clear potentially sensitive transactions. The proposed regulations set out time frames for the government to invoke the national security screening process. They also require foreign investors to disclose more information than previously about the foreign investor — a requirement that applies both to reviewable transactions and to transactions that are merely notifiable.

The March 2009 amendments to the *Competition Act* that bear most notably on foreign investment decisions concern the Canadian pre-merger notification procedures. These have now been substantially aligned with the equivalent US procedures under the *Hart-Scott-Rodino Act*. No change has been made to the substantive test for prohibiting anti-competitive mergers.

Under the new procedures, parties to a notifiable merger must file the requisite information, and then wait 30 days. By the end of the 30-day period, either the Competition Bureau will issue a second request for additional information or, if no such second request is made, the parties are free to close the transaction. If the parties receive a second request, it will set out the further information that must be submitted. The parties must assemble the requested information, submit it to the Competition Bureau, and then wait a further 30 days before closing their transaction — unless the Competition Tribunal blocks the closing upon application by the Bureau.

The 2009 amendments do not materially change Canada's ownership and control rules that apply in certain targeted industries, such as telecommunications and broadcasting. Nor do they alter merger approval rules that can apply to other industries such as large transportation undertakings. All of these rules continue to be relevant to a potential foreign investor. See the related article in this issue.

Click on the following links for a more detailed analysis of the 2009 amendments and of the proposed regulations to the ICA.

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PENSION LAW UPDATE

The Supreme Court Sides with Employer in the *Kerry* Case

The August 7, 2009 decision of the Supreme Court of Canada in the *Kerry* decision relating to pension plans essentially upholds the findings of the Ontario Court of Appeal from 2007. The highlights are as follows:

- Provided that (i) there is a single, ongoing pension plan with both a defined benefit (DB) and a defined contribution (DC) feature, (ii) the members of both parts are beneficiaries of the pension trust fund, and (iii) the employer may lawfully take contributions holidays in respect of the DB feature, then it is not unlawful under the *Pension Benefits Act* (Ontario) or the common law to also apply the surplus in the trust fund to take employer contribution holidays in respect of the DC members of the plan.

- Vis-à-vis payment of pension plan expenses, unless an employer has clearly committed to paying a plan expense, it is not obliged to pay plan expenses and it is not unlawful to charge reasonable and *bona fide* plan expenses to the pension trust fund (in this case Kerry (Canada) Inc. had committed to paying trust expenses and had continued to do so, but the expenses in dispute related to plan expenses such as actuarial, legal, accounting etc. in the administration of the plan). The court also ruled that, unlike the Ontario Court of Appeal, it saw no differences between expenses paid to third-party service providers and payment for in-house administration provided by the employer, provided that in each case the expense was reasonable and *bona fide*.

- The amendment of a pension plan to allow the employer to charge pension plan expenses to the trust fund is not prohibited merely because the trust agreement or pension plan (or both) contains an "exclusive benefit" clause. However, expenses incurred to review the plan terms in support of a decision to add a DC provision was for the sole benefit of the employer and should not be charged to the pension plan.

- With respect to cost awards in litigation of this type, the court upheld the ruling that the Financial Services Tribunal has no jurisdiction to order litigation costs payable from a pension fund where the fund is not a party to the proceeding (as it was not here) and that while a court has authority to order litigation costs be paid from a pension trust fund in some cases, where the litigation is not for the advantage of all of the beneficiaries of the pension plan, then the matter is "adversarial" and such costs should not be awarded from the pension trust fund.

The foregoing is necessarily an abbreviated highlight of the decision and it must be remembered that all cases turn on their individual facts. Also, seven Justices of the Supreme Court of Canada heard this matter and while five of them supported the Ontario Court of Appeal decision in concluding that the DC contribution holidays were not unlawful, two

of the justices disagreed with that conclusion. Employers should take this decision as a welcome "good news" story after a difficult several months on the pension front.

This article was previously published as an e-Alert. For a more detailed discussion of the *Kerry* decision, please see our August Legal Update.

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TAX LAW UPDATE

Time to Restructure: Canadian ULC Structures Adversely Affected by Amended Canada-US Tax Treaty

The Canada-US Income Tax Convention (Canada-US Treaty) was recently amended to include a so-called hybrid denial rule. This rule will adversely affect Canada-US cross-border structures involving Canadian unlimited liability companies (ULC). Over the last several years, ULCs have been used in many cross-border structures, including those employed by technology enterprises.

As the hybrid denial rule is subject to a delayed coming-into-force rule, it will generally apply after January 1, 2010.

The amended Canada-US Treaty will deny treaty benefits where a US resident receives income, profit or gain from an entity that is treated as being fiscally transparent under US laws but not under Canadian law (e.g., a Nova Scotia ULC). This rule is broadly worded and applies to many situations where there is no apparent tax policy abuse. Tax treaty benefits will be denied where a US resident receives dividends or interest from a ULC even where there is no double-dip in respect of a deductible payment, such as interest, and the denial of tax treaty benefits will extend to structures used for legitimate business reasons. Generally, the effect of this rule will be to subject affected payments to 25 per cent Canadian withholding tax.

Administrative comments from both the Canadian taxing authorities and the US Treasury do not suggest the rule will be narrowly applied.

Taxpayers having such Canadian ULC structures should review their structures prior to 2010 and consider whether a restructuring is appropriate.

This article previously appeared in *McCarthy Tétrault Co-Counsel: Technology Law Quarterly*.

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