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Ontario Chapter

timely disclosure obligations after *Coventree*

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“OSC says Coventree withheld looming ABCP crash from investors”

September 28, 2011



as corporate
counsel to a
public company,
how can you
prevent *Coventree*
from happening?



timely disclosure obligations after *Coventree*

1. the facts
2. regulatory framework
3. guiding principles
4. takeaways and observations

findings of fact led to conclusion of OSC panel

- Coventree was incorporated in 1998. It became a public company in November, 2006.

business

- Coventree was the largest non-bank sponsor of asset-backed commercial paper (“ABCP”) in Canada; a niche investment bank that sponsored and managed conduits. The conduits were trusts that issued ABCP. Coventree also administered third parties’ conduits and made investments in other companies.
- ABCP issued by Coventree-sponsored conduits was distributed to investors by investment dealers under agreements entered into between the conduits and investment dealers.

findings of fact led to conclusion of OSC panel (cont'd)

- The distribution of ABCP was made under a prospectus exemption where the ABCP had been given an approved credit rating.
- Dominion Bond Rating Service (“DBRS”) was the sole provider of ratings for Coventree’s ABCP.
- Conduits purchased income-producing assets that were either traditional assets (such as mortgages, auto loans, and credit card receivables) or structured financial assets (such as CDOs) resulting mainly in credit arbitrage transactions.
- Conduits funded the purchase of these assets through the issuance of ABCP to investors. The income earned allowed the conduit to pay interest on the ABCP and other expenses.

findings of fact led to conclusion of OSC panel (cont'd)

- Coventree earned income as securitization agent from the conduits.
- Revenue payable to Coventree in future years as “revenue backlog” constituted a significant asset of the company.

decision

- The OSC held that *Coventree* had breached sections 75(1) and (2) of the OSA twice. The first breach related to the impact of a DBRS press release in January 2007 and the second related to the events leading up to the disruption of ABCP market in August 2007.

findings of fact led to conclusion of OSC panel (cont'd)

DBRS January release

- On January 19, 2007, DBRS announced a change to its rating methodology (the "January Release") in respect of the credit arbitrage business - this change would not impact already existing transactions. Coventree confirmed with DBRS by phone on January 22, 2007 the meaning of the press release.
- Management discussed materiality and concluded that no disclosure was required. Disclosure committee did not meet to consider the issue. Outside legal advice was not obtained.

findings of fact led to conclusion of OSC panel (cont'd)

DBRS January release (cont'd)

- Coventree did not expect credit arbitrage business to be a significant source of its future growth or revenues; would have little impact on revenues over the next 3 years because of backlog. The President noted that DBRS had a history of announcing new restrictive criteria and then reversing or changing its position. Market price of stock not impacted by disclosure of event in subsequent MD&A.

findings of fact led to conclusion of OSC panel (cont'd)

DBRS January release (cont'd)

- Coventree disclosed on May 14, 2007 in an MD&A filed in respect of Q2 2007 (Sept. 30 year-end) that the DBRS January Release had the effect of “substantially curtailing its ability to grow, if not halt in the short term” its credit arbitrage business. App. 80% of Coventree’s business in Q1 and Q2 of 2007 was derived from the credit arbitrage business. New funding and creation of backlog was important to Coventree; and were negatively impacted by DBRS January Release.

findings of fact led to conclusion of OSC panel (cont'd)

events leading up to August 1, 2007

- inability to issue new ABCP
- difficulty rolling outstanding ABCP
- ABCP spread widening
- Credit default swap spread widening
- concerns about potential collateral calls
- sales of assets to raise cash
- inability to fund purchase of new assets

findings of fact led to conclusion of OSC panel (cont'd)

August 1, material change occurred

- OSC held disclosure required by August 2; basically concluding that Board reached the wrong conclusion at an August 1 meeting.
- Materiality threshold reached:
 - its conduits were unable to carry out any new securitization transactions, whether traditional securitizations or credit arbitrage transactions - those transactions represented approximately 90% of Coventree's revenues for the period ending June 30, 2007
 - its conduits were unable to purchase assets from Coventree's traditional asset originators

findings of fact led to conclusion of OSC panel (cont'd)

August 1, material change occurred

- its credit arbitrage business, which until very recently had represented approximately 80% of its revenues, was viewed by Coventree as dead or dying
- the business of its wholly-owned subsidiary, Nereus, was no longer viable
- its conduits were unable to issue any new ABCP for any purpose including for buying back maturing ABCP or funding possible collateral calls
- its conduits were having increasing difficulty rolling their maturing ABCP and were doing so only with the reluctant market support of the Caisse in rolling its holdings of Coventree sponsored ABCP

findings of fact led to conclusion of OSC panel (cont'd)

August 1, material change occurred (cont'd)

- interest rate spreads on Coventree sponsored ABCP had widened to an unprecedented level
- its conduits were “perched on” collateral call triggers
- its conduits were selling assets worth millions of dollars to accumulate cash to fund possible collateral calls: \$188 million and was expected to increase to \$610 million by August 7
- there was a very substantial supply/demand imbalance in the ABCP market
- Coventree had no way of knowing if or when market conditions would return to normal

findings of fact led to conclusion of OSC panel (cont'd)

August 1 and 2

- board considered issuing press release
- draft press release prepared by President – did not seek outside legal advice
- strategic council met on Aug 2 to discuss draft – draft focused on widening spreads
- draft circulated with recommendation that press release not be issued

part I: regulatory framework



Canadian public companies must disclose a “material change” under securities legislation



what is a “material change”?

- change in the business, operations or capital that would reasonably be expected to have a significant effect on market price or value of any of the issuer’s securities, or
- a decision to implement such a change made by the board or by senior management who believe confirmation by board is probable

how must a material change be disclosed?

- press release “forthwith” AND
- material change report filed as soon as practicable and in any event within 10 days

are there any exceptions?

- Issuer may promptly file report on a confidential basis and not issue a press release if:
 - disclosure would be “unduly detrimental to an Issuer’s interests”; **or**
 - senior management has decided to implement the material change and it is probable that board will confirm, and there is no reason to believe that any person has traded with knowledge of the material change

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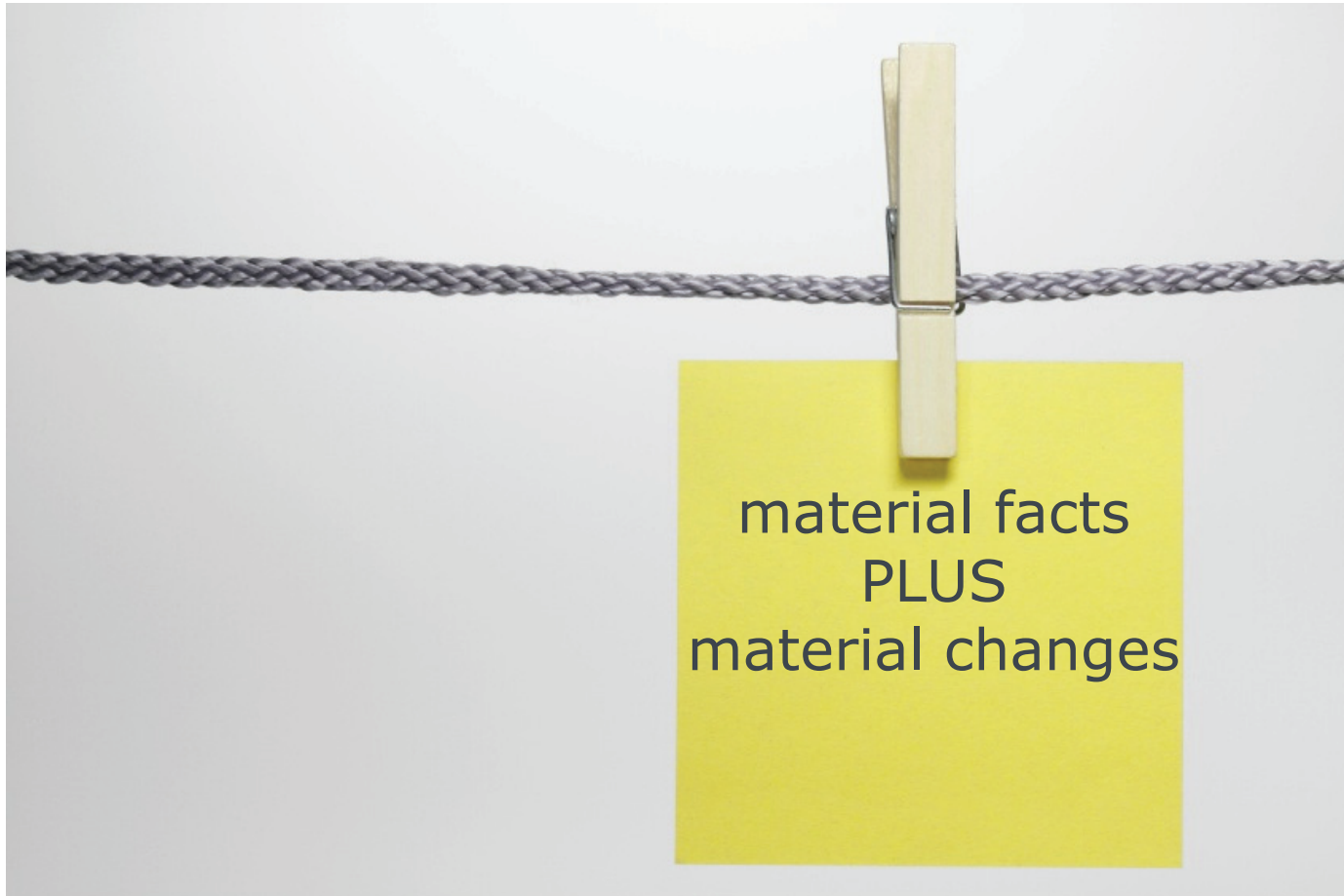
confidential reports rarely used

- concern with civil liability
- it would be rare for a continuous disclosure document to be issued at a time when a material change report has been filed on a confidential basis and such continuous disclosure document not contain a misrepresentation.

companies listed on TSX/TSXV must disclose “material information”

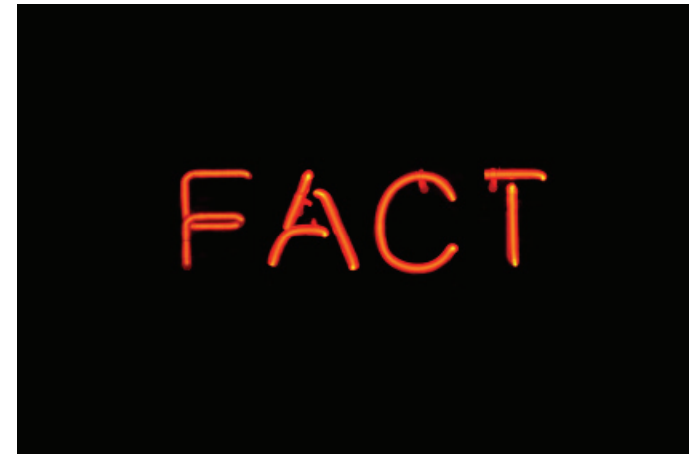


what is “material information”?



what is a material fact?

fact that would reasonably be expected to have a significant effect on market price or value of securities



timely disclosure
of material facts:
is it enforced?



timely disclosure
of material facts
is not always
practical; but it
is important



National Policy 51-201 – best disclosure practices

1. establish a corporate disclosure committee
2. establish a written corporate disclosure policy
3. involve the board or appropriate committee in public disclosure
4. establish a written insider trading policy and blackout periods

part II: guiding principles from
Coventree



there must be
a **change** in
the business,
operations or
capital of an
issuer



in determining whether a change is material, the test is objective



determination is to be made at each moment in time...premature disclosure concern is no defence



in determining whether a change is material, a key test is whether the information would be important in making an investment decision



an external development
may, but will not usually,
be a material change



it is irrelevant if disclosure could have a material adverse impact on third parties or the issuer



implementation
of a risk
management
strategy may be
a material change



the disclosure
decision is not
protected by
the business
judgment rule



the OSC will not evaluate the disclosure decision against the standard of perfection or with the benefit of hindsight



prior disclosure
of the risk giving
rise to the material
change is not
enough



disclosure in a public disclosure document, other than a press release and a material change report, is not enough



seek “objective outside legal advice” where individuals making the disclosure decision have a conflict of interest



sanctions

- Sanctions against Coventree included a cease-trade order, an administrative penalty of \$1,000,000 and \$250,000 in costs.
- Sanctions against each of Mr. Cornish (President and director) and Mr. Tai (CEO and director) included:
 - administrative penalties of \$500,000;
 - orders to resign from positions held as a director or officer of a reporting issuer (other than Coventree); and
 - a one-year prohibition from becoming or acting as a director or officer of a reporting issuer (other than Coventree).

sanctions

- These sanctions were considerably less severe than OSC staff's request which included that:
 - Coventree pay an administrative charge of \$5M;
 - Exemptions do not apply to Mr. Cornish and Mr. Tai for five years;
 - Mr. Cornish and Mr. Tai each pay an administrative penalty of \$5M and be barred from acting as a director or officer for 5 years; and
 - the parties pay full costs of the investigation of \$1.5M.
- In addition, Staff had also requested that neither Cornish nor Tai be able to be indemnified by Coventree. The OSC held that it did not have such powers under section 127 of the OSA.

part III: take-aways and observations

- hindsight, whether acknowledged or not, may still play a role in determining whether an issuer complied with its timely disclosure obligations

take-aways and observations (cont'd)

- management directors and other directors and officers who have superior qualifications are subject to greater risk of liability
- good faith, not profiting from a breach, a high level of co-operation with regulators and being diligent will not protect a responsible officer or director from liability

take-aways and observations (cont'd)

- the OSC will not show deference to decisions made by directors or senior officers even if those directors and officers acted in good faith
- however, decision-makers who make the disclosure decision with the benefit of and in accordance with “objective outside legal advice” may be in a far better position if they find themselves before the OSC

the appeal

- we understand that Cornish and Tai (but not Coventree) have appealed the OSC decision

questions?

