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Pulling Out All the Swaps: Alberta Securities Commission Finds Total Return Swaps Abusive

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The Alberta Securities Commission (ASC) recently ruled that certain Brookfield entities' (Brookfield's) conduct and disclosure in connection with its hostile takeover bid for Inter Pipeline Ltd. (IPL) were clearly abusive to IPL shareholders and the capital markets, and therefore contrary to the public interest. The ASC sanctioned Brookfield's use of cash-settled total return swaps by ordering an increase in the minimum tender condition to Brookfield's bid from 50% to 55%, the first time that a Canadian securities regulator has adjusted the minimum tender condition since the implementation of the new bid regime in 2016. The decision, issued on July 12, 2021, has significant implications for the use of derivatives by bidders, although the full extent of those implications will not be clear until the ASC's reasons are released.

Background

Brookfield began acquiring shares of IPL in March 2020. Between June and October 2020, it also entered into cash-settled total return swaps (TRS) with Bank of Montreal (BMO). The TRS provided Brookfield with economic exposure to IPL akin to owning IPL shares without actually owning them. Because Brookfield's beneficial ownership of IPL was below 10%, it was not required to disclose its ownership and derivative position in an early warning report. Accordingly, when Brookfield announced its intention to make an unsolicited takeover bid for IPL on February 10, 2021, it surprised the market by disclosing that it already held approximately 9.75% of IPL's outstanding shares and had economic exposure to another 9.9% through the TRS.

On February 18, 2021, IPL announced a strategic review process and shortly thereafter adopted a supplemental shareholder rights plan that treated interests in financial derivatives like the TRS as equivalent to beneficial ownership for purposes of the 20% rights plan trigger. This had the effect of preventing Brookfield from acquiring any additional IPL shares or swap exposure, but did not prevent Brookfield's bid for IPL from proceeding.

On June 1, 2021, IPL announced the execution of a share-for-share transaction with Pembina Pipeline Corporation (Pembina) at an implied premium of approximately 17.8% to Brookfield's offer. The agreement contemplated a $350-million (or 4.2%) break fee payable to Pembina if the deal fell through. Brookfield responded by increasing its offer and then filed an application with the ASC challenging what it perceived to be improper defensive tactics and seeking orders cease-trading the rights plan and the Pembina transaction and restraining the payment of the break fee. IPL and Pembina cross-applied for orders deeming the TRS shares to be beneficially owned by Brookfield and therefore excluded for purposes of the minimum tender condition, deeming the TRS shares to be voted in the same proportion for and against the Pembina transaction as all non-Brookfield shares are voted, and cease-trading the Brookfield bid.

Break Fee

Brookfield argued that the break fee was an improper defensive tactic because it was agreed to following a flawed process that unfairly tilted the playing field in Pembina's favour, and that the size of the fee was excessive in the circumstances. IPL and Pembina responded that the break fee was within the customary range of 2% to 5% and that it was necessary to attract Pembina as a white knight and thereby increase value for IPL shareholders. Unsurprisingly, the ASC dismissed Brookfield's challenge to the break fee.

Rights Plan

Brookfield asked the ASC to cease-trade the rights plan on the basis that IPL's strategic review process was complete and that the rights plan therefore no longer served a valid purpose. Staff supported IPL and Pembina in their opposition to Brookfield's request on the basis that the rights plan preserved rather than limited shareholder choice by preventing Brookfield from acquiring "negative control" by increasing its ownership position (presumably based on the assumption that the shares underlying the swap were under Brookfield's influence and that, uninhibited by a rights plan, Brookfield could acquire control over almost 25% of the votes). Moreover, although the rights plan was not going to be submitted to shareholders for approval, the fact that it expired the day after the vote on the Pembina transaction was arguably tantamount to a vote on the rights plan itself. The ASC declined to cease-trade the rights plan.

Cash-Settled Swaps

The focus of the ASC's order was not on the complaint brought by Brookfield, but rather on the cross-complaint filed by IPL regarding Brookfield's use of the TRS. IPL and Pembina argued that Brookfield's use of the TRS allowed it to skirt early warning reporting requirements that are designed to allow boards, potential competing acquirers and shareholders to assess and plan for the possibility of a forthcoming bid. They also suggested that BMO, which was both the swap counterparty and an affiliate of Brookfield's financial advisor, was incentivized to vote the TRS shares against the Pembina transaction and to tender them to Brookfield's bid because of its affiliate's entitlement to a $15 million fee if the bid were successful and because of Brookfield's stature as one of the largest and most influential companies in Canada. Finally, IPL and Pembina contended that Brookfield's press releases and other public disclosure in which it aggregated its ownership and economic interests in IPL, asserting that it was the single largest investor with an aggregate economic interest of 19.65%, were misleading and confusing, and dissuaded other potential bidders from participating in the auction. Brookfield argued that it complied in all respects with the early warning reporting requirements since it had no right to vote or influence the voting of the TRS shares, and that there was nothing improper with its use of TRS to remain below the 10% reporting threshold.

It was apparent that the ASC panel had grave concerns with Brookfield's use of and disclosure relating to the TRS, finding that it was "clearly abusive to IPL shareholders and the capital market, and therefore contrary to the public interest." It also found that "Brookfield's limited disclosure regarding the [TRS] adversely affected IPL shareholders and the IPL auction process." Although the ASC determined that it was unable to grant a remedy restraining the voting by the swap counterparty of the IPL shares on the Pembina transaction, it issued orders

- increasing the minimum tender condition to Brookfield's bid from the statutory 50% to 55%; and
- directing Brookfield to disclose (i) the name of the TRS counterparty; (ii) the dates of the International Swaps and Derivatives Association agreements between Brookfield and the TRS counterparty; (iii) the dates of the swap transactions pursuant to which Brookfield acquired its economic interest in IPL shares; (iv) certain specified information concerning Brookfield's commercial relationship with the TRS counterparty; and (v) the existence of, amount of, and conditions for the payment of the completion fee set out in an engagement letter between BMO Nesbitt Burns Inc. and Brookfield.

Implications of the Orders

As we await the ASC's written reasons, two areas of uncertainty loom:

- **When is the use and disclosure of swaps abusive?** It is a certainty that lawyers and bankers will pore over the written reasons when they are available to divine the implications for the not-uncommon use of cash-settled total return swaps in Canada. It seems clear that there was no finding that Brookfield and the swap counterparty were joint actors, or that Brookfield was the deemed beneficial owner of the IPL shares held by the swap counterparty. Nor was there any finding that Brookfield had contravened its statutory early warning reporting obligations. So it will be illuminating to see what elements of the use and disclosure of the TRS gave rise to a finding of abuse. Was it the risk that the counterparty might be influenced by its relationship with Brookfield, or the fact that its affiliated investment bank would be entitled to a success fee on the bid? Would ethical walls between the bank and its investment bank not have addressed that concern? Was it the fact that Brookfield acquired ownership of IPL shares close to, but short of, an ownership level that would have required early warning reporting disclosure, including disclosure of its economic interests? If so, what are the implications of that very common behaviour for other market participants? Or was it the fact that Brookfield's press releases

and other public disclosure frequently described its ownership and economic interests in IPL as an aggregate economic interest of 19.65%, which, according to IPL, confused the market and had a chilling effect on the auction process? The order gives rise to many questions, and much uncertainty will plague swap market participants until the written reasons are issued.

- **Is "empty tendering" a new evil?** In its oral ruling, the ASC remarked that it was setting the minimum tender condition at 55% to address concerns with empty voting. Although the evidence suggested that BMO had no intention to vote any TRS shares for or against the Pembina transaction, it was unclear whether or not it would tender any TRS shares to Brookfield's bid. Although empty tendering may be a more accurate term than empty voting, the panel was clearly troubled by the possibility of a party tendering shares in circumstances in which it did not have the same economic interest as the rest of an issuer's shareholders. How exactly the panel arrived at a 55% minimum tender condition will be something to watch for.

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