

# DIRECTORS' AND OFFICERS' LIABILITY UPDATE

OCTOBER 2011

## ONTARIO SECURITIES COMMISSION FINDS COVENTREE INC. BREACHED DISCLOSURE OBLIGATIONS

In December 2009, the Ontario Securities Commission (the "OSC") commenced a proceeding against Coventree Inc. ("Coventree"), its CEO Dean Tai ("Tai") and Geoffrey Cornish (Coventree's President) to determine whether they complied with their obligations to disclose material facts and material changes in respect of Coventree's operations in the asset backed commercial paper ("ABCP") market. The OSC's decision was released on September 28, 2011, and focuses on Coventree's public disclosures during the "credit crisis" in August of 2007.

Although the decision addresses a number of complex issues related to the ABCP market, the thrust of the decision is that the OSC holds issuers and their officers and directors to a very high standard on disclosure issues even in the face of unprecedented turbulence, disruption and unpredictability in the market in which the issuer operates.

### The Facts

Coventree was an investment bank that specialized in structured finance in the ABCP market, which the OSC described as:

"In 2006/2007, Canadian ABCP was either sponsored by a bank or other large financial institutions or by a non-bank or 'third party sponsor'. Banks sponsored ABCP was issued by special purpose vehicles, usually in the form of a trust (referred to as a "conduit"), that was sponsored by a bank. Third party sponsored ABCP was issued by a conduit sponsored by a non-bank or a third party entity, such as Coventree."

During this time Coventree had three primary lines of business. It acted as a securitization agent for Coventree sponsored conduits, it administered conduits sponsored by third parties and it made investments in other issuers.

## DISCLOSURE OF MATERIAL FACTS AND MATERIAL CHANGES

A "material fact" is any fact that "would reasonably be expected to have a significant effect on the market price or values of securities."

The definition of "material change" is more narrow and is defined as "a change in the business operations or capital of an issuer that may reasonably be expected to have a significant effect on the market price or value" of securities.

It is only a change to the "business operations or capital" of an issuer that can trigger a "material change".

The focus of the OSC's proceeding against Coventree related to Coventree's role as a securitization agent for its sponsored conduits, whereby Coventree arranged traditional securitization transactions and credit arbitrage transactions. In this role, Coventree would (i) select and arrange the purchase of assets by conduits; (ii) enter into credit default swaps; (iii) arrange for liquidity in other arrangements necessary to carry out securitization transactions; and (iv) submit transactions to rating agencies.

The OSC determined that "the ability of Coventree sponsored conduits to carry out securitization transactions to issue ABCP and to "roll" ABCP as it matured, was a critical part of Coventree's business."

### **The Credit Crisis**

In August of 2007, the global credit markets tightened and it became very difficult for financial institutions to access credit. The OSC found that this "credit crisis" affected Coventree's business as follows:

"(a) there was no new issue capacity for Coventree sponsored ABCP;

(b) there was a significant reduction in demand for ABCP

issued by Coventree sponsored conduits...;

(c) dealers reported difficulty in rolling ABCP issued by Coventree sponsored conduits;

(d) the term for which some investors "rolled" their ABCP became shorter and there was significant increase in overnight rolls;

(e) it took longer each morning for the dealers to complete sales of Coventree sponsored ABCP and more ABCP was being returned...;

(f) there appeared to be some flight to quality, meaning some investors were trading out of third-party sponsored ABCP to bank-sponsored ABCP or government debt;

(g) dealers were reporting that their market-making lines for Coventree sponsored ABCP were fully or close to fully extended; and

(h) dealers were not providing bids for Coventree sponsored ABCP in the secondary market."

These events occurred in or about July/August 2007 and the primary issue before the OSC was whether Coventree was obliged to disclose these occurrences as material changes.

### **The OSC's Analysis – The Uncharacteristic Effect of the Credit Crisis on Coventree**

The OSC recognized that the "credit crisis" was an event that was external to Coventree's business and operations. Typically, pursuant to National Policy 51-201, section 4.4, issuers "are not generally required to interpret the impact of external political, economic and social developments on their affairs and make disclosure." The OSC explained that:

"Section 4.4 of NP 51-201 is premised on the assumption that investors will be aware of external economic developments and their general effects on reporting issuers. Where those developments occur, and do not have an uncharacteristic effect on a particular issuer, no material change disclosure by a reporting issuer may be required."

However, the OSC explained that there is a disclosure obligation when those external events "will have or has had a direct effect on the business and affairs of a company that *is both material and uncharacteristic of the effect generally experienced by other companies engaged in the same business or industry.*" [Emphasis Added]

The OSC concluded that the "credit crisis" had such an effect on Coventree's business and operations that it was required to file a material

change report. For example, the OSC determined that Coventree sponsored conduits could not issue new ABCP, purchase maturing ABCP, meet potential collateral calls, or, in effect, carry on its securitization business because of the lack of liquidity in the market resulting from the "credit crisis". These changes were, in the OSC's view, material and uncharacteristic of the general effects of the "credit crisis" and, therefore, triggered a disclosure obligation.

The OSC explained that notwithstanding that Coventree did not have perfect information as to the nature, length and cause of the "credit crisis" it was still obliged to disclose the significant effects that it expected the "credit crisis" to have on its business or operations:

"It is not premature disclosure to disclose those actual events and developments, and their consequences to Coventree's business, even if there is uncertainty as to their causes, future effects, financial impact or duration. An issuer can make appropriate disclosure of relevant events and developments as they exist and have occurred, even if the future is uncertain. An

issuer does not subject itself to any liability... for premature disclosure where the disclosure made relates to events and their consequences that have occurred and is accurate, balanced and appropriately qualified."

The OSC also addressed Coventree's submission that it did not want to prematurely file a material change report that may have panicked the market when it was attempting to negotiate a resolution to the issues caused by the "credit crisis." The OSC rejected this position stating:

"If events occurred that gave rise to a material change with respect to Coventree (as we have found), the materiality of those events is not somehow delayed or qualified because of the possibility of some future negotiated solution or outcome.

...

Disclosure to shareholders of the material changes that occurred by the close of business on August 1, 2007 could not await the outcome of a possible negotiated solution among all of the market participants."

In the result, the OSC concluded that Coventree breached the *Securities Act*, by among other things, failing to file a material change

report and that Cornish and Tai acquiesced, permitted or authorized the breach. The OSC noted that Cornish and Tai failed to obtain legal advice from outside legal counsel on Coventree's disclosure obligations and the OSC was critical of Cornish and Tai in this regards.

The OSC will schedule a hearing to determine the appropriate sanction.

### **Conclusion**

The decision is significant because it reaffirms the high standard to which the OSC holds issuers and their officers and directors on disclosure issues. In August 2007, the global credit markets were facing unprecedented turbulence and the OSC nonetheless determined that, in the midst of it, Coventree (and Tai and Cornish) should have disclosed to the market how that turbulence would affect Coventree's business and operations. This decision clarifies the OSC's expectation of the type of disclosure an issuer should make when faced with "external events" that may affect its business or operations.

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