IN THE MATTER OF THE SECURITIES ACT
R.S.O. 1990, CHAPTER S.5, AS AMENDED (the Act)

— AND —

IN THE MATTER OF
NEO MATERIAL TECHNOLOGIES INC.
AND PALA INVESTMENTS HOLDINGS LIMITED AND
ITS WHOLLY-OWNED SUBSIDIARY 0833824 B.C. LTD.

SUBMISSION OF STAFF OF THE ONTARIO SECURITIES COMMISSION

1. This submission sets out staff's views regarding the application that will be considered at the Commission hearing scheduled for May 7, 2009. While we do not propose to finalize our position prior to having the benefit of the evidence presented by the parties at the hearing, this submission is intended to indicate our views at this stage of the proceedings and the basis for those views. The facts giving rise to this application are set out in the documents filed by the parties. We do not repeat them in detail in this submission.

OVERVIEW AND RECOMMENDATIONS

2. At issue are two shareholder rights plans and whether the Commission should exercise its public interest jurisdiction to cease trade one or both of the plans.

3. On February 9, 2009, Pala Investments Holdings Limited (Pala) announced that, through a wholly-owned subsidiary, it intended to acquire (the Pala Offer) up to approximately 20% of the outstanding common shares (the Neo Shares) of Neo Material Technologies Inc. (Neo). The Pala Offer was formally launched on February 25, 2009. It is a hostile, partial bid.

4. Pala structured its Offer to comply with the "Permitted Bid" definition of Neo's

shareholder rights plan then in effect (the First Rights Plan). The First Rights Plan was approved at the annual and special meeting of Neo shareholders in June 2004 and later ratified by shareholders at the annual and special meeting in April 2007.

5. On February 12, 2009, the Board of Directors of Neo adopted a second shareholder rights plan (the Second Rights Plan) in direct response to the Pala Offer. The Second Rights Plan is substantially similar to the First Rights Plan (which continues to remain in place) except that the Second Rights Plan also bans partial bids.

6. On April 21, 2009, Pala announced that it would amend the Pala Offer to (i) decrease the maximum number of Neo Shares to be acquired pursuant to the Offer from approximately 20% to approximately 9.25%, (ii) increase the cash offer price for the Neo Shares, and (iii) extend the expiry time of the Offer to May 15, 2009. Consequently, if the Pala Offer is now successful, Pala's ownership in Neo will increase from approximately 20.65% of the outstanding Neo Shares to 29.9%. Pala formally amended the Pala Offer on April 27, 2009 by the filing of a notice of variation and extension.

7. The Neo shareholders overwhelmingly approved the Second Rights Plan at the annual and special meeting held on April 24, 2009 (the 2009 Neo Shareholders' Meeting). Over 80% of Neo Shares were voted at the 2009 Neo Shareholders' Meeting on the resolution to approve the Second Rights Plan and over 80% of Neo's disinterested shareholders voted in favour of the Second Rights Plan.

8. Pala submits that it is in the public interest to cease trade both the First Rights Plan and the Second Rights Plan to give Neo shareholders the opportunity to exercise their inherent right of ownership to decide for themselves whether to tender to the Pala Offer.

9. Neo submits that there is no public interest basis for the Commission to override the informed decision of the Neo shareholders to approve the Second Rights Plan (which, Neo argues, is also inherent approval of the First Rights Plan). By approving the Second Rights Plan, Neo shareholders have made an informed decision in respect of the Pala

Offer – they have collectively decided to "just say no".

10. In staff's view, the evidence supports the conclusion that Neo shareholders made an informed decision to approve the Second Rights Plan and effectively say "no" to the Pala Offer. There is no need for the Commission to exercise its public interest jurisdiction at this time and staff recommend that the Commission dismiss the application.

ISSUE

11. All parties agree that the Pala Offer was structured to comply with the definition of "Permitted Bid" under the First Rights Plan. In staff's view, no action is required by the Commission in connection with the First Rights Plan as it does not prevent Pala from successfully completing the Pala Offer.

12. The Pala Offer is not a "Permitted Bid" under the Second Rights Plan since it is not a bid for *all* of the Neo Shares. If the Commission does not cease trade the Second Rights Plan, the Pala Offer cannot proceed.

13. In staff's view, the Commission only needs to consider one issue. It needs to consider whether on May 7, 2009, a cease trade order of the Second Rights Plan is necessary to protect the public interest.

ANALYSIS

Public Interest and Take-Over Bids

14. The objectives of the take-over bid provisions are a subset of the Act's broader purposes. The objectives of the take-over bid provisions are stated in subsection 1.1(2) of National Policy 62-202 *Take-Over Bids — Defensive Tactics* (NP 62-202), with the primary objective being the "protection of the bona fide interests of the shareholders of the target

company".

15. The Commission may consider any number of factors relevant in deciding whether to exercise its public interest jurisdiction to protect the bona fide interests of target shareholders. Examples of these factors were set out in *Re Royal Host Real Estate Investment Trust and Canadian Hotel Income Properties Real Estate Investment Trust* (1999), 22 OSCB 7819 (*Royal Host*). (See paragraph 64 of the Neo Memorandum of Fact and Law).

16. Which factors are relevant will vary from case to case since all rights plans are unique to the circumstances of the bid. See *In the Matter of Falconbridge Limited* (2006) 29 O.S.C.B. 6783 (*Falconbridge*) at paragraph 36.

17. The Commission has consistently considered shareholder support of a rights plan in evaluating whether to cease trade the plan. In addition to being one of the "Royal Host" factors, the Commission specifically acknowledges in subsection 1.1(3) of NP 62-202 that it is "prepared to examine target company tactics in specific cases to determine whether they are abusive of shareholder rights. Prior shareholder approval of corporate action would, in appropriate cases, allay such concerns".

18. Staff submit that, in light of the overwhelming support for the Second Rights Plan expressed by informed shareholders in the face of the Pala Offer, the shareholder support factor alone should be determinative. Therefore, the Commission should not intervene and cease trade the Second Rights Plan unless the Commission is of the view that:

- in approving the Second Rights Plan, Neo shareholders were insufficiently informed about the Second Rights Plan and the Pala Offer;

- there is evidence to suggest that management or the board of Neo coerced or unduly pressured Neo shareholders to approve the Second Rights Plan; or

- there is evidence that the Neo board process in evaluating and responding to the Pala Offer, including the decision to implement the Second Rights Plan, was not done in the best interest of the Neo shareholders.

Informed Shareholder Approval

19. In deciding to maintain a rights plan in the face of a hostile bid, the Commission in *Re MDC Corporation and Regal Greetings & Gifts Inc.* (*Regal*) (1994), 17 O.S.C.B. 4971 put substantial weight on the fact that 71% of shareholders had approved the board's decision to implement the plan one week before the hostile bid was launched. The management information circular informed shareholders of the plan's purpose, which was to give the directors time, if appropriate, to pursue alternatives to maximize shareholder value in the event of an unsolicited bid. Moreover, since approximately 80% of the target's common shares were held by institutional shareholders, the Commission concluded that the views of the holders of the majority of the common shares could have been readily ascertained. The Commission stated at page 4980 that:

> No shareholders, other than MDC, came forward to ask us to terminate the Plan so as to allow the RGG bid to be completed. Two substantial shareholders (or representatives of shareholders) told us that "the time had not yet come". No other evidence was led on the subject by MDC. Accordingly, we had no reason to believe that the shareholders of Regal, other than MDC, wanted us to terminate the Plan as against MDC at the time of the hearing.

20. The Alberta Securities Commission recently considered the impact of shareholder support of a rights plan where shareholders approved the plan in the face of a hostile bid. In *Re Pulse Data Inc.* (2007), 2007A.B.A.S.C. 895 (*Pulse Data*), the Alberta Securities Commission dismissed the bidder's application to cease trade the rights plan where approximately 74% of the shares voted at the shareholders' meeting were voted in favour of the rights plan. In so doing, the Alberta Securities Commission stated at paragraph 102:

> In our view, this very recent and informed Pulse Shareholder approval, given in the absence of any imminent alternatives to the Offer, demonstrated that the

> continuation of the Rights Plan as at 27 September 2007 was in the *bona fide* interests of Pulse Shareholders.

21. In considering the impact of shareholder approval in the face of a hostile bid, the Alberta Securities Commission emphasized that such approval must be informed.

22. In *Pulse Data*, the Alberta Securities Commission was of the view that the outcome of the shareholder vote represented an informed decision of the target shareholders. Prior to voting, shareholders had disclosure of all relevant information about the offer, the rights plan and the effect of the plan on the offer. Relevant information came from multiple sources – the bid circular, directors' circular and information circular in connection with the shareholders' meeting called to seek approval of the rights plan.

23. Collectively, the various disclosure documents gave Pulse shareholders the necessary information to evaluate the rights plan in the face of the hostile bid. This information included information about alternative transactions, the board's plans going forward, the value of the offer and the effect the rights plan would have on the offeror's ability to make a creeping take-over of the company.

24. Staff submit that the Neo shareholders made an informed decision when they voted on the Second Rights Plan. Before voting, Neo shareholders received copies of the Pala Offer circular, Neo's directors' circular and Neo's management information circular (the 2009 Management Information Circular) in connection with the 2009 Neo Shareholders' Meeting.

25. The 2009 Management Information Circular stated that the "[t]he New Rights Plan was designed to prevent unfair attempts to make a creeping takeover of the Corporation (such as the Pala Partial Offer)".

26. There is further evidence of an informed shareholder decision in this case in the fact that several Neo institutional shareholders voted in favour of the Second Rights Plan, despite

their normal policy of voting against rights plans that ban partial bids. This vote in favour of the Second Rights Plan went against the recommendation of RiskMetrics, an institution whose voting guidelines are used in Canada by institutional shareholders, which strongly suggests a fully informed decision on the part of Neo's shareholders in this instance.

27. By voting for the Second Rights Plan, Neo shareholders knew, or ought reasonably to have known, that they were voting against the Pala Offer. There is no evidence to suggest otherwise.

28. At the time of the vote, Neo shareholders had not received Pala's notice of variation and extension, which varied the terms of the offer to increase the offer price and reduce the maximum number of Neo Shares to be acquired under the Pala Offer. Staff do not believe this should affect the conclusion that the Neo shareholders made an informed decision to reject the Pala Offer, as modified. Pala issued a press release on April 21, 2009 outlining the terms of the bid variation. In light of the variation, Neo waived the proxy deadline in respect of the 2009 Neo Shareholders' Meeting. As a result, Staff believe that Neo shareholders had sufficient time in which to consider the revised Pala Offer and alter their voting instructions.

No Evidence of Coercion

29. In examining shareholder support, the Commission will scrutinize how that support was obtained.

30. In *Regal*, the Commission found "no suggestion of coercion or undue managerial pressure imposed on the shareholders to ratify the plan". The plan was ratified by owners of 80% of the outstanding shares just prior to the hostile bid being launched. There was no evidence brought before the Commission in *Regal* to demonstrate that any shareholders other than the bidder wanted the plan cease traded at the time of the hearing. This led the Commission to conclude in its decision that:

> …the only evidence before us at this time is to the effect that it is the shareholders' choice to have the Rights Plan in place in order "to give the board of directors time, if appropriate, to pursue alternatives to maximize shareholder value in the event of an unsolicited take-over bid".

31. The fact that a target may approach and consult institutional shareholders in considering implementing a rights plan does not necessarily mean shareholders have been coerced or unduly pressured to approve a plan.

32. In *Regal*, the Commission was "told that Regal management had consulted with its institutional shareholders about the Rights Plan and modified it to reflect their concerns". Despite that consultation, the Commission found "no suggestion of coercion or undue managerial pressure imposed on shareholders to ratify the Rights Plan".

33. The Alberta Securities Commission made a similar conclusion in *Pulse Data* where it stated at paragraph 101(d):

> There was no suggestion of managerial coercion or inappropriate managerial pressure being brought to bear on Pulse Shareholders to approve the Rights Plan. Indeed, we noted that ISS, an independent advisory service, recommended to its institutional shareholder clients that they vote in favour of the Rights Plan at the special meeting of Pulse Shareholders…

34. Pala asserts in its Reply (at footnote 6) that Neo waived the 48-hour proxy cut-off for the 2009 Neo Shareholders' Meeting "so as to enable itself to continue to solicit proxies in its favour and with knowledge of the identity of shareholders who had already voted against the Second Shareholder Rights Plan".

35. Staff is not aware of any evidence suggesting there has been such solicitation or that such solicitation, if it occurred, was coercive.

Board Process

36. In *Pulse Data*, the Alberta Securities Commission stated that it was reluctant to interfere with a decision of the target board that has a fiduciary duty to act in the best interests of shareholders, particularly where that decision had very recently been approved by informed shareholders.

37. In *Re Cara Operations Limited* (*Cara*) (2002), 25 O.S.C.B. 7997 (*Cara*) at paragraphs 57 and 61, the Commission stated that at least two underlying principles emerge from the rules and polices for take-over bids and the various rights plan hearings. The first is the principle of procedural fairness. The second, is the principle of the fiduciary duty of the directors, members of the special committee of directors and their advisors. The exercise of fiduciary duty "should be reflected in conduct and recommendations that are based upon the best interest of the shareholders generally and not those of any group of shareholders, bidders, potential bidders or others."

38. The Commission also recognizes the importance of the fiduciary duty of the directors in the context of take-over bid transactions. Section 1.1(3) of NP 62-202 states that:

> [I]t is inappropriate to specify a code of conduct for directors of a target company, in addition to the fiduciary standard required by corporate law.

39. The Commission will scrutinize the integrity of the board process. Where there is evidence that the process has been compromised or is questionable, it will be more difficult for the Commission to conclude that board or special committee actions are taken with the view to the best interests of the target shareholders.

40. Board process will be compromised where advisors to the special committee are not independent. In *Cara*, the Commission was concerned that a longstanding legal advisor to the target could not truly act as an independent advisor to the special committee. In *Re*

CW Shareholdings Inc. (1998), 21 O.S.C.B. 2899 at 2908 the Commission placed less reliance on the special committee's review of the bid where the committee was "set up for purposes of convenience only, and not as an independent committee".

41. Decisions by a target board or special committee which suggest entrenchment also compromise board process. In *Cara*, the special committee recommended, and the board approved, reimbursement payments to the target chairman for expenses incurred by the chairman in respect of a potential "white knight" bid. The Commission commented on the behaviour of the board and special committee noting,

> The decision … showed conduct that caused us to believe that the special committee and the directors who approved the reimbursements were not motivated solely by the best interests of the shareholders.

42. Pala suggests that the Neo board and management have taken steps, such as adopting the Second Rights Plan, to entrench themselves. Staff submit that these submissions are unproven and that the Commission should disregard Pala's suggestion.

43. In staff's view, the evidence suggests that the Neo board acted in the best interests of its shareholders. Neo's board appointed an independent special committee to review the Pala Offer. The special committee retained independent legal and financial advisors to assist it with this review.

CONCLUSION

44. The Commission recognizes that defensive tactics such as shareholder rights plans can, in appropriate circumstances, be adopted for legitimate purposes, such as for the purpose of obtaining a better bid (subsection 1.1(6) of NP 62-202). In this instance, the Neo board claims to have adopted the Second Rights Plan to prevent a creeping take-over through a partial bid, and in particular, the Pala Offer.

45. The evidence suggests that the Neo board exercised its fiduciary duty in adopting the

Second Rights Plan. The majority of Neo shareholders accepted that the purpose of the Second Rights Plan was legitimate, and they approved the plan.

46. NP 62-202 does not support the conclusion that directors cannot restrict the ability of shareholders to exercise their fundamental right to dispose of shares as they see fit. Rights plans by their very nature do this and they are not prohibited by NP 62-202.

47. Past cases support the conclusion that there comes a time when a rights plan must go. The benchmark for determining when that time has come has generally been when the rights plan no longer serves its purpose – to provide time for the board to create an auction or consider other alternatives to maximize shareholder value.

48. In this instance, the Second Rights Plans stands in the way of the Pala Offer and therefore continues to serve its purpose as per the will of the substantial majority of Neo shareholders.

49. As stated in subsection 1.1(3) of NP 62-202, the Commission is "prepared to examine target company tactics in specific cases to determine whether they are abusive of shareholder rights. Prior shareholder approval of corporate action would, in appropriate cases, allay such concerns".

50. The shareholder approval in this case isn't simply *prior* approval of a defensive tactic. It is much more significant – it is a ratification of a defensive tactic aimed specifically at the Pala Offer.

51. In staff's view, the informed decision by the overwhelming majority of Neo shareholders to approve a defensive tactic directed specifically at the Pala Offer *should* allay any concerns the Commission may have about the Second Rights Plan being, as of today, and based on these facts, abusive of shareholder rights.

52. Having regard to the foregoing submissions, staff recommend that the Commission dismiss the application.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

May 4, 2009

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