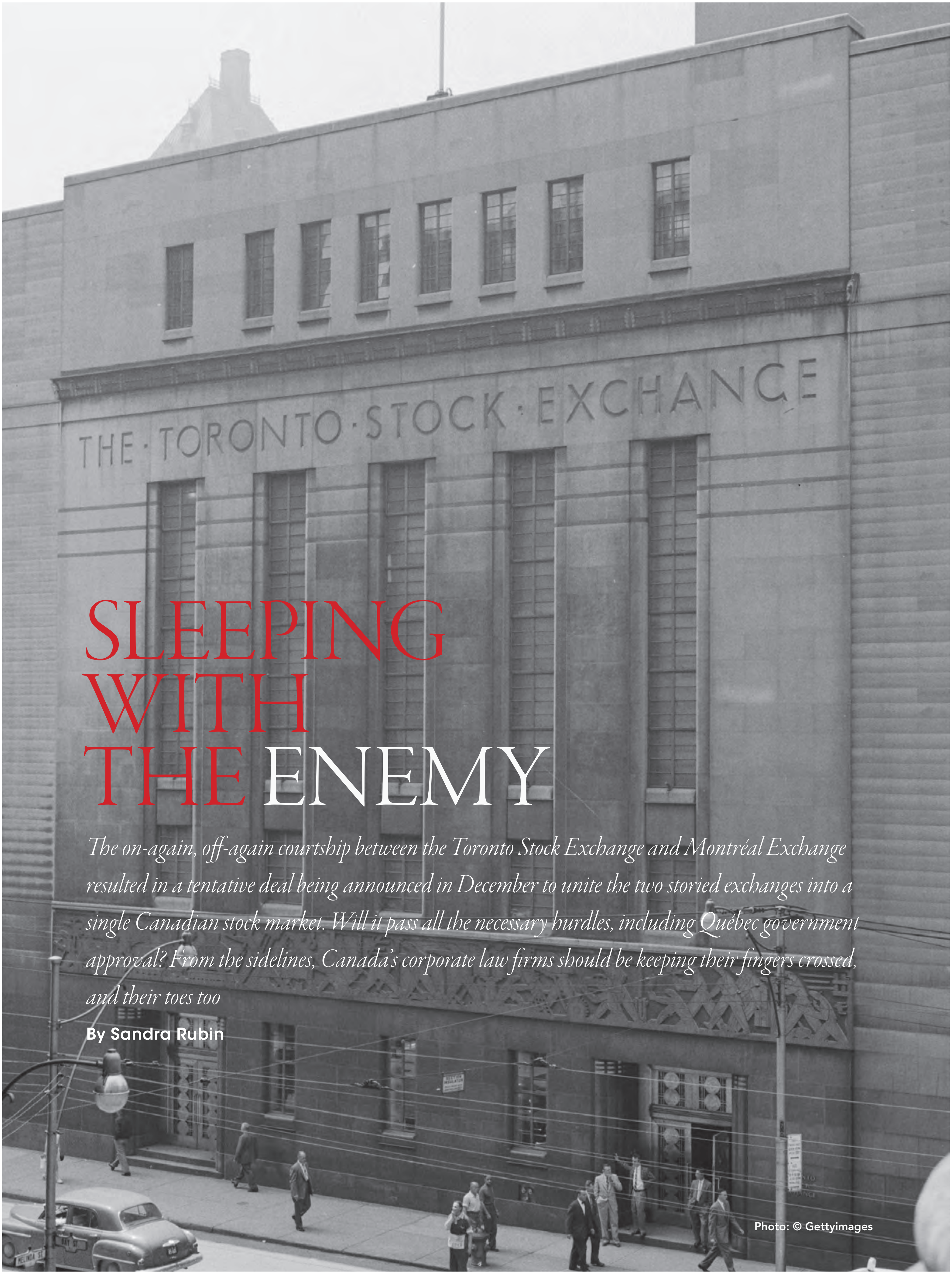

SLEEPING WITH THE ENEMY

The on-again, off-again courtship between the Toronto Stock Exchange and Montréal Exchange resulted in a tentative deal being announced in December to unite the two storied exchanges into a single Canadian stock market. Will it pass all the necessary hurdles, including Québec government approval? From the sidelines, Canada's corporate law firms should be keeping their fingers crossed, and their toes too

By Sandra Rubin

Photo: © Gettyimages

Heads may have stayed put, but eyes certainly rolled when the Toronto Stock Exchange (TSX) and the Montréal Exchange (MX) acknowledged just before Halloween that they tried and failed to agree on a deal to create a single Canadian stock market. It was déjà vu all over again. With exchanges around the world rushing to consolidate and expand their global reach, Canada was being treated to the spectacle of Québec and Ontario squabbling over who would drive the bus.

Despite the decidedly unpromising start, they rolled out a friendly $1.3-billion deal Dec. 10 that would see TSX Group Inc. take over the MX and form one unified Canadian exchange operating under a renamed TMX Group Inc. But the last chapter hasn't been written, because while in the purely legal sense this might be a fairly ordinary public company merger, in any other sense it is anything but.

Just look at the road to agreement. It was long and lurching, laced with political landmines (much like the debate over a national securities regulator) and rutted by that old wellspring of antagonism that's plagued the two historic adversaries for over a century.

And here's the thing. Even though the exchange officials and small armies of deal counsel deal finally managed to wring out an accord supported by both boards, the amalgamation still needs the blessing of a number of parties including the Autorité des Marchés Financiers (AMF), Québec's market regulator, and two-thirds of MX shareholders.

On the surface, the proposed takeover seems to contain many conciliatory elements. It leaves equities trading in Toronto while derivatives trading remains in Montréal — as does the MX head office. And MX will continue to manage the Montréal Climate Exchange. (Most of this was considered an absolute must if there was to be any hope of winning MX support.) But TMX Group has a Toronto head office, a Toronto-based chairman, and just five of 18 board seats for Québec directors for the first three years, with a guaranteed 25 per cent of seats for Québec residents after that.

Will it fly? Well, the announcement was barely hours old before the Caisse de dépot et placement du Québec, the province's powerful pension fund, challenged the plan. The Caisse, which owns nearly 8 per cent of MX, called for a "public debate" on the proposed deal. Henri-Paul Rousseau, the Caisse's CEO, said he wanted to know "where the decision-making centre will be" and what will happen to the operations in Montreal where the MX has developed "leading-edge" expertise in derivatives.

"We would like to know what the Toronto Stock Exchange's intentions are in this regard before we take our analysis further," he said. "A public debate is needed."

That's not a good sign, although the autonomy of the MX always promised to be a politically charged issue in its home province of Québec. When news of a possible merger first surfaced in late summer, there were immediate demands that the province's minority Liberal government act to keep control of the MX in Montréal. And until the deal announced last month receives all the requisite approvals and closes in the first quarter of 2008, no one can be totally sure it is saleable this time around either.

"Don't have any illusions about this," says a Montréal lawyer who asked not to have his name used in connection with the politics of the merger. "This transaction needs to be acceptable to all stakeholders in Québec — that's the government, the AMF and the public. A couple of things can happen here. The first is shareholders can turn it down, which is unlikely because of the price offered, the second is the AMF could say no or impose conditions Toronto can't live with."

Ah. The legacy of Canada's two solitudes has always been the ticking time bomb in the room. But Canada's dwindling sphere of influence globally and a growing number of alternative trading systems have been the ticking time bombs outside the door.

"This deal was a little bit different from the start because of the political element and the concerns expressed by the Montréal Exchange, the regulator and the government...so we had all of that to work through all that in addition to the normal issues," says Maryse Bertrand, a corporate partner who led the team at Davies Ward Phillips & Vineberg LLP that represented TSX Group.

Also on Bertrand's team were Sébastien Roy, Sylvie Guillemette, Alain Murad (corporate), Brian Bloom and Fred Purkey (tax), and George Addy and Chris Margison (competition).

"I'm representing the TSX, of course, and we think we'll prevail. I think this transaction is a very generous one to the shareholder of the Montréal Exchange. There will always be dissenters and nay sayers but we hope before people scuttle something like this, they'll think of the consequences for the Montréal Exchange. It would clearly be detrimental to its business, its shareholders and its ability to do a transaction with somebody else."

The 1999 non-compete agreement that carved the Canadian market up to give TSX Group Inc. a monopoly on equities trading and the MX the sole right to trade derivatives has kept the two factions apart for close to a decade.

Michael Gans; Blake, Cassels & Graydon LLP

By the time the peace treaty expires in March 2009, if the deal uniting the two storied exchanges hasn't closed, should the politics of the union prove to be too great a stumbling block, they'll have little option but to bloody one another competing for a greater share of a dwindling domestic market.

The country's corporate law firms have a vested interest in how this unfolds.

Michael Gans, an M&A partner at Blake, Cassels & Graydon LLP in New York, says there's international work to be picked up, including inbound south-north US work, once Canadian exchanges get their act together.

The heightened regulatory restrictions that flow from the *Sarbanes-Oxley Act*, particularly section 404 and the internal compliance rules, are driving increasing numbers of smaller US companies looking for liquidity to look outside their own borders, he says. They're looking at exchanges such as the Alternative Investment Market (AIM), a sub-market of the London Stock Exchange (LSE), and NYSE Euronext, the holding company created through the combination of NYSE Group, Inc. and Euronext N.V. in 2006, and – to a lesser extent – Toronto.

Gans, co-founder of Blakes New York office, says TSX officials have been holding road shows in New York, trying to convince US issuers that Canada is a good market for them. A Toronto-Montréal turf war would have weakened that position.

"They've had some success, but I think really just on the margins at this point," he says. "So from my perspective, a merger between the two exchanges should allow them to devote more resources to attracting international listings, particularly with a focus on the US.

"Having two smaller exchanges compete with one another just, by necessity, detracts from their ability to focus on the international front and from the capital resources they have available to spend on things like trading functions and marketing. As a Canadian lawyer in the US, it would be quite interesting to me and quite interesting to us as a firm if Toronto could get some traction as a viable alternative listing structure for US companies."

The thing is, the Canadian market may have been frozen in time for the last decade but the rest of the world has been anything but. In Europe, there's been a frenzy of consolidation with the LSE buying Borsa Italiana S.p.A. and the Paris, Amsterdam, Brussels and Lisbon exchanges banding together to form Euronext.

A new law came into effect Nov. 1 giving birth to a European juggernaut. The Markets in Financial Instruments Directive (MiFID) creates a common market for shares, commodities and derivatives trading for 30 countries across the European Economic Community.

"When you've got Nasdaq and the New York Stock Exchange making acquisitions on a global basis, you've got to sit there and say, what's the future for Canada if we're not competitive?," says Jon Levin, a senior corporate and M&A player at Fasken Martineau DuMoulin LLP. "We've already seen a leakage of listings to AIM; that's why we opened a London office.

"The world is a changing world and unfortunately, we tend to be very parochial about these things and we don't look at the big picture. This issue of Toronto merging with Montréal may not be of direct relevance to law firms but if our exchanges aren't viewed as being good stock markets to list on because they just aren't seen to be big enough players, and we see a leakage of that work to London, that's just not good for Canadian law firms, Canadian investment banks or Canadian accounting firms."

Hundreds, if not thousands, of corporate and securities lawyers are saying amen.

Most people who work in Canada's legal and financial communities seem to think consolidation of is the only model that makes sense, so there was a collective sigh of relief when the two exchanges announced a deal two weeks before Christmas.

Some had been worried the debate would keep getting dragged back to a national securities regulator — and the larger question of whether Canada's fragmented system works in a wired world in which companies can list on dozens of exchanges or alternative trading systems, each trying to make the listing process smoother and cheaper.

"The issue of whether the stock markets should merge and whether we should have a national securities regulator are interwoven — they're both part of the global trend toward capital markets efficiency," says David Brown, an M&A lawyer at WeirFoulds LLP in Toronto. "We need to get the country's regulatory bodies and exchanges in one understandable definable location or body, so that when people are going out and raising money and want their equities listed, they're only dealing with one entity.

"You should be dealing with one exchange and one set of rules that are understandable to everybody. It lowers the cost of raising capital and it attracts companies within and outside the jurisdiction. That would absolutely be a good thing for Canadian law firms."

Québec remains the wild card. While the Québec government was believed to be onside as of press time, it's difficult to predict whether that support will hold should there be widespread public pushback.

The deal requires the approval of holders of two-thirds of MX's shares at a special shareholders' meeting set for Feb. 13. The MX board is recommending shareholders vote in favour of the transaction and will be tendering its 7 per cent stake in the company.

It has all the hallmarks of a Valentine, a triumph of good-sense capitalism over the politics of nationalism — but unless the deal sells in Québec, no one can be rule out the possibility there could yet be a runaway bride.

The Duo

Goodness knows, Richard Nesbitt, CEO of the TSX Group, has wanted this union for some time. The two exchanges came agonizingly close to a deal in October that would have left Toronto trading securities and Montréal as Canada's options exchange. If they weren't actually at the church, they were planning the wedding rehearsal dinner. But at some point, things fell apart in a messy way.

Some people suspected Luc Bertrand, president and CEO of the MX, was the more reluctant of the two, but they nailed down a deal Bertrand could live with and he won approval from his board. It was Nesbitt who could not get his entire board to approve the deal because of "discomfort" that a Quebecker would run the combined company, according to a report on Radio-Canada in October. (In fact, Bertrand is a fluently bilingual native of Cornwall, ON). The network singled out TSX chairman Wayne Fox as having been opposed to the idea of joining forces if Bertrand was running the show.

Richard Nesbitt; TSX Group Inc.

"We're seeing the behaviour of a man, a man from Toronto, the chairman of the TSX," Québec Finance Minister Monique Jérôme-Forget told the French-language network. "It's possibly something we see often enough, Toronto being a little haughty toward Montréal."

The TSX denied that it was an English-French matter and reports surfaced that it was politics alright, but politics of a different sort. *The Globe and Mail* reported the two sides had agreed Nesbitt would be chairman and Bertrand CEO, but a dispute arose over job descriptions (in other words, which one would be in the driver's seat).

"Look, people are smart in Montréal and people are smart in Toronto," says a French-speaking lawyer who asked not to be named. "But in something like this, egos, personalities, sensitivities complicate it. It's not a straight-up merger."

You don't need a translator to understand that what he's saying was this was never going to be an easy proposition. The deal may be ruled by law — but it will be governed by politics and fuelled by popular sentiment.

Nesbitt and Bertrand seemed to have a history of, if not exactly bad blood, a sense that destiny was hurtling them toward confrontation. By March of next year they will likely be working closely together at the helm of a merged exchange.

Nesbitt is a pillar of the Toronto financial establishment. Meanwhile, Bertrand has become a hometown hero for completely reinventing the old Montréal Stock Exchange as a vibrant derivatives market.

Luc Bertrand; Montréal Exchange

"It's quite amazing what he's done; he started with almost nothing in 1999 and built this Montréal exchange," says Steeve Robitaille, a securities practitioner at Stikeman Elliott LLP in Montréal who represented the brokers in the initial public offering last spring.

"They developed software that, from what I understand, is the most efficient in derivatives and options trading. And the majority of employees at the Montréal Exchange work in technical assistance or building and improving the software, so it's more like a new tech company than a financial company. Having the foresight six or seven years ago to invest so much money in software while all the other exchanges were using hardware shows great vision. He's seen a hero in that sense."

Bertrand and Nesbitt have at least this much in common: Each talked merger and armed for battle.

Bertrand lined up with the Boston Options Exchange (BOX), taking a 31 per cent ownership stake (which the MX is trying to boost to 53 per cent) and forged a deal with the New York Mercantile Exchange (NYMEX) that had NYMEX taking a 10 per cent stake in the MX and working together on a new Canadian Resources Exchange to trade futures on heavy Alberta crude.

Nesbitt found his own US allies. TSX did a deal with New York-based International Securities Exchange, Inc. to create a new Canadian derivatives exchange that was to start running the moment the non-compete with the MX expires. Its fate is now up in the air. And he found a partner for TSX's Natural Gas Exchange (NGX): the Atlanta-based Intercontinental Exchange (ICE) — creating a race with Montréal to bring Canadian crude futures contract to market.

Both sides were obviously ready to rumble, the question was only with who. It was reported NYMEX and ICE both put forward takeover proposals to MX, but that Nesbitt and Fox were determined to best everyone else on price in order to achieve a made-in-Canada solution that would keep the country's already small markets united. When the first round of talks fell apart before the summer, it was apparently TSX that picked up the phone sometime in November and tried a new approach.

Suddenly, on the eve of Conrad Black's sentencing in a US court, came the news they finally reached the pact. The plan calls for Nesbitt to become CEO and run the stock side of the business, which will remain in Toronto, with Bertrand named deputy CEO and head the derivatives arm, which will remain in Montréal. Fox (who apparently scuttled the deal in October) will become chairman of the newly formed TMX.

Will that be enough to make the deal saleable in Québec? That's the $1.3-billion question.

Both teams are trying to make sure that doesn't happen. The agreement sets out a $46-million break fee if the MX ultimately accepts a competing offer, although TSX Group would have the right to match a rival bid.

The Union: The Nitty Gritty

Amidst all the drama of negotiations collapsing and being revived, trying to get a handle on what the deal structure would look like has been tricky. Ogilvy Renault LLP, the MX's longtime external counsel, and Torys LLP, the TSX's outside counsel, both said they couldn't comment, as did Osler, Hoskin & Harcourt LLP, Davies Ward Phillips & Vineberg and a raft of individual securities lawyers in both Montréal and Toronto who begged off due to an existing mandate or conflict. Both exchanges declined a request to talk with general counsel (it's safe to assume they have a non-disclosure agreement).

In the end, it was Davies that acted for the TSX and Ogilvy for the MX with Marc Lacourcière leading a team that included Frank Picciola, Andrew Bleau and Pete Wiazowski (M&A), Christine Dubé (exchange regulation), Jules Charette (tax) and Denis Gascon (competition).

But you don't need an insider's view to see one thing didn't shape up as some people were predicting. Many people thought any merger or takeover was going to have to deal with the 10 per cent ownership caps both exchanges have written into their charters. But the caps, far from being an impediment, turned out to be not even a speed bump.

The deal was done under Québec's *Companies Act* as an amalgamation of the MX with a newly created Québec company, resulting in a new MX that is a wholly owned subsidiary of the TSX Group — which will be renamed TMX Group.

"It looks to me like they followed the model they used in the past with the TSX and TSX Venture Exchange, with one modification," says Philip Anisman, a well-respected Toronto-based securities practitioner and scholar. "The TSX and MX will both be direct subsidiaries of TSX Group, while the Venture Exchange is an indirect wholly owned subsidiary. That means that the MX is equivalent in the structure to the TSX.

"There are a couple of other interesting things here. The press release announcing the deal was very careful to point out that MX will continue to be regulated by the AMF and that the AMF as well as OSC must approve any changes to the TMX ownership restrictions. Alberta did not get this power when the Venture Exchange was acquired by TSX.

"You can infer there must have been consultations with the OSC and AMF that led to the acceptance of this model. What this means is changes in ownership restrictions will require approval of both the AMF and OSC, which is interesting because Québec will maintain regulatory control of indirect ownership of the MX, as well over its operations as the lead regulator.

"I think it's pretty safe to infer that this transaction has at least staff approval – at least that – from the two regulators."

It's going to need more than that. In addition to selling the deal to shareholders of the MX, the OSC and AMF, it needs approval of the Competition Bureau, the Toronto Stock Exchange, the United States Securities and Exchange Commission.

When the deal was finally announced, there was a fair amount of angsting over whether it would go through. But Ed Waitzer, a securities and M&A partner at Stikeman Elliott in Toronto and both a former vice-president of the TSX and a former chairman of the OSC, says something surprising.

He says he's not sure it really matters whether the Canada's senior exchanges amalgamate or compete.

The Debate on the Sidelines

In truth, the debate in the legal community never centred as much on how the deal would get done as it did on whether it should get done at all. Many who work in the heartland of Canada's financial deal-making communities were convinced it should.

"With all these new trading systems the whole industry is being fractionated," says Garth Girvan, an M&A partner at McCarthy Tétrault LLP. "There are more and more players popping up, and only the strong will survive.

"If we have a chance of having a real strong base trading system in Canada, one that's competitive, it makes sense for those two to get together regardless of the politics. Otherwise, I think each of them runs the risk of being marginalized by others. I think it's only these Canadian-based exchanges that will pay attention to the Canadian market which, on a global scale, is pretty small."

David Brown; WeirFoulds LLP

Jeff Barnes, an M&A partner at Heenan Blaikie LLP in Toronto, says there was concern that if Toronto locked horns with Montréal and put a lot of energy into building a competing derivatives market, it could have become vulnerable on other fronts.

"Realistically the TSX is a regional exchange, outside of mining and maybe oil and gas but from a Canadian lawyer's point of view, the TSX is still a lot better than any other market at providing junior-stage funding," says Barnes. "They've got to keep their eye on the ball. If they appeared to not be doing that, the risk wasn't that the work flows to Montréal it's more that it would flip to the AIM. The AIM and the larger board on the London Exchange are the two big threats right now."

Craig Thorburn, an M&A partner at Blakes in Toronto, says people felt strongly the relatively small Canadian exchanges had more important things to worry about.

"You see the old-line stock exchanges like the OMX in the Nordic countries, like the LSE, like Nasdaq, getting acquired and consolidating with one another," Thorburn says. "You also see a bunch of specialized US-based exchanges reaching into Canada — the Island Exchange, Goldman Sachs Group, Inc. has got its own system on the go, you've also got the Canadian banks getting together to put their own stock exchange together for the trading of their own shares, moving a lot of trading off the TSX and on to a proprietary exchange.

"I believe that since that arrangement was put in place making the TSX as 'the' Canadian exchange, it has benefited in the fight for profile in a world where the Canadian portion of equity trading is ever-diminishing and volumes in China, India and elsewhere skyrocket. In the same way I see value in a single national securities regulator, I also think there's value in having a larger better-financed exchange that's able to go out and seek listings from more companies in different places."

In the oil patch, it was never so much Toronto versus Montréal as Canada versus the rest of the world, says Robert Engbloom, a corporate, securities and M&A partner at Macleod Dixon LLP in Calgary, adding Canadian exchanges had their work cut out for them holding on to their market share without fighting one another.

"With the growth in the number of international, particularly junior international resource and energy companies, it's always an issue as to where they list — AIM, Toronto or [the TSX] Venture exchange," he says. "I think you'll clearly see more Canadian companies listing on AIM because it provides access to a capital market that is perhaps broader based and more familiar with international businesses than ours is."

But, just when you think everyone is lining up one way, there's Waitzer.

"To be honest, I'm not sure it matters," he says. "There are strategic advantages to having a linkage between the equity exchange and the derivatives market because a lot of trading strategies cross over the two. But from that perspective there's probably a pretty good argument that a combined exchange would be in a stronger competitive position. But I'm not sure this is a public-interest issue, I think it's a shareholder issue. Does it make sense for shareholders?

"There are a whole bunch of alternative trading systems already. In fact, the securities administrators have been trying to encourage alternative trading systems to reduce transaction costs and give investors a choice about where they transact."

Like Waitzer, Anisman is not convinced a merger between the two exchanges is critical for Canadian issuers. If the proposed deals falls apart and there is competition, he says, traders will simply go to the most efficient market. What will be critical, he warns, is if shareholders back the proposed merger but one securities commission or the other scuttles the deal because provincial politicians doesn't like the address of the merged head office or the fact someone from the other province is running the show.

"It seems to me a squabble between provincial governments about who should control a merged stock exchange is a perfect example of why we need a national securities regulator. If anything, stock exchanges are national institutions that are an important element of our securities market.

"Given the way stock exchanges work – and they are no longer just floors where people do transactions by hand, but communications networks – I've always thought they're subject to federal regulation on that basis alone. But functionally, it makes little sense to have the regulation of basic national financial institutions subject to multiple jurisdictions which cause delays and divergence of views and could even impose arbitrary limitations on what might be a desirable merger on the basis of personnel or a desire to control its policy from a provincial perspective. That's a very important reason for a national regulator."

That may be an argument for another day. Back in Montréal, in the wake of the deal and the Caisse's reaction to it, the talk was all about whether the deal will be signed and sealed.

Benjamin Silver, a corporate partner at McCarthy Tétrault in Montréal and a longtime member of an advisory committee to Autorité des marchés financiers, says he believes the deal will go through.

"From a commercial point of view, this makes total sense and will be easy to do. Politically, I don't know what kind of pre-clearance they got from regulators, and that is very hard to predict, but are we really losing that much here? The derivative exchange will stay in Montréal. The head office of the TMX Group will be in Toronto, but clearly they've got five MX directors and a very unusual provision that 25 per cent of the directors must be residents of Québec. It's certainly been done to try to pre-empt the political issue and appease those who would decry the fact Québec was losing an important financial institution.

"Whether it works remains to be seen but what's the alternative? The status quo? To have Toronto competing with its own derivative exchange? There's no way in the world it would make sense to have two derivative exchanges in Canada."

Robitaille of Stikeman Elliott says there is an emotional component that can't be so easily dismissed. "The discussion about the exchanges is no different that Alcan being the subject of a takeover. When you have a big head office that's leaving, people in the community are worried that all the head offices are leaving the province — which is the same case in Alberta, British Columbia or Toronto."

If Québec can push past the hurdles of history, the deal will likely get done. On the other hand, it's still possible heads could roll before this whole thing is over. Eyes too.

Sandra Rubin is a freelance legal affairs writer.