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OSC Policy on Control-Selling Deregulation, Ontario Style

There may be more appearance than reality to the Ontario Security Commission approach in a key area of investor protection. Accused by its staff of "disregard for standards" in regulating sales of control stock, the commission said the criticism would have to be studied before a further relaxation of the rules is introduced next year.

An Ontario Securities Commission (OSC) staff memorandum challenged the legality of four OSC approvals, subsequently granted, for the sale of "control block" stock without a prospectus. It further said a new exemption section scheduled to come into effect in March 1981 shouldn't become law without significant qualifications, reflecting the supposed present OSC policy; but it also suggested there may in fact be no OSC policy in the crucial area of control selling. It said the written policy on the question, Policy 3-18, "appears to have fallen into disuse (and) disregard for standards has led to confusion. . . ."

Control stock is the stock held in the issuing company by persons in a position to control the company's affairs. Such stock can't be sold without the issuance of a prospectus, but there are exceptions and exemptions, generally to be granted at the discretion of the OSC.

It is a basic tenet of modern securities theory that sale of large blocks of stock held by company insiders has to be strictly regulated. The reasons are obvious. Insiders could dominate the market by massive selling or blow-offs at market highs. Or they could engage in back-door distributions by issuing blocks of stock to themselves and distributing it to the public as if it were being freely traded in the secondary market, without a prospectus or similar disclosure.

Pending the delayed enactment of the new section, the basic exemption is in section 59 of the old Securities Act and section 73 of the new Act, which came into force September 15, 1979. It says the OSC can, on application by the would-be seller, grant exemption from the prospectus requirement where, in its opinion, "to do so would not be prejudicial to the public interest," a phrase so excellently judicial-sounding that it was transferred verbatim from the old act to the new one.

Policy 3-18, a creation of the OSC in 1971, provides the only elaboration. It says on such applications the OSC "will give particular consideration to the following factors," and it lists them. It says among other things the OSC will consider the size of the control block and the amount of it proposed to be sold, the size of the "float" or stock not in the hands of control persons, as well as the size of the proposed sale as a percentage

of the previous monthly trading volume, and the proposed sales as a proportion of the applicant's holdings. The only actual number, however, is in the paragraph that says the OSC will give consideration to "whether the number of securities proposed to be sold . . . exceeds 10% of the applicant's holdings."

The Toronto Stock Exchange, for its part, has a "four-week moving average" rule. Under that rule, control stock traded on the exchange can't be sold in volumes that exceed, in any week, 100% of the average trading volume per week in the previous four weeks. In other words, the control seller can in effect double the trading volume by his selling. Of course, that rule doesn't apply to over-the-counter stock not listed on the exchange.

But in theory, the OSC applied its own policy as well, both for listed and unlisted stocks. And what criteria did it apply?

The answer is it didn't apply any criteria. Various regulators had this to say.

OSC staff lawyer Thomas Creet, author of the memorandum: "(Policy 3-18) appears to have fallen into disuse."

A TSE official: For listed stocks, the OSC simply relied on the TSE moving-average rule.

Outgoing OSC chairman James Baillie: "I don't know what the old rules were," because during his tenure policy has been geared to the new, even more liberal, section due for enactment in 1981.

OSC vice-chairman Harry Bray: Applications were routinely granted if the application was for less than 10% of the applicant's holdings, but orders were made for stock in excess of that "for special reasons." And no other rules of thumb or criteria as to volume were applied in determining the volume to be approved.

One of the great oral traditions of practice before the OSC is that the applicant should never propose that the commission make new policy "from the bench," as it were. The relief asked for should always be presented as merely an application of the existing OSC policy. In the case

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Hugh Russel Inc. Trading Investigation

The Russel family sold its controlling stock position in Hugh Russel Inc. for \$17 a share two days after Christmas, and the circumstances of the transaction are under investigation by regulatory officials. The company is a large distributor of industrial products and materials, that had \$9.2 million net earnings on \$428 million sales in 1978. It is traded on the Toronto Stock Exchange.

The company's common stock traded between \$12 and \$13 until an announcement was made in November of discussions toward a sale of the Russel family stock holdings. Then for about two weeks the stock traded at \$14-15, closing on December 10 at \$13⁷/₈. During the next ten days up to Christmas, the stock closed over \$15 each day but two. Then December 27, the private-agreement sale was announced at a price of \$17. No follow-up offer to the other shareholders was announced. The stock immediately fell to the \$13-14 range.

The new Ontario Securities Act has a complicated code for takeover situations, and a major purpose is to make sure that when a company's

control changes hands at a premium over the market, the public shareholders are cut in. The statute and regulations spell out exactly when a private agreement takeover has to be followed up by an equivalent offer to all the shareholders. It is when the private agreement price "is an amount 15 per

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OSC Policy

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of the applications that gave rise to the Creet memo, this practice led to contradictory allegations of what the policy is, which the commission, in its reasons for judgment, didn't resolve.

Counsel for at least two of the applicants said their applications would be granted under Policy 3-18 as being "not prejudicial to the public interest," and Creet said all but one would be denied.

The commission ruled that it didn't have to decide on the basis of its Policy 3-18, whatever that involves, and instead it approved all the applications by imposing conditions set out in the new section, which is not yet in effect. The new section, 71(7), provides an automatic exemption for control sellers provided they comply with certain technical requirements. Under its provisions, the control seller must simply file a notice of intention to sell, together with an affidavit that he is unaware of any special circumstances in the company not disclosed to the public, and a report on sales three days after they occur; and the issuing company must not be in default of any of its information-reporting requirements. The final condition stipulates that "no unusual effort (be) made to prepare the market or to create a demand for the securities, and no extraordinary commission (be) paid in respect to such trade." The fact that "no unusual effort" is a ridiculous expression to find in a supposedly enforceable statute — high-pressure, boiler room stock sales are not at all unusual — didn't deter the OSC from relying on these provisions even before they are law. By doing so, it was able to avoid the embarrassment of coming to grips with its supposed Policy 3-18.

The rationale for the "new" approach is tied to the so-called "continuous disclosure" provision of the new Act (section 74), which provides that "material changes" in the affairs of a public company must immediately be disclosed in a press release and filed with the commission. The reasoning is that if control persons have no significant knowledge about the company that isn't also available to the public, there is no further possibility of unfair control selling, something that staff lawyer Creet, for one, found a dubious assumption.

He listed the following factors that would bear upon a tightening, not a relaxing, of the control sale requirements: "Qualitative considerations relating to the purpose of the intended trade and the speculative nature of the issuer; financial considerations relating to the financial stability of the issuer; timing considerations relating to the high-low market levels and trading activity; market impact considerations relating to size of the intended trade as a percent of control group holdings, float, owner holdings, and recent trading volumes." He said there is a "need for a precise statement of currently applicable standards."

In other words, the main aim of section 71(7) is to prevent control holders from taking advantage of the withholding of adverse news about the company to sell their stock at a higher price; even if this is accomplished, there is a wide range of inequitable possibilities.

Creet said by the criteria he proposed all but one of the applications should be denied.

He said the three applications were for "large trades relative to the market" for those stocks, and they were "for financing purposes;" also, "there is no doubt that the proposed trades are distributions to the public," and they could be carried out under a "statement of material facts" — a mini-prospectus available for distributions through the TSE.

"Accordingly," Creet wrote, "the small trades for personal purposes should be granted exemption as they pose minimal conflict between the public interest in mobility of capital for the control shareholders and the public interests in investor protection and orderly markets... By way of contrast, the large trades for financing purposes are all secondary offerings, raise no funds for the issuers, and involve significant conflict between the public interests alluded to above."

All of the applications were approved, under the terms of 71(7).

Creet proposed, also unsuccessfully, that the OSC "restate its requirements" in respect to control selling. He wrote as follows:

"What standards or threshold levels or measures of *de minimis* impact should be taken into account by the Commission when hearing and determining applications under section 73 in respect of trades by control persons in listed securities through the facilities of the TSE? It is submitted that the Commission should restate its requirements in this respect. A stated policy used to form part of Policy 3-18. It appears to have fallen into disuse. Disregard for standards has led to confusion as to

the proper role of rulings and of resort to statements of material facts. As to standards it is submitted that the policy is as follows (this is the "existing policy" ruse; he means the policy should be as follows):

"(1) The Commission will have regard for the purpose of the trade and carefully scrutinize trades proposed for purposes other than raising cash for personal needs.

"(2) The Commission will have regard for the issuers' speculative nature and financial stability as matters going to need to know and investor protection, and will be reluctant to issue rulings in respect of large trades for other than seasoned issuers.

"(3) The Commission will have regard for high-low price and trading volume patterns and will be reluctant to permit control sales where price and volume represent recent 12 month highs.

"(4) The Commission will have regard for the size of the trade relative to its impact on control and will not issue a ruling where the effect would be to bring about a material change in control or increase the float by more than 10%.

"(5) The Commission will have regard for the size of the trade relative to owner holdings and be reluctant to issue rulings where the proposed trade would reduce holdings by more than 20%.

"(6) The Commission will have regard for the size of the trade relative to recent 3 month total and one month average trading volumes and be reluctant to issue rulings where the proposed trade represents more than 10% of the former and 20% of the latter.

"The foregoing is submitted as being policy not for the reason that it is written as such, but (because) such standards make sense and appear, approximately speaking, to be the standards that provide the rationale for previous rulings."

Creet proposed two corollaries.

"It is submitted that section 71(7) should not be brought into force without amendment to incorporate standards which may be prescribed by

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Control block holders in Ontario already have a tremendous edge over their US counterparts in the amount of control stock they are permitted to sell.

US regulation of control selling is contained in Rule 144 under the Securities Act of 1933. It provides that in a three-month period, a control holder may sell an amount up to the greater of (a) 1% of the outstanding stock, or (b) 100% of the average one-week trading volume in the prior period. This fixed rule differs from the discretionary approach of the old Ontario Securities Act (section 59), and the unlimited volume proposed under the new Act (section 71(7)). The following table lists the four recent OSC approvals, and shows the volume approved for sale, the prior average weekly trading volume, and the approved amount as a percent of the weekly volume. The approvals are for a three-month period. In each case, as the next column shows, the US rule would have permitted sale in that period of control stock equal to 100% of the weekly volume.

Line No. 1: Application by Robert Lamond and Rudolph Siegert to sell 80,000 shares of Czar Resources Ltd.

Line No. 2: Application by Great Horn Mining Syndicate Inc. and Cornwall Tin and Mining Ltd to sell 400,000 shares of Consolidated Marbenor Mines Ltd.

Line No. 3: Application by Hugh Borthwick to sell 200,000 shares of Norbaska Mines Ltd.

Line No. 4: Application by Discovery Mines Ltd to sell 400,000 shares of Rayrock Resources Ltd.

Approved Control Sales	Prior Weekly Volume	OSC Approval	Permissible Under Rule 144
1. 80,000	222,000	36%	100%
2. 400,000	163,000	245%	100%
3. 200,000	67,000	297%	100%
4. 400,000	46,000	862%	100%

Although there is "confusion" about OSC standards, cases I looked at over the past year indicate there were many in which the control-sale approval, as a percent of prior weekly volume, exceeded the highest percentage shown in the chart.

The criteria proposed by OSC lawyer Thomas Creet, in respect to market impact, approximates the US rule. □

How Multi Malls won Timmins: Litigation with their Local "Partners"

When Multi Malls Inc. built its 400,000 square foot shopping center near Timmins, it more than doubled the existing retail space for the whole city. A group of Timmins businessmen sued Multi Malls for breach of an agreement to seek zoning for a smaller site, which they held in partnership with Multi Malls. Multi Malls says its lobbying for that site had become futile; the larger site, secretly assembled, didn't require rezoning; and the enormous size of its mall was necessary as a magnet for shoppers to counteract its poorer location. How it all came about was the background to a lawsuit tried in Supreme Court of Ontario last month.

Timmins lawyer Michael Tesluk was part of a local group, incorporated as Tex Mall Properties Inc., that had an option on a potential shopping center site. The group had a statement of interest from S.S. Kresge Co., and a favorable decision from Timmins council. Tesluk was visited by Henry Federer from Toronto with a proposal from Multi Malls Inc., a company controlled by Jack Burnett. (The Tex Mall lawyer said Federer burst in: "this wasn't a break and enter, was it," said the judge.) Jack is the brother of Joseph Burnett who runs the separate Burnac group of companies, also in the shopping center business.

Multi Malls would fund the \$180,000 purchase of the land, to be held as partnership property, and when the zoning process was favorably completed, Multi Malls would pay Tex Mall \$320,000 and Multi Malls alone would get title. It was agreed.

There were two other shopping center proponents, each with its own proposed site. They were Canadian Jamieson Mines Ltd, and Headway Corp. Success required Official Plan and zoning approval by Timmins council and then the Ontario Municipal Board. The major contenders were the Tex Mall/Multi Malls group, represented by the law firm of Thomson Rogers, and Canadian Jamieson, represented by the firm of Goodman and Goodman. The Thomson Rogers firm counted among its members at that time Robert Macaulay, the former Ontario cabinet minister, and as counsel J.A. Kennedy, the former OMB chairman. Bohdan Onyschuk of the Thomson Rogers firm was the Multi Malls lawyer.

By mid 1972 the provincial Municipal Affairs Ministry had all three proposals in the form of Official Plan amendments, all approved by the local council, and all awaiting further consideration either by the ministry or the OMB.

In January 1973 Timmins amalgamated with neighbouring townships, and a ministry official referred the three items back for reconsideration by the new council with a letter suggesting the City study the need, size, and location for any shopping center, and that they consult particularly with the downtown merchants — potential opponents of any shopping center proposal.

The battle was on. Onyschuk wrote to his principal, Jack Burnett: "The (provincial) letter is aimed at delaying approvals for as long as possible. . . . The Council meeting on February 8 is going to be . . . to meet with officials of the Department of Municipal Affairs! I suggest that we go up early that morning and meet with the Mayor and members of council to at least give them enough ammunition to shoot down Albert Elie (author of the ministry letter) and anyone else he brings with him."

Onyschuk later wrote that he was planning "a meeting of the full Council in Timmins at the Senator Hotel in a private dining room where we can discuss with them, over a period of hours, the shopping center development and how it fits in with the long-term planning for Timmins."

Then the ratepayers. "We should immediately move to get a ratepayers group together," Onyschuk wrote, "to support our shopping center project, and to come forward to council with a petition and with strong vocal support for our proposal. It would be important to have this group at the necessary council meetings, and especially when the downtown merchants show up to make their objections known to the municipality. The ratepayer group should even threaten to boycott their stores if they continue to object to the project. I think we can arrange this through Tesluk and (another Tex Mall partner William) Boychuk in Timmins."

Problems quickly developed. The City didn't hire as its consultant the man Multi Malls had in mind, or the man they said they had hired. And the provincial ministry was asking the OMB to delay its hearing pending the completion of the City's market study. Onyschuk wrote that he couldn't fight the adjournment. "I would be using up a lot of brownie points to get the Board to overlook these comments (about the adjournment)." The matter of the consultants was also in hand. "I am going to ensure that our

consultants," Onyschuk wrote Burnett, "supervised by this office, meet and discuss and keep in touch with the consultants for the City of Timmins so that their study does not adversely affect your shopping center. Please have faith in me in this matter."

These and other documents were produced by Multi Malls to show that it was sparing no effort in attempting to rezone the Tex Mall/Multi Malls site.

The crucial events occurred in February 1974.

- On February 13, OMB vice-chairman R.M. McGuire wrote to the City of Timmins asking them which of the proposals was the one favored by the City.

- On February 14, Onyschuk's law partner Robert Macaulay wrote a letter to the Timmins office of Ontario Trust Company introducing Henry Federer: "They need a land agent with tremendous discretion in Timmins." Multi Malls decided to assemble a site in the former Mountjoy Township where rezoning was not required.

- On February 19 at Timmins Council, resolutions in favor of the Tex Mall and Canadian Jamieson sites each lost on tie votes.

- February 21 was the deadline for closing the actual purchase of the Multi Malls/Tex Mall site. In spite of the fact that Multi Malls was putting up the \$180,000 (actually it was a loan from Burnac), the local group hedged, but Multi Malls tendered the closing documents on them, and Multi Malls and Tex Mall acquired the site as partnership property. (The Tex Mall group didn't know about Multi Malls' secret Mountjoy assembly.)

- On March 25, Multi Malls applied for a building permit for a 400,000 square foot shopping center in Mountjoy Township, and the next day provincial Housing Minister Sidney Handelman issued a "freeze order" on lands around Timmins "to avoid any unilateral decisions by any individuals that could prematurely affect the overall commercial planning and development for the entire city," in the words of the press release. The order was later quashed by the Ontario Court of Appeal because the failure to afford a hearing to Multi Malls which had already applied for its building permit, constituted a denial of "natural justice." (The province had been aware of the potential for shopping center development in Mountjoy for at least 18 months, according to documents filed in the lawsuit.)

- At this point, the Tex Mall people say, the roof fell in on them. They were thought to be in cahoots with Multi Malls in the Mountjoy surprise, and Timmins Council, in response to the McGuire letter, resolved they were in favor of the Canadian Jamieson site over the Tex Mall site.

- Ultimately it didn't matter which of the sites the City supported. The only one built was the mammoth Mountjoy Township mall. However, later events were no less interesting, and no less significant for the inevitable Tex Mall/Multi Malls litigation.

Tex Mall eventually said Multi Malls had breached its agreement with them "to attempt to obtain the necessary consents for zoning" for their jointly-held site. Multi Malls said they had done that. They had lobbied; they had commissioned favorable reports; but they weren't precluded from pursuing some other site as well, once the joint attempt seemed futile. The antagonists entered into a colorful exchange of correspondence, which included the dispute about the agreement, and also a dispute between Jack Burnett and Michael Tesluk about legal fees he said were owing him by Burnett. Tesluk was suspended from legal practice by the Law Society for two years in September 1974, apparently for taking legal fees out of his trust account. Tesluk said at most it was a technical offence, and the penalty resulted, Tesluk testified, because Burnett lied to the Discipline Committee in denying he owed Tesluk any fees.

Then there was the question of the partnership land. The agreement said if the zoning wasn't achieved (and it wasn't), then Tex Mall could pay

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How the Rental Industry Got That Way: A Thumbnail Economic Report on the 70s

Private sector participation in the City of Toronto Non-Profit housing program, and more recently builder promotion of projects in the private non-profit sphere, represents the end of a peculiar evolution in rental economics in the decade of the 1970s. It was a period in which the industry transformed itself from a low capital-cost venture emphasizing excellent operating profits into a high capital-cost proposition with resulting high financing charges and lousy operating prospects. The capital cost increases weren't in hard building costs — they were apparently in land and soft costs. Front-end profits, principally in land, took the place of operating profits as the industry's distinguishing feature. The following is a thumb-nail outline of how this came about.

In comparing different cost structures on a uniform basis, the following rates of return are estimated for the first year of operation of an apartment unit:

- Overall return. This is gross rental revenue less operating costs, as a proportion of the total capital cost of a unit.

- The effective mortgage rate after taking into account the level of subsidy available in the first year of operation. This is the equivalent of the so-called "mortgage constant", in that it represents the total financing payments, including principal and interest (but less the available subsidy) as a proportion of the mortgage amount.

- The return after financing charges, as a proportion of equity.

This is the third in a series of articles on the economics of the housing industry.

Diminishing rates of return, and compensating deep early-year subsidies that have to be paid back, made new rental buildings increasingly a thing to be built and sold to the unwary, rather than kept. The measurement of these diminishing rates of return, and of the capital cost (hence mortgage payment) increases that brought them about, suggests factors beyond hard construction costs — presumably land costs — are largely responsible.

Cadillac: How It Was

Consideration of a 1960s rental operating portfolio provides a framework for analysing what happened in the subsidy schemes of the 1970s. Extensive figures are available for the 1968-71 period in the financial statements of Cadillac Development Corp. The company went public in 1968, and from then until 1971 its income-producing properties were exclusively residential. Its reported operating statements can therefore be converted into a set of average per-unit operating results for a rather large group of rental properties.

The following table is constructed from Cadillac's reported figures. It shows, first, the number of units to which the operating figures apply, then the reported yearly per-unit revenue figure, operating costs, and the "overall return." This is followed by the average reported capital cost per unit, and the overall return as a percentage of capital cost, or the overall ratio. Then financing charges per unit, including principal and interest, are expressed as a percentage of the average mortgage amount. Finally the net return is expressed as a percentage of equity. The table illustrates the principle of leverage: if the overall return from a heavily mortgaged asset exceeds the mortgage rate, the rate of return on equity increases substantially.

Cadillac Development Corporation
Rates of Return, 1968-71, based on Reported Operating Results

	1968	1969	1970	1971
Number of Units	7178	8675	9459	10628
Overall Return				
Revenue	\$2088	\$2232	\$2412	\$2496
Operating Costs	924	984	1092	1116
Overall Return	1164	1248	1320	1390
Overall Ratio	9.4%	9.7%	9.6%	9.6%
Mortgage Rate				
Financing	\$816	\$876	\$948	\$984
Mortgage Amount	10,464	10,707	11,300	11,475
Mortgage Constant	7.8%	8.2%	8.4%	8.6%
Return to Equity				
Net Return	\$348	\$372	\$372	\$396
Equity	1,929	2,202	2,507	2,891
Return to Equity	18.0%	16.9%	14.8%	13.7%

The figures indicate: Cadillac's rents, operating costs and overall return were increasing at around 6% per year. However, the reported

average capital cost per unit was increasing at about the same rate, according to the figures, so the overall rate remained constant at around 9.6%. Interest rates (9% by 1968 and 10% by 1970) caused the average mortgage constant to rise to 8.6%, narrowing the gap between the overall rate and the mortgage rate over the whole portfolio, and apparently eliminating favourable leverage in the first year of operation of new projects.

(In fact, the indicated capital cost of new units, which can be extrapolated from the reported figures, is so high as to be rather difficult to believe: notwithstanding, even taking new units at the accepted cost for that period of \$12,000-15,000, the same pattern exists: interest rates of 9-10% caused the favorable first-year leverage to disappear.)

In his 1969 report to shareholders, Cadillac president A.E. Diamond said: "Probably the most significant factor for our industry in 1969 was the increasing effect of high interest rates on the cost of providing rental accommodation. . . . The residential rental market has not as yet reflected, through its rent levels, the extra costs imposed by these interest rates. Consequently, buildings built for absorption by the rental market in 1970 will be unable to produce a reasonable rate of return until rent levels properly reflect these increased costs."

The figures appear to indicate that what Diamond meant by "a reasonable rate of return" was a situation in which the prevailing mortgage rate was below the overall rate so that favourable leverage would be available in the project's early years.

Apart from low interest rates, there was an important and overlooked factor behind these excellent early-year returns available in the 1960s. The cost component for land was minimal. Land acquired at pre-development and pre-zoning prices, and carried at those prices, appears to have been a key to the leveraged early-year returns of that period.

Cadillac's 1968 portfolio of 7178 rental units was carried on its books at an average capital cost of \$12,393 per unit. Most of them were built in the mid-60s, and construction costs suggest those units probably cost around \$12,000 for pure building costs alone. (One example of a 1960s development contract is a 1962 agreement entered into by a group of residential developers, and it illustrates the scale of costs. The principals of New-Style Construction Co. agreed to put up a high-rise apartment building for a construction cost of \$8,900 per unit, with an agreed land cost of \$514 per unit. The agreement added that if necessary, interim construction financing — the major component of so-called "soft costs" — could be directly provided by the principals.) Based on the very little that is known of the economic history of the industry, it appears that the favourable economics of the 1960s were based on a cost structure with land costs of 5% to at most 10% of construction costs. By contrast, in Toronto 1977 ARP projects, land costs of \$8000 per unit were about 30% of the average \$27,000 building costs.

Inaccessibility of data makes it impossible to trace this trend with any continuity. But its effects can be traced in the subsidy programs of the 1970s.

ARP

Mortgage rates reached 10.5% by 1974, when the first of the series of private-sector subsidy programs was announced. Initially it came in two forms, the first being a modification of the Limited Dividend format called the Accelerated Rental Program, and the second, in early 1975, being the first version of the Assisted Rental Program (ARP). "Accelerated" provided for CMHC loans for 95% of cost at a special rate of 8%. "Assisted" (ARP) provided first-year diminishing grant subsidies of \$50 per month per unit. Builder proposals under the first program were at an average cost of \$24,600 nationally and \$28,000 in Toronto. Urban Affairs Minister Barney Danson announced in May 1975 that the response was "absolutely overwhelmingly," and the same month he announced the Assisted Rental Program to service the overflow of builder proposals. The ARP provided first-year grant subsidies of \$50 per month per unit — the earlier program at the costs indicated was worth about \$40 per month, given 10.5% mortgage rates. The differences were that the new ARP program was based on private lender loans, the subsidy was a diminishing one, and there were to be no ongoing rent and income controls. First-year return on equity was set at 5%.

In 1976, with interest rates over 11.5%, the program was revised to provide starting subsidies of up to \$100 per month, now structured as a delayed-repayment loan, and the maximum return to equity was raised to 10%.

Then in 1977, with interest rates back at 10.5%, the provincial "stacking" agreement was announced. Ontario would provide starting grants of up to \$50 per unit in addition to the federal assistance. Units built under that program cost \$35,000 in Ontario generally, and \$39,000 in Toronto.

The following table illustrates the comparative structure of the 1975 ARP program and the 1977 ARP with provincial stacking, as they apply to estimated first-year cash flow for projects in Metropolitan Toronto.

Projected Rates of Return under ARP		
	1975	1977
Rent:	\$330	\$370
Subsidy:	\$50	\$137
Mortgage Rate: 10.5% Mortgage Rate: 10.5%		
Overall Return		
Revenue	\$3960	\$4440
Operating Cost (45%)	1766	1998
Overall Return	2194	2442
Capital Cost	28,000	39,000
Overall Ratio	8%	6%
Mortgage Rate		
Financing	\$2,664	\$3,708
1st Year Subsidy	600	1,644
Payment	2,064	2,064
Mortgage Amount	25,200	35,100
Mortgage Constant	8%	6%
Return to Equity		
Overall Return	\$2,194	\$2,442
Financing after Subsidy	2,064	2,064
Return	130	378
Equity	2,660	3,990
Return to Equity	5%	10%

The table shows two crucial points.

(1) The abnormal 40% increase in capital cost, from \$28,000 in the 1975 proposals to \$39,000 in the 1977 proposals, represented a diminution in the overall return from 8% to 6%, even though anticipated revenue was rising at a normal rate.

(2) The average first-year subsidy level was increased to a level that represented an effective first-year financing rate (including principal and interest) that also diminished from 8% to 6%. This made possible the retention of a theoretical positive return to equity in the first year, despite the diminishing overall rate.

Hard building costs increased some 20% between 1975 and 1979, not 40% (for a discussion of building cost increases see Bimonthly Reports No. 10). The abnormal capital cost increase appears to be due to land costs and soft costs.

The evolution from 1975 to 1977 is apparently the same as what started in the early 70s: abnormally higher capital cost, due largely to

higher land costs, brought about a further diminution in the rate of return. And a still deeper initial subsidy was introduced to compensate for the poorer return.

GPM

In any event, the 1977 program, like the 1975 one, represented another historic high in the first-year subsidy level, and it generated a new wave of Toronto-area projects. The following year, 1978, CMHC effectively ended the provincial stacking agreements, and scaled down its subsidy levels. The new scale — structured first as an ARP loan and then as a Graduated Payment Mortgage (GPM) — set first-year subsidies at the level of \$2.25 for each thousand dollars of mortgage amount. That was equivalent to a subsidy of \$79 as opposed to the average \$137 for Toronto projects with a mortgage of \$35,000. A few Toronto projects were approved in 1978 and built under this program.

It didn't bring about any softening of land prices. Instead, an examination of GPM projects shows their projections differed from the ARP model in simply projecting a lower level of operating costs, and a lower return to equity. In other words, the diminution of subsidy was absorbed without any effect on the front-end costs, and with worse long-term operating prospects.

The following table illustrates how it was done. It shows the typical Toronto ARP of 1977, and then the same project with the GPM assumptions. It reflects the fact that Toronto GPM projects continued to have land costs of \$8000 per unit, but projected operating costs of 35% of rents — instead of the earlier 45% ratio — and lower return to equity. Projects elsewhere in Ontario approved under the GPM program were budgeted in a similar way.

Comparison of ARP and GPM Assumptions		
	ARP 1977	GPM
Overall Return		
Revenue	\$4440	\$4440
Operating Cost	1998	1554
Overall Return	2442	2886
Capital Cost	39,000	39,000
Overall Ratio	6%	7.4%
Mortgage Rate		
Financing	\$3708	\$3708
1st Year Subsidy	1664	945
Payment	2064	2763
Mortgage Amount	35,100	35,100
Mortgage Constant	6%	7.9%
Return to Equity		
Overall Return	\$2442	\$2886
Financing	2064	2763
Return	378	123
Return to Equity	10%	3%

The GPM format was designed to keep pace with increasing capital costs by being tied to the mortgage amount. But 1979 interest rate increases stifled the program. That leaves the Non-Profit program, whose interest-rate writedown is to a fixed percent level, as the only existing rental program in which the proponent is immune to the mortgage interest rate level. □

Next: The Non-Profit scene

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Hugh Russel

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cent in excess of the simple average of the closing price of securities of that class for each day . . . ten business days before the relevant date."

So the relevant prices are the closing prices between December 11 and 24.

This is how the stock closed on the TSE during December:

3rd	141/8	10th	137/8	17th	15	24th	156/8
4	14	11	145/8	18	154/8	27	14
5	137/8	12	155/8	19	155/8	28	136/8
6	14	13	154/8	20	157/8	31	136/8
7	14	14	146/8	21	156/8		

Section 99 of the new Act provides that the OSC, if it is satisfied that the ten-day average "was affected by an anticipated take-over bid or by improper manipulation," can decide what the market price would have been apart from such anticipation or manipulation. And it can decide, in effect, whether or not the follow-up offer has to be made.

Purchaser of the 565,000 common shares — or about 22% of the outstanding common stock — was Bate Chemical Co. Ltd, a subsidiary of Bate Investments Ltd, a private company owned by the family of G.H. Clifford Smith of Toronto. A.D. Russel, one of the vendors, said he would stay on as company chairman. Vendors were A.D. Russel and his family, along with two other senior executives. The deal was worth \$9.6 million. □

OSC Policy

Continued from page 2

regulation. The standards should be not unlike those alluded to above as constituting present Commission policy."

And: "It is submitted that the TSE's orderly market rule should be revised. A daily percent participation rule set at say 5% of bids within prescribed percentage price limits should be substituted for the existing four-week moving average rule so as to prevent bail-outs."

Finally, Creet warned the commission against relying on the merely "technical" provisions of section 71(7) during the 18-month period before it is scheduled to be proclaimed. He said the delay "is intended to permit issuers, investors and the commission to get used to the new disclosure obligations, market impacts and regulatory requirements of the Act insofar as they relax the resale requirements of the former Act in respect of sales from control."

And he explained the expected market effect of the proposed section. "Section 71(7) will have the effect of making control holdings a de facto part of the float for many issuers. Under the former Act control holdings could be sold only after the exercise of a (prior) review by the OSC of a prospectus or section 59 application, or by the TSE of a statement of material facts. Under the new Act no such prior review will be required. Control shareholders will be able to sell, subject to compliance with the technical requirements of section 71(7) as a matter of right. This constitutes a radical change in the rules of the game, and will effect a fundamental change in the market's perception of available supply, and hence of the market's approach to pricing in the face of control stock that will now constitute a permanent overhang saleable on one or two weeks notice. Market makers and players will have to learn that they must check the notices every day if they are to avoid stepping into and being caught up in a control distribution. Time is needed so that the investment community may adjust to the new order.

"Distributions contemplated by the OSC as occurring . . . over 90 days may be effected in 2 to 3 weeks. Control sellers normally take advantage of all time highs in price and volume and of current good news generally known, and of some price sacrifice, to achieve this result. Typically when the news value and price sacrifice exhaust their carrying power the market subsides, sometimes significantly so. . . . Time is needed for the market to adjust to the fact that control shareholders are back in the game."

Creet said that on his reading of the statute, during the transitional period, the OSC is "bound to exercise discretion having reference solely to the public interests in investor protection and orderly markets, and (is) precluded . . . from exercising discretion having reference solely to the public interest in investor protection as addressed by the fact of technical

compliance with the requirements of section 71(7)."

(Which is precisely what the commission did. In theory, judicial review of the commission's action is available on application to the Divisional Court of the Supreme Court of Ontario, alleging the commission exceeded its statutory jurisdiction.)

All of this market-oriented criticism is apparently something of a novelty for the commission, which normally simply applies the letter of the Act and leaves market inequities to be resolved by the investment community. Spokesmen at the OSC and the TSE told me there hasn't ever been a complaint or an investigation arising out of a section 59 (new section 73) exemption.

In this case, the commissioners said they were pleased that the TSE would review with OSC staff the adequacy of the four-week moving average rule. As for unlisted stocks, to which the rule doesn't apply, the commissioners dealt with the issue head-on. They said, "The availability of the 71(7) exemption for unlisted securities troubles us. . . ." They said they saw merit in other criticisms as well, and concluded, "All of these matters, and any other questions that arise as to the use of 71(7) require analysis prior to March, 1981." □

Multi Malls

Continued from page 3

\$180,000 to Multi Malls to get Multi Malls off title and have the land itself. Multi Malls had put up the \$180,000 in the February 1974 closing. There was a problem. Tex Mall had sued Multi Malls for damages for its alleged breach of the agreement. If Tex Mall was now to affirm the agreement by exercising its option, it would lose its claim for damages. (A party to a contract can either claim the contract is breached and sue for damages, or exercise his rights under the contract as still binding, but generally he can't do both.) On the other hand, if Tex Mall didn't exercise the option, then the agreement said the title would revert to Multi Malls exclusively.

The Tex Mall people went to Toronto lawyer Ernest DuVernet, and decided to exercise the option, but hopefully without affirming the underlying contract. (The option was attached to the agreement as a schedule.) Then to make matters worse, having "exercised the option" with a payment of \$5000, they couldn't raise the further \$175,000 to close the purchase. So they had exercised the option at some risk to their damage suit, but they still hadn't gotten Multi Malls off the title.

In the meantime, another setback to the damage claim came in the form of the final OMB ruling. Tex Mall had claimed that the Mountjoy coup had removed any possibility of getting a shopping center zoning for its site. However, the OMB ruled — quite erroneously, as it turned out — that the market could support the Mountjoy plaza and one other! And it granted shopping center status to the Canadian Jamieson site — nothing built there yet — and not to the Tex Mall site. So, says Multi Malls, it was the OMB, exercising its statutory function, and not the actions of Multi Malls, that deprived the Tex Mall site of shopping center status.

Finally, to complete the picture, Multi Malls sued Tex Mall to force it to complete the acquisition of the joint site. In an action for specific performance, it said the option was agreed to by both sides, and either Tex Mall should be obliged to complete it, or pursuant to the agreement, the land should revert to Multi Malls.

Both actions, the Tex Mall damage suit and the Multi Malls specific performance suit were tried together last month before Justice M.A. Craig in the Supreme Court of Ontario. He has reserved judgement. □

Sub Judice Rule

Continued from page 7

"unacceptable to either our legal traditions or to the Bill of Rights. The paper said the contempt rule is adequate for the judge's purposes. But what Judge Dionne said is his order is the contempt rule, in fact the order was asked for "to avoid any uncertainty about the sub judice rule." Obviously the judge thought he was defining the sub judice rule most clearly. While there is no tremendous merit in his approach, it is equally perverse to pretend there is no defect in a rule that can be defined in such a fashion.

Our laws are not supposed to be so vague that anyone, even a judge, could purport to order motor vehicle driving, for example, to cease, in order to avoid uncertainty about the traffic laws. □

Prousky

The practice of real estate lenders' solicitors adopting an informal arrangement with borrowers' solicitors in mortgage transactions doesn't have the legal effect — which it is often thought to have — of absolving the lender's solicitor of liability for negligence, according to a decision by Justice Samuel Grange. He said the acceptance of such a position would encourage "sloth" among the real estate bar.

Grange found Toronto solicitor Victor Prousky, who acted for lender Michael Wynston, negligent in a \$250,000 mortgage transaction. Prousky has appealed.

At issue is who is liable to the plaintiff lender for failing to advise him that the underlying sale was a scheme involving purchase for \$180,000 and an immediate non-arms-length "flip" for \$300,000; the mortgage was for \$250,000 based on the belief that the \$300,000 price was bona fide and involved cash equity of \$50,000 (Bimonthly Reports No. 11). Prousky said he relied on the borrower's lawyer, who thereby became liable, a position Justice Grange rejected. It promises to be a leading case on real estate negligence.

The borrower's solicitor James A. Macdonald gave Prousky's associate a statement of adjustments that didn't disclose the double transaction. Said Grange: "I will readily concede that I do not like it," but he said that and an undertaking by Macdonald to certify title didn't have the legal effect claimed by Prousky.

These are excerpts from the judgment:

"The conclusion that Prousky was negligent is inescapable. He was asked to make sure that the transaction was bona fide, and that the sale was for \$300,000 with \$50,000 cash. The simple most effective way to obtain that assurance would be by a search of title, something the solicitor for the mortgagee should proceed to do automatically, unless there is some arrangement clearly expressed permitting the mortgagee's solicitors to rely on the mortgagor's certificate of title. . . . Even the most cursory examination of the title would have revealed the double transaction. Instead, Prousky took — perhaps 'exactd' would be the better word — a certification of title from Macdonald as well as an execution certificate and the arranging of insurance. The only thing Prousky seems to have done towards fulfilling his duty to his client was to obtain a copy of the statement of adjustments which was clearly inadequate. . . .

"The position of Mr Macdonald poses a much more difficult and complex problem. The argument is that Mr Macdonald by certifying title

— in fact he never did; he only undertook to certify it — and by delivering the statement of adjustments (I cannot find that he ever gave any assurance that the sale was bona fide for \$300,000) became the solicitor for the plaintiff or became somehow bound to Prousky in a way that required him to divulge to the plaintiff or Prousky or both that there was a double transaction and that (the purchaser) was not really buying for \$300,000 or putting up \$50,000 cash.

"The plaintiff called as a witness at trial Mr Kenneth Nathan Karp, whose credentials as an expert in the practice of real estate law are formidable. Mr Karp gave evidence that if a solicitor for a mortgagee were to ask another solicitor merely to search a title and send in his notes of title, the other solicitor would not have undertaken the position of solicitor to the mortgagee, but if he goes further and expresses an opinion on the mortgage or the title, he does become so retained with all the concomitant duties of the confidential relationship. If that be so, I should have no difficulty in finding Mr Macdonald negligent."

Grange agreed with case law that if a fiduciary relationship such as that of lawyer and client is established, then that relationship imposes "the duty of making a full and not a misleading disclosure of facts known to him. . . ." In this case the duty would be for Macdonald to disclose the double transaction.

Grange said in these circumstances that relationship wasn't established, and it would be a bad thing for real estate practice if it were.

"The difficulty with applying the doctrine here is that I cannot find in the circumstances of this case that Mr Macdonald ever undertook the obligation of solicitor either to Mr Prousky or the plaintiff, nor that he had that obligation forced upon him. All he did was answer a casual question as to title and as a condition of closing undertake to do what Mr Prousky should have done as part of his retainer. There is no question that he was acting as solicitor for the mortgagor throughout; indeed he was so described in the undertaking. Everything he did was for his own client; it may be that a benefit accrued to the plaintiff (or more properly the plaintiff's solicitor, whose workload was lightened) but he did not thereby become his solicitor. To rule that he did would not, in my mind, promote integrity among solicitors but rather encourage sloth. . . . It was Mr Macdonald's obligation not to disclose facts contrary to the interests of his client; if he were to become solicitor also for the mortgagee he would be bound to do just that. Surely that obligation cannot be imposed upon him and upon his client gratuitously and by implication." □

Sub Judice Rule

This is a translation of the text of remarks made last June by Judge Rene Dionne of the Quebec Superior Court following a pre-trial motion. The crown attorney had requested a change of venue of the trial of a unionist for arson, on account of the activities of a local defence committee. The remarks deal with the sub judice rule. It is not a statutory rule but a judge-made or common law rule. It is that a publication or statement is in contempt if it is calculated to interfere, or does interfere, or has a tendency or possibility of interfering with the course of a judicial proceeding.

"Following the presentation of this motion," the Judge said, "counsel for the petitioner (the crown) asked the court to make a special order prohibiting publication of comments, evaluations, or opinions, as well as any information campaigns (de commentaires, d' appreciations, ou d' opinions, de meme que toutes campagnes de sensibilisation) about this case.

"Is it necessary to recall that the sub judice rule applies from the initial appearance of the accused before a judge and the recording of his plea of not guilty? Evidence before me during the motion for change of venue showed that certain persons have held this rule of little account. In the immediate area of Thetford Mines, press conferences were held at which there were open expressions of comment which had a tendency to influence (susceptibles d' influencer) public opinion and damage the climate of impartiality that must prevail at the trial of the accused. These press conferences received wide local media coverage.

"A so-called information campaign was started with the avowed intent of 'establishing the innocence of the accused.' Pamphlets were distributed at the door of parish churches, pamphlets certain parts of which constitute

simply a pleading on behalf of the accused. These comments, expressions of opinion, and information campaigns have prompted the crown to ask for a change of venue.

"The avowed aim of the crown in asking for a special order is to avoid any uncertainty (ambiguite) about the sub judice rule, which, in the words of the learned crown prosecutor, has been 'flouted' by certain persons. It is a question of forewarning those who might be tempted, by ignorance or otherwise, to have the accused judged 'sur la place public,' and thus substitute themselves for the judicial machinery.

"The lawyer for the accused indicated he had no objection to the order asked for 'to the extent that the order, emanating from the court, will make people more conscious of their duty with respect to the sub judice rule.'

"It is well to recall that whoever publishes anything having the effect of interfering with the impartial course of a court proceeding commits contempt of court. For example, the public expression as to the guilt or innocence of an accused person constitutes a contempt of court.

"Therefore, for the protection of the accused as well as in the public interest, and also in the interest of any person who might be tempted to transgress the sub judice rule, thereby exposing himself to severe legal penalties, the Court orders: That information campaigns, public comments, and circulation of expressions of opinion about the case of the Queen vs Gervais Lessard shall cease, under penalty of law.

"This order takes effect immediately, and for information purposes it will be permissible to publish it."

This remarkable document was the object of a joint press conference in Montreal in November, participated in by the Law Union of Ontario and other groups, all of which denounced it. The *Globe and Mail* called it

Continued on page 6

Mann and Martel Settle their Tax Case: Taxation Dept Alleged Offshore "Cloaks and Disguises"

The Federal Justice Department alleged companies controlled by members of the Mann and Martel families had income recirculated to them through various Bahamian entities. Pleadings filed in Federal Court detail the alleged "schemes." The parties are pursuing a settlement.

Income tax litigation involving George Mann, David Mann and Paul Martel, begun in 1971 and scheduled for trial late last year was adjourned last month. It was to have been a heavyweight event with Douglas Laidlaw and McCarthy and McCarthy acting for the Taxation Department, and Walter Williston of Fasken and Calvin for the taxpayers. However, the parties are drafting terms of a settlement agreement, which will have to receive approval of the Federal Court.

In the early 1960s, Martel and the two Manns restructured their real estate brokerage business as a limited partnership called Mann and Martel, in which 15% of the profits belonged to companies they controlled, while 85% of the profits went to Canada Trust Co. as trustee for something called the Ridelle Trust, which in turn remitted its income to a Bahamian company called Ridelle Holdings Ltd. Ridelle Holdings, being a non-resident of Canada, paid withholding tax of 15% on its income to the Canadian Tax Department.

Then in 1966 the setup was altered to make Ridelle Holdings a "personal corporation" with "a degree of Canadian ownership." Under this structure, income of such an entity was deemed to be distributed to the shareholders who had contributed its capital, which in this case was another Bahamian company, Arawak Holdings Ltd. This was supposed to trigger another withholding tax situation, namely when a company with "a degree of Canadian ownership" (Ridelle) pays or is deemed to pay a dividend to a non-resident (Arawak). Under this system, Arawak paid Canadian withholding tax of 10%.

In other words, the system used two withholding tax systems in succession, the first involving payments to a non-resident (Ridelle) for "income from an estate or trust," and the second involving payments to a non-resident (Arawak) by a company "with a degree of Canadian ownership" (Ridelle). The change apparently came about as a result of fears that revisions to the Canadian income tax legislation would interfere with the first system.

The tax department said the moneys paid to the offshore companies were re-circulated in various ways back to Mann and Martel; that the moneys constituted income of the Canadian holding companies of Martel and the two Manns; and it reassessed for the full amount of income tax as opposed to the lesser amounts of withholding tax that were paid at the time. It alleged, with respect to the taxation years 1964-69, "various plans or schemes to avoid payment of tax on income earned by the partners of Mann and Martel."

The principals appealed the reassessment in Federal Court in 1971, and the tax department filed a reply, setting out its allegations. In the first place, the tax authorities said, the various entities in the alleged schemes "made it appear" that Canada Trust Company contributed \$90,000 to the Mann and Martel partnership when it supposedly became a partner. What really happened, the tax people said, was an exchange of cheques as follows:

The principals of Mann and Martel advanced Glenayr Holdings Ltd, a Bahamian company, \$93,500;
Glenayr advanced Arawak \$92,000;
Arawak advanced Ridelle \$91,567;
Ridelle advanced Canada Trust \$90,000;
Canada Trust "drew a cheque for the sum of \$90,000 payable to Mann and Martel, which was delivered to the principals of Mann and Martel. . . . At all times it was the intention that Canada Trust would not make any real payment or contribution."

Then, under the first setup, according to the government's allegations, the income funds were made to flow as follows:
Mann and Martel paid 85% of its profits to Canada Trust as partner;
Canada Trust, as trustee, distributed these profits to Ridelle as beneficiary (paying 15% withholding tax);

Ridelle paid the moneys to Arawak as its sole beneficial shareholder; Arawak passed the moneys on to Glenayr Holdings Ltd for which it was trustee;

Glenayr, "upon the direction of the principals of Mann and Martel," would return to any or all of the principals of Mann and Martel, by way of dividend, all amounts received from Arawak, which amounts in turn would be advanced to Mann and Martel.

It was their "hope and expectation," says the tax department allegation, that the funds' exit from Canada would be covered by the withholding tax; and that the funds' re-entry to Canada from the Bahamian company Glenayr wouldn't be taxable to the recipients by virtue of section 28(1)(d) of the Income Tax Act. That section said when a company receives a dividend from a non-resident corporation controlled as to 25% by the receiving corporation, the dividends aren't taxable.

This "scheme," as the tax department called it, was operative in 1964 and 1965. Then during 1965, the tax department said, the Mann and Martel principals thought proposed amendments would "frustrate the scheme" at the trust income/withholding tax stage, and "the arrangements . . . were revised."

The alleged flow of funds was now to be as follows:

Canada Trust still receives 85% of partnership profits;
Canada Trust distributes the profits to Ridelle, now a "personal corporation" with "a degree of Canadian ownership";
Ridelle is deemed to distribute substantially all its income to Arawak (10% withholding tax paid);

Via Arawak and Glenayr, the funds are to be received by the principals of Mann and Martel, still exempt on re-entry to Canada under section 28(1)(d).

The taxpayers are Paul Martel Realty Ltd, George Mann Ltd, David Mann Ltd, and Townsview Properties Ltd. They agree with the tax department that Mann and Martel made \$3.2 million profit from 1964-68. But they say Canada Trust as trustee for Ridelle "was entitled to receive" 85% of those profits, and that the withholding tax was properly paid and accepted by the tax department. And they say they were "not entitled to any part" of the distribution to Canada Trust, and that "the reassessments are in error in treating any part of the said sums as (their) income." □

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