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COR#02/021

Decision

Mercury Partners & Company Inc.

and

Canadian Venture Exchange Inc., VisuaLABS Inc., and Quest Ventures Ltd.

Section 28 of the *Securities Act*, RSBC 1996, c. 418

Hearing and Review

Panel	Adrienne Salvail-Lopez	Commissioner
	Joan L. Brockman	Commissioner
	Roy Wares	Commissioner
Dates of Hearing	February 5-6, 2002	
Date of Decision	February 27, 2002	

Appearing

David R. Haigh, Q.C. Michael J. Donaldson Winston W. Yee Stewart Muglich	For Mercury Partners & Company Inc.
Susan A. Griffin Nadine Casey French	For Canadian Venture Exchange Inc.
Anthony L. Friend, Q.C. Nick P. Fader Scott Bower Tracey P. Gibb	For VisuaLABS Inc.
John D. Blair Derrick R. Armstrong	For Quest Ventures Ltd.
J.A. (Sasha) Angus	For Commission Staff

Decision of the Commission

Introduction

[para 1]
On November 28, 2001, the Canadian Venture Exchange Inc. conditionally approved an issuance of shares by VisuaLABS Inc. to Quest Ventures Ltd. On December 14, 2001, Mercury Partners & Company Inc. applied under section 28 of the *Securities Act*, RSBC 1996, c. 418 for a hearing and review of the Exchange's decision.

Background

[para 2]
VisuaLABS Inc. was continued under the *Business Corporations Act*, R.S.A. 2000, c. B-9 and is listed on the Exchange. VisuaLABS' operations are described in the company's financial statements for the nine months ended September 30, 2001, as "the research, development, licensing and provision of advanced imaging technologies for application in all forms of electronic image displays."

[para 3]
VisuaLABS focused on the development of two technologies. The first was a 3D visualization technology that would allow viewers to see 3D images without using glasses or headgear. The second was a "grout free" technology that would allow several liquid crystal display panels to be put together to build one large, high resolution screen.

[para 4]
VisuaLABS presented what it claimed was the first working prototype of its grout free technology at the company's annual and special meeting on July 3, 2001. However, VisuaLABS concluded later that month that, in fact, the "prototype" was a standard 42 inch television purchased at a Calgary consumer electronics retailer and slightly modified. VisuaLABS claimed that this deception had been carried out by Sheldon Zelitt, a director and past president of VisuaLABS.

[para 5]
VisuaLABS' president and director, John Kendall, had learned of the deception and called a board meeting for July 20, 2001. On July 26, 2001, VisuaLABS issued a news release disclosing the deception. The news release stated that, after reviewing the situation, a special committee of the board had concluded that neither the grout free nor the 3D technology was as advanced as the company had previously represented. The news release noted that Zelitt and his wife had received their shares in the company as consideration for the 3D technology and stated that VisuaLABS expected "to take steps to have the shares held by Mr. and Mrs. Zelitt cancelled without consideration and to pursue other available claims and remedies." The news release also stated that VisuaLABS had terminated the employment of the Zelitts and would ask them to tender their resignations as directors. The Zelitts held 7,674,624 of the 17,024,444 outstanding shares of VisuaLABS. They held these shares directly or through The Downsview

Investment Group Limited, a company incorporated by the Zelitts for estate and tax planning purposes.

[para 6]
The Zelitts refused to resign as directors but ceased to participate in meetings of VisuaLABS' board.

[para 7]
In August 2001, VisuaLABS retained counsel to evaluate claims the company might have against the Zelitts. VisuaLABS' counsel, in turn, retained Deloitte & Touche LLP to do a forensic audit of the company's financial transactions and technologies.

[para 8]
In a letter to the shareholders dated August 28, 2001, Kendall said that the special committee had reported to the board on July 24 and 25 that "it had found no evidence supporting the existence of either the GroutFree technology or the hardware dependent 3-D technology held out by the Corporation." Kendall also said that the board was evaluating the feasibility of a business plan that would enable the company to move forward as a going concern, as well as considering other alternatives, such as winding up the company. According to the company's latest financial statements, for the six months ended June 30, 2001, the company's principal asset was $8,370,671 in cash and short-term deposits.

[para 9]
On August 28, 2001, VisuaLABS commenced an action against the Zelitts in the Court of Queen's Bench of Alberta seeking various orders. One of these was an order rescinding the issuance of the Zelitts' shares on the basis that they had been obtained by fraud and without consideration, as the technology in exchange for which they had been issued never existed.

[para 10]
Also on August 28, VisuaLABS obtained an interim order under which the Zelitts are "restrained, enjoined and prohibited from transferring, exercising rights, including but not limited to voting rights, or otherwise dealing with any shares in VisuaLABS Inc. which they directly or indirectly own or in which they have a legal or beneficial interest". The order also requires the Zelitts to deliver to the Court all of their share certificates, which "shall not be dealt with in any manner whatsoever until further order" of the Court. The Zelitts can bring a motion to amend, vary or set aside the order on two clear days written notice.

[para 11]
VisuaLABS advised us that the Zelitts have denied any wrongdoing and have repeatedly threatened to bring a multi-million dollar counterclaim against VisuaLABS. VisuaLABS also advised that it has pursued settlement negotiations with the Zelitts since at least November 1, 2001.

[para 12]
In September 2001, VisuaLABS was approached by Quest Ventures Ltd. Quest is a merchant bank based in Vancouver. All of the shares of Quest are held by A. Murray Sinclair and Brian Bayley. Sinclair and Bayley each sit on the boards of over a dozen public companies. However, neither had any prior connection with VisuaLABS or its management.

[para 13]
Negotiations ensued. On Friday, November 23, 2001, Nick Fader, counsel for VisuaLABS, wrote to Brian Kaine, Supervisor, Corporate Finance at the Exchange, requesting that a minimum price be set for a proposed private placement.

[para 14]
After receiving the letter, the Exchange observed that there had been an increase in the trading volume and price of VisuaLABS' shares; after opening at $0.21 on November 23, the share price closed at $0.32 on a volume of 487,600 shares. In contrast, between November 1 and 22, the share price had varied between $0.15 and $0.26 on daily trading volumes of between 2,500 and 100,550 shares.

[para 15]
The Exchange halted trading in VisuaLABS' shares at the end of trading on November 23, pending an announcement from the company. The Exchange also reviewed VisuaLABS' public files and obtained a copy of the interim court order regarding the

[para 16]
Though VisuaLABS did not know it at the time, 210,500 of the shares traded on November 23 had been purchased by Mercury Partners & Company Inc. On its website, Mercury describes itself as follows: Mercury is "a financial services company engaging in merchant banking and private equity in Canada and the United States. Mercury's investment objective to acquire influential ownership in companies and through direct involvement bring about the change required to realize the strategic value of the companies it invests in." Mercury had been purchasing VisuaLABS shares on the Exchange since July 2001.

[para 17]
On Monday, November 26, Fader emailed Kaine a draft news release, noting that it was still under consideration and might require revision. Among other things, the draft disclosed that VisuaLABS continued to pursue claims against the Zelitts and was "well advanced in settlement discussions" and that any settlement acceptable to VisuaLABS would include cancellation of the Zelitts' shares. However, the draft also observed that "[a]t this time there can be no assurance that settlement discussions will be successful."

[para 18]

Later that day, Kaine sent an email in response, attaching his comments on the draft and advising that "any private placement will be based on the prevailing market prices of the company's shares at the time of issuance of a press release announcing the transaction." In his comments on the draft news release, Kaine deleted the reference to the settlement negotiations with the Zelitts being well advanced.

[para 19]
On Tuesday, November 27, Kaine had a telephone conversation with Derrick Armstrong, counsel for Quest. In a note to file, Kaine recorded that Armstrong had informed him that:

- an agreement had been reached between VisuaLABS and Quest;
- the new directors of VisuaLABS would be Sinclair, Bayley, John Fleming and Glenn McCowan;
- Kendall would remain as president and McCowan as chief financial officer of VisuaLABS; and
- no settlement had been completed with the Zelitts and that there was a real possibility that a settlement would not be completed.

Kaine advised Armstrong that the price fixed on November 23 would be unacceptable and requested a copy of the letter of intent between VisuaLABS and Quest.

[para 20]
One of the directors referred to by Quest's counsel was Fleming. Fleming is a Calgary businessman who has served as chair and chief executive officer of several public companies. He is not a director, officer, employee or shareholder of Quest. However, he has sat on the boards of at least three companies with Sinclair, Bayley or both. As well, in an early warning acquisition report filed in March 2000 by Sinclair, Bayley and a third person respecting their acquisition of 53.8% of the shares of Lagasco Corp., they indicate that Fleming was a joint actor with them in connection with the acquisition.

[para 21]
On the afternoon of November 27, Darrell Peterson, counsel for VisuaLABS, sent a facsimile to Kaine, consisting of a cover page and the letter of intent. On the cover page, Peterson advised that the price would be $0.25. At the bottom of the cover page Kaine made some handwritten calculations: "$^{4}/_{21}$ = 19% or $^{4}/_{14}$ = 29%".

[para 22]
The letter of intent was addressed to VisuaLABS by Quest and was dated November 26. It confirmed that Quest would purchase 4,000,000 shares. This would increase the number of VisuaLABS's outstanding shares to 21,024,444, 19% of which would be held by Quest. Two paragraphs in the letter of intent related to VisuaLABS' board:

> We understand that certain existing board members on the Board of directors of the Corporation (the "Board") may wish to resign in view of the new direction of the Corporation. We propose that those board members submit their resignations concurrent with the completion of the Private Placement, on the understanding that John Kendall remains a member of the Board. In addition, we propose the appointment to the Board of Glenn McCowan, the current Chief Financial Officer of the Corporation, and three nominees of the Subscriber to fill the vacancies of the resigning board members. It is contemplated that the three nominees are, John Fleming of Calgary, Alberta, Brian Bayley of Vancouver, British Columbia and A. Murray Sinclair Jr. of Vancouver, British Columbia.
>
> This would result in the Board consisting of 7 members, as we presume that Sheldon Zelitt and Joy Zelitt have not tendered their resignation to the Board.

[para 23]
One paragraph addressed VisuaLABS' business:

> Immediately upon completion of the Private Placement, or as soon thereafter as is reasonable, we propose to call a special general meeting of the shareholders of the Corporation, to approve among other things, a board of directors that will not include Sheldon Zelitt and Joy Zelitt, in the event that they have not tendered their resignations prior thereto. The meeting will also address a change of the direction of the Corporation from a research and development company to an investment company.

[para 24]
The letter of intent also confirmed that Quest had "been advised of the ongoing efforts of the Corporation in its attempts to reach a settlement with Sheldon Zelitt and Joy Zelitt" and that Quest supported, and proposed to continue, those efforts.

[para 25]
Finally, the letter of intent advised that Quest "will require that a severance package be accepted by Mr. McGowan"; McGowan was to resign on June 30, 2002, and receive one

[para 26]
On the evening of November 27, Mercury contacted Kendall and advised him that Mercury had acquired a significant share position in VisuaLABS. At that time, Mercury held 1,555,750 shares. This represented 9% of the 17,024,444 shares then outstanding, but would be only 7% of the 21,024,444 shares outstanding after the Quest private placement.

[para 27]

On the morning of Wednesday, November 28, Mercury sent VisuaLABS a notice requisitioning a shareholders meeting. Prior to a meeting of VisuaLABS' board later that day, VisuaLABS made inquiries into Mercury's background. At the meeting, concluded that the Quest transaction was still the best option for VisuaLABS.

[para 28]
Also on November 28, counsel for Quest sent another draft of the news release to Kaine. This draft was titled: "VisuaLABS Inc. Announces Changes to Board, Corporate Redirection and Private Placement". The first sentence stated that VisuaLABS "announces that it has completed changes to its board of directors in conjunction with (i) a redirection of its corporate activities and (ii) a recently completed equity offering." The draft also discloses that Deloitte & Touche had prepared their draft report and that, based on their preliminary conclusion, "it appears that [VisuaLABS'] technologies will not have any meaningful value in the hands of [VisuaLABS]."

[para 29]
Also on November 28, Kaine had a telephone conversation with Armstrong and Melinda Park, counsel for Quest. Kaine's note to file regarding the conversation reads in part as follows:

> The following representations were made and accepted by CDNX in determining if a change of control was occurring in the Company and if shareholder approval for the Quest PP [private placement] was necessary.
>
> - No change of management. McCowan and Kendall have been senior management of the Company, prior to the Zelitt resignations and will remain so.
> - Fleming is independent of Quest.
> - The Company and Quest are arm's length.
> - Retention of Senior Officers, McCowan (CFO and Director) and Kendall (CEO and Director)
> - Staff retained and R&D business of Company still proceeding
> - Sheldon and Joy Zelitt remain on the Board. Quest hold 2 seats out of a total of 8 seats on the board. The plan is to hold a shareholders meeting so as to remove Sheldon and Joy. Quest would then retain 2 out of 6 seats on the board.
> - As the court order was issued exparte, the Zelitts', under the terms of the order, have the ability to commence an appeal so as to overturn the court order, with 48 hours advance notice. The courts retain the authority to reinstate the voting

provisions and remove the trading restrictions upon the Zelitt shares. Counsel for the Zelitts' has threatened to take this action for some time.

- The Zelitt shares are by their terms, still voting shares, i.e. it is only a result of the court order that the shares are restricted from trading at this time. As such, counsel for Quest is of the opinion that all rights to the Zelitt shares are retained and can not be ignored on any transaction. Two examples raised are: a) if an offer to purchase was made for the Company's shares, the offer must be made for the Zelitt shares as well, regardless of the court order, and b) if a dividend or distribution was made by the Company, the Zelitt shares must be included.

[para 30]
Later on November 28, Kaine sent an email to Peterson conditionally approving the issuance of 4,000,000 shares to Quest at a price of $0.25 per share. Kaine also advised that the Exchange had no objection to the appointment of Sinclair, Bayley and Fleming to VisuaLABS' board. Finally, Kaine advised that trading in VisuaLABS' shares would be reinstated in coordination with VisuaLABS' issuance of a news release announcing the transaction.

[para 31]
On the evening of November 28, VisuaLABS issued a news release that read in part as follows:

> **VisuaLABS Inc. Announces Changes to Board, New Private Placement and New Corporate Direction**
>
> VisuaLABS Inc. (CDNX:VLI) announced today that it has changed its board of directors in conjunction with a private placement equity offering of 4,000,000 common shares at $0.25 per share for total proceeds of $1,000,000. The sole subscriber to the private placement was Quest Ventures Ltd.
>
> The Corporation is pleased to announce that A. Murray Sinclair, Brian E. Bayley, John Fleming and Glenn McCowan, the Chief Financial Officer of the Corporation, have joined its board of directors. Alan Jones, Eldon Smith, Luther Haave and Philip Lapp have resigned from the board of directors of the Corporation. Glenn McCowan will remain as Chief Financial Officer and John Kendall will remain on the board of directors and continue to act as Chief Executive Officer of the Corporation. The board of directors of the Corporation therefore now consists of John Kendall, Glenn McCowan, A. Murray Sinclair, Brian E. Bayley, John Fleming, Sheldon Zelitt and Joy Zelitt.
>
> Quest Ventures Ltd., is owned and operated by Messrs. Sinclair and Bayley. Quest Ventures Ltd. is based in Vancouver, British Columbia and is engaged primarily in the business of merchant banking.

> Under the new board of directors, the Corporation intends to call a shareholders meeting as soon as possible, where it intends to present to the shareholders a proposal to change the business of the Corporation to an investment corporation. Details of the investment parameters proposed for the Corporation will be set out in an information circular to be provided in relation to the proposed meeting. Additionally, the directors may also propose a change of name of the Corporation.
>
> The Corporation continues to pursue claims against its former Chief Executive Officer and is in settlement discussions. Although the new board supports continuation of the settlement discussions, there is no assurance that settlement discussions will be successful.
> . . .
>
> The Corporation's legal counsel has now received the final report from Deloitte & Touche Inc. as to the results of its forensic audit and the status of the Corporation's technologies. Such report has been prepared for the Corporation's legal counsel in connection with the litigation by the Corporation against its former Chief Executive Officer, and therefore is subject to solicitor-client privilege and it is not currently proposed to release the report itself. However, based on the findings in the Deloitte & Touche report, it is clear that the Corporation's 3-D and Grout-Free technologies will not have any meaningful value in the hands of the Corporation going forward.

[para 32]
The private placement was completed on November 28. VisuaLABS issued the 4,000,000 shares to Quest and Quest paid the $1,000,000 to VisuaLABS.

[para 33]
VisuaLABS was required to file its financial statements for the nine months ended September 30, 2001, on or before November 29. It appears that VisuaLABS filed these financial statements on or after November 28, as the last note to the financial statements refers to the private placement to Quest on November 28. The note states that "as a result of the private placement, four of the existing members of the Board also resigned and three representatives from Quest along with the Company's current Chief Financial Officer agreed to replace the resigning members."

[para 34]
Trading in VisuaLABS' shares resumed on November 29. The closing price that day was $0.30. At the end of the following week, the share price closed at $0.45.

[para 35]
Also on November 29, Winston Yee, counsel for Mercury, wrote to the Exchange expressing concern about the Quest transaction and suggesting that it contravened various Exchange policies and the continuous disclosure requirements of the Act. Yee requested that the Exchange, among other things, require shareholder approval of the private

placement to Quest and the change in directors. Yee sent a supplemental letter to the Exchange on December 4.

[para 36]
On December 3 and 5, Kaine facsimiled copies of Yee's letters to Armstrong for his review and response. Kaine also sent the December 5 facsimile to Martin Lambert, counsel for VisuaLABS. Kaine blocked out the references in Yee's letters to Mercury and its counsel because, as Kaine advised in his facsimile of December 3, "counsel for the complainant would not authorize the release of the complaint letters".

[para 37]
On December 5, Lambert responded to Kaine, concluding in his letter that the complaints were "without foundation and should be summarily dismissed."

[para 38]
Also, on December 5, Kaine emailed Yee asking for additional information and requesting authorization "to release these complaints to [VisuaLABS] and Quest."

[para 39]
On December 7, Yee responded to Kaine's email and authorized the release of his November 29 and December 4 letters to VisuaLABS and Quest "upon the condition that any responses and submissions made by [VisuaLABS] and Quest also be provided to Mercury."

[para 40]
Also on December 7, Armstrong responded to Kaine, advising him that "these allegations are refuted in the strongest fashion by Quest and VisuaLABS." Armstrong also stated that "[t]he board of directors of VisuaLABS have, from our perspective, acted in the best interests of VisuaLABS and its shareholders, have complied with all securities laws and stock exchange policies, and have made a reasoned and responsible decision to select certain new experienced board members, obtain a commitment from those board members through equity participation, and seek a new direction for the company that will properly, and in the best interests of the shareholders, utilize its remaining asset, which is now solely cash."

[para 41]
On December 10, McGowan sent a letter to Kaine in response to Mercury's complaints. He referred Kaine to the letters from Lambert and Armstrong for the legal arguments, and went on to make the business arguments, as to why the Exchange should not require the shareholder approval requested by Mercury. McGowan advised Kaine that VisuaLABS still had three scientific staff "who are continuing research in two technology areas that are a continuation of our fundamental and core business." However, McGowan also noted that those three staff, along with the rest of VisuaLABS' staff, would be terminated upon completion of the notice periods required under their employment contracts.

[para 42]
None of the response letters – from Lambert, Armstrong or McGowan – was given to Mercury.

[para 43]
On December 13, 2001, Nadine Casey French, Legal Counsel, Corporate Finance at the Exchange sent a letter to Yee confirming the decision of November 28 to conditionally approve the private placement and advising that VisuaLABS had closed the private placement. The letter stated that: "The application was reviewed and the Exchange determined that the application was in compliance with Exchange requirements and, in particular, Policy 4.1. The Exchange further determined that shareholder approval was not required in these particular circumstances." The letter provides no information as to the reasoning behind the Exchange's determinations.

[para 44]
On January 2, 2002, VisuaLABS issued a news release announcing that it had reached an agreement in principle to settle the outstanding disputes between VisuaLABS and the Zelitts. The agreement required the Zelitts to resign as directors of VisuaLABS and to surrender to the company all but 1,000,000 of their 7,674,624 shares. The remaining 1,000,000 shares would be sold and the proceeds paid to VisuaLABS to discharge, in whole or in part, debts totalling $1,575,133 owed by the Zelitts to VisuaLABS. The shares would be voted by an unnamed third party.

[para 45]
On February 5, 2002, VisuaLABS issued a news release announcing that the documents required to execute the settlement had been signed on February 1. However, the settlement would not be effective until VisuaLABS obtained the necessary regulatory approvals. VisuaLABS also announced that Sheldon Zelitt had resigned as a director and that two new directors had been appointed - Richard Clark and Lukas Lundin.

[para 46]
If the Zelitt settlement is approved, and 6,674,624 of the Zelitts' shares are surrendered and cancelled, VisuaLABS will have 14,349,820 shares outstanding. Assuming Quest still holds 4,000,000 shares, Quest would then hold 28% of VisuaLABS's outstanding shares.

Analysis

[para 47]
Section 28 of the Act authorizes a person directly affected by a decision made under a policy of the Exchange to apply for a hearing and review of that decision. Section 165(3) to (5) of the Act applies to the application. Section 165(4) provides that, on a hearing and review, the Commission may confirm or vary the decision under review or make another decision it considers proper.

[para 48]
Mercury argued that it was directly affected by the Exchange's decision to conditionally approve VisuaLABS' issuance of shares to Quest. Neither VisuaLABS nor Quest challenged Mercury's standing in this matter. Our Commission found in a similar set of circumstances that a minority shareholder of a company was a person directly affected by a decision of the Exchange respecting that company: *Re Bradstone Equity Partners,* [1998] 23 BCSC Weekly Summary 15. The Ontario Securities Commission, in even more analogous circumstances, made the same finding: *Re Canada Malting Co*. (1986), 9 0SCB 3565. Applying the principles established in these two cases, we find that Mercury is directly affected by the Exchange's decision and that the matter is properly before us pursuant to section 28 of the Act.

[para 49]
Section 4.6 of BC Policy 15-601 Commission Hearings addresses the form and scope of hearings and reviews. That section reads in part as follows:

> The hearing and review process is not intended to provide parties with a second opinion from the Commission on a matter decided by an SRO [self regulatory organization]. The Commission's concern is to ensure that the decision under review is reasonable and has been made in accordance with the law, the evidence and the public interest. If the decision meets those criteria, the Commission is generally reluctant to interfere simply because it may have made a different decision in the circumstances. For this reason, a hearing and review is generally conducted like an appeal.
> . . .
>
> In a hearing and review of a decision of an SRO when the Commission does not proceed by way of a new hearing, the Commission will generally confirm the decision of the SRO unless
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> (1) the SRO has erred in law,
>
> (2) the SRO has overlooked material evidence,
>
> (3) compelling evidence is presented to the Commission that was not tendered at the original hearing, or
>
> (4) the Commission's view of the public interest is different from the SRO's.

[para 50]
In reference to the fourth, or public interest, ground, the Commission has cautioned that "[t]his discretion should be used sparingly to deal with circumstances where the decision has clearly failed to protect the public interest, and not to simply impose our own view where we might have a difference of opinion." *Vancouver Stock Exchange and Brian Biles* [1997] 27 BCSC Weekly Summary 13.

[para 51]
In the Exchange's letter to Mercury of December 13, 2001, the Exchange advised that VisuaLABS had applied for approval of its private placement under Exchange Policy 4.1 Private Placements and that the Exchange had determined that the application complied with Exchange requirements, in particular Policy 4.1.

[para 52]
Mercury argued that the Exchange had failed to consider or apply Exchange Policy 5.2 Changes of Business and Reverse Take-Overs in making its decision. The Exchange submitted that it had considered Policy 5.2 and concluded that it would not apply.

[para 53]
We will consider both Policy 4.1 and Policy 5.2 in our review of the Exchange's decision.

Policy 4.1 Private Placements
[para 54]
Policy 4.1 requires a company to give written notice to the Exchange before the company issues any shares. Section 1.10 of the policy describes the circumstances in which the Exchange will require shareholder approval of the share issuance and how that approval must be obtained. Specifically, section 1.10(a) to (c) provides as follows:

(a) If the issuance of the Private Placement Shares and the Listed Shares issued on conversion of a Warrant or Convertible Security will result in, or is part of a transaction involving a Change in Control or change in absolute control (≥50%) of the Issuer, the Exchange will require the Issuer to obtain shareholder approval of the Private Placement.

(b) The shareholder approval may be by ordinary resolution at a general meeting or by the written consent of shareholders holding 50% or more of the issued Listed Shares, so long as they are not the placees nor Related Parties of the Placees.

(c) The Information Circular of the Issuer for a general meeting must disclose the Private Placement in sufficient detail to permit shareholders to form a reasoned judgement concerning the Private Placement, including the details of the consideration involved and the names of the Placee(s) gaining absolute control or forming a control block. The Issuer must provide a copy of the Information Circular and the minutes of the general meeting to the Exchange.

[para 55]
A Change of Control is defined in Exchange Policy 1.1 Interpretation as follows:

"Change of Control" includes situations where after giving effect to the contemplated transaction and as a result of such transaction:

(a) any one Person holds a sufficient number of the Voting Shares of the Resulting Issuer to affect materially the control of the Issuer, or

(b) any combination of Persons, acting in concert by virtue of an agreement, arrangement, commitment or understanding, hold in total a sufficient number of the Voting Shares of the Resulting Issuer to affect materially the control of the Resulting Issuer,

and in the absence of evidence to the contrary, any Person or combination of Persons acting in concert by virtue of an agreement, arrangement, commitment or understanding, holding more than 20% of the Voting Shares of the Resulting Issuer is deemed to materially affect the control of the Resulting Issuer.

[para 56]
Voting Shares are defined in Policy 1.1 as follows:

"Voting Share" means a security of an Issuer that:

(a) is not a debt security, and

(b) carries a voting right either under all circumstances or under some circumstances that have occurred and are continuing.

[para 57]
The basis on which the Exchange concluded that the private placement would not result in a Change in Control is set out in Kaine's memo to file of November 28. Kaine accepted the argument of Quest's counsel that the Zelitts' shares were Voting Shares. Kaine also based his decision on the representations of Quest's counsel that VisuaLABS and Quest were at arm's length, that the staff and senior management of VisuaLABS would not change, that VisuaLABS' research and development business was still proceeding, and that, as Fleming was independent of Quest, Quest would hold only two seats on VisuaLABS' board.

[para 58]
We heard argument as to whether or not the Zelitts' shares should be considered Voting Shares for the change of control calculation, as the August 28 interim court order prohibited the Zelitts from voting the shares. In making their decision, the Exchange accepted Quest's argument that the Zelitts' shares were Voting Shares. Without determining whether the Exchange was correct, we will assume for the moment that it was, and that the Zelitts' shares are Voting Shares for the purposes of the change of control calculation.

[para 59]

On this assumption, VisuaLABS would have had 21,024,444 shares outstanding after the private placement to Quest. Quest's 4,000,000 shares would have represented 19% of those outstanding shares. This is just below the 20% at which a Change in Control is deemed to occur. Therefore, the Exchange would have had to look to the results of the transaction and to determine whether Quest would hold a sufficient number of the Voting Shares of VisuaLABS to affect materially the control of VisuaLABS.

[para 60]
Mercury referred us to *Re Cartaway Resources Corporation* 2000 BCSECCOM 88, in which our Commission considered the definition of "control person" in the Act, which imposes a test similar to that imposed in Policy 1.1 for a Change of Control. The Commission observed at paragraphs 164 and 165 of that decision:

> In *R.v. Armaugh* (1994), 6 C.C.L.S. 260 at 263 the Ontario Court of Justice considered the meaning of control person in the context of determining whether there had been an illegal distribution. Although there is no definition of 'control person' *per se* in the Ontario Securities Act, it is referred to in the definition of distribution, which includes:
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>> *"…a trade in previously issued securities of an issuer from the holdings of any person, company or combination of persons or companies holding a sufficient number of securities of that issuer to affect materially the control of that issuer, but any holding of any person, company or combination of persons or companies holding more than 20 per cent of the outstanding voting securities of an issuer shall, in the absence of evidence to the contrary, be deemed to affect materially the control of that issuer".*
>
> The court determined that because of this wording there may not be a definitive conclusion in all circumstances as to whether a person is or is not a control person. Therefore it concluded there must be an examination of the entire circumstances of each case and it becomes a question of fact for the trier to make a determination of material control, bearing in mind the 20% deeming rule. Quoting from David Johnston, *Canadian Securities Regulation* (1977) at p.144 the court noted:
>
>> *"The critical requirement is not control per se, but material effect on control. Although not expressly so defined, in ordinary circumstances control means the ability to exercise a majority of the voting rights at shareholders' meetings, and more particularly, the power to elect a majority of the board of directors. Furthermore, it is de facto or practical control rather than de jure control. Thus the percentage holding of voting shares required to exercise control will vary with the size of the company, the number of outstanding shares, and the manner in which they are held."*

[para 61]

further confirmation that VisuaLABS no longer had any business in his letter of December 7 in which he observed that VisuaLABS' only remaining asset was cash. Finally, McGowan advised Kaine in his letter of December 10 that all of VisuaLABS' staff would be terminated on completion of the notice periods under their contracts. VisuaLABS was no longer an active company; it had become a shell.

[para 65]
Fourth, VisuaLABS had an Exchange listing and over $5,000,000 in cash. However, as we noted above, it did not have a business. Under these circumstances, it seems unlikely that Quest would invest such a significant amount as $1,000,000 in VisuaLABS unless Quest anticipated being able to control the company.

[para 66]
Fifth, Quest was acting as if it had control over VisuaLABS. In its letter of intent: Quest proposed the manner in which four of VisuaLABS' current directors would resign; Quest proposed the retention of Kendall on the board, and the appointment of McGowan and three of its "nominees" to the board; and Quest proposed to call a special general meeting to consider changing VisuaLABS from a research and development company to an investment company. It was Quest's counsel that, on November 27, advised Kaine of the

details of the private placement and, on November 28, persuaded Kaine that the private placement would not result in a Change of Control of VisuaLABS. It was also Quest's counsel that, on November 28, sent Kaine a draft of the news release that VisuaLABS would issue later that day.

[para 67]
Sixth, the newly constituted board of VisuaLABS would contain seven directors. Two were the Zelitts, who were no longer involved in the company's affairs. One was Kendall, whom Quest had agreed should remain on the board. The other four - McGowan, Sinclair, Bayley and Fleming - had been proposed by Quest. McGowan would be leaving VisuaLABS in June 2002 with a severance package approved by Quest. Sinclair, Bayley and Fleming had been characterized in Quest's letter of intent as
isuaLABS' September 30 financial statements as
"representatives from Quest" (though we do not know if the Exchange saw the reference in the September 30 financial statements).

[para 68]
Sinclair and Bayley were clearly not independent of Quest. Fleming as well had a history of involvement with Sinclair and Bayley. Fleming sat on the boards of at least three companies with Sinclair, Bayley or both. In an early warning acquisition report filed in March 2001 by Sinclair, Bayley and a third person respecting their acquisition of the shares of Lagasco Corp. they indicate that Fleming was a joint actor with them in connection with the acquisition. We are of the view that Fleming could not be considered to be independent of Quest.

[para 69]
We recognize that the Exchange may not have known the history of Fleming's involvement with Sinclair and Bayley. However, the reference in Quest's letter of intent to Fleming being Quest's nominee should have spurred them to further inquiry.

[para 70]
It appears from the evidence that the Exchange failed to examine the entire circumstances of the case. After reviewing these circumstances, we find that, after giving effect to the private placement, Quest would hold a sufficient number of VisuaLABS' Voting Shares to affect materially the control of VisuaLABS. Therefore, the transaction resulted in a Change of Control of VisuaLABS that, pursuant to section 1.10 of Policy 4.1, would have required VisuaLABS to obtain shareholder approval of the transaction.

[para 71]
As we have reached this conclusion, we do not need to consider whether the Zelitts' shares were Voting Shares for the purposes of Policy 1.1.

Policy 5.2 Change of Business and Reverse Take-Overs
[para 72]

Policy 5.2 "applies to a transaction or series of transactions entered into or proposed to be entered into by an Issuer, which result in a Change of Business ("COB") or Reverse Take-Over ("RTO")."

[para 73]
A Reverse Take-Over is defined as "a transaction or series of transactions, which results in at least one item from each of paragraph (a) and (b) below:

(a) any one or more of:

(i) a Change of Business, or

(ii) a Fundamental Acquisition;

and

(b) any one or more of:

(i) a Change of Control; or

(ii) a Change of Management of the Issuer;

(iii) the issuance of more than 100% of the number of outstanding securities that were outstanding before the transaction(s); or

(iv) new shareholders owning more than 50% of the securities or voting control of the Issuer through newly issued securities, a transfer of previously issued securities privately or through the Exchange or a combination of such issuances and transfers;

unless:

(c) the newly issued securities as described in (b) are to be issued to the shareholders of an Issuer listed on a Canadian stock exchange or NASDAQ under a formal bid made pursuant to Securities Laws."

[para 74]
Policy 5.2 sets out the procedures to be followed in respect of a Reverse Take-Over. One of those procedures, described in section 4 of the Policy, is shareholder approval.

[para 75]
French's letter to Mercury's counsel of December 13, 2001, stated that the Exchange had determined that VisuaLABS' application was in compliance with Exchange requirements and that shareholder approval was not required. However, there was no information in

that letter, or in any of the evidence before us, as to the basis for the Exchange's determination that Policy 5.2 was not applicable.

[para 76]
VisuaLABS and Quest argued that the private placement to Quest, the changes in VisuaLABS' board and the proposed change in VisuaLABS' business were separate, unconnected events. The documents contradict their position.

[para 77]
In its letter of intent, Quest proposes that the changes in the VisuaLABS board occur "concurrent with the completion of the Private Placement". Quest also proposes to call a special general meeting of VisuaLABS' shareholders "immediately upon completion of the Private Placement, or as soon thereafter as is reasonable". At that meeting, the shareholders would address a change in VisuaLABS' direction, from a research and development company to an investment company.

[para 78]
The draft VisuaLABS' news release sent to Kaine by Quest's counsel on November 28 is titled "VisuaLABS Inc. Announces Changes to Board, Corporate Redirection and Private Placement". The draft news release stated that "VisuaLABS announces that is has completed changes to its board of directors in conjunction with (i) a redirection of its corporate activities and (ii) a recently completed equity offering."

[para 79]
We are satisfied that the private placement to Quest, the changes in VisuaLABS' board and the proposed change in VisuaLABS' business were a "series o
purposes of Policy 5.2.

[para 80]
Did this series of transactions result in a Reverse Take-Over?

[para 81]
First, would there be a Change of Business? A Change of Business is defined in Policy 5.2 as "a transaction or series of transactions which will redirect an Issuer's resources toward a business which is of a substantially different nature than its current business, so that over the next 12 months at least 25% of the assets, liabilities, planned expenditure or revenues, management time commitment or issued shares of the Issuer will be devoted to the new business."

[para 82]
As we observed earlier, VisuaLABS no longer had a business; its technologies had no meaningful value, its sole asset was cash and it would soon have no employees. Under these circumstances, any business undertaken by VisuaLABS would constitute a Change of Business. In McGowan's letter to Kaine of December 10, McGowan represented that VisuaLABS' research and development business was continuing. Even if this was the

case, the business of an investment company is of a substantially different nature than the business of a research and development company. Further, it is almost certain that VisuaLABS would become an investment company within 12 months of the private placement to Quest; VisuaLABS proposed to call the shareholders meeting to address the proposal as soon as possible after the private placement and the proposal would likely be approved, given that Quest would hold at least 19% of VisuaLABS' shares.

[para 83]
In its statement of points, the Exchange refers to Policy 5.2 and submits that the Exchange "concluded that although there was a **proposed** "change of business" the Quest Transaction did not involve a Change of Business" as defined in Policy 5.2.

[para 84]
We disagree. Policy 5.2 specifically applies to transactions "entered into or proposed to be entered into" by a company. Under the circumstances, we find that the proposed change of VisuaLABS' business to an investment company was a Change of Business as defined in Policy 5.2. We also observe that Policy 5.2 requires shareholder approval of a Change of Business whether or not it occurs in connection with a Reverse Take-Over.

[para 85]
Second, would there be a Change of Control? A Change of Control is defined in Policy 1.1. We found earlier that the Quest private placement would result in a Change of Control as defined in that Policy.

[para 86]
Finally, even assuming that there would not be a Change of Control, would there be a Change of Management? A Change of Management is defined in Policy 1.1 as:

(a) a reconstitution of the board of directors of an Issuer so that the majority of the board of directors is comprised of Persons who were not members of the board of directors before the reconstitution; or

(b) a reconstitution in both the senior management and the board of directors of an Issuer so that the control and direction over the Issuer's business and affairs is predominantly in the hands of Persons who, before the reconstitution, were not senior officers or directors of the Issuer.

[para 87]
Before the private placement, VisuaLABS' directors were Kendall, Sheldon Zelitt, Joy Zelitt, and four others. After the private placement, VisuaLABS' directors were Kendall, Sheldon Zelitt, Joy Zelitt, Sinclair, Bayley, Fleming and McGowan. Thus, after the private placement, four of seven of VisuaLABS' directors - a majority - were persons who were not members of the board before the private placement.

[para 88]

In its statement of points, the Exchange submitted that it had "concluded that a technical application of the Change of Management was not required in relation to the Quest transaction." However, there is no evidence as to how the Exchange reached this conclusion.

[para 89]
Again, we disagree with the Exchange. We see no reason to not apply the definition of Change of Management as set out in Policy 1.1. Consequently, we find that there was a Change of Management of VisuaLABS as defined in that Policy.

[para 90]
We have found that the series of transactions between VisuaLABS and Quest resulted in a Change of Business, a Change of Control and a Change of Management of VisuaLABS. Therefore, we find that the series of transactions was a Reverse Take-Over under Policy 5.2, pursuant to which shareholder approval was required.

Decision

[para 91]
We have found that the Exchange was incorrect in its view that the series of transactions involving VisuaLABS and Quest did not result in a Change of Control, a Change of Business and a Change of Management of VisuaLABS for the purposes of Policy 1.1, Policy 4.1 and Policy 5.2. This led the Exchange to conclude that there was neither a Change of Control under Policy 4.1 nor a Reverse Take-Over under Policy 5.2 and, therefore, that the approval of VisuaLABS' shareholders was not required.

[para 92]
We are of the view that the Exchange's decision clearly failed to protect the public interest. We have two concerns in particular.

[para 93]
The first is that market participants should have confidence that the Exchange will apply its policies in a consistent and fair manner after considering all of the relevant circumstances. We believe that the Exchange failed to do this when it concluded that the series of transactions in issue did not result in a Change of Control, a Change of Business and a Change of Management pursuant to its policies.

[para 94]
The second is that companies undertaking transactions that will have a significant impact on their shareholders should be required to take whatever steps are necessary in the circumstances to ensure that those shareholders are treated fairly. This is the reason behind the requirement in the Exchange's policies for shareholder approval in connection with Changes of Control, Changes of Business and Reverse Take-Overs. It is our view that the Exchange failed to consider the fair treatment of VisuaLABS' shareholders when it made its decision.

[para 95]
Consequently, it is our view of the public interest that the Exchange should have required VisuaLABS to obtain shareholder approval of the private placement to Quest, the changes in VisuaLABS' board and the proposed change in VisuaLABS' business.

[para 96]
Unfortunately, the Exchange's decision has already been implemented. The shares have been issued to Quest and the changes in VisuaLABS' board have been made. Therefore, simply reversing the Exchange's decision is not a viable option.

[para 97]
In an effort to find a workable solution, Mercury pointed us to the dissent in the decision of the Ontario Securities Commission in *Canada Malting*. This was a hearing and review of a decision of The Toronto Stock Exchange in which that exchange permitted Canada Malting to make a private placement of shares to its two largest shareholders - The Molson Companies Ltd. and John Labatt Limited - without requiring the approval of the company's disinterested shareholders. As in the case before us, the shares had already been issued by the time of the hearing and review. Two members of the panel upheld The Toronto Stock Exchange's decision. The third panel member, Vice-Chair Salter, dissented and determined that Canada Malting should have been required to obtain shareholder approval before issuing the shares. In the concluding paragraph of his reasons, Vice-Chair Salter described the orders he would have had had the Commission make:

> Labatts (through its wholly-owned subsidiary Ogilvie Mills Ltd.) and Molsons were parties to the hearing and review conducted by the Commission and so we may properly make an order that affects them as well as Canada Malting. Our order should reverse the decision of the Filing Committee and require that the private placement be put before the disinterested shareholders of Canada Malting for their approval. The question for that meeting of shareholders, to be determined by a simple majority of the votes of disinterested shareholders present in person or represented by proxy at the meeting, will be whether to ratify the October, 1985 issue of shares to Labatts and Molsons, or to instruct the board of directors of Canada Malting to take all necessary steps to reverse that issue of shares. Our order should direct the board, Labatts and Molsons forthwith to implement any such instructions. If any dispute should arise among Canada Malting, Labatts and Molsons as to compliance with our order, the Commission might on further application instruct its staff to apply to the Court under section 122 of the Act for such further order as the Court may consider appropriate.

[para 98]
We are of the view that orders similar to those described by Vice-Chair Salter would be appropriate in the circumstances before us. Both VisuaLABS and Quest are parties to this hearing and review. Therefore, under sections 28 and 165(4) of the Act, we consider it proper to reverse the decision of the Exchange and order that:

1. on or before May 30, 2002, VisuaLABS hold a meeting of its shareholders (the "meeting") at which the shareholders will vote whether to

   (a) ratify VisuaLABS' issuance of 4,000,000 shares to Quest on November 28, 2001, or direct the board of VisuaLABS to take all necessary steps to reverse the issuance of shares to Quest,
   (b) ratify the appointments of McGowan, Sinclair, Bayley, Fleming, Clark and Lundin to the board of VisuaLABS, and
   (c) approve a change in VisuaLABS' business to that of an investment company;

2. each ratification or approval must be by way of resolution passed by a majority of the votes cast at the meeting, other than votes attaching to shares

   (a) owned, directly or indirectly, by Quest, the officers or directors of Quest, the officers or directors of VisuaLABS, or the associates of any of them, or
   (b) owned, directly or indirectly, by Sheldon Zelitt, Joy Zelitt or Downsview;

3. the information circular provided to the shareholders in connection with the meeting disclose all material facts relating to each of the three matters to be ratified or approved;

4. if the shareholders do not ratify the issuance of shares to Quest, the boards of VisuaLABS and Quest take all necessary steps to reverse the issuance of shares to Quest; and

5. if any issues arise in connection with our order, any of the parties may apply to the Commission for further direction.

[para 99]
VisuaLABS may put other matters before the shareholders at the meeting or hold the meeting at the same time as its Annual General Meeting.

[para 100]
During the hearing and review, Mercury raised concerns about the price at which VisuaLABS had issued the shares to Quest. This matter is more appropriately dealt with by VisuaLABS' shareholders at the meeting, where they will decide whether to ratify the share issuance to Quest. Therefore, we have not addressed the concerns raised by Mercury in our decision.

[para 101]
At the conclusion of the hearing and review, Mercury also sought orders under sections 27 and 161 of the Act.

[para 102]
Section 27 of the Act authorizes the Commission to make any decision respecting a decision made under a policy of the Exchange, if the Commission considers it to be in the public to do so. As we have already made our decision under section 28 of the Act, we do not need to consider Mercury's application under section 27.

[para 103]
Section 161 of the Act authorizes the Commission to make orders after a hearing, if the Commission considers it to be in the public interest to do so. It is in the Commission's sole discretion to hold a hearing and to make one of the orders described in section 161. In exercising this discretion, the Commission may permit a person to apply for an order under section 161, as Mercury has done in this case.

[para 104]
We have concluded that the Exchange should have required VisuaLABS to obtain shareholder approval of the private placement to Quest, the changes in VisuaLABS' board and the proposed change in VisuaLABS' business. Consequently, we have ordered VisuaLABS to put these matters before its shareholders at the meeting. In our view, it is imperative that the status quo be maintained to the greatest extent possible until the meeting is held. For example, we expect that, until the meeting, VisuaLABS will carry out only those activities and incur only those expenses that arise in the ordinary course of business. Further, we consider it to be in the public interest to order:

1. under section 161(1)(c) of the Act that the exemptions described in sections 44 to 47, 74, 75, 98 or 99 do not apply to VisuaLABS until the meeting has been held; and

2. under section 161(1)(c) of the Act that the exemptions described in sections 44 to 47, 74, 75, 98 or 99 do not apply to Quest in respect of the 4,000,000 VisuaLABS shares issued to Quest on November 28, 2001, until the meeting has been held.

February 27, 2002

[para 105]
For the Commission

Adrienne Salvail-Lopez
Commissioner

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Joan L. Brockman
Commissioner

Roy Wares
Commissioner