CANADA BUSINESS CORPORATIONS ACT

DISCUSSION PAPER

INSIDER TRADING

RELEASED: FEBRUARY 1996

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EXECUTIVE SUMMARY

INSIDER TRADING

The objective of this paper is to generate discussion regarding proposals to amend the insider trading provisions of the Canada Business Corporations Act (CBCA), including the option to repeal some or all of these provisions. Generally, "insiders" are those people who have access to confidential information of a corporation. Without regulation of improper insider trading (trading while in possession of material confidential information), insiders could take advantage of outside investors.

The paper analyzes whether the CBCA's insider trading provisions are still needed and, if they are still needed, what changes should be made to modernize them. This is done by first examining if it would be better to eliminate all the CBCA's insider trading provisions or keep and update them. The paper then examines individually the three main aspects of the current CBCA insider trading provisions to determine if these elements, on their own, should be repealed or updated. These three main aspects of the current CBCA insider trading provisions are:

A) Insider Reporting: insiders are required to file insider reports disclosing their trading in the securities of "their" corporations;

B) Speculative Trading Prohibitions: insiders are prohibited from selling shares which they do not own or have a right to own (short selling) and from buying or selling a call option or put option in respect of a share of a distributing corporation of which he or she is an insider;

C) Civil Liability: insiders can be held liable if they make use of specific confidential information for their own benefit or advantage in connection with a transaction in shares of a corporation.

Finally, the paper considers whether an insider trading penal liability provision should be added to the CBCA.

The recommendations contained in this paper are not in any sense the final word on changes to the CBCA's insider trading provisions. They represent current thinking but are not government or even departmental policy. This paper, and the consultations that will follow, are intended to solicit from the public their views on insider trading regulation under the CBCA.

Repeal all CBCA insider trading provisions

Provincial securities laws cover reporting of insider trades and civil and penal liability for improper insider trading/tipping. As a result, some argue that the CBCA's insider trading provisions which largely address the same issues are duplicative, may create an unnecessary regulatory burden and have a negative impact on the competitiveness of CBCA corporations.

Proponents of maintaining the CBCA's provisions argue that the CBCA helps to ensure that there is at least some minimum level of regulation/enforcement for CBCA corporations across the country. For investors in CBCA corporations, the legislation provides a single regime on which they can rely for protection. Further, it can be argued that eliminating all of the CBCA's insider trading provisions would result in a rather limited reduction in duplication while limiting the enforcement options available to address improper insider trading.

The paper recommends that the CBCA continue to regulate insider trading and then goes on to examine individually the three main aspects of the current CBCA insider trading provisions to determine if these elements, on their own, should be repealed or updated.

Reporting requirements

Currently, almost all insiders who report under the CBCA must also file a report with each applicable provincial and international jurisdiction that regulates securities. As a result, the savings from repealing the CBCA's insider reporting provisions would likely be minimal. However, given that most insiders are captured by provincial legislation, the benefits of maintaining the CBCA insider reporting regime may also be minimal.

No recommendation is made concerning whether to maintain or repeal the CBCA's insider reporting provisions. Instead, the paper sets out two alternative options: (1) eliminate the CBCA insider reporting provisions; or (2) maintain the provisions. Under the latter option, the paper suggests that the issue of duplicative filings could be dealt with through blanket exemption orders issued, where appropriate, by the CBCA Director.

The paper also reviews several ways in which the reporting requirements, if retained, could be updated:

- The time given for insiders to report trades, or declare that they have become insiders, be decreased to within 10 days of becoming an insider or making a trade.
- The CBCA adopt changes, similar to those recently proposed by the Ontario Securities Commission with respect to "early warning" reporting (modified as appropriate) that recognize the difficulties institutional investors have complying with insider reporting rules.

- The penalties be increased to a maximum fine of $1,000,000 and/or a period of up to two years in jail.

Speculative trading prohibitions

The speculative trading provisions prohibit insiders from short selling and from buying or selling certain call or put options. The primary concern addressed by these provisions appears to be that insiders should not be allowed to place their personal interest before the interests of the corporation in the discharge of their duties (conflict of interest). Arguments have been presented illustrating some legitimate business reasons why trading in these instruments should be allowed. However, difficulties in proving improper insider trading with confidential information and the conflict of interest and corporate governance concerns make an absolute prohibition of certain high conflict speculative trades attractive from a policy perspective.

The paper recommends that the speculative trading prohibitions be maintained and amended. The paper further discusses several ways in which the provisions, if they are maintained in the CBCA, could be updated, including:

- The speculative trading provisions be amended so as to prohibit only the purchase of put options and the sale of call options.
- The prohibitions be broadened to apply to short sells and certain options in respect of any securities (the current prohibitions are restricted to share transactions).
- The CBCA adopt, for the speculative trading provisions, a new definition of "insider" that only covers those persons in such a close relationship with the corporation that they have the potential for a conflict of interest in their dealings with and on behalf of the corporation.

Civil liability

Currently, both the provincial securities acts and the CBCA have insider trading liability provisions, thus creating duplication. However, the CBCA cause of action can be relied on by investors across Canada to challenge the activities of insiders of any CBCA corporation in any court in Canada (assuming the court has jurisdiction over the particular defendant). Also, arguably, the CBCA's civil liability provision is drafted more broadly than its provincial counterparts and may allow plaintiffs to bring an action even where they did not enter into a transaction with the insider. The paper recommends that the insider trading civil liability provisions of the CBCA be maintained and amended.

The paper then considers a large number of ways in which the civil liability provisions, if maintained, could be updated, including:

! Insiders who wrongfully communicate material confidential information (tipping) be specifically subjected to civil liability.
! Subsection 131(4) of the CBCA be amended so as to delete the "makes use of" requirement. Instead, the CBCA would provide a strict prohibition on trading (and tipping if it is adopted) while the insider has knowledge of material confidential information.
! Defences to the liability provisions be added to the CBCA or the regulations to counterbalance the elimination of the "makes use of" requirement.
! The limitation period be extended from two to three years after the discovery of the facts that gave rise to the cause of action but any action must be commenced within six years from the date of the transaction or wrongful communication.
! The word "direct" be removed from subsection 131(4) of the CBCA to help clarify that relief is available to persons who suffered a loss "as a result of the transaction," whether or not they actually traded with the insider.
! Adopt a simplified set of class proceedings rules (perhaps to be developed through the regulations).

<u>Addition of penal liability provision</u>

The CBCA does not currently provide for penal liability for improper insider trading. This omission makes the CBCA insider trading provisions more difficult to enforce and limits the CBCA Director's participation in the enforcement of international securities matters. However, the benefits of adding a penal liability provision must be considered in light of resource constraints. Since there are insider trading penal liability provisions in provincial securities laws, some may be of the opinion that it is inappropriate for the CBCA to add a penal liability provision for insider trading.

The paper recommends that a penal liability provision prohibiting improper insider trading and wrongful communication of material confidential information be added to the CBCA. This recommendation is conditional on evidence of support for this amendment. If penal liability provisions are added to the CBCA, the paper makes a number of recommendations, including:

! The CBCA apply the penal liability provision only in relation to the securities of distributing corporations.
! A transaction not be required for a tipper or tippee to be found guilty.

CANADA BUSINESS CORPORATIONS ACT

INSIDER TRADING

1. INTRODUCTION

[1] The objective of this paper is to generate discussion regarding proposals to amend the insider trading provisions of the Canada Business Corporations Act[1] (CBCA), including the option to repeal some or all of these provisions.

[2] The paper begins by providing background information on the CBCA's insider trading provisions, places them within the Canadian insider trading regulatory environment, and examines past efforts that have been made to update the provisions. The paper then analyzes whether the CBCA's insider trading provisions are still needed and, if they are still needed, what changes should be made to modernize them. This is done by first examining if it would be better to eliminate all the CBCA's insider trading provisions or keep and update them. The paper then examines individually the three main aspects of the current CBCA insider trading provisions to determine if these elements, on their own, should be repealed or updated. These three main aspects of the current CBCA insider trading provisions are:

A) Insider Reporting: insiders are required to file insider reports disclosing their trading in the securities of "their" companies;[2]

B) Speculative Trading Prohibitions: insiders are prohibited from selling shares which they do not own or have a right to own (short selling)[3] and from buying or selling a call option[4]

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[1] R.S.C. 1985, c. C-44, as amended. The insider trading provisions are found in Part XI, sections 126-131.

[2] The theory being that if the public is aware of the insider's trading, the insider will be less likely to engage in improper trading (higher risk of detection). It should also be noted that this provision does not prohibit insiders from trading in the securities of their company.

[3] This prohibition does not apply if the insider owns shares convertible into shares sold short, or options/rights to buy shares sold short.

[4] A Call is an option that allows the call owner to buy a certain number of shares (or other securities, commodities, etc.) at a pre-determined price by a certain date. The purchaser of a call is expecting that the stock's price will rise above a certain level. If the price does not surpass this point, the purchaser will not exercise his/her right to purchase the stock and he/she will lose the purchase price of the call option.

or put option[5] in respect of a share of a distributing corporation of which he or she is an insider;

C) Civil Liability: insiders can be held liable if they make use of specific confidential information for their own benefit or advantage in connection with a transaction in shares of a corporation, where such information, if generally known, might reasonably be expected to affect materially the value the corporation's securities.[6]

Finally, the paper considers whether an insider trading penal liability provision should be added to the CBCA.

[3] The ultimate goal of the paper is to examine ways to improve the regulation of insider trading in Canada and consider the appropriate contribution that the CBCA can make to that regulation. One consideration is the benefit of CBCA regulation in relation to the regulatory burden it places on CBCA corporations and their insiders. Another consideration, also with a view to reducing unnecessary regulation, is further harmonization of CBCA rules with those imposed by provincial securities laws. However, some recommendations in the paper do deviate from the existing provisions found in provincial securities and corporations statutes in some areas. This has been done where it is believed that the CBCA's insider trading provisions could, if maintained, add value over and above these laws.

[4] The recommendations contained in this paper are not in any sense the final word on changes to the CBCA's insider trading provisions. They represent current thinking but are not government or even departmental policy. There may be strong objections to the recommendations contained in this discussion paper. There may be alternatives that we have not yet been made aware of. There may even be entirely different ways of looking at the issue of insider trading. This paper, and the consultations that will follow, are intended to solicit from the public their views on insider trading regulation under the CBCA.

2. BACKGROUND

[5] A Put is an option that allows the put owner to sell a certain number of the shares at a pre-determined price by a certain date. The person who buys a put option expects the stock or commodity's price to fall below a certain level. If the price does not fall below that level, the purchaser will not exercise his or her right to sell the shares or commodity and he/she will lose the purchase price of the put option.

[6] There are two categories of persons who can assert a civil liability claim: 1) any person may claim for any direct loss suffered; 2) the corporation itself may claim any direct benefit or advantage received or receivable by the insider as a result of an improper transaction.

A. WHO ARE "INSIDERS" AND WHY ARE THEIR ACTIVITIES REGULATED?

[5] Generally, "insiders" are those people who have access to confidential information of a corporation where it can reasonably be expected that public disclosure of this information will affect materially the value of the corporation's securities. However, the definition of those who constitute "insiders" can differ among and within statutes.

[6] Most regulation of insider trading allows insiders to trade in the securities of the corporation to which they are insiders, as long as they are not in possession of material confidential information concerning the corporation. Insider trading is only prohibited when insiders possess material non-public confidential information (under provincial securities acts) or when insiders use such information for their benefit or advantage while trading in the corporation's securities (under the CBCA).

[7] Insider trading per se is not objectionable. Trades by insiders, that are not based on material, non-public information (proper insider trading), increase market efficiency because the very occurrence of these trades provides information to the market. As well, proper insider trading is a means of building the loyalty of officers, other employees and directors by increasing their involvement in a firm's affairs. The expanded participation of employees and the opportunity for greater rewards encourages productivity and innovation. Finally, proper insider trading increases the number of knowledgeable participants in the stock market, enhancing the ability of shares to settle at a value more representative of a corporation's true worth.

[8] However, without regulation of improper insider trading (trading while in possession of material confidential information), insiders could, because of the privileged access to confidential information associated with their positions, take advantage of outside investors. Consider the following hypothetical example. A director of company X is informed that, after many years of costly research, the company has discovered a cure for a major disease. The director, knowing that the markets will likely react positively to the information and raise the value of the corporation's securities, buys a large quantity of the company's stock from uninformed outside shareholders. These outside shareholders, as former owners of the company, have paid for the research and would likely not sell their shares if they were aware of the inside information. On the grounds of fairness, many see the use by insiders of material confidential information as unacceptable.

[9] In addition to the fairness argument, there is an economic rationale for insider trading regulation. Without insider trading regulation, outsiders would eventually come to expect insiders to take advantage of them in trading. This expectation would lessen confidence in the securities market and have two effects. First, it would reduce the number of people willing to enter into the market and thus decrease the equity funds available to firms. Second, those that do enter the market would expect higher returns because of the threat of being taken advantage of by an insider. Increased cost of capital would result and this would impair the competitiveness of

Canadian business. As a result, one of the principal aims of insider trading regulation should be to prevent improper insider trading and thereby protect the integrity of capital markets.[7]

B. DEVELOPMENT OF THE CBCA'S INSIDER TRADING PROVISIONS

[10] Constitutional jurisdiction to regulate insider trading exists at both the federal and provincial levels. The Supreme Court of Canada has held that the federal corporate law rules on insider trading are constitutionally valid, being an aspect of the federal power to create and regulate federal corporations and endow them with the powers to carry on their business effectively.[8] Because it deals with fundamental corporate relationships, namely those between the corporation, its shareholders, and its directors, officers and employees, insider trading regulation falls within this corporate law power. The provincial jurisdiction in respect of insider trading rules is based on the provincial authority to legislate on matters of property and civil rights.

[11] In 1965, the Kimber Report recommended a statutory regime to deal with insider trading.[9] This report did not recommend banning insiders from buying and selling their corporation's shares. What it did suggest was that insiders be forced to disclose this activity, and that they not engage in improper insider trading. The Kimber Report was the impetus for provincial regulation of insider trading in Ontario and in most other provincial jurisdictions.

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[7] The argument that insider trading is detrimental to the efficient operation of securities markets is not universally accepted. Perhaps the best known proponent of the opposite view, that insider trading is actually beneficial to the operation of securities markets, is Henry Manne, Insider Trading and the Stock Market (New York: Collier-Macmillan Ltd., 1966) and Insider Trading and the Law Professors (1970), 23 Vand. L. Rev. 547. However, conventional wisdom, which this paper agrees with, remains that improper insider trading is "unfair", harmful to the market, and that it should be regulated. For a recent discussion of arguments for and against insider trading regulation, see Johnson and Pazderka, It's No Gamble: The Economic and Social Benefits of Stock Markets (The Fraser Institute, 1995, p.128-131).

[8] Multiple Access v. McCutcheon (1982), 138 D.L.R. (3d) 1 (S.C.C.), per Dickson J. (as he then was) speaking for the majority of six judges. Dickson J. also suggested that the insider trading rules might be valid within a general scheme of securities legislation pursuant to the federal Parliament's power to make laws in relation to interprovincial and export trade and commerce (pages 10-11). Three judges dissented on the grounds that the insider trading provisions of the federal legislation were unconstitutional. In the view of these three judges, the insider trading provision were not an aspect of company law, but were a matter of property and civil rights and therefore beyond the federal power.

[9] J.R. Kimber, Chairman, The Report of the Attorney General's Committee on Securities Legislation in Ontario, Ontario Queen's Printer, Toronto, 1965 (the Kimber Report).

[12] The federal Parliament also adopted the Kimber Report's recommendations when, in 1970, it introduced insider trading provisions in the Canada Corporations Act[10] (CCA). In 1975, the CCA was superseded, with respect to business corporations, by the CBCA. The CBCA contained essentially the same insider trading provisions as the earlier Act. The insider trading provisions of the CBCA have remained almost completely unchanged since 1970.[11]

[13] Currently, both the provincial and federal levels of government have statutory provisions governing insider trading. Federally, insider trading in relation to CBCA corporations is regulated by the CBCA, while insiders of these corporations are also usually subject to regulation under provincial securities laws.[12] This has led many of those subject to the CBCA's insider trading provisions to complain of over-regulation and unnecessary duplication.

C. EFFORTS TO REFORM CBCA INSIDER TRADING PROVISIONS

[14] Efforts have been made to reform the insider trading provisions of the CBCA. A 1991 discussion paper entitled "Insider Trading and the Canada Business Corporations Act" was published by the then department of Consumer and Corporate Affairs (henceforth referred to as the 1991 paper). This paper contained 19 proposals to amend the insider trading part of the CBCA (Part XI). The proposals were aimed, to a large extent, at harmonizing the CBCA with provincial securities legislation. The drafters of the 1991 paper did not consider the possibility of repealing the CBCA's insider trading provisions.

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[10] R.S.C. 1970, c. C-32

It should be noted that the CCA's insider trading provisions were, in a large part, reproduced from provisions found in the Ontario Securities Act of the time which came into force in 1967. The Ontario Act was followed shortly thereafter by similar securities acts in the western provinces: British Columbia (1967), Saskatchewan (1967), Alberta (1970), and Manitoba (1970).

[11] There were two exceptions. In 1978 the addition of a regulation making power concerning exemptions from filing insider reports and some wording clarification were made. In 1994 some clarifications were made with respect to the french wording of the insider trading provisions.

[12] Alberta (ASA), R.S.A. 1981, c. S-6.1;
British Columbia (BCSA), S.B.C. 1985, c. 83;
Manitoba (MSA), R.S.M. 1988, c. S50;
Newfoundland (NSA), R.S.N. 1990, c. S-13;
Nova Scotia (NSSA), R.S.N.S. 1989, c. 418;
Ontario (OSA), R.S.O. 1990, s. S-5
Quebec (QSA), R.S.Q. c. V-1.1; and
Saskatchewan (SSA), S.S. 1988, c. S-42.2.

Some provincial corporations statutes also regulate insider trading of privately-held corporations incorporated thereunder.

[15] In 1994, Bill C-12, An Act to Amend The Canada Business Corporations Act,[13] was given Royal Assent. While this Act did not directly modify the insider trading part,[14] it did indirectly affect it. Once proclaimed into force, new s. 258.2 added by Bill C-12 will give the CBCA Director the power to issue blanket reporting exemptions, provided documents containing similar information are required to be filed by other federal or provincial legislation. Since the provincial securities acts do require the reporting of insider trading, this power could significantly reduce the number of insider reports filed under the CBCA.

[16] The current insider trading environment is significantly different from that which existed at the time the CCA and CBCA provisions were introduced. For instance, there is now a greater variety of investment instruments available to insiders. In addition, the type and number of advisors who have access to insider information of a corporation are greater, and the volume/complexity of transactions is far higher than when the CBCA was introduced.

[17] While the CBCA provisions have remained essentially unchanged throughout the years, provincial regulation of insider trading has undergone constant review and significant change. Not only have the provinces revised their legislation on several occasions, but there have been changes introduced through regulations, policy statements, blanket rulings and orders. As a result, the CBCA's insider trading provisions have not kept up with developments and, if retained, must be modernized.

[18] Comments and issues contained in this paper are the result of the 1991 discussion paper, consultations held in 1994 across Canada, and research performed in this area by consultants,[15] various stakeholders and Industry Canada.

3. CONSULTATIONS

[19] Comments received on the 1991 paper, and persons consulted in 1994, indicated that there were three major directions which the amendments could take:

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[13] S.C. 1994, c. 21.

[14] Other than making certain clarifications with respect to the French wording of the insider trading provisions.

[15] The firm of Stikeman, Elliott, Barristers and Solicitors was retained to examine the CBCA's insider trading provisions. The paper, prepared by William J. Braithwaite with the assistance of Margaret Grottenthaler and Brian M. Pukier, is entitled "Evaluation Report on the Insider Trading Provisions of the Canada Business Corporations Act", and was completed in March 1995.

1. eliminate all the CBCA's insider trading provisions (insider reporting, speculative trading prohibitions, and civil liability provisions), and leave regulation of insider trading to provincial securities statutes;

2. eliminate only the insider reporting provisions of the CBCA and leave the collection of this information to the provincial securities statutes; or

3. keep all the CBCA's insider trading provisions but harmonize them with the various provincial legislation and improve them relative to provincial legislation where possible. If harmonization is pursued, the consultation participants suggested that the amendments:

   - clarify and update the definition of insider trading in the CBCA;

   - exclude from the definition of "insider" managers for institutional investors whose aggregate holding exceeds the 10 percent threshold;

   - introduce a class action remedy for damages caused by insider trading as a better way to compensate victims of insider trading;

   - eliminate the restriction on insiders from trading on the derivatives market; and

   - increase the penalties in the insider trading part of the CBCA.

4. REPEAL ALL CBCA INSIDER TRADING PROVISIONS

[20] As many of those who participated in the earlier consultations suggested all the CBCA insider trading provisions be repealed (insider reporting, the speculative trading prohibition, and civil liability), this section of the paper presents a general analysis of the appropriateness of repealing all of these provisions. In later sections of the paper, a specific analysis of the appropriateness of repealing each main element of the insider trading provisions is performed. For example, in the section of the paper discussing the CBCA's insider reporting requirements, there is a specific examination of repealing the CBCA's insider trading reporting requirements.[16] Other sections of the paper,[17] which examine the speculative trading prohibition and the insider trading civil liability provisions of the CBCA, contain examinations of repealing these elements on their own.

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[16] See section 5(A) of this paper entitled, "Repeal of Insider Reporting Provisions".

[17] See sections 6(A) entitled, "Repeal Speculative Trading Prohibitions: Short Sales and Trading in Puts and Calls", and 7(A) entitled, "Repeal Civil Liability".

A. ARGUMENTS FOR REPEALING ALL CBCA INSIDER TRADING PROVISIONS

[21] The main arguments for repealing all the CBCA's insider trading provisions are that the provisions are largely duplicative, may create an unnecessary regulatory burden, and as having a negative impact on the competitiveness of CBCA corporations. In essence, because the provincial securities acts also regulate this activity, the CBCA's provisions may add very little extra value.

[22] The regulation of insider trading with respect to public companies has traditionally been seen as principally a matter of securities law. This view is based on the belief that the primary policy rationale for insider trading regulation is to protect the integrity of capital markets.

[23] Another argument for repealing the CBCA insider trading provisions is that duplicative regulation of the same subject matter, with comparable policy objectives, is inefficient and may also impose extra and unnecessary costs upon businesses and investors. It can be argued that such duplicative regimes constitute an unnecessary regulatory burden requiring Canadian corporations to spend time and incur costs reviewing the statute, regulations or policy statements in order to ensure that such corporations either comply with or obtain exemptions with respect to provisions which may be either duplicative or, in certain respects, different. These extra costs may be impeding the competitiveness of CBCA firms. Unless it can be demonstrated that there is a significant benefit from federal regulation, avoiding duplicative regulation is a factor in favour of deleting the federal provisions.

[24] Proponents of the repeal option have also argued that the duplication is especially unnecessary because the provincial securities laws in Canada, with respect to public companies, contain comprehensive insider trading regulations. These laws cover reporting of insider trades, prohibitions against improper insider trading/tipping and civil liability for improper insider trading/tipping.[18]

B. ARGUMENTS AGAINST REPEALING ALL CBCA INSIDER TRADING PROVISIONS

[25] While one of the main reasons for insider trading regulation is to protect the integrity of capital markets, there may be other important corporate law reasons for regulating insider trading. For instance, insider trading rules are also intended to promote good relations between management and shareholders. As well, use of the corporation's confidential information to

[18] In addition, the provincial securities acts also have prospectus filings, material changes reports and continuous disclosure. These information disclosure rules are relevant because improper insider trading is all about trading with information that has not been publicly disclosed.

secure a profit may constitute a breach of the fiduciary duty some insiders may owe to the corporation.

[26] It can also be argued that the CBCA's insider trading provisions form one aspect of the overall rules in federal corporate law dealing with conflict of interest. Other provisions in the CBCA dealing with conflict of interest include s. 44 (financial assistance provisions), s. 120 (officers and directors disclosure of material interest), s. 122 (fiduciary and care duties of directors and officers), and s. 241 (oppression remedy). Moreover, insider trading civil liability provisions are applicable to both publicly traded and privately held corporations. These policy reasons explain why most corporate laws in Canada include insider trading civil liability provisions for non-distributing corporations.[19]

[27] With respect to the cost savings for CBCA corporations from eliminating the CBCA's insider trading provisions, repealing these provisions would likely result in a rather limited reduction in duplication while limiting the enforcement options available to address a contravention of insider provisions. Deleting the CBCA's provisions would only eliminate one of the many insider trading regimes in Canada. Rarely would insiders of public companies not be required to comply with at least one province's insider trading provisions.

[28] In addition, while the provincial securities laws in Canada have worked at harmonizing their securities acts, there are still significant differences. There remains inconsistency between the provincial acts in terms of the penalty for a breach of the insider trading provisions. This means that penalties could vary for insider contraventions depending on the provincial statute under which a prosecution is pursued.[20] In contrast, proponents of maintaining the CBCA insider trading rules argue that the CBCA helps to ensure that there is at least some minimum level of regulation/enforcement for CBCA corporations across the country. For investors in CBCA corporations the legislation provides a single regime on which they can rely for protection. The CBCA and the Director may be the only effective recourse for investors in smaller markets or where there are constraints on the jurisdictional reach of the provincial legislation or regulators.[21]

[29] The CBCA's insider trading provisions allow the federal government to aid in regulating insider trading in Canada. For instance, there have been cases with respect to both improper insider trading and insider reporting where the Director appointed under the CBCA has identified possible wrongdoing and either actively participated in the review of the issue, on its own or in

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[19] For public corporations, insider trading is dealt with by the provincial securities acts and not by provincial corporate laws.

[20] For instance, in Ontario a person who contravenes any part of the OSA is guilty of an offence and is liable to a fine of up to $1 million and/or imprisonment of up to two years. On the other hand, in Manitoba a person who contravenes the insider trading reporting requirements is liable to a maximum fine of only $1,000.

[21] For a detailed discussion of these issues, see section 7(A) of this paper.

cooperation with the securities commissions, or referred the issue to the securities regulators. With the option raised in this paper to introduce a penal provision,[22] the Director appointed under the CBCA could have a more active enforcement role in regulating insider trading in Canada, which could be complementary to the provincial regimes.

[30] As the 1991 paper noted, there is increasing automation of trading in securities, resulting in more trading across provincial and national boundaries. These increasing links between the Canadian and foreign economies support the need for a comprehensive regulatory framework to address insider trading abuses that cross provincial or national borders. Because the CBCA provisions cover all CBCA corporations, no matter in which jurisdiction they conduct business or issue securities, the provisions provide uniform legislation and protections for both domestic and foreign investors.

[31] Finally, by maintaining jurisdiction over insider trading with respect to CBCA corporations, the federal government can ensure that its present and future policy objectives, which may not be identical to those of the provincial governments, can be achieved.[23]

C. RECOMMENDATION

[32] There are strong policy reasons for deterring trading by insiders on the basis of non-public confidential information. It is, therefore, proposed that the CBCA continue to regulate insider trading and not repeal <u>all</u> the CBCA's insider trading provisions. However, each key element of the CBCA's insider trading provisions (insider reporting, the trading prohibition, and civil liability) is examined in order to determine if any of these elements, on their own, should be repealed.

5. REPORTING REQUIREMENTS

A. REPEAL OF INSIDER REPORTING PROVISIONS

<u>Issue:</u>

[33] Whether to repeal the insider trading reporting requirements of the CBCA.

<u>Background:</u>

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[22] See section 8 of this paper.

[23] For example, this paper recommends maintaining the CBCA prohibition on speculative trading (section 6).

[34] The insider reporting requirements of the CBCA and provincial securities legislation serve to deter improper insider trading in the following two ways:

! improprieties are less likely to occur if there is greater likelihood insiders will be discovered and publicly exposed; and

! if trades are reported, then investors and regulators have a source of information which they can use to police whether improper insider trading is taking place.

[35] Currently, almost all insiders who report under the CBCA must also file a report with each applicable provincial and international jurisdiction. One could argue that this duplicative filing increases the likelihood of detecting wrongdoing by insiders. In this way the CBCA reporting requirements could add value if they increase the probability of detecting improprieties. However, the increase in detection, and therefore deterrence, as a result of CBCA insider reporting may be marginal since insiders must already comply with the reporting requirements of numerous jurisdictions.

[36] Some have also argued that because investors under the current system only need to look at one source for insider trading information with respect to CBCA corporations, it facilitates inquiries by investors and thus increases the likelihood of detection. This argument loses some of its weight if one accepts that investors in publicly traded corporations know that the information is also available from the provincial securities regulators in any of the provinces where the corporation's securities have been publicly traded. If this is the case, then investors can just as easily consult these sources as the federal Corporations Directorate.

[37] The form used to file insider reports under the CBCA is identical to that filed under the securities laws of Ontario, Alberta, Manitoba, British Columbia, Saskatchewan and federal financial institutions statutes. Since each jurisdiction has an obligation to publish a report containing the information on this form, investors in distributing corporations have access to the information from many sources. Although this common form (harmonization) creates administrative efficiencies for insiders in terms of filings and is not overly costly for the federal government to operate, it re-enforces the perception that the CBCA's insider reporting provisions add very little extra value for investors.

[38] There is considerable overlap in the provincial concept of "reporting issuer" and the CBCA term "distributing corporation." Corporations that are covered by one term are almost invariably covered by the other. This means that, to a large extent, the corporations whose insiders are covered by both the provincial and CBCA insider reporting provisions are the same corporations. Only in the following circumstances would a CBCA "distributing corporation" not be a "reporting issuer" for the purposes of insider reporting:

! if a CBCA corporation distributes securities in a foreign country but not domestically;

- if the CBCA corporation distributes securities only in P.E.I., New Brunswick, the N.W.T. or the Yukon;

- if the provincial securities regulator exempts a reporting issuer from filing insider reports and a similar exemption is not granted under the CBCA.

[39] CBCA corporations that only issue securities abroad and not domestically are not the norm but there is evidence that at least some CBCA corporations fall into this category.[24] However, these corporations are likely covered by insider trading legislation in the foreign jurisdiction, which is more likely to be relied upon by investors in these corporations in any event.

[40] The number of CBCA corporations that issue securities publicly in only P.E.I., N.B., the N.W.T. and the Yukon is likely extremely small. As a result, almost all Canadian publicly-traded corporations are subject to provincial insider trading reporting requirements unless they have received an exemption from the provincial securities regulators. It would be very rare for an exemption to be granted under provincial legislation and not also under the CBCA.

[41] There is considerable overlap in the concept of "insider" for reporting purposes under the CBCA and provincial securities legislation. However, the CBCA does not just duplicate the provincial securities legislation's definition of "insider" and in some ways it is broader. The following are defined as "insiders" by the CBCA but not by the provincial securities acts:

- distributing corporations that purchase securities of their affiliates;

- 10 percent shareholders of companies that become insiders of the distributing corporation or of which the distributing corporation becomes an insider and the directors and officers of the 10 percent shareholders;

- a director, officer or 10 percent shareholder of a distributing corporation who enters into a business combination with a body corporate.[25]

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[24] There is evidence that some CBCA corporations, particularly those in the high technology sector, have issued securities only in the United States. If the CBCA's insider reporting requirements were eliminated, these corporations would only report trades by insiders to the United States Securities and Exchange Commission (SEC) and not to Canadian regulators. On the other hand, if the CBCA's insider reporting provisions were kept, then the insider reports filed by insiders of CBCA corporations, would be the only insider reports with respect to these trades available in Canada. While the practice of only issuing securities in the United States is somewhat rare at the moment, it may become more common in the future.

[25] CBCA, s. 126, definition of "insider" and "deemed insiders".

[42] While these are significant differences, some may question whether it is worthwhile having a reporting regime in the CBCA to catch these relatively small groups. The securities acts already require reporting by the vast majority of insiders who are required to report under the CBCA.

[43] In order to alleviate the high degree of duplication, the CBCA allows the Director appointed under the CBCA to exempt persons from the reporting requirements. Subsection 127(8) and new section 258.2, when it is proclaimed in force, permit the Director to grant exemptions.[26] More specifically, section 258.2 allows the Director to issue blanket exemption orders in cases where similar reports are required to be filed under other federal or provincial legislation. Such orders, if made with respect to insider reports, could significantly reduce the number of insiders who are required to file insider reports under the CBCA. Only those insiders not captured by provincial securities acts, but who do have to file under the CBCA, would submit an insider report to the Director under the CBCA. Reliance on this new exemption power in these circumstances could avoid duplication by requiring only those not subject to provincial regulation to report. In addition, reliance on the exemption power would maintain a federal presence in the enforcement of insider reporting violations, and may be an alternative to repealing the insider reporting provisions of the CBCA. However, questions may be raised as to whether it is worthwhile maintaining the CBCA's insider reporting requirements if the CBCA Director would exempt the vast majority of insiders and only require a few exceptions to file insider reports under the CBCA.

[44] Insiders of public companies would still have to file insider reports in various provincial, and perhaps international, jurisdictions. Therefore, the resulting savings from repealing the CBCA's insider reporting provisions would likely be minimal. However, given that most insiders are captured by provincial legislation, the benefits of maintaining the CBCA insider reporting regime may also be minimal.

Option 1:

[45] Repeal the CBCA insider reporting requirements. This entails deleting section 127 and amending section 129 to remove the reference to section 127.

Option 2:

[46] Maintain the CBCA insider reporting requirements. The issue of duplicative filings could be dealt with through blanket exemption orders issued, where appropriate, by the CBCA Director.

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[26] Subsection 127(8) allows the Director appointed under the CBCA to exempt any person, on a case by case basis, from the insider trading reporting requirements.

This would eliminate, to a significant degree, duplicative filing and still provide for reporting by insiders of CBCA companies who would not otherwise be required to file.

[47] If it is decided that the CBCA's insider trading provisions should be retained, modernization of these provisions needs to be considered. Some changes to the CBCA's insider reporting provisions, proposed during earlier consultations, are discussed below.

B. TIMING FOR INSIDER REPORTING

Issue:

[48] Whether to decrease the time period given for insiders to report trades or to report that they have become insiders.

Background:

[49] The CBCA reporting provisions require the filing of insider reports within 10 days of the end of the month in which either the person becomes an insider or makes a trade (Ontario, Manitoba, Nova Scotia, and Newfoundland give insiders the same time period). However, Alberta, British Columbia, Quebec, and Saskatchewan provide for a somewhat more timely disclosure in that the report must be filed within 10 days of becoming an insider or making a trade.

[50] With the time period allowed under the CBCA, an insider could transact on the first of May and it may not be reported until June 10. This information then has to be published in the Corporations Bulletin. As a result, it can take up to three months for a trade by an insider to become public. Some have suggested that this is too long a time period as interested parties would not receive the information in a timely enough manner.

[51] On the other hand, it can be argued that a change in reporting period will not materially improve deterrence. If the reporting period is shortened, and yet information is only published monthly, then there would still be a considerable delay before the information becomes public. Of course, trading reports are public information and can be obtained anytime from the CBCA Director, even before publication. However, investors could only speculate that a trade has been made by the insider and contact the CBCA Director on the chance that this is the case.

Recommendation:

[52] If the CBCA's insider reporting provisions are retained, it is recommended that the time given for insiders to report trades, or declare that they have become insiders, be decreased to within 10 days of becoming an insider or making a trade.[27] This would be concurrent with the requirements some provinces have adopted and that other provinces are likely to adopt.

C. EXEMPTION FROM INSIDER REPORTING FOR INSTITUTIONAL INVESTORS

Issue:

[53] Whether to provide certain exemptions from the insider reporting requirements for institutional investors and managers of institutional investors' funds.

Background:

[54] Over the past forty years, there has been a dramatic change in the way Canadians invest their savings. Canadians have reduced their emphasis on self-directed investment in securities markets and instead have entrusted their dollars to institutional investors who manage their investments for them. As a result, the size of equity holdings and aggregate market power of institutional investors has increased dramatically.

[55] During the preliminary consultations on the CBCA held in 1994, some suggested that managers for institutional investors whose aggregate holdings exceeds the 10 percent threshold, be exempted from the CBCA's insider reporting requirements. Those making this argument stated that institutional investors who surpass the 10 percent threshold are not "active" in the affairs of the corporation and should not be treated the same as other shareholders. The managers of these funds, in essence, do not occupy themselves with the day to day running of the corporation and are, therefore, not privy to inside information. In addition, it was argued that these managers

[27] It is recommended in the next section of this paper (section 5(C)) that passive investors have available an alternative monthly reporting requirement. Passive investors would therefore retain the 10 days after the end of the month reporting period and not have to report within 10 days after a trade. The CBCA currently does not have an early warning regime. The option of including one is explored in another Industry Canada discussion paper on take-over bids. The proposed OSC rule would exempt certain insiders (namely shareholding only insiders without inside information, board representation or legal control) from complying with the insider reporting regime if they file under the early warning system or the alternative monthly reporting regime (see rule 10.1 of OSC proposal). These latter systems are much less onerous with respect of the number of reports to be filed. Insider reports must be filed for all trades. Early warning disclosure reports must be filed only with 2 percent (or 5 percent) increases or decreases in ownership.

trade in securities as part of their job and that the insider reporting requirements just add unnecessary paper burden.

[56] However, there is evidence that the characterization of institutional investors as "passive" may no longer be accurate. For example, institutional investors are currently active in ensuring that good corporate governance practices are in place at firms in which they invest. Given the growing importance of institutional investors in today's markets, this more active role is generally seen as a positive development. The introduction of an exemption or reduced reporting requirement based on the idea that institutional investors are not active in corporations in which they hold shares, and thus not privy to inside information, could hamper this development and thus be undesirable.

[57] None of the provincial jurisdictions which regulate insider trading currently provide for an institutional investor exemption from the insider reporting provisions of their securities laws. However, the Ontario Securities Commission (OSC) has recently released a draft rule on "The Early Warning System and Related Take-over Bid, Insider Trading and Control Block Distribution Issues" which includes a proposal for "Aggregation Relief."[28] The proposal seeks "to recognize the increasing diversity and integration of the Canadian financial services industry."[29]

[58] The two most important changes suggested by the OSC proposal are: (1) alternative monthly reporting; and (2) aggregation relief. Alternative monthly reporting would allow a "passive investor" to file an early warning report within 10 days after the end of the month if the voting or equity securities owned or controlled by that person exceed 10 percent or more of the securities of a class.[30] Section 101 of the OSA currently requires that a press release be issued immediately after, and that an early-warning report be filed within 2 days of the person owning or controlling 10 percent or more of a class of shares. In general terms, alternative reporting would be available only to those persons who do <u>not</u> intend to:

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[28] The OSC's proposals were publicly released on October 20, 1995 in (1995) Vol. 18 OSCB 4887. The proposals are outlined in two documents which are entitled:

"Notice of a proposed rule under the <u>Securities Act</u> (Ontario): The Early Warning System and Related Take-over bid, Insider Trading and Control Block Distribution issues"; and

"Rule #! Under the <u>Securities Act</u> (Ontario): The Early Warning System and Related Take-over bid, Insider Trading and Control Block Distribution issues".

[29] Page 1 of the notice on the proposed rule.

[30] In addition, those to whom alternative reporting is available would only report within 10 days of the end of the month any increase or decrease of 5 percent or more of the outstanding securities of a class held by the person. This contrasts with a 2 percent increase or decrease of ownership, which is to be reported within 2 days of the change, that is required by the standard early-warning disclosure system as specified in section 101 of the OSA.

- make a formal bid for securities;
- propose a transaction that would be an exempt private agreement take-over bid, in reliance on clause 93(1)(c) of the OSA;[31] or
- propose a reorganization, amalgamation, merger, arrangement, or similar business combination with the reporting issuer.

In addition, alternative reporting would not be available if a joint actor[32] with that person or company has any of the above intentions or if the person possesses material information that has not been publicly disclosed. The proposed rule would also exempt certain insiders[33] from submitting insider trading reports if they have filed under the alternative monthly reporting system (or under the full early warning disclosure system).[34]

[59] The "aggregation relief" proposal is designed to provide "for exemptions from early warning reporting, insider reporting, take-over bid and control block distribution prospectus requirements to permit dis-aggregation of independently managed holdings of securities, including independently managed mutual funds." Under the proposal, a person or company that, either alone or in conjunction with its affiliates, carries on business or investment activity through two or more "business units",[35] is, with respect to those business units, exempt from aggregating these business units' holdings together for the purpose of early-warning disclosure, if:

- the decisions to acquire, dispose, hold, vote those securities are made separately; and

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[31] Paragraph 93(1)(c) of the OSA states that a take-over bid is exempt if "all of the following conditions apply,

i) purchases are made from not more than five persons or companies in the aggregate, including persons or companies outside of Ontario,
ii) the bid is not made generally to security holders of the class of securities that is the subject of the bid, and
iii) the value of the consideration paid for any of the securities, including brokerage fees or commissions, does not exceed 115 per cent of the market price of the securities of that class at the date of the bid determined in accordance with the regulations."

[32] A "joint actor" of or with a person or company means another person or company acting jointly or in concert with the first-mentioned person or company within the meaning of s. 91 of the OSA (the section defining acting jointly or in concert).

[33] Namely, shareholding insiders without inside information, board representation or legal control.

[34] OSC proposed rules on early warning disclosure: rule 10.1.

[35] "Business unit" is defined by the OSC on page 11 of the proposal as "a legal entity or part thereof, or a combination of legal entities or parts thereof, that engage in a separate and distinct business or investment activity, and may consist of one or more branches of a financial institution."

- no person or company from the other business unit also advises with respect to, or has influence over/knowledge of decisions to acquire, dispose, hold, or vote securities for, by, or on behalf of the applicable business unit other than people in senior management or individuals engaged solely in clerical or administrative duties who do not make decisions to acquire, dispose, etc. securities.

Recommendation:

[60] It is proposed that institutional investors not be exempted generally from the CBCA's insider trading reporting requirements. However, it is recommended that the CBCA adopt changes, similar to those recently proposed by the OSC with respect to "early warning" reporting (modified as appropriate), that recognize the difficulties institutional investors have complying with the "standard" insider reporting rules. This would provide institutional investors, and managers of their funds, with the possibility of using alternative monthly reporting[36] and/or aggregation relief. Any further changes to provincial securities rules, which may result from these efforts by the OSC, would have to be considered carefully.

D. INSIDER REPORTING FINES AND PENALTIES

Issue:

[61] Whether the fines for non-compliance with the CBCA's insider reporting provisions should be increased.[37]

Background:

[62] The CBCA provides for fines of up to $5,000 and/or imprisonment for a period of up to six months if a person does not comply with the insider reporting provisions or files a report that omits relevant or contains false information. These penalties have not been altered since the CBCA's enactment in 1975. There have been suggestions that the CBCA's penalties are inadequate and should be raised to the level in provincial securities laws or a level that reflects the effects of inflation.

[63] The provincial securities laws provide for much higher penalties. The general offence provision of the OSA provides for penalties of up $1,000,000 and/or imprisonment for a period of

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[36] See issue 5(B) above for a discussion of the timing of insider reporting.

[37] CBCA, subss. 127(9), 127(10) and s. 250.

up to two years.[38] Many other provinces have similar levels of penalties.[39] In Alberta, the maximum prison sentence is five years less a day.[40] In Quebec, failure to furnish an insider report is subject to a fine of between $1,000 and $20,000, in the case of a natural person, and between $1,000 and $50,000 in the case of a corporation.[41] The QSA also provides for fines of between $5,000 and $1,000,000 if the insider makes a misrepresentation on an insider report.[42] The Quebec Securities Commission can also order the corporation to cease the issuance of its securities for as long as the insider report is not filed.[43] No prison sentence is provided for. In Manitoba, the fine is much lower, with a maximum of only $1,000 when a person or corporation fails to file an insider report or files a report with false or misleading information.[44] There is no prison sentence.

Recommendation:

[64] That the penalties in subss. 127(9) and 127(10) of the CBCA be increased to a maximum fine of $1,000,000 and/or a period of up to two years in jail. This is considered a sufficient deterrent, and is in line with the penalties contained in some provincial securities statutes.

6. SPECULATIVE TRADING PROHIBITIONS

A. REPEAL SPECULATIVE TRADING PROHIBITIONS: SHORT SALES AND TRADING IN PUTS AND CALLS

Issue:

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38 OSA, s. 122.

39 ASA, s. 161; BCSA, s. 138; MSA, s. 111; NSA, par. 129(1)(c); SSA, subs. 131(3).

40 ASA, subpar. 161(2)(b)(ii).

41 QSA, subs. 195(3), s. 202.

42 QSA, subs. 197(4), s. 204.

43 QSA, s. 265.

44 MSA, subs. 111(1).

[65] Whether to repeal the CBCA prohibitions on insiders of a distributing corporation from selling shares which they do not own or have a right to own (short selling) and from buying or selling a call or put option in respect of shares.[45]

Background:

[66] Under the CBCA, certain insiders of a distributing corporation are prohibited from knowingly selling, directly or indirectly, a share of the distributing corporation or any of its affiliates unless:

- they own the share and have fully paid for it;
- they own another share convertible into the share sold;
- they own an option or right to acquire the share sold.[46]

[67] In addition, an insider is prohibited from buying or selling a call or put option in respect of a share of the corporation or any of its affiliates.[47] Contraventions of these prohibitions are subject to a summary conviction offence with a maximum fine of $5,000 and/or imprisonment for up to six months.[48]

[68] The speculative trading prohibitions (CBCA, s. 130) have been justified on a number of bases. When these prohibitions were adopted in 1970, they were justified in the materials prepared for Parliament explaining the policy rationale for the amendments (the 1970 briefing book) as follows:

> The first portion of this section has its source in section 16c of the U.S. Securities and Exchange Act of 1934. The prohibition against short sales is easily justified on the ground that such sales are nothing more than pure speculation by an insider on a decline in the prices of its own company's shares in the short run. It can safely be

[45] CBCA, subss. 130(1) and 130(3).

[46] The insider must within 10 days after the sale either:

a) exercise the conversion privilege, option or right and deliver the share so acquired to the purchaser; or
b) transfer the convertible share, option or right to the purchaser.

[47] CBCA, subs. 130(2).

[48] CBCA, subs. 130(4).

> presumed that in such a situation the insider is really trading on the basis of specific confidential information the release of which would produce a price drop. In a code of proper conduct for insiders there does not appear to be any justification to allow such insiders to get involved in short sales. The insider surely has no investment purposes in making such a transaction and the company is certainly not deriving any benefit therefrom.

As will be discussed later, it is important to note that section 16c of the U.S. Securities and Exchange Act (1934)[49] was the basis for some of the CBCA's speculative trading prohibitions. With respect to subs. 130(2), this provision was justified in the 1970 briefing book as follows:

> The provision would prohibit an insider from buying a call option or a put option in respect of the securities of his company. Such trading involves speculation, on the part of the insider, in the securities of his company and the insider should not be allowed to place his personal interest before the interests of his company, in the discharge of his duties as an insider.

The Dickerson report,[50] which recommended that the trading prohibitions be kept, stated that:

> There is nothing to be said in favour of allowing an insider to "sell short" the shares of a corporation in which he is an insider. The prohibition is enforced by a penalty provision because it is difficult, if not impossible, to create a practicable civil remedy.

Finally, the materials prepared for Parliament explaining the policy rationale for the CBCA provisions (the 1975 CBCA briefing book) argued that:

> These provisions, which are included in the U.S. federal law but which are not included in Ontario law, have been continued in order flatly to prohibit insiders from executing "leveraged" trades that could permit an insider to multiply many times over the profit he would make on an ordinary trade.

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[49] Securities Exchange Act (1934), Pub. L. No. 73-291, s. 16, 48 Stat. 881 [codified as amended at 15 U.S.A. s. 78p (1988)].

[50] Dickerson, Robert W.V., Proposals for a New Business Corporations Law for Canada, Volume I, Information Canada, Ottawa, 1971, p. 91 (the Dickerson Report).

This report was commissioned by the federal government and its recommendations formed the basis of the CBCA.

[69] In summation, there appears to have been two main justifications given for the speculative trading prohibitions. These are that:

1) one can assume speculative trades are made on the basis of confidential information; and

2) insiders should not be allowed to place their personal interest before the interests of the company in the discharge of their duties (conflict of interest).

[70] Another justification originally given for the speculative trading prohibition, namely that it is improper to allow insiders to make "leveraged" trades which can result in them making many times the profit of ordinary trades, seems to be less convincing.

[71] As alluded to in the second justification, the CBCA's speculative trading prohibitions can be seen as dealing more with corporate governance/corporate law concerns than with the protection of capital markets/securities law concerns. There is some evidence that when the U.S. introduced prohibitions on short selling in section 16c of the Securities and Exchange Act, the section upon which some of the CBCA's speculative trading prohibitions are based, the concern was with corporate governance matters.[51] The corporate governance concern with speculative trades can be understood by examining short sales. Short sellers sell securities which they do not own. In some cases, they may borrow securities to sell and later they purchase securities to repay the loan of the original securities. In essence, short sellers profit if the price of the securities declines between the time they sell the securities and when they have to purchase securities to cover the sale (or the loan, if they borrowed securities). The short seller is betting against the corporation, as he/she might be when selling a call or purchasing a put. As a result, short sales can place insiders in a conflict of interest situation.

[72] The corporate governance concern is that those insiders who have some influence over corporate decisions could use their power to make decisions that could potentially harm the value of the corporation's shares. Speculative trading prohibitions, such as those in the CBCA, may be important tools in aligning the interests of those who manage corporations with the interests of stockholders and the corporation itself. One United States legal commentator described this alignment of interests as follows:

> The key is that publicly held companies are managed by people who do not own them. The separation of management from ownership that defines publicly held companies has disturbing implications for the way they do business, calling into question the legitimacy of large-scale corporate enterprise. By moving the interest of those

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[51] See, for a full discussion of why s. 16 of the United States Securities and Exchange Act prohibits short selling by insiders, Steve Thel, "The Genius of Section 16: Regulating the Management of Publicly Held Companies", (1991) 42 Hastings L.J. 393.

> who control corporations into alignment with the interests of stockholders, section 16 addresses a distracting and destructive opportunity that the separation problem creates, and in so doing it encourages those in control to run publicly held companies in the public interest.[52]

Section 16 of the U.S. Securities and Exchange Act (1934) deals with speculative trading.[53] While there may be sound business reasons for such sales or purchases, such as risk management (hedging), the concerns expressed above that these trades are inherently more dangerous than other trades can be used to justify the CBCA's prohibition on insiders from short selling and trading in puts and calls.

[73] With respect to the provincial securities statutes, they do not have a specific prohibition against short selling or trading in puts and calls in respect of the corporation. However, the general prohibition found in most provincial securities laws against trading in the corporation's securities while in the possession of material confidential information, may apply to such transactions.[54] These provincial prohibitions usually apply to trading in puts, calls, and other securities whose price varies with that of the corporation's securities as well as trades in shares.[55]

[74] It has been asserted that maintaining the current CBCA prohibitions on trading in these instruments is contrary to the goal of harmonization and the policy rationale that prohibits trades <u>only</u> when the insider possesses confidential information. In addition, arguments have been presented illustrating some legitimate business reasons why trading in these instruments should be allowed.[56] However, even if there are valid business reasons for trading in these instruments, difficulties in proving improper insider trading with confidential information and the conflict of interest/corporate governance concerns expressed earlier, make an absolute prohibition on certain high conflict speculative trades attractive from a policy perspective.

<u>Recommendation:</u>

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[52] Ibid at p. 399.

[53] In addition, s. 16 deals with other conflict of interest situations, such as the short-swing rule (s. 16(b)).

[54] ASA, subs. 119(2); BCSA, subs. 68(1); MSA, subs. 112(1); NSA, subs. 77(1); NSSA, subs. 82(4); OSA, s. 76; QSA, ss. 187 and 189.1; SSA, subs. 85(3).

[55] See for example subsection 76(6) of the OSA.

[56] For example: A junior officer may wish to invest in the long-term performance of his/her employer company but does not yet have the funds to do so. He can lock-in his/her acquisition costs by purchasing a call option.

[75] Maintain but amend the prohibitions on short sales and trading in puts and calls. Even though these provisions are not in complete harmony with those of the provinces, they represent a valid policy choice by the federal government to prohibit activity which could place insiders in a conflict of interest situation. If the restriction is maintained, changes to these provisions should be considered in order to modernize them. Please see below for proposed changes to the speculative trading prohibition element of the CBCA.

B. AMEND SPECULATIVE TRADING PROHIBITIONS: HARM TO CORPORATION

Issue:

[76] Whether to restrict the speculative trading prohibitions to those circumstances where there is potential for the insider to harm the corporation.[57]

Background:

[77] As mentioned in the section of this paper on the repeal of the speculative trading prohibitions, short sales place those insiders with the power to influence corporate decisions in a possible conflict of interest situation. These insiders can profit from using their power in the corporation to have decisions made that would harm the value of the corporation's shares. A similar conflict exists for insiders who purchase put options or sell call options. However, insiders who sell a put option or purchase a call option will only profit from the options if the value of the corporation's stock increases. In these cases, the interests of the insider become aligned with the interests of the corporation and the (other) shareholders. A prohibition of these trades does not further the objective of eliminating potential conflicts and appears to be unnecessary. However, the insider could be subject, because of an expanded definition of securities recommended in section 7(D) of this paper, to the other insider trading provisions making him or her civilly liable for trading in securities while in the possession of confidential information.

Recommendation:

[78] It is recommended that subsection 130(2) be amended so as to prohibit only the purchase of put options and the sale of call options.

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[57] CBCA, subs. 130(1) and subs. 130(2).

C. AMEND SPECULATIVE TRADING PROVISIONS TO APPLY TO SALE OF SECURITIES

Issue:

[79] Whether to expand the scope of the current speculative trading prohibitions to apply to short sells and puts and calls in respect of any securities.[58]

Background:

[80] The speculative trading prohibitions relate to the sale of a "share" and puts and calls in respect of a "share" of the corporation or any of its affiliates. The CBCA defines a "share" as a voting share. However, there is a similar potential for conflict of interest with respect to securities other than voting shares.

[81] "Security" in the CBCA currently means shares or debt obligations issued by the corporation. Section 7(D) of this paper recommends the expansion of this definition for the purposes of insider trading so as to include puts, calls, options and other securities whose market price varies materially with that of the securities distributed by the corporation. This change would make the definition of "security" similar to that found in provincial securities acts.

Recommendation:

[82] Where the word "share" is used in section 130, replace it with the word "security." This change will better cover those situations where conflict of interest problems arise.

D. NEW DEFINITION OF "INSIDER" FOR SPECULATIVE TRADING PROHIBITIONS

Issue:

[83] Whether to reconsider the definition of "insider" for the purpose of the speculative trading prohibitions.[59]

Background:

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[58] CBCA, s. 130.

[59] CBCA, s. 130 and subs. 126(1).

[84] The speculative trading prohibitions currently apply to those who are considered "insiders" for the purposes of insider reporting. As a result, the speculative trading prohibitions apply to a broad class of people including:

a) a director or officer of a distributing corporation;
b) a distributing corporation that acquires shares issued by it;
c) a distributing corporation that acquires or sells shares issued by any of its affiliates;
d) a person who beneficially owns more than ten percent of the shares of a distributing corporation or who exercises control or direction over more than ten percent of the votes attached to shares of a distributing corporation;
e) directors, officers, and major shareholders (as defined in "d" above) of a corporation that is an insider to another corporation or enters into a business combination[60] with another corporation.[61]

Some believe that this class of persons is too broad.

[85] In order to consider who should be included in the definition of "insider" for the purposes of the speculative trading prohibitions, it is appropriate to re-examine the policy rationale for prohibiting some insiders from trading in speculative instruments. In the section of this paper on the possible repeal of the speculative trading prohibitions,[62] the strongest policy rationale given for maintaining the speculative trading prohibitions was the corporate governance concern over possible conflicts of interest if speculative trades by insiders are allowed. It can therefore be argued that, for the purpose of the speculative trading prohibitions, only those insiders who can influence corporate decisions and who can be in a conflict of interest position should be included as insiders. For example, the President of the corporation has influence over corporate decisions and could be in a conflict of interest position with respect to short sales and the purchase of a put or the sale of a call. A more detailed examination of who might be included is provided in Appendix A.

[86] The other main policy rationale put forward with respect to speculative trades was that "one can assume that speculative trades are made on the basis of confidential information." However, many of these concerns could be dealt with by amended civil liability provisions which would make insiders civilly liable if they traded in the corporation's securities while in the possession of material confidential information. For example, the definition of "securities" could

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[60] "Business combination" is defined in subs. 126(4) of the CBCA as "an acquisition of all or substantially all the property of one body corporate by another or an amalgamation of two or more bodies corporate."

[61] See CBCA, subss. 126(1) and 126(3) - definition of "insider" and "deemed insiders."

[62] See section 6(A) of this paper entitled "Repeal Speculative Trading Prohibitions: Short Sales and Trading in Puts and Calls".

be expanded to include short sales, puts, calls and other instruments whose price varies materially with the value of the corporation's securities [see section 7(D)] and potential liabilities could be increased [see section 7(L)].

Recommendation:

[87] It is recommended that the definition of insider for the purposes of the speculative trading prohibitions be reconsidered. The new definition should cover persons in such a close relationship with the corporation that they have the potential for a conflict of interest in their dealings with and on behalf of the corporation. In particular, those insiders subject to the trading prohibition on short sales, etc., should include the following:

- director or officer of a distributing corporation;
- directors or officers of a corporation that is an insider to a distributing corporation;
- directors or officers of a subsidiary;
- directors and officers of a corporation that enters into a business combination with a distributing corporation; and
- a person employed or retained by the corporation.

Please see Appendix A for a detailed analysis.

E. MAXIMUM PENALTY FOR BREACH OF SPECULATIVE TRADING PROHIBITIONS

Issue:

[88] Whether to increase the maximum penalty for a breach of the speculative trading prohibitions.[63]

Background:

[89] Currently a contravention of the speculative trading prohibitions subjects the insider to a summary conviction offence with a maximum fine of $5,000 and/or imprisonment for up to six

[63] CBCA, subs. 130(4).

months. Given the large profits which can be made by breaching the trading prohibitions, this penalty is considered an inadequate deterrent.

[90] While there is no specific prohibition against short selling in the provincial securities or corporations legislation, such transactions are covered by the general prohibition against improper insider trading (which prohibit an insider from trading with the knowledge of a material fact or material change). Provincial penalties for a breach of these provisions varies but the maximum penalty is two years in jail and/or a fine of $1 million or three times the profit made (whichever is greater).[64]

Recommendation:

[91] A maximum penalty of two years in jail and/or a fine of $1,000,000 or three times the profit made (or loss avoided), whichever is greater, is recommended. This is considered a sufficient deterrent and yet provides the flexibility for a very large fine where the profit made is especially large.

7. CIVIL LIABILITY

A. REPEAL CIVIL LIABILITY

Issue:

[92] Whether to repeal the insider trading civil liability provisions of the CBCA.

Background:

[93] The CBCA makes certain persons liable[65] if they make use of specific confidential information for their own benefit or advantage in connection with a transaction in a security of a corporation, where such specific confidential information, if generally known, might reasonably be expected to affect materially the value of the corporation's securities.[66] In contrast with provincial insider trading provisions which apply only to "reporting issuers", the CBCA's insider trading

[64] ASA, par. 161(6)(c); BCSA, subs. 138(4); MSA, subs. 136(4); NSA, subs. 122(4); NSSA, subs. 129(4); OSA, subs. 122(4); SSA, subs. 131(6).

[65] CBCA, s. 131, definition of "insider" and "deemed insiders".

[66] CBCA, subs. 131(4).

liability provision applies to transactions in connection with both distributing and non-distributing corporations. The civil liability provision applies to any insider of a corporation.

[94] There are two categories of persons who can assert a civil liability claim against an insider. First, any person may claim for any direct loss suffered, unless the specific confidential information was known or should have been known by that person. Second, the corporation itself may claim any direct benefit or advantage received or receivable by the insider as a result of an improper transaction.

[95] Currently, the CBCA civil liability provision is rarely used because of the need to demonstrate that the defendants "made use of" the confidential information. However, provincial securities statutes have eliminated the "makes use of" requirement. This change, and other improvements, could be emulated in the CBCA if the civil liability provisions of the CBCA are kept.

[96] Factors relevant to a determination of whether the CBCA insider trading civil liability provisions should be repealed or maintained and updated are now discussed.

i) Duplication of Causes of Action

[97] Currently, both the provincial securities acts and the CBCA have insider trading liability provisions. However, a plaintiff needs only one cause of action in order to obtain relief or compensation. Although one can argue that maintaining a largely duplicative cause of action in the CBCA involves no significant costs to potential plaintiffs or the government, and that it provides an additional choice of enforcement venue, the extra cause of action may impose compliance costs on businesses.

ii) Jurisdictional Advantage of CBCA

[98] Unless the CBCA insider trading liability provisions provide benefits over the provincial insider trading liability provisions, they are of no real benefit to plaintiffs. One advantage of the CBCA cause of action is that it can be relied on by investors across Canada to challenge the activities of insiders of any CBCA corporation in any court in Canada (assuming the court has jurisdiction over the particular defendant). So, for example, if improper insider trading has taken place in Quebec by an Ontario resident with respect to a CBCA corporation, one proceeding can be brought in Ontario by all the injured shareholders, no matter their place of residence. It is clear that the CBCA rules apply wherever the trade is made.

[99] On the other hand, the applicability of provincial rules is less clear. For example, suppose that the insider is a resident of New Brunswick and conducts a trade in Quebec, with Quebec residents, in the securities of a company which is a reporting issuer in Ontario.

Since New Brunswick has no insider trading cause of action, and since the issuer is not a reporting issuer in Quebec, the only available cause of action is that of the OSA. Can the Quebec plaintiffs rely on the OSA's cause of action? There is no structural impediment to a New Brunswick court applying a cause of action conferred by a statute in another province. On its face, the OSA applies to any insider so long as the issuer is a reporting issuer in Ontario. However, the jurisdiction of the OSA may not reach that far. Even if the OSA is applied, it is not clear that a New Brunswick court would recognize the cause of action in the OSA. The civil cause of action is essentially a statutorily created tort action, akin to fraudulent misrepresentation. With respect to torts, the Supreme Court of Canada has held that the applicable law is the law of the place where the tortious activity occurred[67]. In our example, that place would be Quebec and, as Quebec law does not create a cause of action for trading on the basis of material information of corporations that are reporting issuers in other provinces, the plaintiffs may obtain no relief.

[100] By contrast, Quebec residents could clearly use the CBCA rules, either in Quebec or in New Brunswick if the reporting issuer was a CBCA corporation. This jurisdictional advantage of the CBCA should not be over-stated as many corporations are reporting issuers in more than one province, and insiders are often residents of the jurisdiction where the corporation is a reporting issuer. This problem is, however, more than a theoretical gap and illustrates that CBCA improper insider trading liability provisions may be required to protect CBCA investors.

iii) Wider Class of Plaintiffs Under CBCA

[101] The CBCA states that any person who suffers a direct loss as a result of an improper transaction by an insider is entitled to compensation.[68] On the other hand, the provincial legislation only confers the cause of action for improper insider trading on persons who purchase or sell securities with the offending insider.[69] Arguably, the CBCA provision is drafted broadly enough to allow plaintiffs to bring an action even where they did not enter into a transaction with the insider.

[102] When improper insider trading takes place through a stock exchange, there may be no contractual relationship between the insider and the aggrieved purchaser or seller. The provincial cause of action suggests that this contractual relationship is necessary. However, in many cases, because of the nature of public markets, it will be difficult to

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[67] Tolofson v. Jenson, [1994] 3 S.C.R. 1022.

[68] CBCA, par. 131(4)(a).

[69] ASA, subs. 171(1); BCSA, subss. 119(2), 119(3) and 119(5); MSA, subs. 113(1); NSA, subs. 134(1); NSSA, subs. 142(1); OSA, subs. 134(1); QSA, s. 226; SSA, subs. 142(1).

trace the insider's trade to the plaintiff's trade and thus establish a contractual relationship.[70] As a result, the CBCA cause of action may be available to a wider class of plaintiffs than the provincial improper insider trading cause of action.[71]

iv) Definition of Insider

[103] Neither the CBCA nor the provincial securities legislation, with the exception of the QSA,[72] currently include within the definition of "insider" any persons who acquire confidential information that they know to be such even if they do not acquire it from an insider. An example would be a printing company employee using material information included in a take-over bid circular before the information is made public. The CBCA could advance insider trading regulation by ensuring that such people are covered for insider trading liability purposes.

Recommendation:

[104] It is recommended that the insider trading civil liability provisions of the CBCA be maintained and amended. Possible amendments are outlined below.

B. BROADEN THE DEFINITION OF INSIDER

Issue:

[105] Whether to broaden the definition of "insider" for liability purposes to ensure that all persons who trade while in possession of material confidential information are covered.[73]

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[70] On a stock exchange it is often difficult to trace who exactly traded with the insider and thus establish a contractual relationship. For a discussion of this please see: P. Anisman, "Takeover Bid Issues and Insider Trading Legislation", in P. Anisman, R.J. Balfour, W.J. Braithwaite, Basic Securities Law, Toronto, Department of Education, The Law Society of Upper Canada, 1991, F-80.

[71] This is discussed in section 7(L) of this paper.

[72] QSA, subs. 189(6).

[73] CBCA, subs. 131(1) to subs. 131(3).

<u>Background:</u>

[106] The current CBCA definition already covers a wide spectrum of insiders.[74] However, recent amendments to provincial securities laws have introduced other categories of insiders, further widening the net for liability purposes. Those now considered insiders by provincial securities acts include:

- insiders, affiliates or associates of a person proposing to make a take-over bid or persons proposing to become a party to a business combination (OSA, par. 76(5)(a));
- persons who, although no longer linked to the corporation, had access to material confidential information while they were insiders of the corporation (OSA, par. 76(5)(d));
- persons who have acquired material privileged information that they know to be such concerning a corporation (QSA, subs. 189(6)). This category would cover instances of improper insider trading by persons who may have misappropriated material confidential information from a source other than a tipper. An example would be a printing company employee using material information included in a take-over bid circular before the information is made public;
- all reporting insiders including directors and officers of a subsidiary or affiliate; and
- professional advisors to the corporation or to persons that are proposing to make a take-over bid for or become party to a business combination with the corporation.

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[74] Section 131 of the CBCA defines "insider" for insider trading civil liability purposes. It includes as insiders:

a) the corporation;
b) an affiliate of the corporation;
c) a director or officer of the corporation;
d) a person who beneficially owns more than ten percent of the shares of the corporation or who exercises control or direction over more than ten percent of the votes attached to the shares of the corporation;
e) a person employed or retained by the corporation;
f) a person who receives specific confidential information from a person, and who has knowledge that the person giving the information is an insider;
g) a body corporate that becomes an insider of a corporation, or enters into a business combination with a corporation, a director or officer of the body corporate is deemed to have been an insider of the corporation for the previous six months or for such shorter period as he was a director or officer of the body corporate; and
h) a corporation that becomes an insider of a body corporate, or enters into a business combination with a corporation, a director or officer of the body corporate is deemed to have been an insider of the corporation for the previous six months or for such shorter period as he was a director or officer of the body corporate.

Recommendation:

[107] That the CBCA be revised so that all of those listed above as insiders be considered insiders for liability purposes under the CBCA. This would promote greater harmonization, facilitate enforcement, and cover most instances where insider trading might be expected to occur.

C. DEFINITION OF "BUSINESS COMBINATION"

Issue:

[108] Whether to expand the definition of "business combination" in subsection 131(3) of the CBCA.

Background:

[109] The CBCA definition of "business combination" now applies only to amalgamations and acquisitions of all or substantially all of the property of one body corporate by another. Provincial securities laws cover other forms of business combinations which fundamentally change the corporate structure, such as arrangements and similar material business combinations.[75] The definition of "business combination" applies to determining who are deemed insiders for the purposes of civil liability under subsection 131(2).

Recommendation:

[110] It is proposed that the definition of "business combination" be broadened to include arrangements and similar material business combinations.

D. DEFINITION OF "SECURITIES"

Issue:

[111] Whether to expand the definition of "security" for liability purposes so as to cover a wider class of instruments.[76]

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[75] OSA, s. 1, definition of "reporting issuer", paragraph e.

[76] CBCA, subs. 131(4), and a new provision.

Background:

[112] The CBCA defines "Security" as "a share of any class or series of shares or a debt obligation of a corporation and includes a certificate evidencing such a share or debt obligation."[77] Subsection 131(4) of the CBCA, the provision which imposes insider trading civil liability, refers to "a transaction in a security of a corporation"(emphasis added).

[113] Provincial securities laws have a much wider definition of "security." The definition in these statutes include a variety of instruments representing investments based on the underlying shares of the company (puts, calls, options, etc.). The OSA and BCSA include certain securities which are not issued by the corporation but the price of which varies proportionately (in the case of puts and calls) or materially with the price of the corporation's securities.[78]

[114] It has also been recommended that the definition of security should include phantom stock plans[79] and other similar compensation instruments for insiders of companies. Insiders can profit from inside information by using these plans. For instance, suppose that the board of directors of company X receive confidential information affirming that the company has discovered huge gold reserves at one of its test sites. These directors could then sign up for, or establish, a phantom stock plan before the information about the gold find is publicly released. In this way, they have benefited from the inside information and have done indirectly what they are prohibited by the CBCA and provincial securities laws from doing directly. In either case, the activity negatively impacts upon the integrity of the market. On the other hand, it may be appropriate to leave such areas of conflict to be dealt with through fiduciary duty protections.

Recommendation:

[115] In order to deter insider trading violations, section 131 of the CBCA should be revised so as to include a broader definition of "security." This would add puts, calls, options and other securities whose market price varies materially with that of the securities distributed by the corporation. This provision would be similar to that found in provincial securities acts and would help to harmonize Canadian legislation in this respect.

Option:

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[77] CBCA, subs. 2(1), definition of "security".

[78] OSA, subs. 76(6); BCSA, subs. 119(1); QSA, s. 189.1

[79] A phantom stock plan is one where the participants in the plan receive a cash bonus based on the appreciation in the value of the company's stock. In this way participants in the plan do not have to purchase shares and are not considered shareholders.

[116] The broader definition recommended above could be amended to also include phantom stock plans and other similar compensation vehicles.[80]

E. WRONGFUL COMMUNICATIONS PROHIBITION

Issue:

[117] Whether to specifically impose liability for the wrongful communication of material confidential information (tipping).[81]

Background:

[118] Paragraph 131(1)(f) and subsection 131(4) of the CBCA provide that a person who receives and makes use of specific confidential information from an insider, the tippee, is subject to the civil liability provisions. However, it is unclear whether the CBCA prohibits the communication of the information by the tipper to the tippee. Moreover, no liability is imposed on the tipper. The CBCA could be amended to clarify that it prohibits the wrongful communication of material confidential information.

[119] Provincial legislators have recognized the need to constrain confidential information within authorized business circles. As a result, the provincial securities acts now specifically prohibit the wrongful communication of material confidential information.[82]

[120] On the other hand, regulators have also recognized that in the course of valid business transactions it may be necessary for an insider to communicate confidential information. They have therefore adopted exceptions to the prohibition on tipping as well as saving clauses. For a more complete discussion of saving clauses/defences, please see section 7(I) of this paper.

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[80] Implementation of this option would require careful drafting. For instance, one of the new defences proposed in section 7(I) of this paper is that the seller had knowledge of the material confidential information. In this case, it is the corporation that is the "seller" and the corporation would be knowledgeable about the material confidential information.

[81] New provision.

[82] See: OSA, subss. 76(2) and 76(4); QSA, s. 188.

Recommendation:

[121] It is proposed that insiders who wrongfully communicate material confidential information be specifically subjected to civil liability and, with respect to information about a distributing corporation, also to penal liability.[83]

F. WRONGFUL COMMUNICATION: NECESSITY OF A TRANSACTION

Issue:

[122] Whether liability provisions with respect to the wrongful communication of material confidential information (tipping/advising) should apply to situations where the communication of the information did not result in a transaction.[84]

Background:

[123] Under provincial securities legislation, there are three types of liability with respect to the wrongful communication of material confidential information. These are: (1) civil liability for damages; (2) accountability to the corporation; and (3) penal liability. The requirement that a transaction result from the wrongful communication varies depending on the type of liability.

(1) Civil Liability for Damages

[124] In a civil liability situation it is necessary for a transaction to occur for there to be damages. The CBCA and the provincial securities acts require a transaction to occur for the liability provision to be applicable.[85]

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83 See section 8 of this paper.

84 CBCA, subs. 131(4).

85 CBCA, subs. 131(4); OSA, subs. 134(2); BCSA, subs. 119(3); QSA, s. 227.

(2) Accountability to the Corporation

[125] In some jurisdictions a transaction is necessary for accountability to the corporation to apply,[86] while in other jurisdictions a transaction is not necessary and would still find a tipper accountable for any benefit accruing from the wrongful communication even in the absence of a transaction.[87]

(3) Penal Liability

[126] Neither the OSA nor the QSA require that a transaction occur for the penal offence provision to apply.[88] The concern is that, even if the tippee did not trade, he/she may inform others. These other people could in turn, inform more people and the chain of tippees would grow longer. As this happens it becomes more and more likely that a trade will occur and it becomes more and more difficult to prove that the person who traded knew the information was confidential and originated from an insider. Furthermore, this type of activity creates rumours that may affect trading in the security. If there is unusual trading in a security prior to the public announcement of information, confidence in capital markets is eroded regardless of whether the trading was based on rumour or actual knowledge of inside information.

Recommendation:

[127] It is recommended that the CBCA:

- maintain the necessity of a transaction with respect to civil liability to investors;
- make a tipper accountable to the corporation for any benefit accruing from the wrongful communication even in the absence of a transaction by the tippee;

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[86] CBCA, subs. 131(4); QSA, s. 228.

Note, however, that the CBCA currently makes only the tippee liable while the provincial securities acts make the tipper and tippee liable to the corporation. Section 7(E) of this paper recommends that the CBCA be amended to make the tipper liable to the corporation as in the provincial securities acts.

[87] BCSA, subs. 119(5); OSA, subs. 134(4).

A tangible benefit to the tipper in the absence of a transaction by the tippee could be, for example, the payment of a fee to the tipper for the information.

[88] OSA, s. 122; QSA, s. 204.

! not require a transaction for a tipper or tippee to be found guilty of contravening the proposed insider penal liability provision.[89]

G. REFERENCE TO "SPECIFIC" INFORMATION

Issue:

[128] Whether to delete the reference to "specific" information in determining the type of information for which insider trading/tipping is prohibited.[90]

Background:

[129] Subsection 131(4) of the CBCA provides that an insider may be liable if he/she traded on the basis of specific confidential information that, if generally known, might reasonably be expected to affect materially the value of the security. "Specific" is not a defined term nor is it a common term to which a clear interpretation can be attached. It is usually interpreted as the probability of an event's occurrence. Therefore, the information must relate to an event that is at such an advanced stage that it is likely to occur. Breaches of the insider trading provisions would therefore be restricted to instances where the information is reliable, precise and relating specifically to the corporation. This would bar from consideration confidential information that is general in nature and not sufficiently mature.

Recommendation:

[130] It is proposed that the term "specific" be deleted from the determination of what constitutes insider information. This would eliminate a vague term which could hamper the use of the insider trading liability provision. Finally, the goal of greater harmonization of insider trading provisions would be achieved as the provincial securities acts do not use the term "specific."

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[89] Please see section 8 of this paper for proposals to establish insider trading penal offence provisions in the CBCA.

[90] CBCA, subs. 131(4).

H. "MAKES USE OF" REQUIREMENT

Issue:

[131] Whether to eliminate the "makes use of" requirement from the insider trading civil liability provision.[91]

Background:

[132] Subsection 131(4) of the CBCA provides that an insider who, in connection with a transaction in the securities of a corporation, makes use of any specific confidential material information, is liable to compensate any aggrieved person and is accountable to the corporation for any benefit or advantage received.

[133] The fact that the insider "makes use of" material confidential information is a required element of the cause of action and therefore must be proved by the plaintiff in a civil action against an insider. This is widely considered an insurmountable evidentiary obstacle. This requirement also allows an insider to avoid liability by showing that, although he/she had knowledge of confidential material information and traded, the trade was not based on this information and "the information was not a factor in what he did."[92] It has been argued that this element of proof is too onerous and that it should be addressed in order to facilitate enforcement and compliance with the CBCA insider trading provisions.

[134] The insider trading provisions of many provincial securities acts (including Quebec, Ontario and British Columbia) have been amended so as to delete the "makes use of" requirement. Instead, the provinces have opted for a strict liability approach, limited by specific statutory defences. Under these rules, insiders who trade having material confidential information are liable unless they can prove one of the defences available to them, such as, that they reasonably believed that the information had been generally disclosed.[93]

Recommendation:

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[91] CBCA, subs. 131(4).

[92] Green v. Charterhouse (1976) 12 O.R. (2d) 280, at p. 307.

[93] See the following for examples of defences contained in provincial securities laws: BCSA, par. 119(3)(d) to par 119(3)(g); OSA, par. 134(2)(d) to par. 134(2)(g); QSA, s. 188.

[135] It is proposed that subs. 131(4) of the CBCA be amended so as to delete the "makes use of" requirement. It is also recommended that the words "for his own benefit or advantage" found in subs. 131(4) be eliminated, as they are essentially part of the element of "making use" of the information.[94] Instead, similar to some provincial securities laws, the CBCA would provide a strict prohibition on trading (and tipping if it is adopted) while the insider has knowledge of material confidential information. Some specific defences would be stated in the CBCA or in the regulations. These specific exculpatory provisions would provide guidance to insiders and to the judiciary as to what are considered appropriate circumstances for trading or tipping while in possession of material confidential information. These defences are discussed below in more detail in section 7(J).

[136] The amendment would protect the investing public, promote confidence in the marketplace, and promote harmonization.

I. STATUTORY DEFENCES[95]

Issue:

[137] Whether statutory defences should be added to the CBCA insider trading liability provisions (and to the tipping liability provisions, if adopted), or to the CBCA regulations, to counterbalance the elimination of the "makes use of" requirement.

Background:

[138] Currently an insider, as defined, may be found liable under subs. 131(4) of the CBCA if, in the course of a transaction in a security of the corporation or any of its affiliates, he/she:

a) makes use of any specific confidential information for his/her own benefit or advantage;

and if the information:

b) is not generally known; and

c) might reasonably be expected to affect materially the value of the security. (emphasis added).

[94] The question of benefit would come into play, however, in the damages owing to the corporation for insider trading (CBCA, par. 131(4)(b)).

[95] CBCA, subs. 131(4).

[139] A plaintiff must prove all of the above elements of the cause of action to obtain compensation. Conversely, insiders can avoid paying compensation if he/she can present evidence disproving one of these elements of the cause of action.

[140] The previous section of this paper recommends eliminating the "makes use of" requirement and the adoption instead of a strict liability approach similar to that found in provincial securities acts. It is also recommended that the words "for his own benefit or advantage" found in subs. 131(4) be eliminated, as they are essentially part of the element of "making use" of the information. Lastly, the elimination of the requirement that the information be "specific" is recommended.[96] However, it is not proposed that any of the other elements of the cause of action (namely that <u>an insider</u> <u>trades</u> <u>with knowledge</u> of <u>material</u> and <u>confidential information</u>) be eliminated.

[141] The "makes use of", "for own benefit" and "specific" requirements, could be replaced by specific defences built into the CBCA that would provide exemptive relief from the strict application of the insider liability provisions. Many such defences are already found in provincial securities legislation.[97] Some of these could be:

1) **Reasonable belief that the information had generally been disclosed**

[142] The basic defence provided by securities legislation is that although the information is confidential, the insider reasonably believed that the information had been "generally disclosed."[98] This protects the insider who has taken care to avoid insider trading. It has been suggested that the concept of "generally disclosed" is vague and could be open to misinterpretation. Instead, the wording "generally disseminated to the public" has been recommended.

2) **Material Information Known by Plaintiff**

[143] Another basic defence provided by provincial securities legislation is that the information, although not generally known, was known or ought reasonably to have been known by the aggrieved person. In this situation, the plaintiff has not been prejudiced by the insider's knowledge and should not be able to claim damages against the insider. Knowledge by other parties to a transaction would not be, however, a defence to an action by the corporation to disgorge any benefit received by the insider.

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[96] See section 7(G) of this paper.

[97] See, for example, BCSA, pars. 119(3)(d) to (g), QSA, ss. 187-188 and OSA, s. 134.

[98] If the expression "generally disclosed" is vague in the English version, it appears that it is not the case in the French version of the OSA ("divulgué au public") and in the QSA ("connu du public").

3) **Necessary Course of Business**

[144] With the proposed provision imposing liability for the tipping of material confidential information by an insider, there may be a requirement to provide an exemption for communication by an insider in the necessary course of business (OSA, s. 76(2)). This defence may be needed so as not to impede the valid course of business transactions. Variations to the "necessary course of business" test, such as "reasonable course of business" or "ordinary course of business", could be used. A practitioner has suggested that there should be an additional requirement that the tipper "reasonably believed" that the tippee would not use the confidential information to either trade or cause another person to trade.

4) **Chinese Walls and Other Arrangements**[99]

[145] "Chinese walls" are the policies and procedures implemented by a person or company to prevent the transmission of confidential information to others within a firm or company. Such organizations may have confidential information and may trade but, because of "chinese walls", the decision to purchase or sell securities is made independently by persons without knowledge of that information. OSC Policy 10.2, "Guidelines for Establishment of Procedures in relation to confidential information", provides detailed rules of what is expected of firms. It has been recommended that any "chinese wall" defence be applied very narrowly in respect of an insider of an issuer. Specifics of the minimum standards for use of this defence could be set by regulation.

5) **Agency Contract Exemption**

[146] One could exempt from liability those transactions which are made by persons who knew material confidential information, if they entered the transaction as an agent for another person pursuant to an unsolicited order from that other person.[100]

6) **Share Purchase Plan**

[147] Trades made by an insider who knew of material confidential information could be exempted if he/she purchased shares pursuant to a duly structured automatic share purchase plan, or other similar plan, and the plan was entered into prior to the insider obtaining knowledge of the material confidential information. It has been recommended that the defence should be limited to purchase plans where the purchase is automatic and non-discretionary. If the insider can decide when purchases are made, there should be no

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[99] See, for example, OSA regulations, subs. 175(1).

[100] See, for example, OSA Regulations, par. 175(2)(a).

defence. Reference was made to a recently adopted provision of the Quebec Securities Act to this effect.[101]

7) Trade made as a result of prior contractual obligation

[148] It has been recommended that there be a defence that the purchase was made as a result of a binding obligation entered into by the insider before he or she was aware of the inside information. For example, a purchase by a put writer as a result of an exercise of a put option entered into months before should not be caught by the prohibition, as the writer is obligated to purchase the security. However, the exercise of a call warrant would be caught, as there is no obligation on the part of the holder to exercise the option. The onus should be on the defendant to prove the existence of the contract.[102]

Recommendation:

[149] It is proposed that the defences to the liability provisions be clearly stated in the CBCA or the regulations so as to avoid interpretive difficulties. In particular, it is proposed that the CBCA adopt the seven elements listed above in the background section. These elements would be drafted broadly enough to allow the courts sufficient discretion in their evaluation of insider conduct so as to ensure that legitimate business activity would not be impeded.

J. MEASURE OF DAMAGES

Issue:

[150] Whether to add to the CBCA a specific measure of damages provision to facilitate the court's determination of damages in civil liability proceedings.[103]

Background:

[151] Paragraph 131(4)(a) of the CBCA provides that an insider who improperly trades "is liable to compensate any person for any direct loss suffered by that person as a result of the transaction." In light of the difficulty of assessing damages with respect to impersonal trades in the securities of distributing corporations, some provincial securities acts include provisions to

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[101] QSA, subs. 187(2); OSA Regulations, par. 175(2)(b) is less stringent.

[102] See also OSA Regulations, par. 175(2)(c).

[103] New Provision.

help guide the courts in their assessment of damages.[104] These provincial provisions provide discretion to the court to consider such other measures as may be relevant under the circumstances.

[152] The provincial civil liability measure of damages provisions use an "average market price" test with respect to the securities of distributing corporations for which a market exists.[105] However, for non-distributing corporations, there is no market for their securities and thus the "average market price" test is inapplicable. Unlike the provincial securities acts, the CBCA's insider trading civil liability provision is applicable to non-distributing as well as distributing corporations. Therefore, a "fair value" test would have to be added as well.

[153] It should be noted that the measure of damages provision would only apply with respect to civil liability pursuant to paragraph 131(4)(a) of the CBCA and not to the "accountability to the corporation" provision. This is because the corporation is not entitled to damages but rather to the disgorgement of the benefits received or receivable by the insider.

[154] Finally, a practitioner has suggested that it is probably not a sufficient deterrent for insiders to be merely liable for the profit made. The practitioner suggested that insiders should be exposed to an amount which is three times the full amount of damages otherwise determined. In the case of face-to-face market transactions and transactions in the securities of a non-distributing corporation, the same practitioner suggests the maximum civil liability should be equal to double the profit made or loss avoided: once to the opposite party to the transaction and once to the corporation itself.

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[104] OSA, subs.134(6); BCSA, subs. 119(7).

[105] The measure of damages for improper insider trading is defined in subsection 134(6) of the OSA. It reads as follows:

> In assessing damages under subsection (1) or (2), the court shall consider,
>
> a) if the plaintiff is a purchaser, the price paid by the plaintiff for the security less the average market price of the security in the twenty trading days following general disclosure of the material fact or material change; or
>
> b) if the plaintiff is a vendor, the average market price of the security in the twenty trading days following general disclosure of the material fact or material change less the price received by the plaintiff for the security,
>
> but the court may instead consider such other measures of damages as may be relevant in the circumstances.

Recommendation:

[155] It is recommended that a specific measure of damages be added to the CBCA. This should facilitate the determination by the courts of damages to be paid under the civil liability provisions. The approach adopted in the OSA and BCSA would be followed with respect to the securities of distributing corporations for which a market exists. In addition, the CBCA would, like the provincial securities laws, give the court discretion to consider such other measures as may be relevant in the circumstances. These changes would further harmonize Canadian legislation. With respect to the securities of non-distributing corporations for which no market exists, the CBCA should give the court discretion to consider other measures of damages as may be relevant under the circumstances.

K. LIMITATION PERIOD FOR COMMENCING A CIVIL ACTION

Issue:

[156] Whether to change the limitation period and clarify the language of subsection 131(5).

Background:

[157] Subsection 131(5) of the CBCA establishes a limitation period for insider trading civil liability and reads as follows:

> An action to enforce a right created by subsection (4) [the insider trading civil liability subsection] may be commenced
>
> a) only within two years after the discovery of the facts that gave rise to the cause of action or
>
> b) if the transaction was required to be reported under section 127, only within two years from the time of the reporting under that section.

[158] The wording of subsection 131(5) of the CBCA raises the following concerns:

! the limitation period of two years may be too short for effective use in civil actions;

! since paragraph 131(5)(b) only applies to reporting insiders and not to other insiders for liability purposes, it would no longer be relevant if the option in this paper to eliminate the CBCA's insider reporting provisions is implemented;

- since the CBCA does not limit the time in which the discovery may occur, but rather limits the time frame within which an action may be commenced following the discovery of facts, an open-ended period is created. This means that an action could be brought many years after the transaction took place. While this would be an advantage for the plaintiff, some believe that it is unjust to submit an insider to such an unlimited time period.

[159] The limitation period in the provincial securities statutes varies from province to province. In most of the provinces, the limitation period for civil liability is the earlier of:

- 180 days after the discovery by the plaintiff of the facts that give rise to the cause of action or

- three years after the date of the transaction.[106]

However, some have expressed the belief that these periods are too short and that they should be significantly extended. This, it is argued, would increase the likelihood that plaintiffs would take action against insiders who may have engaged in improper insider trading. On the other hand, others have argued that two years is more than sufficient time to start a legal action. In addition, extending the limitation period may make it difficult for defendants, years after the fact, to locate documents and witnesses (e.g., employees may have since departed).

<u>Recommendation:</u>

[160] It is proposed that the limitation period be extended from two to three years after the discovery of the facts that gave rise to the cause of action. However, the CBCA would impose an obligation on plaintiffs to be diligent in commencing an action by stipulating that any action must be commenced within six years from the date of the transaction or wrongful communication.

[161] It is also proposed that if the reporting requirements are repealed, paragraph 131(5)(b), which applies only to reporting insiders, be deleted from the CBCA.

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[106] BCSA, subs. 124(b); NSA, subs. 138(b); NSSA, par. 146(1)(b); OSA, subs. 138(b); SSA, subs. 147(b).

Pursuant to ASA, subs. 175(b) the limitation period is the earlier of 180 days after the recovery by the plaintiff of the facts that gave rise to the cause of action or one year after the date of the transaction.

The QSA specifies a one-year limitation period from the knowledge of the facts that give rise to the action (s. 235) and three years from the date of the transaction (subs. 236(1)).

The MSA does not specify a limitation period.

L. COMPENSATION OF VICTIMS

Issue:

[162] Whether to amend the CBCA to facilitate the compensation of investors for damages or losses suffered as a result of improper insider trading or wrongful communication of confidential information.[107]

Background:

[163] Subsection 131(4) of the CBCA now provides for the compensation of persons who suffer a direct loss as a result of insider trading. However, the current provision is not conducive to the exercise by aggrieved investors of their legal rights. While it is easy to identify victims in private transactions, it is more difficult to identify aggrieved parties when securities are traded anonymously on the public market. Moreover, since an insider may have traded with a large number of investors with relatively small investments, the legal costs to institute court proceedings could be too high to make the recovery of losses suffered worthwhile.

[164] Given these problems, some have argued that current civil remedies available to aggrieved investors, including subs. 131(4), only provide a theoretical right of action.[108] Because of this criticism, it is believed that mechanisms facilitating the compensation of insider trading victims are needed.

[165] The U.S. Securities and Exchange Commission (SEC) has facilitated restitution by depositing, in compensatory funds for the benefit of aggrieved investors, a portion of the fines recovered pursuant to its proceedings. In Canada, the settlement of an investigation by the Ontario Securities Commission surrounding short selling by Seakist Overseas Ltd. resulted in the establishment of an $18 million fund to compensate investors.[109]

[166] Other options were raised in the 1991 discussion paper. These were:

(1) Enabling the CBCA Director to initiate proceedings on behalf of aggrieved investors (similar to s. 205 of the CBCA with respect to take-over bids);

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[107] New Provision.

[108] See for example: Gillen, Mark R., "Sanctions Against Insider Trading: A Proposal for Reform", The Canadian Bar Review, Vol. 70, No. 2, June 1991, pp. 232-235.

[109] See "De Groote group hit for $23 million" Globe & Mail, April 29, 1993, page B1.

(2) Introducing a class proceedings provision;

(3) Providing in the CBCA that an applicant is not required to give security for costs;

(4) Conferring in the CBCA wider powers for the courts to order a defendant, on the finding of liability or through an out-of-court settlement, to disgorge monies or benefits illegally obtained into a fund set up for the benefit of investors; and

(5) Providing the court with the power to order a defendant to reimburse the costs of an investigation and of proceedings in connection with a matter.

[167] The 1991 discussion paper did not adopt a favoured approach but rather comments were sought. Two comments were received on this point. The first comment asked "whether the use of a class action system, as done in the United States, is not sufficient to meet the stated objectives." The second was more detailed and made the following recommendations:

- expressly make the insider liable to all participants in the market who suffered a loss as a result of insider trading;
- allow for actions to be brought by the Director under the CBCA;
- allow for disgorgement to be ordered by a court;
- allow for private class actions.

i) Victims who can seek compensation

[168] Compensation under provincial securities legislation for damages suffered by insider trading is only available to those persons who actually trade with the insider (privity requirement).[110] By contrast, CBCA subs. 131(4) appears to be more broadly drafted. It makes insiders "liable to compensate any person for any direct loss suffered by that person as a result of the [insider trading] transaction ...". Depending on the interpretation given to "direct loss", the provision does not appear to be restricted to those persons who transacted with the insider, but also applies to those who suffer a loss "as a result of the transaction." One option to clarify the intent of the provision might be to remove the word "direct."

[169] Removing the word "direct" could enhance the compensation of innocent parties who trade at the same period as the insider, as well as enhance the deterrent impact of the civil

[110] See, for example, s. 134 of the OSA ("liable to compensate the seller or purchaser of the securities") and s. 226 of the QSA ("responsible for the harm suffered by the other party to the transaction").

liability provisions. However, the absence of a privity or any causation requirement would add certain complexities in determining which parties are entitled to recover from the insider. Many more securities than those sold or purchased by the insider[111] are likely to be traded in the market prior to the release of the confidential information. It would be unfair and punitive to make the insider pay for all the losses suffered as a result of all these trades, although some maximum limit, such as three times the profit made (or loss avoided) by the insider, could be placed on the insider's liability.[112]

[170] One practitioner has stated that "a privity requirement does not make sense in the context of impersonal, market transactions effected on securities exchanges or in over-the-counter markets. Where privity is required, it imposes an impossible or, at least, costly barrier to a plaintiff. There is no rational policy basis for rewarding one party to a market transaction while denying recovery to another where both trade at the same time and both do so in ignorance of the fortuitous circumstances that an insider has traded while in possession of material, confidential information."

ii) Class Proceedings

[171] The costs of legal action, particularly in relation to the gains expected, are a major factor in litigation. Where there are numerous plaintiffs with relatively small losses, an action by one person alone is not viable. Class proceedings legislation enable one lawsuit to be brought by a "representative plaintiff" on behalf of other similarly injured parties. Lawyers acting on behalf of that plaintiff are entitled to receive sizable compensation in the form of contingency fees (when the action is successful). It is a procedural mechanism which is intended to provide an economical and efficient means to achieve redress for widespread harm or injury.

[172] Ontario, Quebec and British Columbia are the only provinces who now have class proceedings legislation.[113] These statutes apply to all types of civil litigation, including litigation involving corporations. Unfortunately, class proceedings under these statutes

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[111] Or otherwise affected by a trade by an insider (e.g., in derivatives relating to a security).

[112] It should be noted that a treble damages provision was not recommended above (i.e., a provision under which an aggrieved security holder could claim three times the damages suffered). Plaintiffs would only be able to recover their actual loses, but the insider could be liable for up to three times the profit made (or loss avoided) in respect of losses suffered by many marketplace participants.

[113] Ontario Class Proceedings Act, 1992, S.O. 1992, c. 6; Quebec Code of Civil Procedure, R.S.Q. c. C-25, articles 999 to 1051; and B.C.'s Class Proceedings Act (Bill 16) was proclaimed into force on August 1, 1995.

are likely only available to investors who can sue in that particular jurisdiction.[114] Many CBCA corporations have investors from across Canada and the world who would, therefore, not be able to benefit from the class proceedings in such provinces. Also, the Quebec legislation only permits natural persons to bring a class action,[115] which would therefore not be available to the many corporate bodies which invest in CBCA corporations, including institutional investors.

[173] The three provincial statutes provide a detailed set of rules on certification of the proceedings (court approval), representative plaintiffs, contingency fees and other issues. Presumably, any treatment by the CBCA would have to include a number of rules on the procedures although a detailed procedural code seems inappropriate for specific legislation such as the CBCA.

[174] There may be concerns about increases in the level of litigation in the corporate sector. In the United States, there is a thriving shareholder class action industry. It has been estimated that at any one time there are over a hundred shareholder class action suits pending before U.S. courts.[116] However, it is believed that few, if any, of these class actions relate to insider trading violations.[117] Moreover, with the difficulties in proof associated with insider trading claims, it is unlikely that the availability of a class proceedings mechanism will lead to an explosion of litigation.

iii) Other options

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[114] For example, the recent settlement of the Ontario and Quebec class actions against Bristol-Myers Squibb by Ontario and Quebec women having health problems because of breast implants manufactured by the company did not apply to other Canadian women who might have a cause of action. "Only women in Ontario and Quebec are eligible for the settlement because only those two provinces have class-action legislation, one of the lawyers who negotiated the deal said." Quoted from "U.S. firm to pay $28 million over implants", Globe & Mail, June 19, 1995, page A7.

In addition, s. 2 of the B.C. Class Proceedings Act states that for a person to instigate a class proceeding, or be a part of a class in a class proceeding, that person must be a resident of British Columbia.

[115] Article 999(c).

[116] Comments of Sherrie Savett, Philadelphia lawyer, at the conference on "Securities and Shareholder Litigation", The Canadian Institute, Toronto, October 14-15, 1992.

[117] Apparently, the actions are largely based on sudden share price drops that were not anticipated by financial statements or other corporate disclosure. The corporation and directors are sued for failing to undertake timely disclosure.

[175] As mentioned earlier, it has been suggested that the CBCA provide that an applicant not be required to give security for costs. This is already done in some sections of the CBCA. For example, subs. 242(3) of the CBCA provides that complainants using the derivative and oppression remedies are not required to give security for costs. In addition, subsection 242(4) also provides that the corporation can be ordered to pay the interim costs of a complainant, including legal fees and disbursements, but the complainant may be held accountable for such interim costs on final disposition.[118]

<u>Recommendation:</u>

[176] It is recommended that:

(A) the word "direct" be removed from subsection 131(4) to help clarify that relief is available to persons who suffered a loss "as a result of the transaction," whether or not they actually traded with the insider. Some maximum limit, such as three times the profit made (or loss avoided) could be placed on the insider's liability;

(B) CBCA subsections 242(3) and (4), dealing with security for costs and applications to have the corporation pay interim costs, be adopted for insider trading proceedings; and

(C) a simplified set of rules on class proceedings, perhaps to be developed through the regulations, should be adopted. As part of this remedy, wider court powers to disgorge illegal profits into a fund for victims could be developed.

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[118] This may not be directly applicable to an insider trading proceeding where the defendant is an insider, not the corporation. In a derivative action, the complainant sues on behalf of the corporation. In an oppression action, the complainant is suing because the corporation or its directors have acted in an oppressive or unfairly prejudicial manner. In each of these cases, it may seem more justifiable that the corporation can be forced to pay interim costs. However, insider trading hurts the corporation (by hindering its ability to raise capital). The corporation is given a remedy to disgorge profits from insiders, but may be reluctant to do so because the insider controls or influences decision-making in the corporation. Allowing a victim of insider trading to apply to have the corporation pay the interim costs may be a means to get corporations involved in efforts to limit insider trading.

8. PENAL LIABILITY PROVISION

A. ADDITION OF PENAL LIABILITY PROVISION

Issue:

[177] Whether to introduce an insider trading penal liability provision to the CBCA to further deter improper insider trading and wrongful communication of material confidential information.[119]

Background:

[178] In most jurisdictions there has been a movement towards stricter regulation of insider trading by prohibiting trading by insiders with knowledge of material confidential information. Although the provinces, and other international jurisdictions, prohibit and penalize improper insider trading through penal liability provisions, the CBCA does not currently provide for penal liability in this regard. This omission makes the CBCA insider trading provisions more difficult to enforce and limits the Director's participation in the enforcement of international securities matters.

[179] In addition, if the CBCA contains a penal liability provision for insider trading, a successful prosecution under it could aid those who may be planning a civil action. Since the burden of proof in a penal action is much more rigorous than under a civil action, a successful prosecution would indicate that civil actions would likely be successful against the insider. The penal investigation might also reveal evidence which could help the plaintiff in a civil action.

[180] These benefits must be considered in light of resource constraints. Since there are penal liability provisions in the provincial acts, some may be of the opinion that it is inappropriate for the CBCA to add a penal liability provision for insider trading. Given these concerns, it may be more appropriate to continue to provide only a civil remedy.

Recommendation:

[181] It is recommended that a penal liability provision prohibiting improper insider trading and wrongful communication of material confidential information be added to the CBCA. The penal

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[119] New provision.

Sources: ASA, par. 161(6)(c); BCSA, subs. 138(5); MSA, subs. 136(4); NSA, subs. 122(4); NSSA, subs. 129(4); OSA, subs. 122(4); SSA, subs. 131(6); QSA, s. 204.

liability provision would be limited to insider trading with respect to the securities of distributing corporations. The maximum penalties would be two years in jail and/or $1,000,000 or three times the profit made (or loss avoided), whichever is greater. These penalties would be in-line with those in some provincial securities laws.[120]

[182] The CBCA should also expressly empower the court to make, in the case of a direct or face-to-face securities transaction (but not an impersonal, market transaction), a civil restitution order following a criminal conviction for insider trading. The constitutionality of a restitution order as part of a criminal sentence was upheld by the Supreme Court of Canada.[121]

[183] The stigma attached to the commission of an offence together with significant penalties, should act as a major deterrent against such violations. In addition, in this era of global trading, a penal liability provision should help to facilitate the Director's participation in international enforcement efforts.

[184] This recommendation is conditional on evidence of support for adding an insider trading penal liability provision to the CBCA. In light of penal liability provisions in the provincial securities acts and fiscal constraints, the government should not proceed without evidence of support by CBCA investors and the marketplace.

B. APPLICATION OF PENAL LIABILITY PROVISION

Issue:

[185] Whether the penal liability provisions should apply to securities of non-distributing corporations.[122]

Background:

[186] The insider trading civil liability provision is applicable to insiders of both distributing (corporations whose securities are publicly traded in the market) and non-distributing corporations. However, the main purpose of an insider trading penal liability provision is to protect the public interest. This is done by ensuring order and fairness in the corporate environment and by safeguarding the efficiency and effectiveness of equity markets. Improper

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[120] See: ASA, par. 161(6)(c); BCSA, subs. 138(4); MSA, subs. 136(4); NSA, subs.122(4); NSSA, subs. 129(4); OSA, s. 122; SSA, subs. 131(6).

[121] R. v. Zelensky et. al. (1978) 86 D.L.R. (3d) 179.

[122] New Provision.

insider trading can have a negative impact on investor confidence in the fairness of the equity market. These concerns are not as pressing for non-distributing corporations because their securities are traded through private transactions. On the other hand, there may be a public interest in ensuring order, fairness and the efficient allocation of resources in all corporations, distributing and non-distributing.

Recommendation:

[187] That the CBCA apply the penal liability provision only to the securities of distributing corporations.

C. PENAL LIABILITY PROVISION: DEFINITION OF PROFIT

Issue:

[188] Whether to provide a definition of "profit" to assist in the determination of fines with respect to contraventions of the insider trading and wrongful communication provisions.[123]

Background:

[189] As discussed above, it is proposed that the penal liability provision prohibiting improper insider trading and tipping while in the possession of confidential information be added. Punishment for this offence would include imprisonment and/or fines of up to three times the illegal profits.[124] As a result, it may be useful if a definition of "profit" is included in the CBCA so as to assist the court in the determination of the maximum fine.

123 New Provision.

124 See section 8(A) of this paper for the penalties recommended.

[190] The approach taken could follow that used by the provincial securities acts which already define "profit."[125] However, although the provincial acts are similar in scope, the definitions used are not uniform.[126]

[191] As this paper only recommends an offence provision with respect to the securities of distributing corporations, it is not necessary to introduce factors other than market price to the offence provision.

Recommendation:

[192] It is recommended that a definition of "profit" be added to the CBCA. The proposed approach should be based on the three-tiered definition set out in subs. 122(5) of the OSA. This approach should assist the court in the determination of fines.

9. CONCLUSION/SUMMARY

[193] As mentioned at the outset, the objective of this paper is to generate discussion regarding proposals to repeal or amend the insider trading provisions of the CBCA. After providing background information on the insider trading provisions found in the CBCA and placing them within the insider trading regulatory environment in Canada, the paper examined how the CBCA's insider trading provisions may be revised.

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[125] Subsection 122(5) of the OSA defines "profit in the following three ways:

a) if the accused purchased securities in contravention of subsection 76(1), the average market price of the security in the twenty trading days following general disclosure of the material fact or material change less the amount that the accused paid for the security;

b) if the accused sold securities in contravention of subsection 76(1), the amount that the accused received for the security less the average market price of the security in the twenty trading days following the general disclosure of the material fact or material change;

c) if the accused informed another person or company of the material fact or material change in contravention of subsection 76(2) or (3) and received any direct or indirect consideration for providing such information, the value of the consideration received."

[126] For example, QSA, s. 204 uses a somewhat different test than subs. 122(5) of the OSA.

[194] The paper found that the current CBCA insider trading provisions are out-of-date and recommends that a number of changes be made to update them. In general, the paper recommends:

- maintaining and improving the speculative trading prohibitions on short sales, put options and call options;
- maintaining and improving the insider trading civil liability provisions; and
- adding an insider trading penal liability provision.

No recommendation is made concerning whether to maintain or repeal the CBCA's insider reporting provisions. Instead, two options are outlined:

- eliminate the insider reporting provisions of the CBCA;
- maintain the CBCA insider reporting provisions. The issue of duplicative filings could be dealt with through blanket exemption orders issued, where appropriate, by the CBCA Director.

[195] The changes recommended in the paper would reduce the regulatory burden on CBCA companies, while still acting to deter improper insider trading in Canada. The changes would also increase harmonization of insider trading laws while, in some cases, adding extra value over the existing provisions found in provincial securities and corporations acts. In these ways, it is believed that the proposals for revision of the CBCA's insider trading provisions could improve the regulation of insider trading in Canada.

[196] However, the recommendations contained in this paper are not in any sense the final word on changes to the CBCA's insider trading provisions. They represent current thinking but are not government or even departmental policy. The purpose of the paper is to solicit comments from various stakeholders who have an interest in the efficient and fair regulation of insider trading.

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APPENDIX A

SPECULATIVE TRADING PROHIBITIONS: DEFINITION OF "INSIDER"

This Appendix analyses some of the persons who are currently captured by the speculative trading prohibitions or who might be considered "insiders" for the purpose of the prohibitions. The analysis centres on these people's ability to make corporate decisions and the subsequent possibility of them using this power to promote their personal interests over the corporation's interests (conflict of interest).

i) Director or Officer of a Distributing Corporation

[197] Officer is defined in section 126 to include "(a) the chairman, president, vice-president, secretary, treasurer, comptroller, general counsel, general manager, managing director or any other individual who performs functions for a corporation similar to those normally performed by an individual occupying any such office, and (b) each of the five highest paid employees of a corporation including any individual listed in paragraph (a)." Both directors and officers can influence corporate decisions and should be considered insiders for the purpose of the trading prohibition.

ii) Person Who Owns or Controls 10 Percent or more of Votes Attached to Shares

[198] Shareholders owe no duty to make decisions that are in the best interest of the corporation. They have invested in the corporation but are expected to buy or sell their shares when they determine it is in their best interest to do so.

[199] On the other hand, shareholders who have large blocks of shares that put them in a position of power within the corporation, could use this power to lower the value of the corporation's shares and thus profit from a short sale or the purchase of a put option or the sale of a call option. However, by doing this they have harmed the value of their 10 percent or greater investment in the corporation. It is therefore unlikely that a person who owns or controls 10 percent or more of the votes attached to a corporation's shares would act counter to the interests of the corporation. For this reason, shareholders should not be included in the definition of an insider for the purposes of the speculative trading prohibitions.[127]

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[127] If 10 percent shareholders are included, then aggregation relief (see issue 5(C) of this paper entitled "Exemption from Insider Reporting for Institutional Investors") may be considered for passive investors (institutional investors).

iii) A Distributing Corporation Who Purchases Shares Issued By It

[200] The current speculative trading prohibitions apply to a distributing corporation which purchases shares issued by it. However, the corporation can not be in a conflict of interest situation with itself. For this reason a corporation which short sells, purchases a put or sells a call option with respect to its own shares, should not be considered an insider for the purpose of the trading prohibitions.

iv) A Distributing Corporation Who Purchases Shares of its Affiliates

[201] Normally it would not be in the interest of the corporation to act against the interest of an affiliate. Even where the best interest of the corporation is counter to the best interest of its affiliate, the corporation is under no duty to act in the best interest of an affiliate. For this reason, a corporation who short sells, purchases a put or sells a call option with respect to the shares of its affiliates, should not be considered an insider for the purpose of the trading prohibitions.

v) Directors or Officers of a Corporation that is an Insider to a Distributing Corporation

[202] If a corporation is an insider to another corporation, then there exists the potential that the directors and officers of the insider corporation could act in their own self interest and counter to their corporation's interest. For example, imagine that company X is the largest shareholder of company Y. A director or officer in company X could use their position of power to harm the value of company Y's shares. In the meantime, the director or officer could have purchased a put option or sold a call option with respect to company Y's shares. This places the director or officer in a conflict of interest as he/she is acting counter to the interest of corporation X by harming the value of corporation Y's shares. For this reason, directors and officers of a corporation that are an insider to a distributing corporation should be considered insiders for the purposes of the trading prohibitions.

vi) Directors or Officers of a Subsidiary

[203] The directors or officers of a subsidiary should be included in the definition of insiders, as the performance of a subsidiary affects the value of the parent's securities. Thus these directors and officers could deliberately make decisions that harm the performance of the subsidiary and indirectly profit from the decline in the value of the parent corporation's shares. Thus directors and officers of a subsidiary should be included as insiders for the purpose of the trading prohibitions.

vii) Directors and Officers of a Corporation that Enters into a Business Combination with a Distributing Corporation

[204] Similarly, these directors and officers should be included for the same reason that directors and officers of subsidiaries are included (see above).

viii) Ten Percent or More Owner of a Corporation that Enters into a Business Combination with a Distributing Corporation

[205] This group should not be included in the definition of insider for the same reason as a person who owns or controls 10 percent or more of votes attached to the distributing corporation's shares is not included (see above).

ix) A Person Employed or Retained by the Corporation

[206] People employed or retained by the corporation should be included in the definition of insider as these people could make decisions that could harm the value of the corporation's securities (for example, by divulging strategic information to competitors). Therefore, they should not be allowed to profit from this activity by short selling or purchasing a call or selling a put option.

x) A Tippee

[207] Tippees are not in a position to make corporate decisions that could harm the value of the corporations shares. For this reason, tippees should not be included as insiders for the purpose of the trading prohibitions.