

Bullet Proof Your Disclosure Practices¹

Introduction and Overview

The provisions of the *Securities Act* (Ontario) (the “Securities Act”) in respect of liability for continuous disclosure (Part XXIII.1 of the Securities Act) came into force on December 31, 2005. These amendments are complex and created new causes of action for secondary market investors against a wide range of potential defendants with respect to misleading continuous disclosure filings and other documents, public oral statements and omitted material disclosure in Ontario. They facilitate class action lawsuits by investors who buy or sell securities of a public issuer that is a reporting issuer in Ontario or has a real and substantial connection to Ontario (a “responsible issuer”) during the period beginning when a misrepresentation about the issuer is made by persons associated with the issuer in public documents or orally, or when the issuer fails to make timely disclosure of a material change, and ending when the disclosure is corrected or made. The legislation includes caps on potential liability, unless it can be shown that the defendant authorized, permitted or acquiesced in the making of a misrepresentation or failure to make timely disclosure while knowing it was a misrepresentation or failure.

Virtually identical provisions have been enacted in Manitoba (in effect as of January 1, 2007) and Alberta (not yet proclaimed), and have been put forward in Saskatchewan (first reading on November 6, 2006). British Columbia previously enacted a similar regime, with certain key differences, as part of its Securities Act, 2004, but that act has not been proclaimed, and there is some question about whether British Columbia will instead adopt a regime that is more uniform with the regime adopted in the other provinces.

The key to avoiding liability is to provide timely and accurate continuous disclosure. In addition, issuers should have in place disclosure and document preparation procedures to ensure that defences in the legislation that are based on reasonable investigation by defendants are available in case misrepresentations are made or there is a failure to make timely disclosure of a material change.

Summary Checklist

- (a) **Written disclosure policies and procedures:** All responsible issuers should have written disclosure policies and procedures that are in line with the specifics of the regime.
- (b) **Procedures for verification:** Issuers should have disclosure policies that stress the importance of accurate public disclosures and processes to verify accuracy. Issuers should consider internal certification procedures for all “core” documents which expose potential defendants to the greatest possibility of litigation.
- (c) **Spokespersons and public oral statements:** Strict controls should be placed on who may speak for the issuer.
- (d) **Influence of control persons, insiders and promoters:** “Influential” persons such as control persons, insiders and promoters of a responsible issuer should be informed that they are exposed to liability, along with others, for: (i) misrepresentations in disclosure documents and public oral statements and failures to make timely disclosure of material changes that

¹ By James Farley, Roger J. Chouinard and Alasdair Federico

they seek to influence; and (ii) misrepresentations in disclosure documents and public oral statements relating to a responsible issuer that they themselves release or make. Issuers should include in their disclosure policies: (i) a statement as to the role that such persons play in document preparation and release and materiality assessments; and (ii) further to the discussion under (c) above, a statement that such persons should not speak or release disclosure on behalf or in relation to the issuer other than through the issuer's authorised spokespersons or after vetting by the issuer. In addition, issuers should specify in their disclosure procedures: (i) how influential persons participate in the disclosure preparation and release and materiality assessment processes and to what extent; and (ii) methods for monitoring "influential" persons generally as well as during disclosure preparation and release and materiality assessment processes.

- (e) **Expert review of procedures:** There may be utility to issuers in being able to demonstrate that a review of the adequacy of steps taken to implement and/or enhance disclosure procedures and policies was completed with the assistance of external legal counsel.
- (f) **Forward-looking information:** Issuers should consider whether they want to continue to provide earnings guidance and, if so, whether guidance will be given with respect to annual or quarterly performance. There is a safe harbour for forward-looking information but it requires that the basis for any forward-looking information be reasonable. To rely on the safe harbour, it will not be sufficient to use familiar boilerplate cautionary language. In order to determine whether the basis for any forward-looking information is "reasonable", consideration must be given to who internally or externally is needed to make credible judgments about what is reasonable and will require a reconsideration of how the assumptions and "material factors" underlying such information are arrived at and expressed.

Written disclosure policy and disclosure procedures

In the secondary civil liability context, written disclosure policies and procedures are critical for two reasons: (i) they will assist in avoiding the incidence of misrepresentations or failures to make timely disclosure; and (ii) they will assist defendants in establishing the due diligence defence provided in subsection 138.4(6) of the Securities Act.

A person or company may avoid liability for a misrepresentation in disclosure documents or oral statements if, before the release of the document or making of the oral statement, the person or company conducted or caused to be conducted a reasonable investigation and at the time of the release of the public document or the making of the oral statement, the person or company had no reasonable grounds to believe that the document or statement contained the misrepresentation. Similarly, in the case of a failure to make timely disclosure, a person or company may have a defence if before the failure to make timely disclosure first occurred, the person or company conducted or caused to be conducted a reasonable investigation and the person or company had no reasonable grounds to believe that the failure to make timely disclosure would occur.

Factors to be considered by a judge in determining whether an investigation was reasonable are set out explicitly in subsection 138.4(7) of the Securities Act. One of the factors is “the existence, if any, and the nature of any system designed to ensure that the responsible issuer meets its continuous disclosure obligations.” A separate factor is whether the reliance on the compliance disclosure policy and on the persons responsible for knowing relevant facts was reasonable. The judge will have to consider not just what is written down in the policy but how the system actually works in practice. Defendants’ conduct will be assessed with reference to their specific responsibility for disclosure as well as their position within the organization. Managers will likely be held to a higher standard of due diligence investigation than outside directors.

Core documents

The Securities Act distinguishes between “core documents” and other documents (“non-core documents”). Public oral statements are treated the same way as non-core documents. Core documents are, generally speaking, more comprehensive filings that are submitted to the board of directors for review and approval. It is more difficult to sue for misrepresentations in non-core documents and public oral statements than in core documents. Failures to make timely material disclosure also benefit from this more defendant-friendly regime.

For misrepresentations in non-core documents and public oral statements and failures to make timely disclosure of material changes in an issuer’s affairs, a plaintiff must show that the misrepresentation or failure to make timely disclosure of a material change was made knowingly or recklessly, or otherwise as a result of “gross misconduct.”

In the case of core documents, a plaintiff need not prove that there was fraud or negligence on the part of the defendant in making the misrepresentation or failure to make timely disclosure of a material change. The onus will be on the defendant to establish a due diligence or other defence.

When used in relation to a responsible issuer or an officer of such an issuer, “core documents” are: prospectuses, take-over bid circulars, issuer bid circulars, directors’ circulars, rights offering circulars, management’s discussion and analysis, annual information forms, information circulars, annual financial statements, interim financial statements, material change reports and other documents as may be prescribed by the regulation. When used in relation to a non-management director, the list is the same except that material change reports and other documents as may be prescribed by the regulations are not included.

- (a) Responsible issuer and officers

MI 52-109 requires CEOs and CFOs of public issuers to file interim and annual certificates confirming that disclosure controls and procedures are in place and that the effectiveness of such controls has been evaluated. CEOs and CFOs should in turn request certificates from managers with similar statements with respect to their areas and expertise, if necessary, in order for the CEO and CFO to make their public certifications. If this process is established appropriately, it should form the basis for the due diligence defence under Part XXIII.1 of the Securities Act with respect to the above documents. Public issuers should examine the feasibility of extending these procedures, with appropriate modifications, to all core documents.

In evaluating disclosure controls and procedures, issuers and their officers should consider the following:

- **Accuracy:** Typically, disclosure policies and procedures emphasize techniques for evaluating the materiality of developments but take the accuracy of disclosures for granted. Verification of facts is critical in the context of the secondary market civil liability regime and policies and procedures should be implemented or amended, as the case may be, to cover the accuracy of disclosure specifically and explicitly.
- **Effectiveness:** Before disclosure procedures are memorialized in a written document, their effectiveness should be evaluated. The procedures must both capture all material information and make sure that it is accurate. Are there “checks and balances” in the procedures to validate information? Is the same information checked by different persons with different functions? If information is included in disclosure which is not derived from the issuer’s internal controls for financial reporting, procedures to substantiate the information should be considered. For example, if an issuer asserts that it has become the second largest supplier of widgets, can it point to adequate back-up? If the information is technical, for example, related to a subject that is normally the subject of expert knowledge, have the appropriate internal or external subject matter experts signed off on it?
- **Interactive process:** Is the process interactive, involving sufficient dialogues regarding material information and events within the issuer, and are rounds of revisions considered by the persons involved?
- **Reliable and timely information:** Do the issuer’s systems gather information in a reliable and timely manner? Has the disclosure process worked to date?

MI 52-109 does not require responsible issuers and their officers to file certificates with respect to material change reports. However, establishing procedures to ensure their accurate and timely preparation and filing are key to establishing a due diligence defence under secondary market civil liability in respect of any misrepresentations that they may contain. While a particular material change report may be drafted and filed by investor relations persons or internal or external counsel, it should, in all cases, receive sign off from a business person with first hand knowledge of the material change.

(b) Non-management directors

Non-management directors must establish a due diligence defence with respect to the core documents listed above other than material change reports. However, what a non-management director must do to establish such a defence is likely different from what an officer, who is directly involved in document preparation, must do. The decided corporate law cases on the role of non-management directors and the list of factors in Part XXIII.1 of the Securities Act direct a judge to consider both the role and responsibility of any particular defendant in determining how the defendant may establish a due diligence defence. Directors would be expected to ensure appropriate and effective procedures are in place but would not necessarily be expected to have any involvement with disclosure preparation.

The *Danier Leather* case, decided in the context of primary market prospectus civil liability, contains an important and relevant discussion on the role of management versus non-management directors in the due diligence process. The *Danier Leather* decision recognizes that senior management of an issuer is pivotal in the information gathering process and in ensuring adequate disclosure. Members of senior management are obliged to know or obtain knowledge of all significant information about the issuer, and obliged to disclose it to other participants in the process (in this case the prospectus preparation process) including non-management directors. This discussion suggests that in the secondary market civil liability context, it may also be reasonable for non-management directors of an issuer to rely on senior management to bring significant information about the issuer to their attention. It would be useful to memorialize the foregoing principles about information gathering and sharing in the policies and procedures.

In determining whether the “reasonable investigation” element of the due diligence defence has been satisfied, a judge must consider the role and responsibility of the person in the preparation and release of the disclosure document, or in ascertaining the facts contained therein. Accordingly, non-management directors may not want to get “too close” to the preparation of disclosure documents. If they get involved in the preparation and release of disclosure, they are likely to be held to a higher standard in determining whether they conducted a reasonable investigation.

Non-management directors are specifically allowed to rely on others in certain contexts; that is, directors are not liable for breach of their statutory duty of care under corporate law if they rely in good faith upon financial statements of a corporation represented to them by an officer or in a written report of the auditor to present fairly the financial position of the corporation in accordance with GAAP, or a report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by any such person.² Non-management directors may be able support a due diligence defence for secondary market civil liability by showing that they have discharged their duties under corporate law and that the procedures that are in place are appropriate ones.

Directors should consider the pros and cons of taking notes of meetings or decisions in which they participate. Taking notes may be a useful way for a director to establish that a director made a reasonable investigation. In that respect, the notes should focus on the process involved, but note-takers should take care that note-taking does not become a matter of formality replacing actual diligence. On the other hand, having notes could

² See *Business Corporations Act* (Ontario), subsection 135(4).

open up the director to greater scrutiny in the event of a lawsuit. Note-takers should be particularly cautious of the information they capture in notes and the implications of that information. A judge considering notes taken by a director could decide, by inference based on information recorded in notes, that the director did not have reasonable grounds for a belief that there were no misrepresentations, or potentially that the director had knowledge of a misrepresentation, which could remove the director's liability cap.

Non-core documents

A plaintiff must establish overt misconduct on the part of the defendant or prove that the defendant was aware of or reckless as to the existence of the misrepresentation or the failure to make timely disclosure in order to succeed in an action under Part XXIII.1 of the Securities Act regarding non-core documents such as press releases.

As with material change reports, while a particular press release may be prepared by investor relations persons or internal or external counsel, it should in all cases receive sign off from a business person with first hand knowledge of the subject matter of the press release.

Presentations and oral statements

Presentations and oral statements, such as speeches at annual meetings, earnings calls and quarterly calls should be scripted (to the extent possible) and reviewed after delivery to identify and correct any misrepresentations or selective disclosure. Records of presentations and oral statements should be kept.

To the extent that forward-looking information is included, there must be a reasonable basis for making a forecast or projection and it will be important to: (i) include reasonable cautionary language; (ii) identify the forward-looking information as such and identify material factors which could cause actual results to differ materially from the forecast or projection; and (iii) state material factors or assumptions that were applied in drawing a conclusion or making a forecast or projection.

In light of recent Ontario Securities Commission ("OSC") settlements, including *ATI Technologies*, some issuers are re-evaluating the use of earnings guidance. If an issuer decides to continue to provide guidance, it will be necessary to consider how the "material factors" and "assumptions" will be expressed. "Material factors" and "assumptions" are not synonymous and both must be set out. Material factors will include "risk factors" but may go beyond conventional risk factors. For example, an issuer's results could be affected by a material acquisition or disposition and these could occur without any of the risks to the business coming to pass. The safe harbour depends on setting out information about factors and assumptions proximate to the forward-looking information. Incorporation by reference does not appear to be permitted to satisfy this requirement.

Assigning specific responsibility for portions of disclosure on the basis of expertise

An issuer should establish definitive personal responsibility for verifying the accuracy and completeness of the various portions of disclosure documents based on subject matter expertise. For example, officers in charge of specific areas such as litigation, environmental matters, regulatory matters, intellectual property, insurance and risk

management, and finance should be sent their portions of the document for review and should also be encouraged to prepare disclosure as issues arise in their areas of expertise. The heads of business units should be assigned to review the descriptions of their specific units.

An issuer should assign specific responsibility for reviewing boilerplate language, risk factor disclosure and forward-looking statement disclosure in disclosure documents. Risk factor disclosure and forward-looking statement disclosure should be assigned to a senior officer who will likely have the best feel for the true risks in the business taken as a whole. Any risk factor section and forward-looking statements warning should be reviewed and updated, where appropriate, regularly (i.e. quarterly).

Assigning responsibility for reviewing developments in case law, securities commission settlements and disclosures of competitors

Issuers should assign responsibility to a person or a small group of persons for keeping informed regarding developments in case law and securities commission enforcement proceedings affecting disclosure practices. Such person(s) should also review relevant notices, reports and policies/rules issued by the OSC. Reviewing the disclosure of competitors will likely be of interest as well, as it will assist in arriving at materiality judgments. The person(s) assigned this responsibility should report to the issuer's disclosure committee (or in the absence of such a committee, to the CEO and CFO) periodically and promptly in the event of any major development in the law or practices.

Documenting the process conducted in connection with the preparation of disclosure documents to establish reasonable investigation defence

Issuers should consider appointing a person responsible for documenting the review process for each filing. This could be in the form of a chronology specifying the names of individuals and dates they reviewed draft reports as well as a record of meetings of the committees involved in the preparation of the report, but as a practical matter, producing a chronology and summaries takes company resources and could become an unwieldy process if it is too detailed or covers too many documents. Alternatively, the appointed person could be responsible for maintaining the disclosure policy and ensuring that the policy is always followed, so that the person could verify that it would have been followed in the case of the document in question (even though he/she potentially had no recollection or notes of the precise actions taken).

Issuers may also consider implementing a practice of having a person uninvolved in the preparation of a document review it as a proxy for the average reader. The role of this person would be to identify areas of confusion or ambiguity and to ask questions to ensure that those responsible for preparing the document have not overlooked something obvious because of their familiarity with the material.

Foreign/international issuers

The secondary market civil liability regime in Part XXIII.1 of the Securities Act applies not only to reporting issuers in Ontario, but also to "any other issuer with a real and substantial connection to Ontario, the securities of which are publicly traded." The definition of "document" includes documents that are available and filed in foreign jurisdictions. It also includes "any communication the content of which would

reasonably be expected to affect the market price or value of a security.” It is possible that shareholders of non-Canadian companies will pursue actions in Ontario courts under Part XXIII.1 of the Securities Act once it is in force.

U.S. issuers may feel that they are adequately prepared for the implementation of the secondary market civil liability regime as they are already complying with disclosure procedure requirements under the *Sarbanes-Oxley Act of 2002* and are subject to U.S. Rule 10b-5. U.S. issuers should be advised that Part XXIII.1 of the Securities Act differs from Rule 10b-5 in several respects. First, in a Rule 10b-5 action for a misrepresentation, a plaintiff is required to prove “scienter” which is defined by the U.S. Supreme Court as a “mental state embracing intent to deceive, manipulate or defraud.” Recklessness has also been found to constitute “scienter.” In the case of core documents, Part XXIII.1 creates a presumption of liability in the case of a misrepresentation. No mental state such as “scienter” is required to be proved. Second, there is no general obligation to make timely disclosure of all material changes under U.S. securities laws. Third, there is no requirement in Canadian law to prove a causal connection between the misrepresentation and the damage, whereas this is required under U.S. law. Fourth, there are liability caps imposed under Part XXIII.1 of the Securities Act. These differences should be considered by international issuers with a real and substantial connection to Ontario.

Forward-Looking Information

On December 1, 2006 the Canadian Securities Administrators published for comment proposed amendments to several national instruments and forms to implement requirements for forward-looking information, including future-oriented financial information and financial outlooks such as earnings guidance.

(a) Preparation and disclosure required upon initial publication.

Under the proposed requirements disclosure requirements will mirror the safe-harbour provisions for forward looking information: issuers will be required to have a reasonable basis for forward-looking information and must include broad disclosure; specifically, an issuer should:

- identify forward-looking information as such,
- caution users that actual results will vary,
- disclose the material factors or assumptions used to develop the information, and
- disclose the issuer's policy for updating the information if it includes procedures in addition to those described below.

(b) Updating

An issuer will be required to discuss in its MD&A events and circumstances that occurred during the MD&A period that are reasonably likely to cause actual results to differ materially from previously released material forward-looking information, including earnings guidance.

An issuer should consider whether the events and circumstances that are reasonably likely to cause actual results to differ materially from previously released forward-looking information trigger the material change reporting requirements.

(c) Comparing to actual

An issuer will be required to disclose in its MD&A material differences between actual results and previously released FOFI or financial outlooks for the period to which the MD&A relates.

(d) Withdrawal

An issuer will be required to discuss in its MD&A a decision made during the MD&A period to withdraw previously released material forward-looking information. This would include a discussion of the assumptions underlying the forward-looking information that are no longer valid.

An issuer should consider whether the events and circumstances relating to a withdrawal decision trigger the material change reporting requirements. As well, in order to properly effect a withdrawal, an issuer should promptly communicate its withdrawal decision.