Submission on Insider Trading Task Force (ITTF) Proposals: Pertaining to Service Providers

CANADIAN BAR ASSOCIATION

February 2004

TABLE OF CONTENTS

Submission on Insider Trading Task Force (ITTF) Proposals: Pertaining to Service Providers

PREFACE i

I. INTRODUCTION 1

II. CANADIAN LAW ON INSIDER TRADING 2

III. UNITED STATES CASES ON INSIDER TRADING 6

IV. COMMENTARY ON THE REPORT: 3.1.2 – BEST PRACTICES FOR INFORMATION CONTAINMENT – SERVICE PROVIDERS 7

A. The Proposal for Lawyers in the November Report 7

B. Best Practices for Accountants 10

C. Banks and Investment Dealers as Service Providers 11

PREFACE

The Canadian Bar Association is a national association representing 38,000 jurists, including lawyers, notaries, law teachers and students across Canada. The Association's primary objectives include improvement in the law and in the administration of justice.

This submission was prepared by the Canadian Bar Association, with assistance from the Legislation and Law Reform Directorate at the National Office. The submission has been reviewed by the Legislation and Law Reform Committee and approved as a public statement of the Canadian Bar Association.

Submission on Insider Trading Task Force (ITTF) Proposals: Pertaining to Service Providers

I. INTRODUCTION

The ITTF published, in November 2003, a report entitled "Illegal Insider Trading in Canada: Recommendations on Prevention, Detection and Deterrence" (the Report). The Report has 32 recommendations for changes to be instituted relating to "Illegal Insider Trading in Canada". The Canadian Bar Association (the CBA) welcomes the opportunity to present its views on the proposals by the ITTF. This is Part I, of a two-part submission by the CBA. This submission is restricted to the recommendations on service providers in section 3.1.2 of the proposals.

The "objective" of the ITTF is stated in the Report as "evaluating how best to address illegal insider trading (emphasis added) on Canadian capital markets". The identification of a legitimate regulatory issue is typically the rationale for changes in the regulatory framework. The ITTF worked from the mandates identified in the Report to:

1. identifying means of reducing the risk of illegal insider trading occurring such as by promulgating best practices for dealers, issuers and service providers to limit the leakage of inside information;
2. increasing the ability of regulators to detect illegal insider trading when it occurs, such as by addressing offshore and nominee account issues and by coordinating the regulation of equities with their derivatives; and
3. increasing the success of deterrence efforts through:
   - better coordination among regulatory agencies,
   - ensuring the laws are adequate, and
   - improved enforcement mechanisms and penalties.

While this submission is restricted to the recommendations on service providers in section 3.1.2 of the proposals, to consider the Report logically it is first necessary to understand the scope of illegal insider trading under Canadian law as it now stands.

II. CANADIAN LAW ON INSIDER TRADING

It is useful to consider the recent Ontario case of *R. v. Harper*. The prosecution by the Ontario Securities Commission ("OSC") showed that Mr. Harper was a person in a "special relationship" with a corporation named Golden Rule. The "special relationship" term includes an "insider". Under section 76(5) of the *Ontario Securities Act* (OSA), insider is defined to mean every director and senior officer of a reporting issuer and a person controlling 10% or more of the voting securities of an issuer. The definition is a direct copy of the United States securities legislation provisions relating to insiders under which the Securities and Exchange Commission operates.

Mr. Harper was a senior officer of Golden Rule and the trial judge found that he had personal knowledge of undisclosed assay results which clearly rebutted earlier published results of a positive gold strike in Ghana. The quoted share price of Golden Rule had gone up remarkably in late 1996 and January 1997 to over $12 per share, presumably based on the positive results. The price sank to about $1 per share after the new assay results were disclosed. During the period before the new assay results were made public, Mr. Harper sold shares to a value of over $4 million and bought shares to a value of just over $1 million on the Toronto Stock Exchange. Mr. Harper was a professional geologist with 30 years experience and had a master's degree in economics. A clearer case of insider trading on undisclosed material information is hard to imagine. But whether it is "illegal" insider trading depends on the statute, in this case the OSA.

Pursuant to section 76(1) of the OSA, no person in a special relationship with a reporting issuer shall purchase or sell securities of the reporting issuer with the knowledge of a material fact or material change with respect to the reporting issuer that has not been publicly disclosed. Under section 76(2) of the OSA, no person in a special relationship with a reporting issuer shall inform, other than in the ordinary course of business, another person of a material fact or material change with respect to a reporting issuer that has not been publicly disclosed.

Under section 122(1) of the OSA, every person that contravenes Ontario securities law is guilty of an offence and on conviction is liable to a fine of not more than $5 million or to imprisonment for a term of not more than five years less a day, or both. It is noteworthy that merely informing another of an undisclosed material fact even if there is never any trade, makes the tipper liable to incarceration for up to five years in jail and to a fine of $5 million. It is not surprising that people view the OSA as somewhat poorly drafted, as the penalty does not relate logically to all sections of the statute.

Subsections 122(4) and (5) of the OSA provide that with respect to subsection 76(1) and (2) of the OSA:

> 4) Despite subsection (1) and in addition to any imprisonment imposed under subsection (1), a person or company who is convicted of contravening subsection 76(1), (2) or (3) is liable to a minimum fine equal to the profit made or the loss avoided by the person or company by reason of the contravention and a maximum fine equal to the greater of,
>
> > (a) $5 million; and
> > (b) the amount equal to triple the amount of the profit made or the loss avoided by the person or company by reason of the contravention.
>
> 5) If it is not possible to determine the profit made or loss avoided by the person or company by reason of the contravention, subsection (4) does not apply but subsection (1) continues to apply.

At trial, Sheppard J. found Harper guilty of insider trading under section 76(1) of the OSA as charged on July 21, 2000, see [2000] O.J. No. 2791. In a second decision relating to sentencing, Sheppard J. considered section 122(1) of the OSA, which at the

time had a fine of $1 million and imprisonment for up to two years. The actual trading by Mr. Harper involved:

a) trading on his account, for which he sold 100,000 shares for $934,000 and bought 240,000 shares for $689,000;

b) trading on account of a corporation wholly owned by him, for which he bought and sold 50,000 shares for a profit of $120,000;

c) trading on behalf of his wife, for whom he bought and sold shares for a profit of $130,000; and

d) trading on behalf of a company the shares of which were owned by his wife in trust for their four children, for which the profit was $2.1 million.

The OSC charged Harper with two counts of insider trading, between specified dates on each count, without separating the various accounts. The judge calculated the loss avoided to be $1.8 million in each of the first and second periods. To that he added 10% (the statute would appear to allow triple the loss avoided) for a total fine of almost $4 million plus a jail term of one year.

At the first level of appeal, the late Justice Roberts accepted the trial judge's facts but reduced the imprisonment term from one year to six months. He also read section 122 (5) of the OSA to apply because it uses the words "by reason of the contravention". Hence, he decided, the Crown must prove that the profit made or loss avoided is linked to the non-disclosure of material facts and not just to market fluctuations. As this had not been proven by the Crown, the fine was reduced to $1 million on each count, the maximum allowed under 122(1) of the OSA as it then stood. The Crown appealed.

In the Ontario Court of Appeal, the appeal was allowed with respect o the concept of "loss avoided" and "profit made" which are defined in subsection 122(6) of the OSA as follows:

> "loss avoided" means the amount by which the amount received for the security sold in contravention of subsection 76(1) exceeds the average trading price of the security in the twenty trading days following general disclosure of the material fact or the material change; ("perte évitée")

> "profit made" means
>
> (a) the amount by which the average trading price of the security in the twenty trading days following general disclosure of the material fact or the material change exceeds the amount paid for the security purchased in contravention of subsection 76(1),
>
> (b) in respect of a short sale, the amount received for the security sold in contravention of subsection 76(1) exceeds the average trading price of the security in the twenty trading days following general disclosure of the material fact or the material change, or
>
> (c) the value of any consideration received for informing another person or company of a material fact or material change with respect to the reporting issuer in contravention of subsection 76(2) or (3). ("profit réalizé")."

The Court said that "by reason of the contravention" meant by reason of the trading before public disclosure was made and did not relate to tying the profit or loss directly to the misleading disclosure. The Court said:

> The interpretation advanced here is also consistent with the scheme and object of the Act, which is to recapture profits made or losses avoided by insiders trading in contravention of Ontario securities law. The interpretation advanced by the Respondent makes it practically impossible to affect that purpose. The overall object of this aspect of the *Securities Act* is to police trading to ensure fairness in the securities marketplace and to sanction contraventions. The clear legislative intent reflected in the language of the subsection is to provide a simple formula by which to quantify the extent of the loss which the Respondent avoided by reason of having contravened the law. As the Appellant puts it, in its factum, "any 'amount' which the Respondent received by illegally selling the securities of Golden Rule which exceeded what he would have received had he waited until he was legally entitled to sell those securities is a loss which the Respondent avoided 'by reason of the contravention'.

But the Court went on to find that the wording of subsection 122(4) of the OSA relates to the profit made or loss avoided by the person or company. Therefore, the trades for his wife and for the children's corporation, were excluded. While even with these exclusions a triple penalty would have amounted to $4 million, there is an automatic 20% surcharge under the *Provincial Offences Act* which the court considered relevant. It therefore maintained the $2 million fine adopted by the initial appeal judge and the incarceration period of six months was not changed.

One important result of the Court of Appeal finding, in its interpretation of section 122(4) and 122(6) of the OSA is to preclude any use of those subsections for a breach of the tipping provision in section 76(2) of the OSA, unless there is some consideration received by the tippee. Accordingly, tipping is only punishable under the general offence provision. While tipping has been alleged by the OSC in at least one prosecution, *Regina v. Plastic Engine Technology* [1991] O.J. No. 1491, the Court said that the Crown would have to prove beyond a reasonable doubt that the insider advised the recipient directly of the actual material information and not just advised the recipient to trade in the shares of the corporation to which the information related. Tipping is, therefore, not really an insurmountable problem. Leaks are allowed.

III. UNITED STATES CASES ON INSIDER TRADING

The cases in the United States involving insider trading liability are voluminous but the 1997 decision of the Supreme Court in *SEC v. O'Hagan* is the most current exposition of the theory behind liability. O'Hagan was a partner in a law firm in Minneapolis that was retained by an English corporation regarding a potential tender offer for Pillsbury, a corporation headquartered in Minneapolis. O'Hagan bought 2,500 Pillsbury options and 5,000 shares of Pillsbury. When the bid materialized a month or two later, O'Hagan sold the securities, making a profit of $4.3 million. The court held that this was a criminal offence predicated on the misappropriation theory. In the course of the majority judgment, Justice Ginsberg explained two theories of insider trading liability, the "classical theory" and the "misappropriation theory". The classical theory of insider trading liability arises when a corporate insider trades on the basis of material non-public information because of the necessity of preventing an insider from taking unfair advantage of uninformed shareholders, to whom the insider owed a fiduciary duty. Such a fiduciary duty does not exist in Canada unless one extends the Lac Minerals decision.

The misappropriation theory holds that a person violates the criminal provisions when she misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of the information. The Court said specifically:

> "Should a misappropriation put such information to other use, the statute's prohibition would not be implicated. The theory does not catch all conceivable forms of fraud involving confidential information; rather it catches fraudulent means of capitalizing on such information through securities transactions."

With respect to tipper and tippee liability, the case of *SEC v. Dirks* (1982) USSC explains the governing concept. The Court there said that the status of the tippee derives from the tipper. Unless the tipper acted improperly, which is to say the tipper acted for personal gain, there is no liability on the tipper and there is no liability on the tippee unless she knows or should know that there has been a breach of the tipper's fiduciary duty. While Seligman suggests that the personal benefit standard is not hard to demonstrate, Arthur Levitt, the former SEC Chairman, called it a "high hurdle" and said "we held our insider trading fire…All of us agreed it would create enormous fear among companies and analysts and could seriously chill the flow of information…We needed a different hook". The SEC then came out with Reg. FD (Fair Disclosure) as a solution.

In the United States, there is also a short swing profit rule which provides that the issuer is entitled to collect any profit from an insider who does not hold the securities traded for at least six months. This concept is easily circumvented and has never been introduced into Canadian legislation, although its potential has been considered and rejected.

IV. COMMENTARY ON THE REPORT: 3.1.2 – BEST PRACTICES FOR INFORMATION CONTAINMENT – SERVICE PROVIDERS

A. The Proposal for Lawyers in the November Report

As the CBA is most concerned with the impact on lawyers, we will deal first with the

recommendations in that area. The Report states that its recommendations are intended to result in a reduction in the risk of increased illegal insider trading by decreasing the amount of insider information leakage through issuers, intermediaries and other service providers and increasing the credibility of the enforcement regime. This is not the policy recommended in the United States. There the idea is to encourage more disclosure.

The Report recommends that the CBA and the provincial law societies work with the CSA to develop "substantive best practices for information containment by lawyers". The Report states that "There are no national or provincial rules or practices for lawyers that address directly the containment of insider information." This statement is incorrect and the fact could have been easily determined in consultation with the CBA. In fact, the CBA did advise the ITTF of the regulatory environment described below, which we believe addresses both directly and indirectly the containment of insider information as a subset of clients' confidential information.

At the present time, all the Law Societies and the CBA have a code relating to confidential information. The basic rule of the CBA is:

> "The lawyer has a duty to hold in strict confidence all information acquired in the course of the professional relationship concerning the business and affairs of his client, and he should not divulge any such information unless he is expressly or impliedly authorized by his client or required by law to do so."

The first two commentaries provide:

> "The lawyer cannot render effective professional service unless there is full and unreserved communication between him and his client. At the same time the client must feel completely secure and he is entitled to proceed on the basis that without any express request or stipulation on his part matters disclosed to or discussed with his lawyer will be held secret and confidential."

> "This ethical rule must be distinguished from the evidentiary rule of solicitor and client privilege with respect to oral or documentary communications passing between the client and his lawyer. The ethical rule is wider and applies without regard to the nature or source of the information or the fact that others may share the knowledge."

All the Law Societies across Canada have similar rules in place.[1] Accordingly, the regulators of the legal profession across Canada have required of all lawyers a uniform policy of strict confidence of all information, material or otherwise, and such policy is in place. Thus the need for further regulatory intervention, in this instance by the CSA, has not been demonstrated.

However, in the Report the recommendation goes on to suggest that issuers listed on a stock exchange in Canada retain only lawyers who have adopted the CSA approved best practices on information containment. This would mean that every lawyer or law firm retained for any area of law, such as employment law, litigation, environmental law, tax law, real estate, intellectual property, competition law or lawyers hired to make submissions to regulators, governments or property assessment commissions would have to adopt the CSA standard on information containment. Moreover, the client would have to demand that the lawyer adopt the CSA "best practices" before agreeing to proceed. This is overreaching as lawyers are already bound by strict confidentiality rules consistent with the CSA proposals and therefore the best practices proposed are unnecessary.

The recommendation in the Report then goes on to say if directors or senior officers fail to fulfill this responsibility then these individuals could be censored by the securities administrators. For such censor to take place, the CSA would have to enquire into the content of communications between the officers of the corporation and its lawyers. This would require disclosure of the lawyer/client relationship, which is contrary to the substantive law of Canada and the ethical obligations of lawyers across Canada.

In the recent case, before the Supreme Court of Canada *Miranda v. Richer* [2003] S.C.J. No. 69, in which the Canadian Bar Association intervened, the court specifically dealt with solicitor-client privilege and "stressed the social importance

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1 http://www.flsc.ca/en/lawSocieties/actRegulations.asp.

of that privilege, whose purpose is to protect the confidentiality of communications between solicitor and client" (paragraph 11). Mr. Justice Le Bel for the majority said:

> "The decisions of this Court have consistently strengthened solicitor-client privilege, which it now refuses to regard as merely an evidentiary or procedural rule and considers rather to be a general principle of substantive law."
>
> "This is particularly so where the information could result in severe penalties of a criminal nature to the officer of the corporation directly involved."

Accordingly, in our view, the suggested Recommendations 3 and 4 are contrary to the law of this Country, are an unnecessary overlay to current rules and are entirely misconceived. The suggestion that the recommendations "should result in little or no cost to market participants" is not supported and should be reviewed for its accuracy.

B. Best Practices for Accountants

From the information provided in the Report, it appears that the ITTF determined that accountants also have professional rules of conduct. The Report says:

> "In a written report, the ICAO explained that it mandates that all members govern themselves in accordance with the profession's rules of conduct. The rules of conduct state that a member of the ICAO shall not disclose any confidential information concerning the affairs of any client (including a former client, employer or former employer) except in certain circumstances. The exceptions are where a professional duty, legal or judicial process of law requires disclosure, where disclosure is necessary to defend the firm or where the client consents to disclosure. In addition, the member shall not use confidential information for personal advantage, the advantage of a third party or to the disadvantage of a client, without the consent of the client. The ICAO rules permit the use of confidential information with consent of the issuer client, however consent is irrelevant in the case of illegal insider trading."

It would therefore appear that in requiring a "set of national best practices", the CSA is again exceeding its jurisdiction for the practices do not relate solely to matters where potential leakage of material information would necessarily be in issue. We would note that there has recently been set up three new regulatory bodies imposed on the accountants, namely the Canadian Public Accountability Board (whose chair of the Council of Governors is David Brown, Chairman of the OSC), the Auditing and Assurance Standards Oversight Council (Chaired by Jim Baillie) and the Accounting Standards Oversight Council (Chaired by Tom Allen). In our view, there is enough

regulation of the profession in Canada without imposing the suggestion in Recommendation 5. As Recommendation 6 depends on Recommendation 5, we assume it will not be enacted. If it were, we doubt that it would withstand a constitutional challenge under the Canadian Bill of Rights.

C. Banks and Investment Dealers as Service Providers

The CBA notes that Recommendation 7 relates only to banks, which are clearly under federal jurisdiction. Accordingly, Recommendation 7 is a request to OSFI, which has the authority to develop regulations if it believes a real problem exists.

Recommendations 8 and 9 refer to information containment by dealers and here there is no nexus to the issuers or obligations on the issuers to enforce some policy on the dealers. If the IDA, as suggested in Recommendation 8 and the various SRO's set out in Recommendation 9 think that the suggestions made are useful, the CBA sees no legal reason not to institute enhanced procedures. We would suggest however that a reference point for consideration is Chapter 4 of Arthur Levitt's book "Take on the Street", which chapter is entitled "Reg. FD: Stopping the Flow of Inside Information". That chapter relies on forcing material information to be disclosed rather than stopping up leaks. A very different approach than underlying the recommendations of the ITTF.