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1991



Consumer and
Corporate Affairs
Canada

Consommation
et Corporations
Canada

Insider Trading

and the

Canada Business Corporations Act

Canada

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INSIDER TRADING

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CANADA BUSINESS CORPORATIONS ACT

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Cette publication est aussi disponible en français.

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Cat. No. RG 35-9/1991 E

ISBN 0-662-19023-8

CCAC No. 10476 91-07



Contains 50% recycled fibres

PREFACE

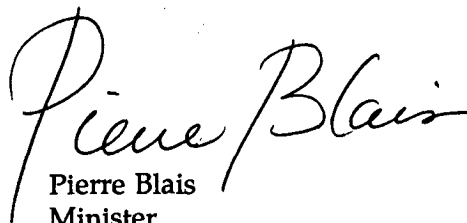
The Government of Canada is committed to the modernization of framework legislation in order to promote a strong economy and confidence in the Canadian marketplace and to contribute to the international competitiveness of Canadian business. The *Canada Business Corporations Act* is an important piece of framework legislation. It ensures order and fairness in the corporate environment and provides a workable structure for governing the relationship between investors and managers.

To ensure that the *Canada Business Corporations Act* reflects evolving commercial and marketplace practices, Consumer and Corporate Affairs Canada is proposing revisions to the Act's insider trading provisions. The proposals outlined in this paper are designed to modernize the Act by accelerating the reporting of trades by insiders, by ensuring greater harmonization with the legislation of other jurisdictions, by facilitating compensation for aggrieved investors and by sending a clear signal to all marketplace participants that improper insider trading is not condoned by Canadian society.

By releasing "Insider Trading and the *Canada Business Corporations Act*," I hope to generate a discussion of the issues surrounding this subject. This paper will be followed by two others—a discussion paper on takeover bids and another on investigations.

All participants—governments, business and investors—have a stake in the operation of an efficient marketplace. I believe it is through consensus building and a strong sense of partnership that this can best be achieved.

In that spirit, I urge everyone who is affected by, or has an interest in, insider trading regulation to take part in the current discussions.

A handwritten signature in black ink, reading "Pierre Blais". The signature is fluid and cursive, with the first name "Pierre" and last name "Blais" clearly distinguishable.

Pierre Blais
Minister

Consumer and Corporate Affairs Canada

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PART I

BACKGROUND AND OVERVIEW

1. Introduction

This discussion paper has been prepared in order to generate discussion both within and outside government regarding federal regulation of insider trading. The purpose of this paper is to explore the rationale for government regulation of insider trading, the arguments for updating the *Canada Business Corporations Act* (CBCA) insider trading provisions and the general approach to CBCA revision and to describe proposals for amending the insider trading provisions of the Act. Part I of the paper summarizes the policy analysis conducted by Consumer and Corporate Affairs (CCA) and Part II discusses possible amendments.

This discussion paper is being distributed to provincial and other regulators, industry, corporate lawyers and other interested parties. The federal government intends to work closely with all of the foregoing in implementing any amendments to federal insider trading rules.

2. Purpose of the CBCA

The CBCA was proclaimed in force on December 15, 1975. The most recent amendments to the insider trading provisions of the Act were passed in 1978-79. The stated purpose of the Act is to revise and reform the law applicable to business corporations incorporated to carry on business throughout Canada and to advance the goal of uniformity of Canadian business corporation law. The Act ensures an orderly and equitable framework for corporate activity by providing a code of obligations and rights for management and shareholders.

Federal regulation of insider trading was first introduced in 1970 under the *Canada Corporations Act*. The drafters of that Act endorsed the recommendations put forward in 1965 by the *Report of the Attorney General's Committee on Securities Legislation in Ontario* (the "*Kimber Report*"). In 1975, the drafters of the CBCA recognized that it was "unnecessary to re-argue the soundness of the principle" underlying the need to regulate insider trading and therefore they largely incorporated the same provisions as in the previous Act. Because of recent changes in commercial and market practices, the Act is being examined in order to ensure it remains effective in regulating insider trading.

3. Rationale for Regulation of Insider Trading

The mission of the Department of Consumer and Corporate Affairs is to promote the fair and efficient operation of the marketplace in Canada. It is in this context that the CBCA, which is oriented towards promoting order and fairness in the corporate environment, protects investors in order to ensure that market stability, fairness and openness exist.

The CBCA covers many of the largest corporations operating in Canada. As of May 1991, there were 185,140 active corporations incorporated under the CBCA, including approximately 750 distributing corporations. Active CBCA corporations constitute about 25 percent of all active business corporations in Canada and account for an even higher proportion of corporate sales. Over 150 of the top 300 Canadian corporations are incorporated under the CBCA.

Former Supreme Court Justice Brian Dickson defined insider trading as follows in the "Multiple Access" case:

Insider trading is the purchase or sale of the securities of a company by a person who, by reason of his position in the company, has access to confidential information not known to other shareholders or the general public.¹

By possessing and using confidential information, the insider is able to make profits or avoid losses with less risk than other traders, and is able to extract trading profits from outside investors who do not possess the same information at the time of the trade. It may be difficult for outside investors to bring civil action against insiders because they may lack complete information. Governments being better able to gather evidence, can therefore serve the public interest in ensuring equity in capital markets through the regulation of insider trading.

As the *Kimber Report* stated in 1965:

The ideal securities market should be a free and open market with the prices thereon based upon the fullest possible knowledge of all relevant factors among traders. Any factor which tends to destroy or put in question this concept lessens the confidence of the investing public in the marketplace and is therefore a matter of public concern.²

A distinction between "proper" and "improper" insider trading is crucial to evaluating the economic impact and policy rationale associated with government regulation of insider trading. Like many other jurisdictions, Canadian legislation is based on the generally held view that it is not

improper to buy or sell securities in one's own company. However, it is improper for an insider to use confidential information acquired by virtue of being an insider in a privileged position to make profits by trading in the securities of that company. Federal law, therefore, does not prohibit insider trading but provides remedies only against insider trading based on confidential information which is material.

The rationale for not prohibiting "proper" insider trading (i.e., trading by insiders that is not based on material, non-public information) is that it can increase market efficiency through the information communicated by its very occurrence. As well, proper insider trading is a means of building employee loyalty by increasing their involvement in a firm's affairs. The expanded participation of employees and the opportunity for greater rewards encourage productivity and innovation. Finally, proper trading by insiders increases the number of knowledgeable participants in the stock market, enhancing the ability of shares to settle at a value more representative of a firm's true worth.

On the other hand, improper insider trading (i.e., trading by insiders based on material, confidential information) constitutes a threat to investors' confidence and to efficient market operations. If investors do not trust the fairness of the market, the amount of equity funds available to the corporate sector is reduced. This could impede the ability of capital markets to facilitate the optimal allocation of resources and decrease the competitiveness of Canadian corporations. Improper insider trading also poses a threat to the good relations that should exist between management and shareholders.

1. [1982] 2 S.C.R., page 161.

2. *Report of the Attorney General's Committee on Securities Legislation in Ontario*, 1965, p. 10.

The legislative controls over insider trading across Canadian jurisdictions are similar in principle and also in terms of the economic justifications and legal rules governing such trading. Insiders are required to report on their ownership of, and transactions in, the securities of their corporations and affiliates. Liabilities may be imposed on insiders who trade on the basis of confidential material information for their own benefit or advantage.

4. Reasons for Amending the CBCA's Insider Trading Provisions

Changes in the Securities Market. Since the provisions were enacted, the securities market has changed dramatically in terms of the volume and complexity of transactions, the range of investment instruments and advisers, and the nature of the securities industry. The Act requires amendment in order to ensure it continues to be able to maintain a fair and orderly corporate environment, to ensure the fairness of securities transactions, to protect investors, and to provide a clear guide to market participants.

Interests of Small Shareholders. The December 1989 survey of share ownership conducted by the Toronto Stock Exchange (TSE)³ indicates that about one-quarter of adult Canadians now own stocks, either through direct ownership or through mutual funds, and that this percentage increased significantly through the 1980s, particularly up to the October 1987 meltdown. TSE research also indicates that about four-fifths of stock market participants can be classified as small shareholders with holdings of stock valued at less than \$50 000. Share ownership rises with household income, but participa-

tion is still significant for middle and lower income families with annual incomes of less than \$50 000. When pension and insurance funds are added to participation through direct ownership and mutual funds, it is clear that a very large number of Canadian families now have a significant financial stake in the efficient operation of the Canadian stock market and a strong interest in effective regulation of insider trading to protect their interests. Financial analysts believe that, as discretionary income rises with the aging of the "baby boom" generation, participation by small shareholders in the Canadian stock market should continue to rise through the next decade. The Government's initiatives to privatize Crown corporations are also designed to attract direct participation and investment by the general public.

Incidence of Improper Insider Trading. Because of the inevitable problems with detecting illegal activity, very little statistical evidence is available on the extent and impact of improper insider trading in Canada. However, there is certainly a perception among industry specialists, the media and the general public that insider trading abuses are on the rise. Many media commentators have stated that insider trading scandals are a key factor in discouraging the small retail investor from fully returning to the stock market after the October 1987 meltdown. The December 1989 survey of share ownership conducted by the Toronto Stock Exchange indicates that, while share ownership has continued to increase over the past three years, most of this increase has been accounted for by mutual funds rather than by the direct purchase of stocks. Individual investors accounted for only about a third of TSE trades in 1989, compared to nearly 50 percent in 1987. For those people who do not own stocks, a major factor behind their decision

3. "Canadian Shareowners: Their Profile and Attitudes", December 1989.

was their growing concern about insider trading. The survey results may suggest that many non-shareowners believe investors need inside information to make money in stocks.

The potential for large profits from insider trading abuses is rising with the globalization of securities markets, changes in commercial practices, and the dramatic growth in the number and size of takeovers. The growing complexity of takeovers has resulted in the use of more outside advisors and in the "tipper-tippee" chain getting longer. Some of the larger insider trading cases in the U.S. involved people with no obvious link to the relevant corporation.

Other jurisdictions are responding to rising public concerns about the incidence and effects of illegal insider trading by strengthening their insider trading statutes. The prevailing view is that, to the extent that the opportunities for and financial benefits from illegal trading are on the rise, the potential costs to the illegal trader in terms of penalties, and to the regulators in terms of detection and enforcement, have to keep pace. Accordingly, the European Community has been considering a Common Directive which would ban illegal insider trading throughout the 12 nation bloc for the first time. The United States Congress has recently considered legislation to further strengthen and refine American insider trading rules.

Globalization. Through the globalization and automation of trading in securities, trading across provincial and national borders is increasing. Trans-border trading potentially adds to the scale and complexity of illegal transactions. As the Canadian economy becomes more closely linked to foreign economies through the Canada-U.S. Free Trade Agreement and successive GATT rounds, Canada requires a comprehensive regulatory framework to address insider trading abuses that cross provincial or national borders. Because the CBCA incorporates many of Canada's largest

corporations, insider trading cases involving trans-border trading could likely involve CBCA corporations.

Harmonization. With recent changes to many provincial statutes, the CBCA insider trading provisions are different from provincial statutes. In addition, differences remain among provincial statutes and their interpretation and enforcement. Updating the CBCA's insider trading provisions could help sustain the harmonization process across Canada and ensure that all shareholders of CBCA corporations are equally protected from illegal insider trading. Harmonization would also help to reduce the compliance costs of regulatees, and would simplify detection and enforcement.

Increased Corporate Restructuring. Complex business combinations, including takeovers, reorganizations and other corporate arrangements, are more prevalent in this era of globalization. Corporations attempt, through corporate restructuring, to better position themselves in an increasingly competitive international market. Examples of new environmental factors favouring such restructurings include the freer flow of capital and freer trade initiatives (Canada-U.S. Free Trade Agreement and Europe 1992). This consequently requires more and more outside expertise, thereby increasing the number of "structural insiders," such as investment bankers, legal advisors, financial and market analysts and union officials, who are receiving material non-public information. Corporate restructurings provide insiders with good opportunities to earn substantial profits from such information.

5. Guiding Principles for Amending the CBCA's Insider Trading Provisions

Consistency With Original Principles. The proposed amendments are designed to be fully consistent with the underlying principle of the Act as expressed in the *Dickerson Report*: "a scheme of law that was clear,

workable and above all written for the businessmen who will operate under it."⁴ CCA believes that in amending existing provisions an attempt should be made to clearly identify the insiders, provide indications of their expected conduct and encourage the establishment of a code of ethics.

Balance and Enforceability. The proposed amendments are designed to provide a balanced approach to insider trading regulation that keeps the insider in the market while protecting the interests of the corporation, the investment community, shareholders, outside investors and the general public. The provisions should not become overly restrictive; however, the proposed amendments are designed to effectively address serious abuses.

The proposed amendments are designed to be easily enforced. They attempt to provide clarity and certainty to investors, enforcement agencies and the courts, and enable the Director under the CBCA to develop an effective compliance strategy.

Efficient Provision of Information. The CBCA should enhance the efficiency of the market for information. For example, the Act could include more timely reporting of major securities transactions by insiders to ensure investors' decisions are guided by up-to-date information.

Clarity. The revised CBCA should provide a clear signal to all market participants that improper insider trading is an abuse that is not condoned by Canadian society and that the federal government is committed to removing such trading from the Canadian stock market. Amendments should therefore be fair but demanding, easily understandable and serve as effective deterrents without paralyzing the necessary flow of information.

Harmonization. Insider trading is regulated in Canada under both corporate and securities laws. Whereas the provisions in federal corporate law apply irrespective of provincial boundaries, securities laws apply only to trading occurring in the relevant provincial territory. Application of the CBCA insider trading provisions should, where possible, be in harmony with current provincial regulatory approaches. Harmonization permits easier understanding by persons subject to the regulatory framework and easier co-operation among corporate and securities regulators.

Flexibility. Amendments should be sufficiently flexible to respond to changes in securities markets as they develop to ensure that the legislation remains flexible and relevant. CCA will therefore attempt, where possible, to make greater use of the regulation-making process.

4. *Dickerson Report*, April 1971, p. 3.

PART II

DETAILED DISCUSSION OF OPTIONS FOR AMENDING THE CBCA'S INSIDER TRADING PROVISIONS

6. Options for Amending the CBCA's Insider Trading Provisions

Part II of this document lists preliminary proposals for revising the CBCA's insider trading provisions. These proposals are designed to show the possible direction for revision, but should not be interpreted as final recommendations.

The legislative proposals described in detail are divided into two sections and can be summarized as follows:

Insider Trading and Wrongful Communication

1. Widen the definition of "insider" for liability purposes. The proposed definition would identify a detailed list of insiders which would cover circumstances not currently covered.
2. Extend the definition of a "security" for liability purposes to cover any type of security, including those not issued by the corporation but whose market price varies materially with the price of the securities of the distributing corporation.
3. Include in the CBCA a criminal offence provision for illegal insider trading and make the penalties consistent with those in provincial securities legislation.
4. Limit the offence provision strictly to the securities of a distributing corporation.
5. Subject wrongful communication to the civil liability and proposed offence provisions in order to cover insiders who wrongly communicate privileged information as well as insiders who

advise a third party to trade on the basis of material confidential information.

6. Indicate that, with respect to the accountability to the corporation and offence provisions, the wrongful communication liability provisions would apply even when no transaction takes place. This would send a signal that society does not condone improper tipping.
7. Add a specific measure of damages in the Act in order to facilitate determination by the courts of the damages to be paid under the civil liability provisions.
8. Remove the "makes use of" test and adopt a strict liability approach in order to harmonize with the provinces and reduce the evidentiary burden.
9. Include statutory defences in view of the strict liability approach being considered.
10. Add a measure of profit in the Act to facilitate the determination by the courts of the fines to be paid under the offence provisions.
11. Delete the reference to "specific" in determining the type of information further to which insider trading/ tipping is prohibited.
12. Extend the limitation period.
13. Facilitate compensation of investors for damages or losses suffered as a result of improper insider trading or wrongful communication of confidential information.

Insider Reporting and Speculative Trading

14. Expand the definition of "insider" for reporting purposes to include "associates" and consider imposing a reporting requirement on nominees in certain circumstances.
15. Expand the definition of "business combinations" in order to cover any combination which may become a source of access to confidential information such as an arrangement, etc.
16. Establish the reporting period by regulation and therefore provide the flexibility to, for example, work with provincial regulators to develop a harmonized scheme that reduces the reporting period.
17. Raise the penalties for reporting and prohibited trading offences. Consider adopting a general offence provision, as found in the Ontario and Quebec securities acts.
18. Maintain the prohibited trading provision and expand the list of securities covered therein in order to capture a broader scope of speculative-type instruments.
19. Clarify the definition of securities for reporting purposes.

CCA is looking forward to receiving the comments of interested parties on these preliminary proposals, which are discussed in more detail in the following pages.

6.1 DEFINITION OF "INSIDER" FOR LIABILITY PURPOSES

PURPOSE

To broaden the definition of "insider" for liability purposes to ensure that all circumstances of insider trading while in possession of material confidential information are covered.

EXISTING LEGISLATION

Sections 131(1) to (3).

CONSIDERATIONS

With the proposed revision of the civil liability provision (see item 6.7, "Civil Liability") and the creation of a statutory offence provision (see item 6.3, "Statutory Offence"), careful consideration has been given to who should be subject to the revised insider trading regulation. Various models have been looked at: from the highly functional and open-ended U.S. approach to the more descriptive (bright-lines) approach found in the CBCA and in provincial legislation. The current CBCA definition already covers a wide spectrum of insiders (reporting insiders, employees, 10 percent shareholders, tippees, etc.). However, recent amendments to provincial securities laws have introduced other categories of insiders, further widening the net of insiders for liability purposes. It could therefore be considered to widen the current definition of "insider" to also cover:

- Insiders, affiliates or associates of a person proposing to make a take-over bid or of a person proposing to become party to a business combination. This category would be wider than the current provision under the CBCA by covering

"associates" but, more significantly, by also covering a wide spectrum of persons linked to takeover and merger activity, circumstances where the opportunity for insider trading is most prevalent. (OSA, s. 75(5)(a)).

- Persons who, although no longer linked to the corporation, had access to material confidential information while they were insiders of the corporation.
- Persons who have acquired material confidential information that they know to be such concerning a corporation. This category, predicated on s. 189(6) of the QSA, 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 an employee of a printing company using material information included in a takeover bid circular before the information is made public.
- The definition should clarify that all reporting insiders are subject to the liability provisions. The current definition would not appear to cover directors or officers of a subsidiary or an affiliate although they are reporting insiders pursuant to s. 126 of the CBCA.

The CBCA and provincial securities acts uniformly use the bright-lines approach to define "insider" because it provides clearer standards of conduct by making clear who is covered by the statutory proscription. On the other hand, the open-ended functional approach used in the U.S. is also appealing since it covers the widest spectrum of insiders. However, a purely functional definition of "insider," where insiders are not specifically identified, could give rise to criticisms as it fails to provide clear indications of who should refrain from trading.

FAVOURED APPROACH

Considering that a bright-lines definition provides clearer standards of conduct by making clear what is proscribed behaviour, it is proposed that the current bright-lines definition be expanded to cover the circumstances listed above. It is believed that this favoured approach would further clarify what constitutes proscribed conduct. It would also promote greater harmonization, facilitate enforcement (mostly by eradicating possible loopholes), and cover instances where insider trading is most prevalent.

6.2 DEFINITION OF "SECURITIES" FOR IMPROPER TRADING PURPOSES

PURPOSE

To ensure that transactions by insiders, as defined in section 131, in market-traded speculative securities are also covered by the civil liability and proposed offence provisions.

EXISTING LEGISLATION

New provision.

CONSIDERATIONS

The current definition of "security" is limited to securities issued by the corporation (shares, debentures, etc.). The most speculative securities are puts, calls and other similar securities, the value of which materially varies with the price of the securities of the corporation. These speculative securities are not issued by the corporation; instead, they are created by market participants. Sections 75(6) of the OSA and 119(1) of the BCSA and to a certain degree section 189.1 of the QSA have extended the definition of "security" for the purposes of improper trading.

There are currently two major gaps in the CBCA in respect of the types of securities covered for liability purposes: first, the liability provision is only applicable to the

securities issued by the corporation as defined in section 2 of the CBCA and, secondly, the absolute prohibition from trading in speculative securities only covers reporting insiders as provided in section 130(2) of the Act. These gaps leave no remedies against non-reporting insiders (i.e., those not listed in s. 126 but covered pursuant to s. 131) who may have improperly traded in speculative securities (where there is greater potential for considerable harm). The current prohibition against trading in speculative securities in section 130(2) of the CBCA only applies to reporting insiders. Furthermore, the penalty it imposes does not constitute a major deterrent (a proposal to increase fines is discussed in item 6.17).

FAVOURED APPROACH

It is proposed that a broader definition of "security" than the current section 2 definition be introduced in section 131. This would add puts, calls, options and other securities the market price of which varies materially with that of the securities of the distributing corporation. This definition would only be applicable for the purposes of section 131 of the CBCA. Trading in these securities while having access to confidential information would therefore give rise to the civil liability and proposed offence provisions. The provision would also harmonize Canadian legislation in this respect and would contribute to deterring insider trading violations.

6.3 STATUTORY OFFENCE: INSIDER TRADING/WRONGFUL COMMUNICATION

PURPOSE

To introduce a statutory offence provision to further regulate the conduct of insiders, to deter insider trading, to facilitate enforcement in this area and to harmonize with the provinces.

EXISTING LEGISLATION

New provision.

CONSIDERATIONS

Following the mergers and acquisitions wave of the early 80s and certain securities scandals associated with it involving insiders, there has been a movement towards stricter regulation of insider trading through prohibiting trading by insiders while in knowledge of confidential information. Most industrialized countries have recognized the need for provisions to curb improper insider trading with a view to protecting the ability of corporations to access equity markets and promote investors' confidence. Although the provinces prohibit and penalize improper insider trading through offence provisions, the CBCA does not currently provide any offence provision in this regard. This

omission creates a discrepancy with provincial laws and renders more difficult the enforcement of the CBCA insider trading provisions or participation in the enforcement of international securities matters by the Director. Amending the CBCA to add an offence provision similar to that of the provinces is therefore under consideration. Significant penalties (imprisonment and fines) would also be considered, as well as a "measure of illegal profits" clause similar to the one proposed for the determination of damages with respect to civil liability (see item 6.7).

FAVoured APPROACH

The addition of a statutory offence prohibiting insider trading and wrongful communication in certain circumstances is favoured for several reasons. First, the stigma attached to the commission of an offence together with significant penalties similar to those recently enacted under provincial securities laws (fines of up to the greater of \$1 million or three times the illegal profits and/or imprisonment) should act as a major deterrent against insider trading violations. Second, in this era of global trading, it would also increase the role of the Director as a regulator by facilitating his participation in international enforcement efforts. In addition, an offence provision that is predicated on provincial securities law provisions should also further harmonize Canadian legislation in this regard.

6.4 APPLICATION OF THE INSIDER PROVISIONS: DISTRIBUTING AND NON-DISTRIBUTING CORPORATIONS

PURPOSE

To determine in which instance, in the context of the CBCA, the insider trading civil and penal liability provisions should apply to securities of distributing corporations, non-distributing corporations or both.

EXISTING LEGISLATION

S. 131(4).

CONSIDERATIONS

With regard to reporting purposes, the CBCA limits the application of the insider requirements to insiders of a distributing corporation; insiders of non-distributing corporations are therefore not subject to insider reporting requirements.

The civil liability provision is applicable to insiders of both distributing and non-distributing corporations. The civil liability provision should apply irrespective of whether the corporation is a distributing or non-distributing corporation, since it provides a private right of redress. However, different considerations arise with respect to the applicability of an offence provision. Because the major purpose of an insider trading offence provision is to protect the public interest - either through ensuring order and fairness in the corporate environment or

safeguarding the efficiency and effectiveness of equity markets - it is suggested that an offence provision should only apply with respect to the securities of distributing corporations, i.e., corporations whose securities are publicly traded in the market. Even though it is recognized that not all the securities of a distributing corporation need be part of a distribution to the public, it is not believed advisable to distinguish between securities issued by a distributing corporation but for which there is no market, and those issued publicly on the market, as such distinctions may render the enforcement of the offence provisions subject to interpretative issues. In fact, it is believed that improper trading in the securities of a distributing corporation, whether a market exists or not for those securities, should give rise to the offence liability since knowledge of improper trading in any securities of a distributing corporation may have a deleterious effect on the price or value of all the securities of the corporation.

FAVOURED APPROACH

It is proposed that the CBCA be harmonized with the provinces by subjecting transactions in any of the securities of a distributing corporation to the statutory offence provision.

Proscribed conduct in the securities of a non-distributing corporation would not be subject to the offence provision because of the private contractual nature of transactions in such circumstances. Public concerns as to the protection of equity markets would be properly addressed through an offence provision limited to distributing corporations.

6.5 WRONGFUL COMMUNICATION PROHIBITION

PURPOSE

To specifically prohibit the wrongful communication of material confidential information (tipping).

EXISTING LEGISLATION

New provision.

CONSIDERATIONS

Section 131 of the CBCA states that "a person who receives confidential information" from an insider he knows to be such is himself an insider and is subject to the civil liability provisions in cases of improper trading. The CBCA was the first Canadian legislation to introduce a liability provision against such persons. The introduction of a "tippee" as part of the definition of insider reflected a reality that existed and continues to exist.

Where the Act creates a liability against the tippee-trader, it is subject to interpretation whether it prohibits such communication per se by a "tipper." The CBCA should thus be clarified to remove any uncertainty as to its application to the wrongful communication of material confidential information. Prohibiting wrongful communication of material confidential information by an insider must certainly be as important as prohibiting improper trading. Provincial legislators have recognized the need to constrain confidential information within authorized business circles. They now specifically prohibit the wrongful communication of material confidential information in a manner similar

to improper trading, subjecting tipping to both the civil liability and offence provisions.

Regulators have recognized that it may be necessary for an insider, for valid business reasons, to communicate confidential information and have therefore adopted exceptions to the rule as well as saving clauses. To fully prohibit communication by an insider of confidential information could undoubtedly impair valid commercial business transactions and could create a bigger problem than the one the prohibition against improper communication is intended to cure. Consequently, defence provisions or saving clauses will be built into the legislation to ensure valid transactions are not proscribed. The issue of defences is further detailed in item 6.9.

FAVoured APPROACH

It is proposed that insiders who wrongfully communicate material confidential information be specifically subjected to both the civil liability and, with respect to the securities of a distributing corporation, the proposed offence provisions. It is considered important to prohibit improper communication in order to prevent insider trading. It is also proposed that not only the communication of material confidential information but also any other method of advising another person to take advantage of material confidential information, however communicated be specifically prohibited. The introduction of a prohibition against tipping or advising is expected to constrain material confidential information within the knowledge of persons close to the decision-making process. The addition of a specific prohibition against wrongful communication will clarify the Act, further harmonize Canadian laws in this respect and facilitate the enforcement of insider trading violations.

6.6 WRONGFUL COMMUNICATION: NECESSITY OF A TRANSACTION

PURPOSE

To determine whether liability provisions in respect of the wrongful communication (tipping/advising) of confidential information should apply only to situations where the recipient of the information (tippee) actually traded or whether it should apply even in the absence of a transaction.

EXISTING LEGISLATION

S. 131(4).

CONSIDERATIONS

It is under consideration that the CBCA, like provincial securities legislation, would provide three types of liability in respect of wrongful communication of material confidential information: (1) civil liability for damages; (2) accountability to the corporation; and (3) penal offence.

(1) Civil Liability/Damages

Sections 131(4) of the CBCA, 131(2) of the OSA, 119(3) of the BCSA and 227 of the QSA require a transaction for the liability provision to be applicable. In all cases, it is necessary that a transaction occur to establish any damages and it is proposed that this approach be maintained.

(2) Accountability to corporation

Current provisions dealing with accountability to the corporation for any benefit received or receivable by the insider (as a result of the communication), although

in existence throughout Canada, are not uniform. In some jurisdictions a transaction is necessary, while in others it is not. Whereas the CBCA and QSA provide that an insider is accountable for any benefit receivable as a result of the prohibited transaction, therefore requiring a transaction, the OSA and BCSA would still find a tipper accountable for any benefit accruing from the wrongful communication even in the absence of a transaction. This latter approach is under consideration.

Although some legislation and commentators have opted to limit "accountability to the corporation" to insiders of the corporation (in short, reporting insiders), it is under consideration, on the basis that any insider who contravened the Act should disgorge said benefits to the corporation, to make all insiders accountable to the corporation for ill-gotten benefits, as is currently the case under the CBCA.

(3) Offence

The CBCA does not currently provide any quasi-criminal remedy concerning improper insider trading or tipping. In considering the elements of a possible offence provision, it should be noted that in neither the OSA nor the QSA is there a requirement that a transaction occur for the offence provision to apply (sections 118 under the OSA and 204 under the QSA). It is under consideration whether the mere fact of wrongfully communicating material confidential information even in the absence of a transaction would in itself be sufficient ground for prosecution.

FAVOURABLE APPROACH

The issue of whether a transaction is necessary for the offence provision to be

applicable with respect to tipping may give rise to diverging views from regulators and the industry. Consequently, a favoured approach will not be proposed at this time. Rather, comments regarding the circumstances where a tipper should be liable of having contravened the insider trading provisions are sought.

6.7 CIVIL LIABILITY: MEASURE OF DAMAGES

PURPOSE

To facilitate the determination by the courts of damages in civil liability procedures.

EXISTING LEGISLATION

New provision.

CONSIDERATIONS

Paragraph 131(4)(a) of the CBCA provides that an insider who improperly traded "is liable to compensate any person for any direct loss suffered by that person as a result of the transaction." In light of the complexity of the securities market and the difficulty of assessing damages in respect of impersonal trades in the securities of distributing corporations, it is under consideration to add a specific measure of damages provision to assist the court in its assessment of damages. The provision would be predicated on similar provisions under provincial securities acts (for example, s. 131(6) OSA and s. 119(2) BCSA) and would therefore also provide residual discretion to the court to consider such other measures of damages as may be relevant under the circumstances. This measure is being considered because it specifically reflects in the calculation of damages how the market reacted after the confidential information became public.

Therefore, while the CBCA may adopt an "average market price" test similar to section 131(6) of the OSA with respect to securities of distributing corporations for which a market exists, it would, however, have to provide a different test, such as "fair value," to reflect

the application of the CBCA civil liability provisions to insiders of both distributing and non-distributing corporations since each raises different market and valuation considerations. For example, where the OSA refers to "average market price," the CBCA would also have to supplement a "fair value" consideration for the securities of non-distributing corporations and securities of distributing corporations for which no market exists. Finally, 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 under paragraph 131(4)(b) where the corporation is not entitled to damages but rather to the disgorgement of the benefits received or receivable by the insider.

FAVOURED APPROACH

Adding a specific measure of damages should facilitate the determination by the courts of damages to be paid under the civil liability provisions. The approach adopted by provinces such as Ontario and British Columbia would be followed for the securities of distributing corporations for which a market exists while different criteria would apply with respect to the securities of non-distributing corporations or of distributing corporations for which no market exists. This should further harmonize Canadian legislation in regard to securities that are part of public distribution and introduce a provision for measuring damages with respect to securities of non-distributing corporations or other securities for which no market exists. It is proposed that, similar to section 131(6) of the OSA, the Act should give the court discretion to consider other measures of damages as may be relevant under the circumstances.

6.8 DELETION OF "MAKES USE OF" DEFENCE

PURPOSE

To facilitate the enforcement of the liability provisions and to harmonize with provincial securities laws.

EXISTING LEGISLATION

S. 131(4).

CONSIDERATIONS

Section 131(4) of the CBCA currently 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.

The insider trading provisions of the securities acts of many provinces, including Quebec, Ontario and British Columbia, have recently been amended. In all cases, a significant amendment was the deletion of the "makes use of" element of defence, which is considered to be an almost insurmountable evidentiary obstacle. Instead, the provinces have now opted for a strict approach by setting specific statutory defences. The "makes use of" defence allows an insider to show that although he/she had knowledge of confidential material information and traded, the trade was not made on the basis of the known confidential information or "that the information was not a factor in what he did" (*Green v. Charterhouse*, (1976) 12 O.R. (2d) 280, at p. 307). The evidentiary burden requiring the prosecutor in an offence provision or the plaintiff in a civil damages action to demonstrate that a trade was indeed made on the basis of confidential material information is very onerous and is a problem that must

be addressed to facilitate the enforcement of the CBCA insider trading provisions.

An alternate option which has been considered is to maintain the "makes use of" element but to add a presumption of use in certain circumstances. Predicated on the findings in *Green v. Charterhouse*, a reversal of onus on the accused would arise once a plaintiff has demonstrated that a person had knowledge of confidential, material information and purchased or sold securities of the corporation. The burden of proof would then be shifted to the insider who would have to prove that he/she did not make use of the information. Although such an option has definite advantages, such as not requiring an exhaustive list of exculpatory defences, it would be onerous on the defendant, even though he/she may use all defences available to assist in meeting the burden. Nevertheless, the range of defences would not constitute a precise code of conduct for insiders and would not provide them with the proper means to assess the legality of their activities.

FAVoured APPROACH

It is proposed that section 131 be amended to delete the reference to "makes use of" and instead to provide a strict prohibition of trading or tipping while having knowledge of material, confidential information. Similar to Ontario and British Columbia, some specific defences would be stated, either in the Act or, to provide additional regulatory flexibility, 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 having knowledge of privileged information, thereby removing any doubt as to the appropriateness of insiders' conduct or the intent of the legislator. These defences would cover elements such as knowledge, due diligence, materiality of information, necessary course of business, "Chinese Walls," etc. and will be discussed in more detail in item 6.9.

This amendment would promote harmonization of insider trading laws in Canada and would send a message as to the seriousness of such improper activity. It is recognized that a strict liability provision may appear harsh but such measures are believed to be necessary to protect the investing public and to promote confidence in the marketplace. The deletion of the "makes use of" defence would be in line with the CBCA's purpose of promoting equity and fairness in the corporate environment through facilitating the suppression of, and hence further deterring, improper insider trading.

6.9 STATUTORY DEFENCES

PURPOSE

To discuss possible statutory defences to the insider trading/tipping liability provisions, particularly in light of the strict liability approach being considered.

EXISTING LEGISLATION

Section 131(4).

CONSIDERATIONS

Under the current regime, a person may be found liable if, in the course of a transaction in a security of the corporation or of an affiliate of which it is an insider, that person:

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

and if the information:

- a) is not generally known; and
- b) might reasonably be expected to affect materially the value of the security.

Therefore, defences such as "not make use of," "non-specificity of the information," "the absence of benefit," "reasonable belief the information was known" and "non-materiality of the information" are currently available.

With the proposed elimination of the "makes use of" defence (see item 6.8) and the proposed adoption instead of a "strict liability" approach similar to that of the provincial securities legislation, it is proposed that reasonable and specific defences should be built into the CBCA to provide exemptive relief from the strict application of the insider liability provisions in certain circumstances. It is recognized that this approach could raise issues with the *Charter of Rights and Freedoms*, but preliminary indications seem to support

this proposed approach by virtue of the fact that for the necessity of an effective remedy, it is required that the burden of proof on the plaintiff be alleviated and perhaps be placed on the person most likely to adduce evidence.

The statutory defences under consideration pertain mostly to defences associated with absence of knowledge or proof of public knowledge, the nature of the information known, communication in the necessary course of business as well as the precautionary measures against communication outside the normal course of business and any other situation whereby trading arrangements were in place prior to the impugned action. The following discusses proposed defences or saving clauses currently under consideration.

1. **Knowledge of confidential information.**

One of the prerequisites of improper insider trading/tipping is that information used by an insider be confidential or, in other words, not generally available to other persons. Another fundamental prerequisite is that the person had knowledge of the confidential information. Therefore, the following would represent elements of defence:

- a) Lack of knowledge of information;
- b) Information, although not generally known, was known by the aggrieved person or there was a reasonable belief that it was known by that person; and
- c) Information was generally available.

2. **Materiality of information.** Contrary to the provincial provisions, the CBCA does not link its "materiality" element to defined concepts such as "material change" and "material fact." Rather, the CBCA liability provisions simply link the materiality of the information to its effect on the value of the securities of the corporation without defining what is material information. The materiality of the information is the other major prerequisite to proving improper insider trading or wrongful communication and

the demonstration that the information was not material would remain an important defence.

3. **Necessary course of business.** With the proposed provisions prohibiting the tipping of information by an insider to another person, it is proposed that only the communication of confidential material information when effected other than in the necessary course of business be proscribed. This defence is necessary in order to not impede disclosure of information in circumstances that would not otherwise be reproachable. (Variations to the "necessary course of business" test, such as "reasonable course of business" or "ordinary course of business" are also under consideration.)
4. **Chinese Walls and other arrangements.** "Chinese walls" are the policies and procedures implemented by a person or company to prevent the transmission of confidential material information to others within a firm or company.

Chinese walls are not a defence per se but an element of defence to help demonstrate that although, for example, a senior member of a firm had knowledge of confidential information, the policies and procedures implemented by the firm would not have permitted the transmission of such information to the other member of the firm who traded in the securities. In short, the implementation of Chinese walls would be used to demonstrate that confidential information was not known by other persons of the firm nor should the knowledge be

imputed to the firm itself when trading in the securities of the corporation for which information was known by other members of the firm.

5. **Agency contract.** Exempting from liability transactions made by a person who had knowledge of confidential information if the transaction was entered into as an agent for another person further to an unsolicited order from that other person is under consideration. As well, exemptions in instances where trades are effected pursuant to a legally binding obligation entered into prior to the acquisition of knowledge of the material confidential information are under consideration.
6. **Share purchase plan.** It is also proposed that trades made by a person who had knowledge of material confidential information pursuant to a duly structured automatic share purchase plan or other similar plan be exempted from liability but only if the person had entered into such a plan prior to the acquisition of knowledge of said information.

FAVoured APPROACH

Generally, it is proposed that the defences to the liability provisions be clearly stated in the legislation to avoid interpretative difficulties. In any event, some defences would be drafted broadly enough to allow the courts ample discretion in their evaluation of insider conduct and to ensure that the insider provisions are not so strict as to impede what would otherwise be considered legitimate activity carried out in the normal course of business.

6.10 OFFENCE PROVISION: DEFINITION OF PROFIT

PURPOSE

To provide a definition of "profit" to assist in the determination of fines with respect to contraventions to the insider trading and wrongful communication provisions.

EXISTING LEGISLATION

New provision.

CONSIDERATIONS

As discussed in item 6.3, it is proposed that a statutory offence prohibiting improper insider trading and tipping be added. These offences would provide, in addition to imprisonment, significant fines of up to the greater of \$1 million or three times the illegal profits. Consequently, it is proposed that the Act include a definition of "profit" to assist the court in the determination of the maximum fine. The provision would follow the approach taken by provincial securities acts which already define "profit." It should be noted that although they are similar in scope, the definitions are not all uniform (for example, s. 118(5) of the OSA and s. 204 of the QSA provide different tests).

It should also be noted that because it is proposed that the application of the offence provision be limited to securities of distributing corporations (item 6.4), it will not be necessary to introduce factors other than market price (see item 6.7).

FAVOURABLE APPROACH

The addition of a definition of "profit" would clarify the proposed offence provision by providing a specific measure of profit in the determination of the maximum fine payable for contraventions of either the insider trading or wrongful communication provisions. The proposed approach is predicated on the three-tiered definition set out in section 118(5) of the OSA by defining "profit" as:

- a) in the event of an improper acquisition, the average market price of the security in the 20 trading days following general disclosure of the material information less the amount that the insider paid for the security;
- b) in the event of an improper disposition, the amount the insider received for the security less the average market price in the 20 trading days following general disclosure of the material information; and
- c) in the event of wrongful communication, the value of any direct or indirect benefit or advantage, financial or otherwise, received for providing confidential, material information.

The proposed definition should assist the court in the determination of fines and should also promote consistency in such determination by following the approach set out in provincial securities legislation.

6.11 SPECIFIC CONFIDENTIAL INFORMATION

ISSUE

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

EXISTING LEGISLATION

Section 131(4).

CONSIDERATIONS

Section 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. Therefore, the CBCA identifies three different criteria--specificity, confidentiality, materiality--to identify the type of information one should refrain from trading on or communicating to others. The criteria of "confidentiality" and "materiality," as also recognized in the provincial securities acts, are essential to the contravention of the insider provisions; the absence of either would not give rise to the liability provisions. The criterion of "specificity," on the other hand, is unique to the CBCA and raises different considerations.

Specificity 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 "likelihood of an event's occurrence," meaning that information need not only be confidential and material but the event must also be at such an advanced stage that it is very likely to occur. Specificity can thus be referred to as the maturity and reliability of the information. If such is the case, to retain the element of specificity in the CBCA would limit considerably the coverage of the insider provisions. Coverage would be restricted to instances where the privileged information is reliable, precise, risk-free and relating specifically to the corporation, thus barring from consideration confidential information of a general nature or information which is not sufficiently mature. Since the provincial securities acts have not adopted the specificity concept, it is believed that the deletion of it in the CBCA would constitute a further step toward harmonization, which is a guiding principle of the CBCA review process.

FAVOURED APPROACH

It is proposed that the specificity requirement be deleted from the determination of what constitutes insider information because the element of specificity is a vague concept which adds little to the primary elements of materiality and confidentiality. If anything, it makes the enforcement of the insider liability provisions more difficult. The deletion of the specificity element would clarify the Act, possibly enlarge the scope of the insider provisions and further harmonize the CBCA provisions with those of the provincial securities acts.

6.12 LIMITATION PERIOD FOR COMMENCING A CIVIL ACTION UNDER THE INSIDER TRADING PROVISIONS

PURPOSE

To extend the limitation period and to clarify the language of section 131(5).

EXISTING LEGISLATION

Section 131(5).

CONSIDERATIONS

Under the insider trading provisions of the CBCA, a civil action may only be brought within two years after discovery of the facts that gave rise to the cause of action or within two years from the time at which a transaction was required to be reported. However, these provisions raise various concerns. First, the limitation period of two years is too short for the effective enforcement of the Act. Second, since paragraph 131(5)(b) only applies to reporting insiders and not to the other insiders for liability purposes, its relevance is questionable. Third, since the Act does not limit the time in which the discovery may take place, only limiting it to the two years from knowledge or discovery, it creates an open-ended period in which an action can be brought many years after a transaction took place. While this would be to the advantage of the plaintiff, some may believe that it may not be in the best interest of the administration of justice to submit an insider to such an unlimited period of time.

FAVOURED APPROACH

It is proposed that section 131 be amended by extending the limitation period from two to three years after the discovery of the facts that gave rise to the cause of action. However, the Act would impose on plaintiffs an obligation to be diligent in commencing an action by further stating that any action may be commenced only within six years from the date of the transaction or wrongful communication.

It is also proposed that the Act be clarified by deleting paragraph 131(5)(b) which subordinates the limitation period to the reporting of a transaction in certain circumstances. The deletion of this provision will ensure a more uniform application of the limitation period and will further harmonize with the provincial securities legislations, which do not have any such provision. It should also be noted that with respect to limitation periods, the provinces are uniform as to the approach but differ slightly with respect to the time periods. The proposed period is somewhat longer than the current provincial securities legislation limitation periods.

The favoured approach could be seen as a balanced provision ensuring the effective enforcement of the insider civil liability provision through an extended limitation period while at the same time promoting due diligence on the part of the plaintiff by requiring that the action be commenced within three years of knowledge and not later than six years after the contravention to the Act.

Finally, although this issue only refers to limitation periods with respect to civil liability, similar limitation periods for the proposed offence provision are under consideration.

6.13 COMPENSATION OF VICTIMS OF INSIDER TRADING

PURPOSE

To facilitate compensation of investors for damages or losses suffered as a result of improper insider trading or wrongful communication of confidential information.

EXISTING LEGISLATION

New.

CONSIDERATIONS

Section 131(4) of the CBCA already provides for the compensation of persons as a result of transactions made by an insider on the basis of confidential information. However, the current provisions are not conducive to the due exercise of their right by aggrieved investors. Hence, whereas parties to private transactions are easily identifiable, it is difficult to identify aggrieved persons when securities are traded anonymously on the public market. Moreover, since an insider may have traded with a large number of small investors, the legal costs these investors would likely have to bear to institute court proceedings could be too high to incite them to recover the losses suffered. Currently, the exercise of this right by aggrieved persons is limited because of the high costs of legal proceedings, the difficulties of making a highly technical proof and of obtaining elements of evidence, as well as the absence of specific provisions in the Act to reduce the legal costs.

The U.S. Securities and Exchange Commission has in the past facilitated restitution to aggrieved investors by depositing, in compensatory funds for the benefit of these investors, a portion of the fines recovered pursuant to civil proceedings.

In the same vein, some provinces are also considering compensatory provisions for the benefit of aggrieved persons in certain circumstances. It is believed that a mechanism facilitating the compensation of victims of insider trading is necessary to ensure the fair and efficient operation of the insider provisions, especially since specialists in the field have on many occasions indicated that the current section 131(4) provides a mostly theoretical right of action, given the difficulties aggrieved investors must confront.

The specific measures to facilitate compensation of victims of insider trading have not yet been finalized and will form the subject of a detailed analysis. Options being considered may include, among others, those enabling the Director to initiate proceedings on behalf of aggrieved investors (similar to section 205 of the CBCA with respect to takeover bids); introducing a class action provision; providing in the Act that an applicant is not required to give security for costs; and conferring in the Act wider powers to the courts to allow them to order that a defendant, on a finding of liability or through an out-of-court settlement, must disgorge into a fund administered by an agent monies or benefits illegally obtained for the benefit of aggrieved investors. In addition, the Act could provide that a court is empowered to order that the defendant reimburses the costs of any investigation and of proceedings in connection with the matter.

Whatever option is chosen, the Director must not be obliged to intervene in all cases; rather, he should have the discretionary power to act when public interest or policy considerations are at stake. A detailed analysis is necessary due to the many issues raised by the various options, such as the determination of aggrieved persons, the technical aspects of establishing a fund, the benefit to first having a criminal conviction before initiating civil proceedings, the limited applicability to non-distributing corporations, and the role of the Director, to name but a few.

FAVOURED APPROACH

It has been decided at this time not to propose a favoured approach but rather to seek comments.

6.14 DEFINITION OF "INSIDER" FOR REPORTING PURPOSES

PURPOSE

To ensure that the definition of "insider" for reporting purposes covers all persons who are closely linked to the corporation.

EXISTING LEGISLATION

Sections 2 and 126.

CONSIDERATIONS

Upon enactment of the CBCA in 1975, its drafters had adopted the "goldfish bowl" theory by which "improprieties are less likely to occur if those tempted to commit them are likely to be discovered and exposed to the glare of publicity" (*Dickerson Report*, Vol. I, page 88). Although it is recognized that the current definition of insider is rather broad and an effort towards paper burden reduction should be made, it is felt that the public accountability principle underlying the reporting obligation overrides the counter-arguments favouring a more restricted definition of insider for reporting purposes. In fact, it is suggested that the current definition should not be restricted as it covers persons who may have access to confidential information. If there are circumstances where the reporting requirements of the Act cannot be justified, s. 127(8) of the Act provides for an application to the Director to be exempted from the reporting requirements.

If anything, slightly broadening the definition of "insider" in the "further interpretation" provision (section 126(2)) by including "associate" in the list of insiders is being considered. The "associates," which are currently defined in section 2 of the CBCA and include spouses or partners of the insiders, would not have to report on their own; rather, insiders would be required to report the transactions or ownership of their associates in the securities of the distributing corporation. This new requirement would not apply to the associates of all reporting insiders since it would overly widen the net of insiders. Rather, it would be limited to the associates of "insiders" as defined in section 126(1)--directors and officers of the distributing corporation and significant shareholders--as these person are closest to the corporation's decision-making. The addition of "associate" to the definition in section 126(2) would serve two purposes: first, to prevent evasion of the reporting requirements by effecting a transaction by a person in close relationship to the insider and second, as a market indicator to investors by disclosing the investment trend in the securities of a distributing corporation by persons close to insiders.

FAVoured APPROACH

It is proposed that a new provision be introduced to require reporting insiders to report the trades of associates of which they are aware. However, the associates (as defined in the Act) will not be under the obligation to report their trading.

ANCILLARY ISSUE

Consideration should also be given to requiring in the Act the reporting of transactions by insiders where the insider is the beneficial owner but the securities are registered in the name of a nominee, agent or trustee. Provincial securities laws have adopted provisions to capture such transactions (sections 104-105 of the OSA and 102-103 of the QSA). The 1979 Task Force for a Securities Market Law for Canada put forward a similar proposal. Under normal circumstances, such trades should be reported by the insiders as "owning or exercising control or direction" over those securities (see section 29 of the CBCA Regulations).

Consistent with the disclosure policy behind insider reporting requirements, consideration is being given to harmonizing with provincial securities laws by requiring an insider to report trades effected through a nominee and, failing that, by requiring the nominee to file the insider reports if he/she knows that traded securities are beneficially owned by the insider and that the latter has failed to file an insider report.

6.15 EXPANDING THE DEFINITION OF DEEMED INSIDER

PURPOSE

To ensure that the deemed insider provision covers all types of business combinations, not only substantial acquisitions of assets or amalgamations.

EXISTING LEGISLATION

S. 126(4).

CONSIDERATIONS

In the course of a business combination between a CBCA distributing corporation and another corporate entity, the Act deems a director, officer or substantial shareholder of the corporate entity to have been an insider of the distributing corporation for the previous six months. These insiders are required to report transactions in the securities of the corporation for the previous six months within 10 days of the end of the month in which they are deemed to have become insiders.

There are concerns that the deeming provisions may not be drafted broadly enough to include other forms of business combinations which result in a fundamental change, such as arrangements, which are increasingly used by corporations. Currently, the "business combination" definition applies to acquisitions of all or substantially all the property of a corporation and amalgamations. Since the OSA and the BCSA also specifically cover arrangements (and the BCSA reorganizations), consideration is being given to broadening the definition of business combination. In order to avoid the risk of rendering the application of the deemed provision too onerous, consideration is being given to qualifying the type of business combination by either restricting it to those similar to the ones already mentioned or by introducing a test such as the materiality of the transaction.

FAVOURED APPROACH

Section 126(4) should be amended to broaden the definition of "business combination" by adding "arrangements" as well as "other similar material business combinations" in the definition. The expanded definition would provide flexibility to cover a wider array of transactions where a fundamental change occurs, such as reorganizations, joint ventures, etc.

6.16 TIMING FOR REPORTING TRADES

PURPOSE

To achieve greater harmonization and to facilitate future amendments of the time period provisions for sending insider reports to the Director under the *Canada Business Corporations Act*.

EXISTING LEGISLATION

Section 127.

CONSIDERATIONS

The CBCA and provincial securities laws require insiders of a corporation to file reports of their ownership or transactions in the securities of the corporation within specified time periods. These insider reports, through their disclosure, are designed to act as a deterrent to improper insider trading whereby improprieties are less likely to occur if those tempted to commit them are likely to be discovered and exposed. Another major purpose of insider reports is that they provide investors with timely information on trades by insiders in the securities of corporations they are closely linked to as directors, officers or significant shareholders.

The delays for sending insider reports are currently stated in the Act. Since it is easier to amend the Regulations than the Act, transferring the time periods to the Regulations is under consideration. This

would allow more flexibility to react promptly and efficiently to changes in the corporate environment which would justify amending the timing for reporting trades. While regulators are striving for harmonization in this regard, as evidenced by the adoption of a uniform insider report, there are still minor discrepancies among regulators with respect to the timing for filing insider reports. For example, while the CBCA and OSA require that reports be sent within 10 days after the end of the month in which a person becomes an insider or whose interest in the securities of the corporation changes, the QSA requires reports to be filed within 10 days of the transaction or of becoming an insider. In order to speed disclosure and access, consideration should be given to shortening the time periods for the filing of insider reports.

FAVOURED APPROACH

It is proposed that future changes of the insider reporting periods under the CBCA be facilitated by amending section 127 to provide that reports shall be filed within the time prescribed by the Regulations. Because it is easier to amend the Regulations than the Act, this transfer of the time period from the Act to the Regulations should provide more regulatory flexibility to react promptly to any changes in the corporate environment or, more importantly, to any renewed efforts by Canadian regulators toward greater harmonization of the insider reporting provisions. It is also proposed that such reports be filed within 10 days of becoming an insider or of a transaction.

6.17 FINES FOR REPORTING AND SPECULATIVE TRADING VIOLATIONS

PURPOSE

To further deter violations of the reporting and prohibited speculative trading provisions under the CBCA.

EXISTING LEGISLATION

Sections 127(9) and 130(4).

CONSIDERATIONS

Compared with other jurisdictions where the maximum fine can be as high as \$1 million for failure to comply with the reporting requirements, the maximum fine of \$5 000 in the CBCA is relatively low.

In the case of prohibited transactions in speculative-type instruments (see item 6.18), where the fine is also \$5 000, the argument may be made that a fine of such a level may not act as an appropriate deterrent against violations which could yield extraordinary profits in a relatively short time period.

The penalties therefore need to be increased in order to ensure due compliance with the reporting or prohibited trading provisions.

FAVOURED APPROACH

It is desirable to increase the fines to underscore the seriousness of contravening these offence provisions under the CBCA. In keeping with recent provincial increases with respect to fines for violations of their securities laws, some of which now reach up to \$1 million, it is proposed that the amount of fines under the CBCA be significantly increased.

Increased fines are expected to act as a deterrent against prohibited trading in speculative-type instruments by insiders and to promote increased compliance with the reporting requirements.

6.18 SPECULATIVE TRADING VIOLATIONS

PURPOSE

To broaden the list of speculative-type instruments that reporting insiders of a corporation are prohibited from trading in.

EXISTING LEGISLATION

Section 130.

CONSIDERATIONS

Under section 130 of the CBCA, all reporting insiders are prohibited from selling short shares of their corporation and from buying and selling puts and calls in respect of these shares. The prohibition against short sales is justified on the ground that such sales may be pure speculation by insiders on the short term decline in the market price of the shares of their corporation. Similarly, buying and selling by insiders of market traded speculative securities, such as puts and calls whose price is predicated on the market value of the shares of the corporation, may also be perceived as contrary to corporate governance principles (such as self-dealing or conflict of interest) and is therefore prohibited. Where the original public policy reason was to allow trading by insiders as an incentive toward the long-term performance of the corporation, trading into short-term market-traded instruments is not supportive of the adopted policy.

Prohibiting trading in certain investment instruments in all circumstances is not uniform with the approach taken by the provinces. Whereas the CBCA prohibits trading in puts and calls by reporting insiders regardless of whether it would occur with the knowledge of material confidential information, provincial legislation such as in Ontario make it a prohibited transaction only when the trades are effected with knowledge of material confidential information.

Currently, an insider is prohibited from trading in puts and calls only. However, there are other investment instruments which may not be "puts" or "calls" but whose market price may vary with the market price of the securities of the corporation. While it is proposed that the prohibition of paragraph 130(2) for reporting insiders be maintained, consideration is being given to expanding the list of securities that reporting insiders would be prohibited from trading in.

FAVOURED APPROACH

It is proposed that section 130(2) be amended by widening the types of securities therein mentioned. Whereas section 130(2) currently covers puts and calls only, it would be broadened to include any security the market price of which varies materially with the market price of the securities of the issuer. This amendment would ensure that the policy behind this provision is applied consistently by eliminating possible loopholes arising from the use of instruments which are neither puts nor calls but whose market price may vary materially with the market price of the securities of the issuer.

6.19 INTERPRETATION OF "OPTION OR RIGHT" FOR REPORTING PURPOSES

PURPOSE

To clarify that puts, calls, etc. need not be reported pursuant to Part XI of the CBCA.

EXISTING LEGISLATION

Section 126.

CONSIDERATIONS

It is not clear whether, in the definition of "share" in paragraph 126(1)(b) of the CBCA, the reference to "options and rights" to acquire a share of the corporation includes both options granted by the corporation and any other market-traded securities not

necessarily issued by the corporation, such as "calls." Options and rights may be interpreted as including "calls."

However, interpreting "options and rights" as including speculative instruments not issued by the corporation would be inconsistent with the prohibition of section 130 against buying or selling puts and calls in respect of a share of the corporation. There is, therefore, a need to clarify the definition.

FAVOURED APPROACH

The definition of "share" in paragraph 126(1)(b) would be amended by providing that options and rights to acquire a share are only those issued by the corporation and, consequently, would not cover puts, calls and other market traded speculative securities.

7. SUMMARY

Canadian confidence in the marketplace comes from the knowledge that transactions will be carried out efficiently and fairly. Ensuring a fair and efficient marketplace is the mission of Consumer and Corporate Affairs Canada. Canadians can be confident because the legislation we administer, such as the *Canada Business Corporations Act*, establishes a framework for business conduct and behaviour. The CBCA assists in informed decision-making and provides protection for the most vulnerable investors.

To achieve the objectives of efficiency and fairness in a constantly changing environment, this Department has undertaken a modernization of its marketplace framework legislation, including the CBCA. We trust the recommendations set out in this paper will provide insider provisions that are both more modern and more in line with comparable legislation across the country. For example, the addition of an offence provision, the removal of the "makes use of" defence, timelier reporting periods, new measures concerning the compensation of victims of insider trading, and substantially increased fines should constitute strong deterrents to improper insider trading and thus contribute to increasing confidence in the marketplace.

The preliminary proposals set forth in this paper should not be interpreted as final recommendations. Rather, the purpose of the paper is to solicit comments from the various stakeholders who have an interest in the efficient and fair regulation of insider trading. Only with such input can a comprehensive revision of the CBCA take place. It would, therefore, be appreciated if you would forward your comments to:

Jim Keon
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Legislative Review Directorate
Consumer and Corporate Affairs Canada
24th Floor, Place du Portage I
50 Victoria Street
Hull, Quebec
K1A 0C9

Thank you in advance for your co-operation.

CACC / CCAC

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