SECURITIES ENFORCEMENT

Prosecuting the Misuse of Material Non-public Information in Canada Insider Trading and (far) Beyond

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Securities legislation across Canada prohibits conduct that is considered a misuse of material non-public information, by making insider trading and tipping unlawful. However, Securities Commissions are occasionally confronted with facts that trouble them, but that do not meet all of the required elements of insider trading or tipping prohibitions. There is a trend in case law that shows that the Ontario Securities Commission, in particular, will resort to its public interest jurisdiction in order to sanction conduct that, in the Commission's view, impugns the integrity of the capital markets, even though it may not violate insider trading or tipping provisions. In so doing, the OSC and other Commissions have effectively expanded the scope of conduct involving the use of material non-public information that may be prosecuted, even though it is neither technically insider trading nor tipping.

It has been argued that this walks a fine line between regulators using their public interest, jurisdiction for the protection of the capital markets in the face of a lacuna in legislation, and using their powers to make up for a "near miss" of an essential element of an alleged insider trading or tipping breach.[1] Below, we highlight several instances in which securities regulators have pursued and obtained settlements or convictions for cases that could be seen as "near misses." We argue that regulators' increased reliance upon their public interest jurisdiction could lead them to take unnecessary (if not improper) liberties with their broad powers to make orders in the public interest, and that any perceived gaps in insider trading or tipping offences should instead be addressed by legislative change, or some other clear and advance notice to industry registrants and market participants.

Insider Trading and Tipping Across Canada

Section 76 of the Ontario *Securities Act*[2] contains prohibitions against both insider trading and tipping. At first blush, the elements of each breach are relatively straightforward. To be found liable for insider trading, a person must: (i) be in a special relationship with an issuer; (ii) have knowledge of a material fact or material change about the issuer; (iii) buy or sell securities while in possession of that knowledge; and (iv) the material fact or material change must not be generally disclosed.[3]

Tipping builds on the elements of insider trading. To be liable, a person must: (i) be in a special relationship with an issuer; (ii) inform another person of a material fact or material change about that issuer; and (iii) the material fact or material change must not be generally disclosed.[4]

While the insider trading provisions in securities legislation across the country are generally similar, there are two nuanced variations. First, there are differences in how the prohibited conduct is framed. For example, subsection 76(1) of the Ontario Act prohibits a person from "purchas[ing] or sell[ing]" securities. By contrast, subsection 147(2) of the New Brunswick *Securities Act*,[5] prohibits a person from subscribing to, purchasing or

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[1] *Re Finkelstein*, OSC online: https://www.osc.gov.on.ca/documents/en/Proceedings-RAD/rad_20150324_azeffp-2.pdfpara. 66.
[2] R.S.O. 1990, c. S.5 as amended (the "Ontario Act").
[3] Ibid. at s. 76(1).
[4] Ibid. at s. 76(2).
[5] *Securities Act*, S.N.B. 2004, c. S-5.5.

trading securities, acquiring disposing or exercising a put or call option, acquiring or disposing of rights under a related financial instrument or changing the person's beneficial interest. The Ontario Act defines the term "security" sufficiently broadly as to include options and derivatives,[6] but it is unclear whether the different definitions might drive different results as between these two jurisdictions.

In addition and perhaps more importantly, certain jurisdictions prohibit insider trading in the securities of an "issuer" and other jurisdictions prohibit insider trading in the securities of a "reporting issuer."[7] As will be further discussed below, this difference is material and could potentially drive a different result depending on which jurisdiction the insider trading occurs in.

There are similar legislative inconsistencies with respect to the prohibition on tipping. A number of jurisdictions have a prohibition almost identical to that found in the Ontario Act.[8] However, the remaining jurisdictions have prohibitions that are broader in scope; in addition to informing another individual of a material fact or change that has not been generally disclosed, these jurisdictions also prohibit recommending or encouraging another individual to purchase securities of the issuer in question. This distinction is important, particularly where allegations of tipping may involve registrants whose job it is to recommend the purchase or sale of securities?

While some of these differences will be addressed for those jurisdictions participating in the proposed Cooperative Capital Markets Regulatory System, it remains to be seen when the new *Capital Markets Act* will be finalized, or how the new regulator will interpret its provisions.

[6] Ontario Act, supra note 2 at s. 76(6).

[7] Ontario provides an example of a jurisdiction that prohibits insider trading of "issuers" as opposed to simply "reporting issuers." By contrast, Quebec prohibits an insider of a "reporting issuer" from trading on privileged information with respect to that issuer. See Quebec *Securities Act,* C.Q.L.R. c. V-1.1, s. 187.

[8] See, for example, the Nova Scotia *Securities Act,* R.S.N.S. 1989, c. 418, s. 82.

[9] See, for example, the British Columbia *Securities Act,* R.S.B.C. 1996, c. 418, s. 57.

Regulators Have Pursued "Near Misses"

While the Ontario Act may be narrower in some respects in terms of prohibited conduct, the Ontario Securities Commission has relied on other statutory provisions to prosecute conduct beyond that which is clearly and expressly proscribed. The recent cases of *Re Donald,o Re Hariharan,Il Re Finkelsteini*[2] and *Re Mooreo* illustrate how the Ontario Securities Commission may rely on its public interest jurisdiction" in addressing conduct that is not captured by the words of its insider trading or tipping prohibitions.

Insider Trading

Re Donald involved allegations of insider trading by Donald — then a vice president at Research In Motion ("RIM"). Donald sat with Wormald, a vice president involved in corporate development, at a dinner following a RIM golf event. During the course of dinner, Donald and Wormald had a brief conversation about Certicom Corp., a company who sold cryptography software to various companies, including RIM. During the course of the discussion, Wormald disclosed to Donald that RIM had previously engaged in discussion with Certicom about RIM acquiring the company, and continued to be interested in a potential transaction. He also told Donald that Certicom's shares were undervalued as compared to their then-current trading price.J[8] The following morning, Donald placed an order with his broker to purchase approximately $300,000 of Certicom stock. RIM subsequently did acquire Certicom, resulting in Donald receiving proceeds of $600,000 for the shares he had acquired.[16]

[10] OSC online: https://www.osc.gov.on.ca/documents/en/Proceedings-RAD/rad_20120801_donaldp.pdf *("Donald").*

OSC online:https://www.osc.gov.on.ca/documents/en/Proceedings-SET/set_201503112alawdekar-hariharan-2.pdf *("Hariharan").*

[12] Supra note 1.

[13] **OSC** online:https://www.osc.gov.on.ca/documents/en/Proceedings-SET/set 20130408_moorerb.pdf *("Moore").*

[14] Ontario Act, supra note 2 at s. 127.

[15] *Donald,* supra note 10 at paragraph 252.

[16] Ibid. at paragraphs 7 and 8.

The OSC concluded without much difficulty that Donald was in possession of material non-public information about Certicom at the time he purchased its shares. The challenge for OSC Staff was to show that Donald was in a "special relationship" with Certicom at the time of his trade. While Donald was an officer of RIM, RIM's discussions with Certicom about a potential transaction had slowed by the time of the golf event. The Panel was unable to conclude that, at the precise time Wormald disclosed the material non-public information to Donald, RIM was proposing to make a take-over bid or otherwise become party to a reorganization, amalgamation, merger, arrangement or similar business combination with Certicom.[12] As a result, the Panel was in the difficult position of having determined that material non-public information had been conveyed and traded on by Donald, but that RIM (and by extension, Donald) and Certicom were not in a special relationship at the time the trading occurred.

The Panel addressed this by considering whether, despite not breaching the insider trading prohibition, Donald had engaged in conduct contrary to the public interest. As an officer of RIM, Donald was a "market participant."[10] In a decision that highlights a theme in Commission jurisprudence, the Panel held: "Market participants... are expected to adhere to a high standard of behavior. In our view, by purchasing securities with knowledge of material facts which had not been generally disclosed, Donald clearly failed to meet that standard and did so in a manner that impugns the integrity of Ontario's capital markets."[10] The Panel found that despite there being no breach of section 76, Donald's conduct directly engaged the fundamental principles of securities regulation and the purposes of the Ontario Act. These findings supported a conclusion that Donald's conduct was abusive of the capital markets and was contrary to the public interest. The Panel sanctioned Donald by prohibiting him from acting as an officer or director of a reporting issuer for a period of five years, reprimanding him and requiring him to pay $150,000 in costs.

In March 2015, Satish Talawdekar and Anand Hariharan entered into a settlement with the OSC regarding allegations of insider trading. Talawdekar was a manager in the technology department of MacDonald, Dettwiler & Associates ("MDA") and, as part of his role, he learned that MDA was to acquire Loral Space & Communications Inc. ("Loral"). Prior to the announcement of the transaction, Talawdekar purchased shares of MDA and tipped his friend, Hariharan. Hariharan then purchased call options on Loral.

At the time of Hariharan's purchase, Loral was not a reporting issuer in Ontario. As a result, and despite the fact that Hariharan received a profit of over USD$68,000 for a single day's trading in Loral, he could not be found liable under subsection 76(1) of the Ontario Act as it existed in March 2015.[20] However, Staff of the OSC agreed with Hariharan that his conduct had impugned the integrity and fairness of the capital markets and was therefore contrary to the public interest. In the settlement approved by the Commission, Staff and Hariharan agreed that he would make a voluntary payment of $35,000, pay costs of $5,000 and be subject to strict limitations on the types of securities he could purchase for the next ten years.[21]

The settlement agreement in ***Re Moore*** provides an interesting and potentially questionable example of the OSC's use of its public interest jurisdiction in the context of a settlement. Moore, an experienced investment banker, settled with the OSC for two discrete trades. His trade in shares of HOMEQ Corp. was as a result of material non-public information he obtained through a misdirected e-mail. However, while the HOMEQ trade clearly met the elements of insider trading, his purchase of shares in Tomkins plc did not. In his role as investment banker, Moore was the relationship manager for CPPIB. While Staff and Moore agreed that his primary contact at CPPIB did not disclose any material non-public information to him, Moore deduced from general comments that his contact made

[17] Ibid. at paragraphs 229, 234 and 235. See, also, s. 76(5) of the Ontario Act, which sets out the definition of "person or company in a special relationship with a reporting issuer."

[18] This term is defined in s. 1(1) of the Ontario Act and includes "a director, officer or promoter of [a reporting issuer]."

[19] *Donald*, supra note 10 at paragraph 319.

" Ontario amended the Ontario Act in June 2015 to expand the definition of insider trading under s. 76.

[21] *Hariharan*, supra note 11 at paragraphs 13 and 15.

that CPPIB was interested in a transaction. He observed his contact at a charity event with the CEO of Tomkins and concluded that CPPIB must be engaged in discussions with Tomkins over a potential transaction. Shortly thereafter, he purchased shares of Tomkins.

Moore settled with Staff on the basis that — in addition to his insider trading with respect to HOMEQ — his purchase of Tomkins was conduct contrary to the public interest. Although no material non-public information was communicated to Moore with respect to Tomkins (a non-reporting issuer at a time when the relevant prohibition was with respect to reporting issuers only), Moore and the Panel agreed that his conduct in making use of information he gained in the context of his role as a registrant, fell below the standard expected of him.[22] Among other penalties, Moore agreed to administrative penalties in the amount of $129,268.94, costs of the OSC's investigation in the amount of $75,000 and a "voluntary payment" of $300,000 specifically for the Tomkins purchase?

Tipping

Re Finkelstein, a decision released in March 2015, involved allegations of both insider trading and tipping. However, the manner in which the OSC approached the tipping allegations with respect to two of the respondents is most demonstrative of its use of its public interest jurisdiction to address gaps or inconsistencies in legislation. Finkelstein, a corporate lawyer, was found liable for tipping Azeff, an old school friend, with material non-public information he obtained about upcoming transactions in the context of his employment with a downtown Toronto law firm.[24] At the time, Azeff and his friend Bobrow were employed as investment advisers with a registered investment dealer. Azeff and Bobrow were found to have engaged in tipping because the Panel held that they "informed" certain others of the information Azeff received (and tipped to Bobrow) from Finkelstein. The Panel also sanctioned Azeff and Bobrow for "recommending" securities to their clients even though they did not specifically inform those clients of material non-public information. For this conduct, the Commission relied upon its public interest jurisdiction?

In exercising its public interest jurisdiction to sanction recommendations by individuals who were in possession of material non-public information, the OSC remained consistent with its earlier jurisprudence in tipping cases: namely, that the mere recommendation to purchase or sell a security while in possession of material non-public information does not meet the requirements of section 76(2). This is so because a trade recommendation is not, in and of itself, material non-public information 2[6] In sanctioning this type of conduct by registrants and other market participants, the OSC uses its public interest jurisdiction to address a gap in legislation that does not exist in other jurisdictions.

Is There a Better Way of Addressing "Near Misses"?

Standards expected of market participants are constantly increasing — this is evident from both the decisions of provincial or territorial securities commissions, and from the rules of Canada's national self-regulatory organizations. Market participants are expected to

n Moore, supra note **13** at paragraphs 30-31.

[23] Ibid. at paragraphs 35-36.

[24] *Finkelstein*, supra note 1 at paragraph 343.

[25] Ibid. at paragraph 343. The OSC took a similar position in *Re Agueci* (OSC online: https://www.osc.gov.on.ca/documents/en/Proceedings-RAD/rad_201502 1 l_agueci-2.pdf; *Agueci).* In that case, the executive assistant in the mining group at GMP Securities learned of material non-public information as part of her job. OSC Staff pursued allegations of insider trading and tipping with respect to numerous trades she and her friends and family placed, but the Hearing Panel was only able to conclude in certain cases that Agueci had actually informed her contacts of the particular material facts at issue. Where it could not conclude Agueci had met the required elements of tipping, it relied upon its public interest jurisdiction to sanction Agueci (see paragraphs 165-167 and 175). Of note, though, are the facts that Agueci had some undisclosed trading accounts she opened in her mother's name, and that she impersonated her mother when placing certain trades. These facts contributed to the Panel's determination to apply its public interest jurisdiction.

[26] see, for example, *In Re ATI Technologies*, 29 O.S.C.B. 8558 at paragraphs 63 and 64; *R. v. Landen*, 2008 ONCJ 561 at paragraph *97; Re Agueci,* OSC online: https://www.osc.gov.on.ca/documents/en/Proceedings-RAD/rad_20150211_agueci-2.pdf at paragraphs 116-118.

engage in "honest and responsible conduct"[27] and registrants are required to "observe high standards of ethics and conduct."[28] It is certainly the case that these developments are laudable, and help promote confidence in Canada's capital markets.

However, regulators should also apply regulatory standards in a fair and efficient manner. Fairness dictates that all market participants should know (or at least have access to) the regulatory standards to which they are held, in advance. Advance and clear notice of all prohibitions of the use of material non-public information by market participants and registrants will also help achieve the principles of timely, open and efficient securities regulation.[29] A clear understanding by industry registrants and market participants of what is expected of them will promote regulatory efficiencies associated with audits and investigations being completed with clear and well-defined expectations.

Backfilling statutory insider trading and tipping prohibitions by applying a general public interest jurisdiction can be both unfair and inefficient — it has been described as "gotcha enforcement" and prosecution in the face of a "near miss" of an essential element of a breach, as defined by the legislatures. Industry registrants and market participants should not be expected to meet standards of which they are unaware. To make legislative changes after, or as a result of, a tribunal decision is to put the cart before the horse — securities commissions are charged primarily with applying, not creating, statutory law."[30] Advance notice should come in the form of legislation, but could also be effected through regulatory staff notices, national instruments or companion policies. Providing clear notice of regulatory expectations would not only be fair, by advising industry registrants and market participants of the specific standard expected of them in advance, but also lead to more effective compliance policies and consistent prosecutorial results.

[27] Ontario Act, supra note 2 at s. 2.1.
[28] IIROC Rule Book Rule 29.1 and MFDA Rule 2.1.1(b).
[29] Ontario Act, supra note 2 at s. 2.1(3)

[30] As was done in response to ***Re Hariharan.*** In June 2015, the Ontario government amended the Ontario Act to expand the prohibited insider trading and tipping to include issuers who were not "reporting issuers."

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