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DELIVERED

Mr. Purdy Crawford
Chair
Securities Review Advisory Committee
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Box 51 First Canadian Place
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Dear Mr. Crawford:

Re: Review of Securities Laws by the Securities Review Advisory Committee

This submission is being made in connection with the review of Ontario securities laws by the Securities Review Advisory Committee. We appreciate the opportunity to make this submission and, as directed, enclose a diskette with the contents of this letter.

Our submissions respond to selected issues from the list outlined in the Committee's request for submissions, including in particular the interplay between the continuous disclosure regime and various prospectus exemptions, and set forth our general views regarding disclosure standards, initiatives to improve continuous disclosure and the current regulatory model. Within those broad issues, we have proposed several more specific recommendations.

Background

In broad terms, the current scheme in the *Securities Act* (Ontario) (the "Act") requires an issuer to provide "full, true and plain disclosure" each time it issues securities pursuant to a prospectus. Investors purchasing under a prospectus have a statutory claim for damages against the issuer, its directors and the underwriters for any misrepresentation in the prospectus. The theory is that if an issuer wishes to access the public markets, the issuer must provide full information to the investing public.

A seller from a "control block" is also subject to the prospectus requirement on the theory that a control block seller has better access to material non-public information and should therefore be subject to certain resale restrictions. There is an exemption for sales from a control block if the issuer is a "seasoned" issuer (*i.e.* has been a reporting issuer for at least 18 months), the securities have been held for at least 6 months (primarily to prevent a back door distribution by an issuer through the shareholder), notice is given to the market, and the seller certifies that it has no knowledge of a material change or of any material adverse information not disclosed to the market[1]. The control block seller would have statutory liability if it sold the shares with knowledge of an undisclosed material fact or material change, if the control block seller is a person in a special relationship with the issuer.[2]

Once an issuer is a "reporting issuer", the issuer is legally required to maintain a continuous disclosure record upon which investors can rely in trading in the secondary market, but the disclosure standard is different. Rather than being required to ensure that the disclosure record contains full, true and plain disclosure of all material facts relating to its securities, an issuer must report only "material changes"[3] and the issuer has no statutory liability to purchasers or sellers in the secondary market for the quality of its continuous disclosure record.

As mentioned above, the Act also prohibits, and imposes civil liability for, trading by insiders with knowledge of an undisclosed material fact or material change.[4] These rules are directed not at ensuring that trades occur with the benefit of full information, but rather that they not occur where there is inequality of information.

It is difficult on a purely analytical level to justify having a different disclosure standard based on the identity of the person from whom a purchaser acquires securities (i.e. from an underwriter or another shareholder in a secondary market trade). In either case, the purchaser or seller should arguably have access to the same relevant information. One way of dealing with this issue would be to raise the disclosure standard pursuant to the continuous disclosure regime and to impose civil liability on the issuer and its directors for all breaches of the continuous disclosure requirements. This is the general trend of proposed changes to the regulatory regime, most notably in response to the Allen Report[5] and

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[1] Section 72(7) of the Act and section 3.11 of Rule 45-501.

[2] Section 134(1) of the Act. This would include a person who beneficially owns, directly or indirectly, voting securities of a reporting issuer or who exercises control or direction over voting securities of a reporting issuer or a combination of both carrying more than 10% of the voting rights attached to all securities. Because the terminology of the control block definition is different, one cannot be certain that a control block seller would be included but it likely would be.

[3] The timely disclosure policies of securities regulators and self regulatory organizations expand this obligation to "material information" but provide broader exceptions.

[4] Sections 76 and 134 of the Act.

[5] *Responsible Corporate Disclosure: A Search for Balance*, Final Report of the Committee on Corporate Disclosure, The Toronto Stock Exchange, March 18, 1997.

in the recent concept proposal by the Canadian Securities Administrators (CSA) for an integrated disclosure system (the "IDS Proposal")[6]. There are, however, problems inherent in such approach as canvassed in the Allen Report. In particular, given that the issuer does not receive any proceeds from sales in the secondary market, it may not have the resources to fully compensate investors for secondary market trades made on the basis of inadequate disclosure.

We recommend approaching these issues from a different perspective. First, the Committee should consider whether the secondary market does, in fact, suffer from a lack of adequate disclosure and, if so, make a judgment whether the appropriate remedy would be to mandate higher standards of disclosure or to bring greater enforcement efforts to bear to ensure issuers meet the current standards. Although we accept that the difference in disclosure standards may not be justifiable on a strictly analytical basis, it is not clear that this difference has resulted in damage to the integrity of the secondary market which would warrant a material increase in the regulatory burden imposed on issuers. Secondly, the Committee should reconsider some of the assumptions on which the current regime is based, with a view to reducing regulation that is no longer required (as opposed to focusing primarily on increasing regulation). The "seasoning" and "hold periods" applicable on the resale of securities purchased under various exemptions and the scope of the control block distribution requirements are specific examples which we deal with below.

Seasoning Periods

Where a person acquires securities under certain specific exemptions (including the exemptions for employee purchases and stock options, amalgamations, arrangements and take-over bids), the first trade in those securities will be subject to the prospectus and registration requirements unless exempted under subsection 72(5) of the Act[7]. That exemption is available where the issuer of the securities (or in the case of an amalgamation, one of the amalgamating or continuing corporations) is a reporting issuer *and has been a reporting issuer for at least 12 months* and certain other requirements are met. The Commission has in at least one recent case granted an exemption eliminating the seasoning period for securities acquired on the exercise of employee stock options following an initial public offering of the underlying securities.[8] However, in that case the order appears to have been granted on the basis that employees in the United States were not similarly restricted, rather than on the basis that the seasoning requirement was not appropriate.

The requirement that an issuer be a reporting issuer ensures that the issuer is subject to the continuous disclosure requirements, so that a purchaser in the secondary market will have the benefit

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[6] (2000) 23 OSCB 633-622 (January 28, 2000)

[7] See also section 9.1 of Rule 45-503.

[8] *Re Creo Products Inc.* (2000) 4 OSCB (January 18, 2000). We understand other orders have been requested on similar grounds, but either refused or the applications are pending. See also *Re Sun Media Inc.* (1997) 4 OSCB 5923 (November 14, 1997), where an order was granted on slightly different grounds where the issuer had been a reporting issuer in the past.

of the continuous disclosure record. The need for a 12 month "seasoning period" is less obvious. The usual supporting argument is that the period allows information about an issuer to be built up and absorbed (including by analysts) and permits the quality of the issuer's disclosure to improve with time. However, the CSA point out in the IDS Proposal that SEDAR and other recent advances in technology permit greater and faster access to information than ever before. In addition, an issuer's disclosure record may actually meet the highest standard immediately after it first becomes a reporting issuer, because of the availability of a prospectus which has had the benefit of the involvement of professional advisors in the initial offering process.[9] The CSA also note the inconsistency in the existing regime, in that it does not generally require seasoning as a means of protecting secondary market investors. If the protection of seasoning is legitimately required (which we dispute), logic would dictate that it be necessary after any initial public offering as well.

We therefore recommend that subsection 72(5) of the Act (and similar requirements such as those in subsection 72(7), section 2.6 of Rule 45-501 and section 9.1 of Rule 45-503) be amended to continue to require that the issuer be a reporting issuer, but not that it have been a reporting issuer for any minimum period.

Hold Periods

Securities acquired under other exemptions (including most notably the private placement exemption) are subject to a different resale regime. In those circumstances, the issuer must be a reporting issuer at the time of the resale (without any seasoning requirement), and the securities must have been held for a minimum period of time which varies depending on the nature of the securities acquired.

The private placement and related exemptions exist on the theory that a sophisticated purchaser has sufficient influence to obtain access to the information it wants from the issuer, and sufficient investment expertise to understand and assess the investment decision it is making. Those persons therefore do not require a document containing "full, true and plain" disclosure of all material facts.

The legislation addresses through the hold periods the possibility that the shares privately placed could be resold immediately to investors who do not meet the requirements of the private placement or similar exemptions and who, presumably, should receive the benefit of a prospectus. Subsection 72(4) of the Act, however, permits a resale without requiring a prospectus, if the issuer is a reporting issuer and the shares have been held for a specific time period. The hold period ensures that the issuer does not effect a back door distribution, by privately placing the shares as a first step with the intention that the shares be resold to the public without a prospectus. The specific hold

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[9] This presumes that an issuer would not be permitted to become a reporting issuer unless it has available on the public record a current disclosure document that meets a standard comparable to that of a prospectus, even if prepared and reviewed in another jurisdiction.

periods were originally implemented for greater certainty as to when such a resale could occur but, based on experience, that objective has been outweighed by complexity and lack of cohesive purpose.

The hold period may also be intended to create a bias in favour of prospectus offerings (because issuers are able to deliver more valuable freely tradeable shares), on the theory that encouraging more frequent prospectus offerings will result in enhanced disclosure which will indirectly benefit all market participants. Given existing initiatives toward enhancing continuous disclosure obligations, this becomes a less valid justification. It is difficult to see the justification for imposing higher costs on the issuer in effecting a private placement (because of the hold period), if there is no substantially higher level of disclosure as a result of a prospectus distribution. Even if a hold period is justified on this basis, however, the differences in the duration of the various hold periods is not supportable.

Under the Act, the applicable hold period will be 6, 12 or 18 months, depending on the circumstances. The minimum 6 month hold period applies only to securities which meet certain technical investment requirements under the *Insurance Act*. Securities which meet those requirements were presumably thought by legislators to be of a higher quality or less speculative. In fact, however, comparable investment tests in similar statutes in Canada have been dropped as those statutes have been modernized, because the tests proved to be highly imperfect indicators of the quality of applicable securities. As well, the Act does not as a general matter attempt to identify and exempt from the prospectus requirements securities which are of a higher quality or investment grade.

A 12 month hold period applies if the securities are listed on a recognized stock exchange. This is somewhat ironic since The Toronto Stock Exchange imposes only a 6 month hold period on private placements. Finally, securities which are neither listed nor satisfy the *Insurance* Act test (and cannot be made to satisfy it), are subject to an 18 month hold period.

In our view, if a hold period continues to be necessary (and it may be that one is necessary at least until a more integrated disclosure system is a reality), the same period should apply in all circumstances and should be harmonized with the requirements of The Toronto Stock Exchange.

Therefore, we recommend that the hold period in subsection 72(4) (and in any similar provision such as section 3.11 of Rule 45.501) be 6 months in each case, regardless of the type of security.

Control Block Distributions

As noted above, the Act imposes prospectus and registration requirements for a trade in securities:

> from the holdings of any person or company or *combination of persons or companies* holding a sufficient number of any securities of that issuer *to affect materially the control of that issuer*, but any holding of any person, company or *combination of persons or*

> *companies* holding more than 20 per cent of the outstanding voting securities of an issuer shall, in the absence of evidence to the contrary, be deemed to affect materially the control of that issuer.
>
> *(emphasis added)*

Sales from a control block are included in the definition of distribution on the assumption that control block holders have better access to information than other participants in the secondary market. For that reason, distributions from a control block are permitted to be made without a prospectus if (among other things) the issuer has been a reporting issuer for at least 18 months (see the recommendation regarding seasoning above), the seller gives the market advance notice by filing a notice of intention and the seller certifies as to certain facts. The certificate must state that the seller has no knowledge of any material change which has not been generally disclosed and no knowledge of any material adverse information regarding the current and prospective operations of the issuer which has not been generally disclosed. [10] The exemption is not available unless the securities have been held by the control block holder for at least 6 months.[11]

We believe that there should be as much certainty as possible in the application or potential application of the control block concept and that the concept should be refined to more clearly reflect the policy concerns which lie behind it.

In that context, the reference to a "combination of persons or companies" is not a concept which has a clear and readily understood meaning. We propose instead the concept of persons holding securities who are *acting jointly or in concert* with respect to those securities. Further, rather than having a broad inclusive definition which is unclear in its scope (by including persons who hold sufficient shares to "materially affect control"), we propose that the definition include *only* persons who beneficially own, directly or indirectly, more than 20% of the outstanding voting or equity securities of the issuer (including securities owned by persons acting jointly or in concert with such holders). Provided there are appropriate exclusions as suggested below, we believe the 20% threshold should apply to equity securities, as well as voting securities, of an issuer.

As well, given the policy objective of the control block distribution provisions, we suggest that persons caught by the 20% control block threshold not be treated as a control person if they can establish that their ownership, although exceeding 20% of the voting or equity securities, does not affect materially the control of the issuer. This might be the case, for example, where there is another person owning more than 50% of the voting shares who controls the election of the board of directors. We also propose that a person be excluded if the person does not have, whether through

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[10] Section 72(7) of the Act.

[11] Section 3.11 of Rule 45-501.

board representation or otherwise, access to the issuer sufficient to provide the person with an informational advantage over other security holders.

We also question the need for the requirement in section 72(7) for the issuer to provide the certificate referred to above. If the concern is access to material non-public information, we believe that the existing insider trading restrictions contained in the Act are adequate to protect the public; and we fail to see why a different standard of "material adverse information" should be applied.

We therefore recommend that the certificate requirement in clause 72(7)(b)(i)(B) be deleted and that paragraph (c) of the definition of distribution be replaced with the following:

> *a trade in previously issued securities of an issuer by a person or company (a "seller") who, together with any person or company acting jointly or in concert with the seller with respect to the particular securities, beneficially owns, directly or indirectly, more than 20% of the outstanding voting or equity securities of an issuer, except where:*
>
> *(i) the seller, together with all persons and companies acting jointly or in concert with the seller with respect to those securities, does not beneficially own, directly or indirectly, a sufficient number securities to affect materially the control of the issuer; or*
>
> (ii) *the seller does not have access to the issuer sufficient to provide the seller with an informational advantage over other security holders, whether through board representation or otherwise.*

IDS Proposal and Allen Report

The CSA proposes in the IDS Proposal a voluntary system which would permit issuers to access the public markets much more rapidly if they adhere to a higher standard of continuous disclosure. Under that standard, issuers would be required to provide annual full, true and plain disclosure in a new annual information form (AIF). Issuers would also have to file quarterly information forms (QIFs) and supplementary information forms (SIFs). The SIF would be akin to the current material change report but would be triggered not only for material changes but for an additional list of facts which are not material changes. Full, true and plain disclosure of the matter requiring the disclosure would be required. One goal of the proposal is to shift the focus of regulation to the continuous disclosure documentation.

The IDS Proposal does not deal with the dilemma an issuer may face if a deadline for filing an AIF under the IDS approaches and it is not possible to provide prospectus-level disclosure at that time (such as when the issuer is in negotiations with respect to a material transaction). There will presumably be statutory penalties for the failure to file (and the market may well note the delay and draw its own conclusions). In addition, the IDS proposal seems to acknowledge that issuers can effectively flip back into the system after breaching its requirements as long as they cure the disclosure default before accessing the public markets. In that context, we are sceptical as to whether the new rules will themselves improve disclosure, or whether in fact the driving force toward improved disclosure should be greater enforcement activity by the Ontario Securities Commission in reviewing continuous disclosure documents.

If the recommendations in the Allen Report are implemented and the issuer is participating in the IDS, civil liability may flow from a failure to file a particular IDS report on a timely basis or from inadequate disclosure in the filing where there have been secondary trades during the intervening period, even if the issuer does not access the market in reliance on its disclosure record. If that is the case, voluntary participation in the IDS may be negatively affected. It may be that if the IDS Proposal is considered beneficial to the quality of disclosure in the secondary market, it should become mandatory. However, we continue to have concerns (expressed in our submissions in response to the interim report which preceded the Allen Report) regarding the proposed regime for civil liability in the Allen Report. The existing protections (including those which prohibit insider trading) may well be adequate to address any concern regarding trading during the period prior to disclosure, rather than imposing a civil liability remedy. At a minimum, if the IDS Proposal is implemented, it will be essential to cap liability for faulty disclosure and to clarify and refine disclosure standards as discussed below.

“Material Change” vs. “Material Fact” or “Material Information”

We would oppose any proposal that the “material change” obligation under section 75 of the Act extend to a broader concept of “material information” or “material facts”. We are particularly concerned with respect to the situation where negotiations have been initiated by an issuer to implement a material transaction. In that circumstance, those negotiations may themselves constitute a “material fact” or “material information” with respect to the issuer (because an announcement of the existence of the negotiations may affect the market price of the securities) but would not constitute a “material change” until agreement had been reached with respect to the transaction. We understand that this distinction is relied upon by many professional advisors in concluding that disclosure of negotiations is not required. We believe it is appropriate for issuers to be able to conduct confidential negotiations without triggering a disclosure obligation, because disclosure of the existence of negotiations in respect of a transaction which ultimately may not occur may (i) have negative effects on the businesses of the parties involved, (ii) provide insufficient information to permit the market to appropriately assess the impact of a possible transaction, and (iii) discourage parties from participating in such negotiations. The provisions of National Policy 40 - Timely Disclosure and the TSE’s timely disclosure policy are the appropriate means to regulate the disclosure of the broader concept of “material information”. Those policies are more flexible than section 75 of the Act in permitting non-disclosure where disclosure would have negative consequences to the issuer and where steps are taken to preserve the confidentiality of the relevant information.

We therefore recommend that issuers be required under the Act to disclose on a continuous basis only material changes (not material facts or material information).

Further, we note that the definition of "material fact" has been used in the Act for two basic but different purposes. It has been used on the one hand in the insider trading restrictions in section 76 and, on the other hand, as a standard of disclosure in the definition of "misrepresentation" and in the various Forms to the Act. We believe that the existing definition, focused as it is on the market effect of information, is appropriate for insider trading purposes but not for purposes of determining whether the appropriate disclosure standard has been met. With respect to the latter, the Commission has adopted in its decisions the test articulated in *Northway*[12] which focusses on whether there is a substantial likelihood that a reasonable person would consider the fact important in making its decision.

We therefore recommend that for purposes of determining whether a "misrepresentation" has occurred and whether disclosure is adequate in a document, such as a prospectus, which requires disclosure of all material facts, a fact would be a "material fact" if "there is a substantial likelihood that a reasonable person or company would consider it to be important in making a decision to purchase or sell securities of the issuer".

Market Manipulation

It also seems appropriate to us for the *Securities Act* to contain an offence for manipulating the market price of a security. We do not consider the relevant provisions of the Criminal Code to be adequate for this purpose and we believe that it should be made clear to all market participants that market manipulation is improper.

We therefore propose adding to the Act a prohibition against manipulating or attempting to manipulate the market price or value of any security for an improper purpose. We believe that a qualifier such as "for an improper purpose" is necessary to distinguish those circumstances from appropriate market conduct which affects the market price of a security.

General

The Committee's request for submissions poses questions regarding the efficacy of our securities regulatory model, both in terms of the quality of investor protection and the efficiency of our regulatory regime and our capital markets.

Securities regulation in Canada has become increasingly complex and rigid, with an attendant increase in compliance cost that is ultimately borne by issuers and the investing public. In view of the relatively small size of Canada's capital market, it is extremely important that our regulatory system be effective without imposing uncompetitive costs on issuers and investors.

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[12] *TSC Industries, Inc. v. Northway Inc.* (1976), CCH Federal Securities Law Reports 90, 069, approved in *Royal Trustco et al v. Campeau Corp. et al*, 31 OR(2d) 75, *Sparling v. Royal Trustco Ltd.* (1984), 45 OR(2d) 484 and *Re Standard Broadcasting Corp. Ltd.* (1985) OSCB 2664.

Securities regulation needs to reflect a balanced mix of general principles and clear rules. A lack of general principles could lead to situations where marketplace conduct is permitted because it is "within the rules", even though it clearly seems to offend appropriate standards of market intermediary conduct and investor protection. In addition, our current regime, which is tending towards an over-reliance on rules with legal effect, has led every experienced practitioner to cite examples of difficulty in complying with rules that are inflexible or do not adequately deal with a given set of circumstances. In these circumstances, compliance is made difficult and expensive.

Ontario's rule-making process is overly complicated, time consuming and expensive. While it is generally acknowledged that the Commission went too far in using policy statements to, in effect, write new law, the pendulum has swung too far the other way. We now have a rule-making process that is no more flexible, timely or responsive than statutory or regulatory amendments. It is increasingly difficult for practitioners to guide clients through a maze of statutory and regulatory requirements, existing policy statements, proposed rules and policy statements and concept releases. We have, in many ways, achieved the worst of all regulatory worlds. Our regulatory system needs a process that permits greater use of policy making to achieve responsive, timely and flexible guidance on the application of regulatory principles to marketplace developments, while retaining a streamlined rule-making process that permits the timely development of legally binding instruments in appropriate cases. The Commission also requires the power to issue blanket orders to respond in a timely manner to short-comings in existing rules.

With respect to the efficiency of our regulatory model, we believe that much work needs to be done to reduce the duplicative and costly system of provincial regulation that exists in Canada. While much effort has been expended in making our current system operate more effectively, it is simply not credible to argue that the involvement of multiple regulators that exists within the CSA can achieve the efficiency of a national securities regulator. Notwithstanding the difficulties that confront a national securities commission initiative, we believe that the current system could be substantially improved if the provincial securities commissions were prepared to adopt true reliance on lead jurisdictions to deal with matters such as prospectus clearance and registration of market intermediaries.

True reliance by provincial regulators on each other does not exist where each provincial securities commission retains its right to be involved in any matter that enters the jurisdiction of the province. In an environment where there are, in practice, only four provincial securities commissions that are actively involved in regulatory initiatives, it should be possible to develop a true system of mutual reliance.

Such an outcome would not only be beneficial in the financing area, but would be of particular value in dealing with registrations. The inefficiency and cost involved in requiring separate registrations in each province is a substantial barrier to providing cost competitive services to investors in Canada. In the current electronic environment many investment products could be efficiently offered to investors from centralized, low-cost environments. The evolution of our regulatory system has not occurred, in part, for competitive and monetary reasons: simply put, some provincial regulators do not want to forego licensing revenue and see the business developed in a low-cost jurisdiction outside their province. This is not an issue of investor protection, it is an issue of investor cost; and it would be in the best interest of those investors if our securities regulatory system could be developed in a manner that allows investors to access capital markets in an efficient and cost-effective manner.

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We appreciate the opportunity of commenting on these matters to the Committee.

While this submission is made on behalf of our firm, it does not necessarily reflect the views of all of our partners. We would be pleased to discuss any aspect of this submission with you at your convenience.

Yours sincerely,

Torys
Per:

SCG/bv
bcc: Jim Turner
Jamie Scarlett
Peter Ballantyne
Gary Solway