

Fasken Martineau DuMoulin LLP
Barristers and Solicitors
Patent and Trade-mark Agents

www.fasken.com

66 Wellington Street West
Suite 4200, Toronto Dominion Bank Tower
Box 20, Toronto-Dominion Centre
Toronto, Ontario, Canada M5K 1N6

416 366 8381 Telephone
416 364 7813 Facsimile



H. Garfield Emerson, Q.C.
National Chairman
Direct 416 865 4350
Direct Fax 416 865 4462
gemerson@tor.fasken.com

August 15, 2002

Five Year Review Committee
c/o Mr. Purdy Crawford, Chair
Osler, Hoskin & Harcourt LLP
Barristers & Solicitors
Box 50, 1 First Canadian Place
Toronto, Ontario M5X 1B8

Dear Mr Crawford

Five Year Review Committee Draft Report

Fasken Martineau DuMoulin LLP is pleased to provide its comments to the Committee on its Draft Report dated May 29, 2002. We have not commented on every aspect of the Draft Report and we have limited our comments to those areas which we believe involve public policy matters of greatest concern. We have included a table of contents to provide reference to the various Parts and Chapters of the Draft Report on which we have commented.

Our contact person who is available to respond to inquiries from the Committee in connection with this submission is:

H. Garfield Emerson, Q.C.
National Chairman
Fasken Martineau DuMoulin LLP
Toronto Dominion Centre
Toronto Dominion Bank Tower
Suite 4200, P.O. Box 20
Toronto, Ontario M5K 1N6

Tel: 416-865-4350
Fax: 416-865-4462
E-Mail: gemerson@tor.fasken.com

Our partners and associates who have participated in the preparation of this comment letter include:

Anil Aggarwal
Aaron Atkinson
Lata Casciano
Garfield Emerson
Stephen Erlichman
David Hausman
Greg Ho Yuen
Paul Martel
W.J. Palmer
Richard Steinberg

Our commentary is annexed to and forms part of this letter.

Yours very truly,

Fasken Martineau DuMoulin

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EXECUTIVE SUMMARY

1. The most urgent and pressing need facing the Commission is to restore trust and confidence in the capital markets in Ontario, and Canada, through expanded and “real time” disclosure requirements for reporting issuers and increased enforcement of the integrity of the accuracy and completeness of filed financial and other material information of reporting issuers.

2. While the issue of a national securities regulatory structure and increased “harmonization” among the 13 provincial securities regulators should continue to be addressed and improved, the Final Report should rather direct its attention on the needs to improve the protection for investors in Ontario’s capital markets. Ontario has historically provided and should continue to provide regulatory leadership in setting capital market conduct standards and investor protection principles in Canada.

3. The SEC has stated, following the enactment of the *Sarbanes-Oxley Act of 2002*, that it intends to adopt final rules that would apply the section 302 certification requirement of that Act to foreign private issuers filing annual reports on Form 20-F and Canadian issuers filing Form 40-F under the SEC’s Multijurisdictional Disclosure System. The Committee should recommend analogous certification requirements for reporting issuers filing periodic reports with the Commission under the Act. It would be incongruous that senior Canadian reporting issuers certify their periodic reports to the SEC but not to the Commission.

4. We remain unconvinced that it is in the interests of investor protection that all hold periods arising from the sale of securities on a prospectus-exempt basis and the seasoning periods for reporting issuers be eliminated. These foundations of the closed system should not be dismantled to allow the “secondary distribution” problem to become a recidivist to muddy the efficacy of accepted investor protection principles.

5. We strongly recommend that the Committee should redirect its focus on and strengthen the timely disclosure obligations of reporting issuers under the Act

- to revise and expand the scope of the now outdated 1978 definition of “material change”;
- to restructure the disclosure requirements for the material change report required to be filed pursuant to subsection 75(2) of the Act;
- to itemize particular company-specific events requiring timely disclosure;
- to require that the full text of agreements entered into by the reporting issuer with respect to a reported disclosure (redacted to

exclude confidential information, if necessary) be filed as a schedule to the material change report; and

- to delete the “market impact” test of materiality and to replace it with the “reasonable investor” test.

6. The Commission should undertake a study to review whether it would be appropriate to enhance the protections of the interests of the minority shareholders of a target company in the context of a partial bid for control. The U.K. and the U.S. currently provide protections for minority shareholders in such circumstances.

7. The Commission should not proceed to prepare a policy statement attempting to set out guidance as to when a shareholder rights plan adopted by the target company must be terminated after the commencement of a unilateral takeover bid.

8. The Commission should reconsider its policy interpretation of “acting jointly or in concert” in subsection 2.3(2) of its Companion Policy 61-501CP in light of the decision of the British Columbia Court of Appeal in *Sepp’s Gourmet Foods v. Janes*, [2002] B.C.J. No. 289 (February 14, 2002).

9. In light of the Committee’s broad mandate and the current relevance of the British Columbia Securities Commission’s five recommendations for mutual fund regulatory reform in Canada set out in its De-Regulation Project, we believe that the Committee should consider and disclose in its final Report whether it supports, in whole or in part, all or any of the five recommendations of the BCSC.

10. We are in general agreement with the recommendation of the Committee that the CSA should introduce a requirement for all publicly offered mutual funds to establish and maintain an independent governance body. We do not believe, however, that the governance body should have the unilateral power to terminate the fund manager. We agree with the Committee’s recommendation that mutual fund managers should be subject to independent oversight of their capital adequacy, personnel proficiency and standards of business practice, but we do not believe that this oversight should be conducted by the independent governance body – rather, it should be conducted by the securities regulator through the registration process.

PART 1
THE ROLE OF THE COMMISSION IN CAPITAL MARKETS REGULATION

Chapter 1: The Need for a Single Regulator

The Committee has concluded that “the *most pressing* securities regulation issue in Ontario and across Canada” is “the urgent need for a single Canadian securities regulator” [emphasis added]. *We concur that this is a priority item, but believe that restoring trust and confidence in the capital markets in Canada, as well as elsewhere, through expanded disclosure requirements for reporting issuers and increased enforcement of the integrity of the accuracy and completeness of filed financial and other material information of reporting issuers is currently an even more pressing matter.*

The importance of the call for a national securities regulator should not be minimized; however, it is not a new concern. There have been numerous commissions, government groups, task forces and organizations that have identified and unsuccessfully attempted to seek resolution of our fragmented securities law regulatory regimes, including:

- the Porter Report (1964)
- the OSC’s CANSEC proposal (1967)
- the Federal Minister of Finance’s initiatives in 1972¹
- the Federal Proposals for a Securities Market Law for Canada (1979)²
- the Federal Government’s Proposals (1994).³

The current Chair of the OSC has recently renewed the challenge to establish a national securities regulator, calling the current financial industry situation “a regulatory system hobbled by excessive cost and complexity. Quite simply, we have too many regulators. Too

¹ The address of the federal Minister of Finance, the Hon. John N. Turner, to the Investment Dealers’ Association of Canada on June 16, 1972 expressed the interest of the federal government in assuming an active role in federal securities regulation. Mr. Turner then stated that “we must move in an orderly way toward the development of a uniform national system of securities regulation and a national exchange system.” Canada appears, 30 years later, to be progressing “in an orderly way”.

² See, Philip Anisman, *The Proposals for a Securities Market Law for Canada: Purpose and Process* (1981), 19 Osgoode Hall Law Journal 329.

³ The problems of the current Canadian regulatory system and a useful review and analysis of the national securities commission proposals are contained in Anisman, *supra*, footnote 2, and in Ch. 16, “Problems in the Current Canadian Regulatory System”, and Ch. 17, “National Commission or Increased Coordination”, respectively, of David Johnson and Kathleen Rockwell, *Canadian Securities Regulation* (Second Edition) (Butterworths, 1998).

many regulatory structures. Too much overlap and duplication”. The OSC Chair has called for the provincial governments to sponsor a “Pan-Canadian commission, created by the provinces and the territories” which would be responsible for “administering securities laws” that are “delegated by each [Province] to the Pan-Canadian Commission”, resulting in “national cohesion under provincial and territorial responsibility”.⁴ The President of the Canadian Bankers Association again recently endorsed the creation of a “national system of financial services regulation” where “all governments responsible for regulating financial services cooperate within a unified system.”⁵

We endorse the Committee’s recommendation that all levels of government in Canada (including the federal government) work to establish a single securities regulator across Canada with responsibility for capital markets (and capital markets conduct) with regional offices.⁶ We do not believe that such a solution can be realistically achieved in Canada without the participation and imprimatur of the federal government, although federal government participation does not need to imply or require that the single regulator must be a “federal securities commission”. A so-called “Pan-Canadian commission” created only by the provinces and territories has, however, the fatal deficiency of the absence of an unambiguous and clear federal and interprovincial jurisdictional base, power and support that is necessary for the effective and efficient regulation of capital market transactions on a national basis, and, particularly, transactions that have an international or cross-border nexus, that only the federal government can contribute.

It is also clear that the federal government has an essential role to play in the regulation of the Canadian financial services industry through, among others, the Bank of Canada, Department of Finance, OSFI and CDIC. In light of the significant ownership of and participation in Canadian wealth management services, the securities and investment industries and debt and equity capital markets generally by the Canadian banks and the expanding involvement by the Canadian insurance companies in such areas, all of which are subject to federal jurisdiction, the federal government has a keen and legitimate interest in the formation of any national securities regulatory regime. This interest arises not only from the increasing importance that such activities contribute to the overall earnings of federal financial institutions but also from the concern that a national securities regulatory scheme does not infringe on the federal government’s paramount duties and ability to provide effective prudential regulation of the Canadian banking and financial services industry.

⁴ David A. Brown, “*Dialogue with the OSC - Keynote Address* (November 20, 2001).

⁵ Raymond Protti, “*Sort it Out or Lose Out: Why Canada Must Fix the Way it Regulates Financial Services*” (Calgary Chamber of Commerce, May 27, 2002).

⁶ The Canadian Provincial Securities Administrators (as the Canadian Securities Administrators were then called) first commenced to issue National Policies in April, 1971.

We must also support the comment of the Ontario Teachers' Pension Plan Board quoted in the Draft Report (paragraph 1.3) that “harmonization”⁷ among provincial and territorial securities regulatory regimes results in a trend to a “race to the bottom”. If it is not a “race to the bottom”, “harmonization” results in a homogenization of standards and a dilution of first class regulatory policies and principles in order to reach a compromise acceptable to 13 different regulatory authorities.

We support the worthy and necessary objective that, in the absence of a single national securities regulator, continued actions to improve “uniformity” and “harmonization” among the 13 regulatory regimes is not only desirable but required in the public interest in order for our capital markets to be able to function within Canada. But provincial and territorial “uniformity” and “harmonization” principles are not sufficient goals in and of themselves, even with the proposed enhancements of “delegation” and “mutual recognition” among the 13 regulators.

There is also the serious concern that, on an ongoing basis, achieving a consensus on the “harmonization” of regulatory issues among 13 regulators results in a “regulatory time lag” that is not acceptable on a public policy basis in order to address changes in the capital markets and to provide useful remedies for the benefit of investors. Canada does not appear capable, under its current regulatory structure, of responding in a uniform, timely and efficient way to remedy the misadventures of public corporations and participants in its capital markets that result in the loss of investor confidence that arise from situations like Enron, WorldCom, Tyco, or, in Canada, Bre-X, Phillips, Livent and YBM Magnex.⁸

As the mandate of the Committee specifically includes a review of the Act to insure that securities legislation in Ontario is up to date and that the Commission has the necessary legislative tools to fulfill its mandate in Ontario, *we recommend that the focus of the Final Report not distract from the needs to protect the important and extensive capital markets that operate in Ontario because of an undue emphasis to attempt to “harmonize” Ontario’s regulatory regime on a Pan-Canadian provincial basis.* Ontario’s own securities regulatory initiatives historically have attempted to achieve world class status based on principle-based

⁷ “Uniformity and harmonization are different concepts. Most, if not all, authorities believe that harmonization must be increased. However, some are satisfied with the status quo level of uniformity. They believe that increased uniformity could stifle innovation and reduce the ability to raise venture capital. In a harmonized system, different jurisdictions have different legislation, but with the same effect across all. ... In Canada, this would mean having the same effective legislation in all provincial and territorial jurisdictions, even if the actual legislation were different in each. Most parts of the current system are not harmonized, as the effects vary (in at least minor ways) in each jurisdiction.” Ch. 16, “Problems in the Current Canadian Regulatory System”, in *Canadian Securities Regulation*, footnote 3, *supra*.

⁸ Investigations of corporate activities that adversely affected Ontario’s capital markets have occurred in Canada, but, unfortunately, not recently. See, *Report of the Royal Commission to Investigate Trading in the Shares of Windfall Oils and Mines Limited* (1965).

investor protection requirements that create confidence in the integrity of the capital markets that operate in Ontario.

First and foremost, Ontario's objectives should continue to be to provide regulatory leadership for the benefit of the securities industry and capital markets in Ontario and for the protection to investors who trade in Ontario. History has shown that Ontario's leadership in setting capital market standards has also had a positive effect in Canada and on other provincial regulatory regimes.

PART 4 CLOSED SYSTEM AND SECONDARY MARKETS

Chapter 10: Continuous Disclosure

10.1 The Importance of Continuous Disclosure

As noted in the Draft Report, investors who purchase their debt and equity securities in the primary and secondary markets must be confident that the filed public record of reporting issuers will provide them with the complete and accurate information on a timely basis that they need to make informed investment decisions. In the wake of the dramatic capital markets and investor confidence crisis caused by Enron, WorldCom and Tyco, among others, *we believe that regulatory reform that contributes to the re-building of investor confidence in the capital markets should be the priority issue on the securities regulatory agenda.*

On June 14, 2002, the SEC published a proposed rule for comment in Release No. 34-46079⁹ which would require an issuer's principal executive officer and principal financial officers to certify with respect to their company's annual and periodic public disclosure reports that, to their knowledge: (i) such officer has read the report; (ii) to his or her knowledge, the information in the report is true in all important respects as of the end of the period covered by the report; and (iii) the report contains all information about the company of which the officer is aware that the officer believes is "important to a reasonable investor" as of the end of the period covered by the report. An officer who provides a false certification could be subject to enforcement action by the SEC and to private actions under the antifraud provisions of the U.S. *Securities Exchange Act of 1934* (the "Exchange Act").

For purposes of this proposed officers' certification, information is "important to a reasonable investor" if:

⁹ SEC Release No. 34-46079, *Certification of Disclosure in Companies' Quarterly and Annual Reports* (June 14, 2002).

- (a) “There is a substantial likelihood that a reasonable investor would view the information as significantly altering the total mix of information in the report; and
- (b) The report would be misleading to a reasonable investor if the information was omitted from the report.”

The SEC believes that the above proposed certification reflected current U.S. disclosure standards for “material” information and followed the standard of “materiality” set out in *TSC Industries, Inc. v. Northway, Inc.*¹⁰ (“TSC Industries”) and *Basic, Inc. v. Levinson*¹¹ (“Basic”).

The materiality test of TSC Industries has been adopted in Canada: *Sparling v. Royal Trustco Ltd.*¹²; *Inmet Mining Corp. v. Homestake Canada Inc.*¹³; *Agbi v. Geosimm Integrated Technologies Corp.*¹⁴; and *Nalcap Holdings Inc. v. Kelvin Energy Ltd.*¹⁵ This test of “materiality” has also been adopted by the Commission, for example, in *Re Macdonald Oil Exploration Ltd.*¹⁶ and *Re Chapters Inc. and Trilogy Retail Enterprises L.P.*¹⁷.

The “probability/magnitude” materiality test of Basic has also been considered in Canada, but the implied civil cause of action for “fraud on the market” articulated by Basic has been rejected: *Re J. Patrick Sheridan*¹⁸; *Carom v. Bre-X Minerals Ltd.*¹⁹; and *Mondor v. Fisherman*.²⁰

As the Committee is also aware, on June 27, 2002, the SEC also issued an order under section 21(a) of the Exchange Act requiring the principal executive officer and principal financial officer of 945 of the largest U.S. domestic public companies to certify personally, in writing, under oath, and for publication, that their most recent disclosure reports filed with the SEC are complete and accurate.²¹ Officers who make false certifications will face personal

¹⁰ 426 U.S. 438 (1976)

¹¹ 485 U.S. 224 (1988)

¹² (1984), 45 O.R. (2d) 484 (Ont. C.A.) at p.5; *aff’d*, Supreme Court of Canada, [1986] 2 S.C.R. 537

¹³ [2002] B.C. J. No. 42 (B.C. Sup. Ct.)

¹⁴ (1998), 228 A.R. 134 (Alta. C.A.)

¹⁵ [1988] R.J.Q. 2768 (C.S. Que.)

¹⁶ (1999), 22 OSCB 6452 at p. 6455

¹⁷ (2002), 24 OSCB 1064 at p. 1067

¹⁸ (1993), 16 OSCB 6345

¹⁹ (1998), 41 O.R. (3d) 780 (Ont. Ct. Just., Gen. Div.)

²⁰ (2001), 15 C.P.R. (4th) 289 (Ont. Sup. Ct.)

²¹ SEC Order No. 4-460, *Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934* (June 27, 2002)

liability. Such certificates are required with Form 10-K or Form 10-Q reports filed with the SEC on or after August 14, 2002.

Pursuant to SEC Order 4-460, each such officer of the specified 945 U.S. public companies is required to certify that “to the best of my knowledge, based on a review of the covered reports”, except as corrected or supplemented by a subsequent covered report,

- (a) “no covered report contained on untrue statement of a material fact as of the end of the period covered by such report...; and”
- (b) “no covered report omitted to state a material fact necessary to make the statements in the covered report, in light of the circumstances under which they were made, not misleading as of the end of the period covered by such report...”.

The certification is also required to disclose whether the officers signing the report reviewed the contents of the statement with the company’s audit committee.

As the Committee is aware, the United States Congress recently enacted the *Sarbanes-Oxley Act of 2002* (the “Act”)²². Under section 302 of the Act, the SEC is required to adopt rules implementing specified statutory certification requirements for principal executive officers and principal financial officers for SEC reporting companies by August 29, 2002. Section 302(a) of the Act requires that the principal executive officer and the principal financial officer certify each annual or quarterly report filed with the SEC under the Exchange Act that:

- (1) the signing officer has reviewed the report;
- (2) based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading; and
- (3) based on such officer’s knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the company as of, and for, the periods presented in the report.

In addition, the certificate with each annual and quarterly report certified by such officers must also include that the signing officers:

- (a) are responsible for establishing and maintaining internal controls;

²² *Sarbanes-Oxley Act of 2002*, 107th Cong. (2002), H.R. 3763.

- (b) have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
- (c) have evaluated the effectiveness of the company's internal controls as of a date within 90 days prior to the report; and
- (d) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.

Further, the certificate must also certify that the signing officers have disclosed to the company's auditors and to the audit committee of the board of directors:

- (i) all significant deficiencies in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize, and report financial data and have identified for the company's auditors any material weaknesses in internal controls; and
- (ii) any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls.

Following the enactment of the *Sarbanes-Oxley Act of 2002*, the SEC advised that it intends to adopt final rules that would apply the certification requirement to foreign private issuers filing annual reports on Form 20-F and Canadian issuers filing Form 40-F under the SEC's Multijurisdictional Disclosure System.²³

We agree with the Committee's recommendation in paragraph 10.4 of the Draft Report that the Act be amended to refer explicitly to continuous disclosure reviews by the Commission of the filed reports of reporting issuers. We believe, however, that this proposal is neither sufficient nor adequate to satisfy investor needs.²⁴

We strongly urge the Committee and the Commission to review SEC Release No. 34-46300 and section 302 of Sarbanes-Oxley Act of 2002 and to recommend that an analogous filing certification procedure be adopted by the Commission and other Canadian securities regulatory authorities for the benefit of investors in Canada. Notwithstanding that an appropriate civil liability scheme may ultimately be introduced across the country that assures adequate private civil law remedies to investors in the secondary markets who rely, or are

²³ SEC Release No. 34-46300, *Certification of Disclosure in Companies Quarterly and Annual Reports* (August 2, 2002).

²⁴ Enhanced review by the SEC of periodic disclosure by reporting issuers is only one, and a minor one, of the many substantial reforms implemented by the *Sarbanes-Oxley Act of 2002*: see section 408 of such Act.

deemed to rely, on misrepresentations contained in documents filed by reporting issuers, *we believe that securities regulators should be directly responsible for enforcement of the accuracy and completeness of filed documents of reporting issuers through an analogous certification requirement to be adopted in Canada.*

It would be incongruous that a Canadian reporting issuer should certify its periodic disclosure reports to the SEC but not to the Commission.

We recommend that the certification requirement for filed periodic reports under the Act be pursued by the Commission on its own in the event that the members of the CSA are not able to reach agreement.

10.5 Harmonization Issues

The Committee has encouraged the CSA “to harmonize Canadian continuous disclosure requirements and create a base or minimum level of continuous disclosure requirements applicable to all reporting issuers”. Our general views on “harmonization” are set out in our comments on Part 1 of the Draft Report. Pursuing harmonization solely as an end in itself tends to lower the required disclosure and enforcement standards necessary to restore investor confidence and may operate to dilute Ontario’s obligation to provide investor protection in its own markets.

In particular, we do not agree with the Committee’s use of the terms “base or minimum” in paragraph 10.5 of the Draft Report to describe the level of disclosure to be adopted. We believe that the terms “base” or “minimum” imply that the lowest common denominator acceptable among the 13 provincial regulators should be accepted nationally as the appropriate level of disclosure and, in our view, such a level is not high enough.

As an example of appropriate higher standards of disclosure, we note that the SEC has recently proposed, among other things, that material contracts not entered into in the ordinary course of a U.S. domestic issuer’s business be filed as exhibits to the issuer’s Form 8-K filings²⁵. *We urge the Committee to recommend that proposed National Instrument 51-102, Continuous Disclosure Obligations, and Companion Policy 51-102CP²⁶ be revised to require increased and comparable standards and levels of timely disclosure of material items and events to those proposed by the SEC in Release No. 33-8106.*

We have also provided comments on the level and scope of disclosure with respect to our review of Chapter 12 of the Draft Report, *infra*.

²⁵ SEC Release Nos. 33-8106; 34-46084, *Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date* (June 17, 2002).

²⁶ (2002), 25 OSCB 3637 (June 21, 2002) and National Instrument 51-102, *Continuous Disclosure Obligations* (2002), 25 OSCB 3718 (June 21, 2002).

10.6 Civil Liability for Secondary Market Disclosures

While we support the Committee’s recommendation in paragraph 10.6 of the Draft Report that a statutory civil liability regime be implemented, we believe that such a regime could only be effective if issuers’ disclosure obligations and filing deadlines are clear and consistent across the country.

The Allen Committee made a compelling case for the adoption of a statutory civil liability regime in March 1997. Since the publication of the Civil Liability Amendments (as such term is defined in the Draft Report) in November, 2000, the Ontario Courts have reaffirmed that “a purchaser of shares in the secondary market cannot be heard to complain about a faulty prospectus”²⁷, a class action settlement was reached and approved by the Ontario Superior Court involving YBM Magnex²⁸ and the *Sarbanes-Oxley Act of 2002* has been enacted in the U.S. to require the principal executive officer and principal financial officer of a reporting issuer (including Canadian “foreign private issuers”) to make certain certifications in the issuer’s quarterly and annual reports (as described above under paragraph 10.1, *The Importance of Continuous Disclosure*). The *Sarbanes-Oxley Act of 2002* has also made changes that result in senior executive officers of reporting issuers having personal financial exposure in the event of company financial reporting misconduct resulting in the need for any accounting restatements, and has extended the limitation period for private rights of action involving securities fraud. It is therefore clear that (i) purchasers in the secondary markets have fewer available avenues for redress than do purchasers in the primary markets; (ii) class action lawsuits and the potential for strike suits are a recognized feature of the Canadian securities landscape; and (iii) the U.S. has recently substantially increased the level of accountability of corporate executives for the completeness and accuracy of an issuer’s continuous disclosure filings.

Class action proceedings will not disappear as a tool for plaintiffs in securities actions. Issuers should regard the Civil Liability Amendments’ procedural mechanisms and limitations on liability as a preferable alternative to the indeterminate outcomes that may arise from class action proceedings brought outside of the Civil Liability Amendments. As well, the competitiveness of the Canadian capital markets depends, in part, on the ability to demonstrate that Canadian securities laws are as protective of investors’ rights as those in other major markets. Accordingly, we agree with the Committee that the CSA’s proposal to create a statutory civil liability regime for continuous disclosure should move forward.

²⁷ *Menegon v. Philip Services Corp.* [2001] O.J. No. 5547, under appeal.

²⁸ *Mondor v. Fisherman; CC&L Dedicated Enterprise Funds (Trustee of) v. Fisherman* [2002] O.J. No. 1855.

Chapter 11: The Closed System

11.3 Recent Reforms to the Exempt Market Regime and the Resale Rules: Do They Go Far Enough?

The analysis of the Draft Report does not appear sufficiently convincing to us to support the recommendation that all hold periods arising from the issue of prospectus-exempt securities of reporting issuers should be eliminated “once other reforms are implemented”. The type and length of applicable hold periods for specific prospectus-exempt securities transactions are, of course, valid subjects for continuing refinement.

It is not proposed at this time to reiterate the investor protection principles that were extensively debated for many years, and first clearly articulated in Canada in the 1970 Merger Report, and which culminated directly in the introduction of the closed system in 1978 and that became fully effective on May 15, 1981. For a review of the public policy debate, see, H. Garfield Emerson, *Vendor Beware: The Issue and Sale of Securities Without a Prospectus under the Securities Act, 1978 (Ontario)*²⁹; *Current Securities and Company Law Developments in Corporate Financing*,³⁰ and *Business Finance under the “Closed System” of the Ontario Securities Act: Statutory Scheme and Pitfalls*³¹.

It does not seem appropriate to us to reintroduce the “investment intent” and purchasing “with a view to distribution” concepts that caused uncertainties and wide divergence of practice, as well as a number of highly questionable “public distributions”, in the period preceding the adoption of the closed system. The “secondary distribution” problems³² solved by the closed system in Ontario following the 1970 Merger Report and by Rule 144³³ in the U.S. following the 1969 Wheat Report³⁴ should not, in the current state of the continuous disclosure regulatory regime, be allowed to become a recidivist to muddy the efficacy of accepted investor protection principles as a result of eliminating all hold periods for the sale of prospectus-exempt securities for reporting issuers and by eliminating all seasoning periods for reporting issuers.

²⁹ (1979), 57 Can. Bar Rev. 195.

³⁰ 1980 Corporate Management Tax Conference, Canadian Tax Foundation.

³¹ Special Lectures of the Law Society of Upper Canada 1982, *Corporate Law in the 80s*, at 29.

³² The “secondary distribution” problem arises from the resale of securities into the public trading markets by purchasers who acquired the securities either by use of some exemption from the prospectus requirements or by means of a “non-public” or private offering or transaction, neither of which required a prospectus standard of disclosure to be made available to the public relating to the issuer or the securities involved. The public policy concern is to protect the investing public from the ultimate distribution of securities into the trading markets through the use of “non-public” offerings and sale exemptions without adequate and timely disclosure of relevant information for investors.

³³ SEC Release No. 5087 (September 22, 1970).

³⁴ *Disclosure to Investors: A Reappraisal of Administrative Policies under the '33 and '34 Securities Acts, Report of the Disclosure Policy Study to the Securities and Exchange Commission* (1969).

Chapter 12: Disclosure Standards

12.1 Material Fact, Material Change and Material Information

The Committee considered whether the standard of disclosure for the purposes of triggering a disclosure obligation for reporting issuers should change from “material change” (as defined in the Act) to “material information”, the standard adopted by the CSA in its former policy, National Policy No. 40 *Timely Disclosure* (“NP 40”)³⁵ and the standard adopted by the TSX in its timely disclosure policy.³⁶ The Committee recommended that the Act’s timely disclosure obligations not be amended to require disclosure of “material information”³⁷ for the following two reasons:

- (i) it will make the issue of when to disclose more problematic and difficult for issuers especially where the disclosure is reviewed in hindsight and, particularly if statutory civil liability is instituted; and
- (ii) it would impose a significant burden on issuers to monitor continually matters external to them for the purpose of informing investors.

While we understand the issues underlying the Committee’s hesitancy to recommend that the standard for timely disclosure be revised from “material change” (as defined in the Act) to “material information”, *we do not agree that the status quo should be maintained in respect of the standard of disclosure for this purpose of triggering a timely disclosure obligation for reporting issuers.* Specifically, we are of the view that, as a minimum, changes be made to the current timely disclosure requirements so that Ontario’s standard of disclosure is more equivalent to and consistent with the increased disclosure standards to result from the

³⁵ National Policy 40 *Timely Disclosure* has been rescinded as part of the adoption of National Policy 51-201 *Disclosure Standards*. See (2002), 25 OSCB 4459 (July 12, 2002).

³⁶ TSX Company Manual, Part IV, section 406 and following, and TSX *Policy Statement on Timely Disclosure and Related Guidelines*.

³⁷ “Material information” is defined in section 407 of the TSX Company Manual as:

“Material information is any information relating to the business and affairs of a company that results in or would reasonably be expected to result in a significant change in the market price or value of any of the company’s listed securities.”

“Material information consists of both material facts and material changes relating to the business and affairs of a listed company.”

“...The Exchange considers that ‘material information’ is a broader term than ‘material change’ since it encompasses material facts that may not entail a ‘material change’ as defined in the Act.”

changes being proposed in the U.S. in respect of the triggering events for the filing of a Form 8-K Current Report.³⁸

As noted in the Draft Report, U.S. domestic issuers do not have a specific statutory duty to make timely public disclosure. Rather, U.S. issuers are required to report periodically on Form 8-K in response to certain triggering events, such as:

- (i) a change in control of the company,
- (ii) the company's acquisition or disposition of a significant amount of assets,
- (iii) the bankruptcy or receivership of the company,
- (iv) a change in the company's certifying accountant,
- (v) the resignation of a company director, and
- (vi) a change in the company's fiscal year.

The SEC is proposing to amend its Form 8-K triggering events to add 11 new expanded disclosure requirements including³⁹:

- (a) entering into, amending materially or terminating a definitive material agreement not made in the ordinary course of a company's business,⁴⁰
- (b) changes to a business relationship with a customer that would have a significant revenue impact on the company,

³⁸ SEC Release Nos. 33-8106; 34-46084, footnote 25, *supra*.

³⁹ *Ibid.*, Form 8-K Current Report, General Instructions, Information to be Included in the Report.

⁴⁰ By way of example, in this case, the filing company must disclose, among other matters:

- (a) the identity of the parties to the agreement and any material relationship between any of the parties other than in respect of the agreement;
- (b) brief description of the agreement;
- (c) rights and obligations of each party to the agreement that are material to the filing company;
- (d) material obligations to the agreement becoming effective;
- (e) duration of the agreement and any material termination provisions; and
- (f) in the case of termination,
 - (i) description of the material circumstances surrounding the termination;
 - (ii) any material early termination penalties incurred by the filing company;
 - (iii) a discussion of management's analysis of the effect of the termination on the filing company.

- (c) the creation of a direct or contingent financial obligation that is material to the company,
- (d) events that trigger a direct or contingent financial obligation that is material to the company, including any default or acceleration of an obligation,
- (e) exit activities, including material write-offs or restructuring charges,
- (f) material charges for impairments to company assets,
- (g) changes in credit ratings, issuance of a credit watch or change in a company outlook,
- (h) changes in the trading of company securities, such as a change in exchange listings, delistings or the issuance of a notice of non-compliance with listing standards,
- (i) the withdrawal by an auditor of an audit report or a company decision that security holders no longer should rely on a previously issued financial statement or a related audit report, and
- (j) any material limitations, restrictions or prohibitions in employee benefit, retirement or stock ownership plans.

In our view, the disclosure standard for timely disclosure for reporting issuers under the Act should be expanded to include specifically the items of disclosure of the nature and type required under the Form 8-K in the U.S., among other things, to ensure that there is a broader, more objective and more appropriate timely disclosure standard in Ontario for the protection of investors in the capital markets in Ontario and that our standard is at least equal to and consistent with the disclosure standard in the U.S.

This is not a knee-jerk adoption of a current U.S. proposal but rather an appropriate and further degree of the implementation of fundamental principles to develop an integrated disclosure system for the issue and resale of securities of reporting issuers in Ontario based on accepted principles of investor protection articulated, among others, in the *Report of the Committee of the Ontario Securities Commission on the Problems of Disclosure raised for Investors by Business Combinations and Private Placements* (February, 1970) (the “Merger Report”) As commented on:⁴¹

⁴¹ H. Garfield Emerson, *An Integrated Disclosure System for Ontario Securities Legislation* in Ziegel (ed.), *Studies in Canadian Company Law* (1974), Vol. 2, Ch. 9, at p. 438.

“The Merger Report also based its proposals to solve the secondary distribution problem [i.e., the resale of privately placed or prospectus-exempt securities into the public trading markets without adequate and timely disclosure to the investors] upon the creation of two classes of companies for securities purposes: ‘reporting companies’ and ‘non-reporting companies’. Generally a reporting company would be one which filed a cornerstone prospectus with the Ontario Securities Commission containing ‘full, true and plan’ disclosure of all material facts relating to the affairs of the company and which subsequently continued to maintain such a prospectus-standard of disclosure. *This would take the form of updating its material corporate information through filing publicly quarterly unaudited financial reports, timely amendments relating to changes in material facts previously disclosed, and annual statements incorporating and updating in one document the prior changes and containing audited financial statements.* The Merger Report recommended that companies required to report under Parts X and XII of the [then] Ontario Securities Act be considered reporting issuers as well as all companies whose securities become listed on the Toronto Stock Exchange or are distributed in Ontario by means of a prospectus.” [emphasis added]

Item 601 of Regulation S-K currently prescribes the exhibits that a registrant must provide in filings under the *Securities Act of 1933* (the “1933 Act”) and the Exchange Act, including with Form 8-K. (See Form 8-K, Item 7(c).) We understand that the proposed changes to Form 8-K in the U.S. also include a requirement to file material contracts as exhibits to the Form 8-K if the Form 8-K is being filed in respect of a transaction that involves entering into, amending or terminating a material contract (including one entered into prior to the effective date of the extended filing requirement).

We are of the view that a substantially similar requirement to file agreements that are the subject matter of or related to a timely disclosure obligation be adopted in Ontario, i.e., a reporting issuer should be required to file agreements as a schedule to the material change report where the reported transaction includes entering into, amending or terminating an agreement. In this regard, an issuer should be permitted to satisfy the requirement to file the agreement by filing a redacted version of the agreement that excludes portions of the agreement that contain confidential operational or financial information, the disclosure of which would be unduly competitively disadvantageous or otherwise unduly detrimental to the reporting company.

As part of an expanded disclosure requirement, we recommend that the material change report be revised to give effect to the foregoing recommendations. Issuers generally provide little or no additional information in the material change report than was disclosed in the corresponding press release. The material change report should be revised to provide clearer instructions for the level and detail of disclosure required and contain specific requirements to annex as exhibits written agreements entered into in connection with the reported event.

The definition of “material change” was introduced in the Act in 1978 as part of the integrated disclosure system reforms initiated in Ontario by the 1970 Merger Report.⁴² The standard for timely disclosure in Ontario has not changed since that time and it is submitted that it is now outdated and ineffective to serve investor interests in the current environment. The current “material change” standard is imprecise and ambiguous and subject to wide variations of legal interpretations and divergence of practice due, in part, to the requirement for there to be a “change” from an existing circumstance, as opposed to the establishment of a “fact” or the occurrence of an “event”, in order to trigger a timely disclosure report. Secondly, when a “change” has been accepted to have occurred, the type of “change” requiring timely disclosure is limited and only applies with respect to a few narrow categories, namely, a change “in the business, operations or capital” of the reporting issuer. There are other significant categories of matters or factors concerning a reporting issuer that are equally or more material to investors. It may be noted that the decision in *Pezim v. British Columbia (Superintendent of Brokers)*⁴³ might well have been different, on the same facts, if decided under the definition of “material change” in the Act, as opposed to under the definition of “material change” in the British Columbia *Securities Act*⁴⁴. In the latter statute, “material change” is defined as a “change in the *business, operations, assets or ownership* of the issuer” [emphasis added]. As stated by Mr. Justice Iacobucci in *Pezim* for the Supreme Court of Canada (at paragraph 89):

“Consequently, I am of the view...that the assay results constituted a *change* with respect to or in the companies’ *assets* and is ‘material’ for the purposes of the Act.”
[emphasis added]

It is open to reasonable debate whether the information resulting from the drilling program constituted a “change” in the “business” or “operations” of the company under the Act. Such a question of whether or not that information required public disclosure under the Act should never even be open to debate, however, because, as a matter of public policy and principle, such a discovery is clearly accepted, virtually unanimously, as a material piece of information for investors requiring timely public disclosure as soon as practicable after

⁴² *Securities Act*, S.O. 1978, c.47. See Emerson, *An Integrated Disclosure System for Ontario Securities Legislation, supra*, at footnote 41 for the public policy and legislative background to the 1978 Ontario *Securities Act*.

⁴³ [1994] 2 S.C.R. 557.

⁴⁴ *Securities Act*, S.B.C. 1985, c.83, section 1(1).

confirmation of the event. See, for example, the facts in *SEC v. Texas Gulf Sulphur Co.*⁴⁵. The principle of market egalitarianism is well stated by the Second Circuit in that case when it referred to that rule as⁴⁶

“based in policy on the justifiable expectation of the securities markets that all investors trading on impersonal exchanges have relatively equal access to *material information...*” [emphasis added]

This principle of investor egalitarianism has been recognized by the courts in Ontario, where, in referring to section 75 of the Act, Masse J. said:⁴⁷

“The essence of this obligation of timely disclosure is directed at ‘equal opportunity’ so as to allow investors to consider all material facts and changes in reaching an investment decision.”

The balance of the current definition of “material change” in the Act relating to the market impact test requirement for disclosure of the “change” is equal unsatisfactory. Without a more detailed analysis at this time, as stated in *Canadian Securities Regulation*⁴⁸:

“This definition [of ‘material change’ in the Act] *harbours great uncertainty*. For example, ‘reasonably be expected’ and ‘significant effect’ are ambiguous terms. The reasonableness requirement should prevent Commissions and courts from using hindsight to second-guess legitimate business decisions in most cases.” [emphasis added]

The public policy issue is, however, not whether a legitimate business judgment concerning a timely disclosure matter should be second-guessed, but rather whether the statutory requirements for timely disclosure in the first instance are as broad and clear as practicable to respond to the principle of market egalitarianism and ‘equal opportunity’ for investors.

We strongly recommend that the Commission develop a new definition for “material change” and an enhanced timely disclosure obligation for reporting issuers under the Act that encompasses:

- *a broader scope of discloseable events*

⁴⁵ 401 F.2d 833 (2d Cir. 1968), *cert denied* sub nom.

⁴⁶ *Ibid.* at p. 848.

⁴⁷ *R. v. Salega*, [1991] O.J. 1702 (Ont. Ct. Justice, Prov. Div.) at p. 15.

⁴⁸ *Supra*, footnote 3, at p. 101.

- *itemized particular company-specific events requiring timely disclosure*
- *a requirement that agreements relating to the reported disclosure be filed as a schedule to the public report*
- *deletion of the “market impact” test of materiality and replacement with the “reasonable investor” test, as enunciated in TSC Industries and adopted in Canada in Sparling v. Royal Trustco Ltd.*

12.2 What is the Appropriate Standard for Materiality?

The Committee has recommended that the existing materiality standard should be changed for all purposes under securities legislation to the U.S. “reasonable investor” standard. We agree that the more appropriate standard of materiality is the “reasonable investor” test and that the materiality standard under Ontario securities law should also be consonant with the materiality standard under U.S. securities law, as we have noted above. It is unclear, however, how the recommendation in the Draft Report would be implemented. We suggest that the Final Report outline the Committee’s proposed changes to the standard as implemented in the Act.

Chapter 13: Selective Disclosure

The Committee endorses the CSA approach to dealing with selective disclosure, i.e., the adoption of National Policy 51-201 *Disclosure Standards*,⁴⁹ which provides guidance and an increased emphasis on enforcement in this area.

While we support the adoption of NP 51-201 by the CSA, we are of the view that certain complementary legislative changes are required. In particular, the Act should be amended to provide “safe harbour” similar to those provided in Regulation FD in the U.S. For example, in Ontario there is no “safe harbour” for dealing with unintentional selective disclosure (“tipping”) as there is in the U.S. We are concerned that the absence of a “safe harbour” may, in some circumstances, weigh against prompt public dissemination of unintended selective disclosure for liability reasons, notwithstanding that under section 3.7 of National Policy 51-201 such prompt public dissemination may be a mitigating factor in an enforcement proceeding. In our view there is no justification why the treatment of unintentional selective disclosure should differ from that in the U.S.

We also note that Item 5 and Item 9 of Form 8-K provide a non-exclusive procedure for filing (in the case of Item 9, the disclosure is deemed not to be “filed” for certain liability issues) and publicly disclosing non-public information required to be disclosed by Regulation FD. A report under Item 5 or Item 9 of Form 8-K is not deemed an admission as to

⁴⁹ National Policy 51-201 *Disclosure Standards* has been adopted by the CSA: (2002), 25 OSCB 4459 (July 12, 2002).

the materiality of any information in the report required to be disclosed solely by Regulation FD. Such an amendment to proposed Form 51-102F3 Material Change Report in proposed National Instrument 51-102 *Continuous Disclosure Obligations* would also be appropriate, particularly in light of the adoption of National Policy 51-201 *Disclosure Standards*, adopted to address concerns about the practice of selective disclosure.

Chapter 14: Financial Statement Issues

14.1 Financial Statement Disclosure

(a) Timing of Release of Financial Statements

As noted in the Draft Report, information technology advances have increased the speed at which financial information can be collected and analyzed. For this reason, the SEC recently issued a proposed rule⁵⁰ accelerating the filing deadlines for large companies from 45 days to 30 days for interim reports and from 90 days to 60 days for annual reports.

On the other hand, the requirements for quarterly and annual financial reporting have been expanded in recent years to include management's discussion and analysis of results for the relevant period, and, in the case of interim statements, to require notes and board of directors or audit committee review. While prompt dissemination of financial results is important, it is equally important that sufficient time be available before the release for review to ensure that the information to be reported will be a fair representation of actual results.

Since the release of the Draft Report, proposed National Instrument 51-102 *Continuous Disclosure Obligations*⁵¹ has been issued pursuant to which the time period reductions proposed by the Report would only apply to reporting issuers listed on the TSX that do not qualify as a non-exempt companies.

We support the Draft Report's recommendation that periods for filing annual financial statements be reduced to 90 days after the fiscal year end and for filing interim financial statements be reduced to 45 days after the end of each quarter.

(b) Auditor Review of Quarterly Financial Statements

OSC Rule 52-501 already requires that interim financial statements be reviewed by the board of directors or by the audit committee on its behalf. We agree with the Draft Report's recommendation that the external auditors should also review interim financial statements.

⁵⁰ Release No. 35-8089; 34-45741; File No. S7-08-02 (April 12, 2002).

⁵¹ (2002), 25 OSCB 3637 and 3718 (June 21, 2002).

(c) Release of Financial Information Prior to Board Approval

The Draft Report expresses a concern that appears to be limited to the release of preliminary information about quarterly and annual financial results before the relevant statements are approved by the board of directors or audit committee. The Draft Report makes no specific recommendation in this regard, but suggests that no statement about financial results should be made without board (or audit committee) approval.

We agree that financial information about quarterly or annual financial results should not be released without board (or audit committee) approval. However, the Act requires immediate disclosure of material changes. Furthermore, existing stock exchange rules require immediate disclosure of all “material information” and specifically refer to earnings prospects. Also, circumstances such as the inadvertent disclosure of material financial information on a selective basis may prompt remedial action. Accordingly, although we believe that it would be appropriate to strive for board or audit committee approval prior to the release of any financial information about quarterly or annual financial results, we believe that such requirement should be expressed as a policy rather than a rule, in order to recognize that timely disclosure obligations might preclude the ability to obtain prior approval in some circumstances.

Furthermore, we suggest that the relevant policy statement be extended to provide for audit committee oversight of the release of all material information concerning financial issues rather than only financial information about quarterly and annual financial results.

(d) Non-GAAP Financial Information

As noted in the Draft Report, the issuance of non-GAAP earnings measures was the subject of a recent CSA Staff Notice. Non-GAAP disclosure has also been the subject of recent comment in the United States.⁵² The *Sarbanes-Oxley Act of 2002* now requires that the SEC issue rules providing that pro forma financial information included in any public disclosure or press or other release must be presented in a manner that is not misleading and that reconciles such information with the financial condition and results of operations under GAAP.⁵³ Although we agree with the Draft Report’s conclusion that no specific statutory changes should be made at this time while discussion about this issue continues, the *Sarbanes-Oxley Act of 2002* requires that the related new SEC rules be issued in final form no later than January 2003; we believe this issue should be revisited once such new rules are in place.

Furthermore, consistent with our support for a policy requirement that disclosure of material information of a financial nature be overseen by audit committees, we believe that the use of non-GAAP financial information and operating measures in public disclosure should

⁵² For example, *Report of the NYSE Corporate Accountability and Listing Standards Committee* (June, 2002), at p.25.

⁵³ *Sarbanes-Oxley Act of 2002*, section 401(b).

be required to be included in the supervisory mandate of the audit committee of all reporting issuers.

(e) Filing Press Releases Containing Financial Information

The Draft Report recommends that all press releases containing financial or earnings information should be required to be filed on SEDAR. While we agree with this recommendation, we believe it does not go far enough.

In today's electronic age, SEDAR should function as a central repository and database for all publicly-available "material information" concerning each reporting issuer. Even if the Committee's recommendation in Chapter 12: *Disclosure Standards* of the Draft Report is accepted so that the Act is not amended to expand the timely disclosure obligation from "material changes" to "material information", there will still be many instances when press releases are issued that contain "material information" that a reasonable investor would consider important in making an investment decision but do not disclose "material changes" as currently narrowly defined in the Act. In such situations, we believe that the press releases should be required to be filed on SEDAR regardless of whether they contain financial or earnings information.

We do not share the Committee's concern that an increased SEDAR filing requirement for press releases "would result in important information being buried". Users of a timely, continuous and integrated public disclosure system that is easily accessible are able to filter material investor information from so-called promotional information. There is a distinct and measurable benefit to being able to rely on a single depository source for reporting issuer public information that is material to investors.

Our recommendations to broaden the timely disclosure obligations for reporting issuers are set out in our comments on Chapter 12: *Disclosure Standards*. We believe that an *integrated* continuous disclosure system should be achieved in the Act and that the requirement to make a public filing with the Commission accessible on SEDAR should not depend upon the subject matter of the disclosure (i.e., whether or not the subject matter is earnings information or otherwise) but on whether the information is such that a reasonable investor would consider it important in making an investment decision (i.e., the accepted standard of materiality).

(f) The GAAP Exemption for Banks and Insurance Companies

We support the first alternative recommended in the Draft Report – that the GAAP exemption available to banks and insurance companies in subsection 2(3) of the Regulation to the Act be removed. Such removal would not preclude OSFI or any other duly authorized regulators from imposing different accounting requirements to assist in fulfilling their prudential regulatory objectives. U.S. insurance regulators have specialized accounting requirements and it is common practice for companies under their regulation to maintain dual sets of financial statements.

There are unique aspects to banks and insurance companies that are now recognized in GAAP. Such standards apply uniformly to all similar companies and ensure comparability of financial results of such companies. Specific rules imposed by financial regulators, whether on a company-by-company basis or more generally to a certain segment of companies, would impair such comparability.

Nevertheless, securities laws must recognize that financial regulators do, from time to time, impose their own requirements. Disclosure rules should specifically require that the implications of any material limitations on the relevant companies resulting from special financial regulatory requirements are explained in the MD&A of affected companies.

14.2 Audit Committees

We agree with the many current initiatives to ensure that audit committees meet higher and consistent standards in fulfilling their responsibility for oversight of financial reporting. At the same time, the imposition of specific obligations must be balanced against the need to ensure that the individuals most qualified to provide the desired oversight are not dissuaded from acting as members of audit committees (or of boards of directors) due to the imposition of vague and imprecise standards, which could potentially lead to personal liability for such members notwithstanding their honest best efforts to fulfil their duties in a diligent and reasonable manner.

We are strongly of the view that, in conjunction with the granting of any rule-making authority in this regard, the personal liability issues for directors also need to be addressed through concurrent enactment of specific statutory “safe harbour” provisions.

14.3 Auditor Independence

As indicated in the Draft Report, the issue of the independence of auditors is a topic of much current discussion. The *Sarbanes-Oxley Act of 2002* has imposed significant new rules in this area. Furthermore, announcements relating to the new Canadian Public Accountability Board have indicated that more stringent standards for auditor independence will be part of its requirements. We agree with both recommendations of the Draft Report in this regard.

PART 5 ENHANCING FUNDAMENTAL SHAREHOLDER RIGHTS

Chapter 15: Shareholder Rights

The amendments adopted in November 2001 to Part XIII of the CBCA, and in particular to the definition of “solicitation” at section 147, have created a discrepancy between

the proxy solicitation rules under the CBCA and the OBCA and the Act that in our opinion should be eliminated by corresponding amendments to the OBCA and the Act.

The CBCA amendments to the definition of “solicitation” added various exceptions, inspired by Rule 14a of the Exchange Act, to improve shareholder communications. These amendments were intended to remove the doubts entertained by some stakeholders regarding the qualification as “solicitation”, under subsection (c) (now (a)(iii)) of the definition of this term in section 147, of certain forms of communications. We believe it is questionable whether the circumstances described at subsections (b)(v), (vi) and (vii), and prescribed in sections 68 and 69 of the *Canada Business Corporations Regulations 2001* were really intended to be covered by the initial definition of “solicitation”, since none of them involved asking shareholders to give their proxy, but in any event they are now expressly excluded from this definition.

Now that the CBCA has been amended, the doubts it purports to eliminate will be exacerbated, by comparison, in the Act and the OBCA. It will be even less clear whether the newly specified communications in the CBCA are or are not a form of “solicitation” under the Act or the OBCA. Moreover, as stated in the Draft Report, the application of the exemption in subsection 88(1) of the Act might become problematic for CBCA corporations if the Act is not similarly amended.

We therefore support the recommendation, in section 15.3 of the Draft Report, that Parts XIX of the Act and VIII of the OBCA be amended to conform with Part XIII of the CBCA with respect to the definition of proxy solicitation.

As for the recommendation that an incorporation by reference be made in the Act to the proxy rules of the Canadian statutes such as the OBCA or the CBCA, we believe such a measure will only become appropriate when it can be ascertained that a higher degree of uniformity (as opposed to “harmonization”) has been attained between all the provincial and federal regimes. Until then, we believe that the Act should continue to specify and contain its own requirements to establish clearly the minimum rules the Commission desires to have followed in Ontario.

Chapter 16: Take-Over Bid Regulation

16.1 Arrangements/Take-Over Bids

In the Draft Report’s recommendation, the Committee concludes that nothing has come to its attention that would support the need to regulate arrangements and take-over bids in an identical fashion. The reasons for the Committee’s recommendation set out in the Draft Report include that, unlike a take-over bid, an arrangement is subject to a shareholder vote following the preparation and circulation of a disclosure document by the subject company’s board and management and court approval with the right of interested parties to make submissions on fairness. The Draft Report also stresses that parties to commercial transactions

should have the freedom to structure transactions to achieve their business purposes (assuming that the process for the implementation of the transactions and the legislative and regulatory rules that governs them provide procedural fairness to all affected parties).

We agree with the recommendation of the Draft Report and point out two additional reasons for not regulating arrangements and take-over bids in an identical fashion. The first is that, unlike take-over bids, the shareholders of a “target” company are customarily granted rights of dissent by the court under the target company’s corporate statute. Second, in circumstances in which the terms of a specific arrangement call out for the application of certain of the legislative safeguards to which take-over bids are subject, the Commission could consider engaging its public interest jurisdiction pursuant to section 127 of the Act.

16.2 Mini-Tenders

We agree with the Draft Report’s conclusions regarding mini-tenders. We are of the view that the Commission’s public interest jurisdiction under section 127 of the Act is sufficient to enable the Commission to address any unfair, deceptive, fraudulent or manipulative conduct or practices relating to mini-tenders. We question the need to adopt a rule specifically related to mini-tenders and believe that CSA Staff Notice 61-301 is helpful both in reminding market intermediaries that Canada securities legislation does not require them to deliver notice of mini-tenders to shareholders and in suggesting certain minimum disclosure standards. If the Committee believes that further guidance to bidders in mini-tender situations may be warranted by the Commission, we recommend the SEC’s guidance on mini-tender provided in SEC Release No. 34-43069; IC-24564 *Commission Guidance on Mini-Tender Offers and Limited Partnership Tender Offers* (July 31, 2000) which outlines examples of certain mini-tender practices which may be fraudulent, deceptive or manipulative practices within the meaning of section 14(e) of the Exchange Act. Given the wide variety of “fraudulent, deceptive or manipulative practices” that are described in the SEC Release, we do not believe that the adoption of a rule by the Commission would be the appropriate regulatory response.

16.3 Issues for Further Study

(a) Partial Bids

While we recognize that shareholders of a target company may need to consider a different calculus when determining whether to tender shares to a partial bid than when determining to tender shares to a bid for all of the shares of a target company, we are not convinced at this time that there is an overriding public interest in favour of the protection of the *bona fide* interests of the shareholders of the target company to change the current regulatory approach in Ontario permitting partial take-over bids.

In considering the issue, we believe that it is not particularly productive to frame the debate concerning the regulation of partial bids by categorizing them within the labels of “coercive” or “inherently coercive”. “Coercive” may have different interpretations to different

investors and participants in the capital markets and, other than perhaps “opportunistic”, is the first word which target boards and their advisors use to criticize bids, often without much forethought. Moreover, labelling partial bids as “coercive” does little to illuminate any of the underlying substantive issues that may adversely affect the *bona fide* interests of the offeree shareholders or further the legal analysis as to whether or what type of regulatory response is warranted or appropriate in the circumstances to protect the interests of the offeree shareholders. We note, for example, in *Re Chapters Inc. and Trilogy International Enterprises LLP*⁵⁴, that following the conclusion of the rather sterile debate as to whether partial bids are or are not inherently coercive (which the Commission found in the negative), the Commission then posed the real and substantive question as to what additional disclosure, if any, would be material to Chapters’ shareholders (and hence required to be disclosed in Trilogy’s bid materials) if it could be successfully established, that in the event of a successful partial bid, the remaining minority shares would be less liquid and have lost any embedded takeover premium and hence less valuable.

We note, as well, that the Commission has not limited discussion of the coercive nature of bids to partial bids only. In *Re MDC Corporation and Regal Greetings & Gifts Inc.*⁵⁵, which dealt with a cash bid by MDC for all of the shares of Regal, the Commission discussed the “fear factor” which might have inclined Regal shareholders to tender to MDC’s bid out of fear of being left as minority shareholders in a company controlled by MDC, having little liquidity for their shares⁵⁶.

We also question the appropriateness of adopting in Ontario legislation similar to that adopted in the United Kingdom which provides that The Panel on Take-overs and Mergers must consent to any partial bid.⁵⁷

The regulatory system and culture in Ontario regarding our takeover bid regime have evolved differently than in the City and are more “North American” and similar to the legal orientation of the U.S. position. Accordingly, we do not consider it appropriate to transfer to a regulatory agency the authority to determine the terms and conditions on which a partial takeover bid could be commenced. As the Committee has concluded elsewhere in the Draft Report, parties to commercial transactions should have, *prima facie*, the freedom to structure transactions to achieve their business purposes, absent structural or procedural unfairness that would adversely affect the *bona fide* interests of the offeree shareholders and absent other overriding

⁵⁴ (2001), 24 OSCB 1064 (February 16, 2001).

⁵⁵ 17 OSCB 4971 (October 21, 1994).

⁵⁶ The “fear factor” was also found by the Commission to exist in the partial take-over bid by Ivanhoe III Inc. for the shares of Cambridge Shopping Centres Limited in *Re Ivanhoe III Inc. and Cambridge Shopping Centres Limited*, 22 OSCB 1327 (February 26, 1999).

⁵⁷ *The City Code on Takeovers and Mergers and The Rules Governing Substantial Acquisitions of Shares*, section 36.1. In the case of an offer which could not result in the offeror holding shares carrying 30% or more of the voting rights of a company, consent will normally be granted.

public interest factors. The Commission can always exercise its public interest jurisdiction to cease trade a bid, full or partial, if it is abusive of the capital markets or it is otherwise in the public interest to do so.

Leaving aside the issue of prior regulatory consent for partial bids, it should be noted that, in further protection of the interests of the offeree shareholders, the City Code also requires that any offer which could result in the offeror holding shares carrying 30% or more of the voting rights of a company must normally be conditional on the approval of the offer being given by shareholders holding over 50% of the voting rights not held by the offeror and persons acting in concert with it.⁵⁸ The rationale behind this U.K. public policy for the protection of minority shareholders deserves further consideration in the context of the possible regulation of partial bids in Ontario where the partial bid is aimed at an acquisition of control. In the U.S., the minority shareholders of the target company would most probably also be protected from a partial bid for control by the board of directors of the target company exercising its fiduciary duties to protect the company and its shareholders and, in its business judgment, not waiving the company's shareholder rights plan in such circumstances, unless the target's board determined, among other things, that the minority was properly protected. The SEC and the U.S. courts would generally not interfere with the target board's judgment absent any conflict of interest. In Canada, however, minority shareholders of target companies subject to partial bids for control do not currently have the protection of either the U.K. City Code rule or the U.S. target board's fiduciary ability to exercise its powers for the protection and benefit of its shareholders.

The Committee should recommend that an informed study and analysis be undertaken by the Commission to review whether it would be in the public interest and appropriate to enhance the protections for minority shareholders of target companies in the context of partial bids for control. Such a study would review, among other things, the Canadian experiences in partial bids, including the pre-bid activities of the offeror, the subsequent effect on or treatment of the minority shareholders following the change of control and the effect of the transaction on the value of the minority's remaining shares, and assess whether there are bona fide shareholder and investor interests that need protection or the provision of new remedies, such as appraisal rights, in certain circumstances.

(b) Defensive Tactics

We do not agree with the Draft Report's recommendation that the Commission should consider preparing a policy statement setting out guidance as to when a shareholder rights' plan or so-called a poison pill adopted by the target company must be terminated after the announcement of a unilateral takeover bid. For such a policy statement to have any utility (even assuming it is appropriate), it must be more than a summary of Commission and other regulatory decisions relating to shareholder rights plans in the context of take-over bids or a list of the factors relevant in determining when a shareholder rights plan should be cease traded

⁵⁸ *Ibid.*, section 36.5.

during a take-over bid, as was set out in the joint decision of the Commission, the British Columbia Securities Commission and the Alberta Securities Commission in *In the Matter of Royal Host Real Estate Investment Trust and Canadian Income Properties Real Estate Investment Trust*.⁵⁹

We are also mindful of the cautionary statements in that decision, with which we agree, that

“it is fruitless to search for the ‘holy grail’ of a specific test, or series of tests, that can be applied in all circumstances. Take-over bids are fact specific; the relevant factors, and the relative importance to be attached to each, will vary from case to case. As a result, a test that focuses on certain factors to the exclusion of others will almost certainly be inappropriate in some of the cases to which we attempt to apply it”.

We also consider it inappropriate for the Commission to pre-determine, or to rule, as a matter of policy, or law, that so-called poison pills, particularly those that have been approved at a meeting of the shareholders of the target company prior to the announcement of any unilateral bid, are always or *per se* inherently or intrinsically adverse to the *bona fide* interests of offeree shareholders, especially, for instance, in the context of partial bids for control following “creeping takeover” tactics or “street sweeps”.

(c) Convertible Securities

The application of the take-over bid rules in the Act⁶⁰ to an offer to purchase convertible securities should be confirmed by the Commission by way of policy statement.

In the United States convertible securities are subject to the SEC’s tender offer rules and it is appropriate for the Commission to prepare formal guidance as to the application of take-over bid rules to convertible securities to clarify the situation in Ontario. In formulating such guidance, the Commission should have regard to the economic substance and legal effect of the purchase of convertible securities. Accordingly, we do not favour an interpretative analysis or guidance based on the “true intention” behind an offeror’s purchase of convertible securities, as such a subjective test, we believe, would, be subject to abuse, have little predictive value and limited usefulness in providing certainty to market participants especially shareholders of the offeree issuer.

⁵⁹ 22 OSCB 7819 (December 10, 1999).

⁶⁰ Act, sections 89(3), 90, 92 and 101(1).

(d) Commission Rule 61-501 – Lock up Agreements and “Acting Jointly or in Concert”

In a recent decision, the British Columbia Court of Appeal held that an arm’s length shareholder who was being treated identically with the minority and who agreed with the control group to support the “going private” transaction was thereby acting “jointly or in concert” with the control group and should be excluded from voting as part of the Special Minority to approve the transaction. This decision in *Sepp’s Gourmet Foods Ltd. v. Janes*⁶¹, has effectively overruled the interpretative view of the Commission for the purposes of insider bids, issuer bids, going private transactions and related party transactions “that an ordinary lock-up agreement with an identically treated shareholder should not in and of itself generally result in arm’s length parties being seen to be acting jointly or in concert”⁶².

In *Sepp’s*, a control block group holding over 50 percent of Sepp’s issued shares (the “Acquisition Group”) proposed a “going private” transaction by means an arrangement under the B.C. *Company Act*. The Acquisition Group requested an arm’s length shareholder (“Rosenberg”), who was to be treated identically with the other minority shareholders, to support the transaction and he agreed to do so. The interim Court Order to permit the holding of the shareholders’ meeting required that the resolution be passed by a “Special Minority Approval” in order to be effective. The “Special Minority Approval” provided that the Acquisition Group be excluded from the vote of the Special Minority as well as “a person or company acting jointly or in concert with any member of the Acquisition Group...” This provision in the Order was not mandated by any provision of the *Company Act* but was included in recognition of the provisions of subsection 8.1(3)(d) of Commission Rule 61-501.

At the shareholders’ meeting, Rosenberg was allowed to vote his shares as part of the “Special Minority”. Had Rosenberg’s shares not been voted, then the required majority vote of the Special Minority would not have been obtained. On appeal, the British Columbia Court of Appeal set aside the Order approving the “going private” plan of arrangement, holding that Rosenberg was prohibited from voting as part of the “Special Minority” because he was “acting jointly or in concert” with the Acquisition Group.

The B.C. Court of Appeal specifically quoted the Commission’s interpretation that an ordinary lock-up agreement with an identically treated arm’s length shareholder should not be seen as acting jointly or in concert: subsection 2.3(2) of Commission Companion Policy 61-501CP. The Court considered that the Commission’s views were matters of “policy rather than interpretation” and that a Companion Policy was not of great assistance in construing an Order of the B.C. Supreme Court, “at least in the absence of some evidence that a similar policy has been adopted in British Columbia”.

⁶¹ [2002] B.C.J. No. 289; 2002 BCCA 108 (February 14, 2002).

⁶² Commission Companion Policy 61-501 CP, subsection 2.3(2).

The Court of Appeal held that entering into an agreement with a control group to support a proposed corporate action is acting jointly or in concert with that group. The Court said at paragraph 36:

“...whatever the intention behind the Order, its effect was to exclude from the Special Minority any person who had agreed with a member of the Acquisition Group to support the arrangement. The provision does not make lock-up agreements “useless”, but does ensure that the Special Minority does not include persons who have already agreed to act in concert or in a united way with the Acquisition Group by voting in favour of the proposal. The prohibition does not extend to persons who enter lock-up agreements after the mailing of the circular, at which time a wider discussion of shareholder interests is likely to take place. But by para. 6(g) of the Order, those who formed the view that their interests will be best served the completion of the arrangement and have (prior to the relevant date) committed themselves to support that view are to be treated in the same manner as members of the Acquisition Group themselves.”

The Commission’s interpretation of “acting jointly or in concert” in subsection 2.3(2) of Commission Companion Policy 61-501CP has always been difficult to reconcile with not only the intent but particularly the specific language of the statutory presumption of subsection 91(1)2 of the Act that provides:

“Every person or company who, as a result of any agreement, commitment or understanding, whether formal or informal, with the offeror...intends to exercise jointly or in concert with the offeror...any voting rights attaching to any securities of the offeree issuer”

shall be presumed to be acting jointly or in concert with the offeror.

In light of the B.C. Court of Appeal decision in *Sepp*’s, the Commission should revise its interpretative position in subsection 2.3(2) of Commission Companion Policy 61-501CP. Should the Commission propose to rescind the clear intent of the statutory presumptions in section 91 of the Act, the Commission should propose for public comment and debate its public policy basis for revising the current legislated presumption in section 91 of the Act and for not treating those persons who act jointly or in concert with an offeror as part of a group that includes the offeror and propose a new definition or set of circumstances of when a person may be acting jointly or in concert with the offeror for purposes of both Part XX of the Act as well as for the special considerations applicable in the case of more sensitive situations requiring a

higher level of “fairness” to minority shareholders involving insider bids, issuer bids, going private transactions and related party transactions. This would provide an opportunity for interested parties to make submissions concerning the appropriateness of such a revised interpretation of “acting jointly or in concert”.

If the Commission does not wish to proceed in this way, the Commission should publicly confirm that the *Sepp*’s decision has overruled its interpretation of “acting jointly or in concert” in Commission Comparison Policy 61-501CP and amend such Policy.

Chapter 17: Mutual Fund Governance

A. General

The press release introducing the Draft Report indicates that pursuant to the *Securities Amendment Act, 1994*, the Government of Ontario gave the Committee the broad mandate “to review the legislation, regulations and rules relating to matters dealt with by the Ontario Securities Commission”. The Draft Report states that in “considering whether any changes are needed to the regulatory regime governing mutual funds, we focused primarily on fund governance”. In the area of mutual fund regulation, there is no doubt that mutual fund governance is an area of great importance, but there are other important issues which also require the views of the Committee and which were subject to public policy debate at the time of the release of the Draft Report.⁶³ In particular, in its De-Regulation Project, the BCSC discussed six concepts which that regulator believes hold significant potential for improving the efficiency and effectiveness of securities regulation in Canada, one of these concepts being a better mutual funds regulatory regime. The BCSC made five recommendations relating to mutual fund regulatory reform in Canada, which it summarized as follows:

- (a) A mandated code of conduct for mutual fund managers, portfolio managers, distributors and dealers would replace many of the current prescriptive requirements dealing with conflicts of interest and sales practices.
- (b) Mutual fund investors would be surveyed to see whether they rely on the information a prospectus provides when making investment decisions. A survey conducted before the current mutual fund prospectus regime was introduced two years ago found that investors did not read mutual fund prospectuses and looked only to their advisers for information on

⁶³ The May 29, 2002 letter from the Committee introducing the Draft Report states that it “considers events and legislative reform as of March, 2002” and also states that the Committee is aware of other current initiatives, including the De-Regulation Project being undertaken by the British Columbia Securities Commission (“BCSC”) which issued its report on February 18, 2002. The Committee suggests that the Draft Report recommendations be considered in conjunction with these initiatives.

investing. If this is still true, the simplified prospectus is not performing its primary function, and we should consider whether to retain the prospectus requirement for mutual funds.

- (c) A new continuous disclosure regime tailored to mutual funds would require up to date, or "evergreen", disclosure of all significant changes and provide relevant information to investors.
- (d) We would consider allowing foreign mutual funds that are subject to a credible regime of regulation to offer their securities in Canada, using documents prepared under the foreign regime. They would have to provide extra disclosure regarding any tax or legal factors specific to Canadian investors.
- (e) The code of conduct and the disclosure system would be supported by enhanced civil remedies for investors.

The five recommendations of the BCSC set out above are far reaching potential changes to the manner in which mutual funds are regulated in Canada today. In light of the Committee's broad mandate and the current relevance of the BCSC's five recommendations for mutual fund regulatory reform in Canada, we believe that the Committee should consider and disclose in its final Report whether it supports, in whole or in part, all or any of the five recommendations of the BCSC.

B. Governance

Turning to the recommendations relating to mutual fund governance in the Draft Report, our comments on the recommendations in the Draft Report are set out below.

17.2 The Case for an Independent Mutual Fund Governance Requirement

The Draft Report recommended that the Commission and the CSA should introduce a requirement for all publicly offered mutual funds to establish and maintain an independent governance body.

We are in general agreement with this recommendation of the Committee. As you are aware, one of our partners, Stephen Erlichman, provided his report to the CSA in June, 2000 entitled "*Making it Mutual: Aligning the Interests of Investors and Managers – Recommendations for a Mutual Fund Governance Regime for Canada*" (the "Erlichman Report"), the principle recommendation of which was that each mutual fund complex should be required to establish a governance regime that has a governing body independent from the manager of the mutual funds. As set out on pages 42 to 45 of the Erlichman Report, Stephen Erlichman suggested as early as 1993 that it might be time to consider a mutual fund governance regime having as its basis independent directors as a possible solution to various conflict issues

in the Canadian mutual fund industry. CSA Concept Proposal 81-402, released in March, 2002⁶⁴, concurs with the Erlichman Report and also recommends an independent governance body. We understand that the CSA is currently reviewing the numerous comment letters received in response to the Concept Proposal, and it appears from the comment letters that there is no clear consensus in Canada that an independent governance body is needed. As the issue of an independent governance body has been raised now for many years, we suggest that it is clearly time for a decision to be made whether the recommendation for an independent governance body for all publicly offered mutual funds will be enacted as law in Ontario and across Canada.

We suggest that when guided by the Committee's principle that "there must be a compelling public policy reason to introduce regulation", it is important to know whether there is any empirical evidence or any academic studies which provide quantitative evidence that an independent governance regime for mutual funds will result (or have a probability of resulting) in improved financial returns to mutual fund investors, whether through better performance of the funds, reduced expenses charged to the funds or a combination of such factors. If there are no relevant academic studies or empirical evidence, then we suggest that an academic study should be commenced promptly, as it is important to see if the increased costs of introducing and maintaining a mutual fund governance regime can be offset not just by the qualitative advantages set out in the Draft Report, CSA Concept Proposal 81-402, the Erlichman Report and other reports referred to therein, but also by sufficient measurable quantitative benefits.

The Draft Report further recommended that the independent governance body should have the right to terminate the mutual fund manager when, in the reasonable opinion of the independent directors, there is cause, including poor performance of the fund, or where the manager has placed its interests ahead of those of unitholders of a mutual fund through self-dealing, conflict of interest transactions or breach of its fiduciary obligations.

There have now been three different recommendations as to whether the power to terminate the fund manager should be given to the governance body and, if it is, then whether this power should be unilaterally exercised by the governance body or exercised only after obtaining mutual fund investor approval. The Erlichman Report recommended that the governance body should not have such a power, CSA Concept Proposal 81-402 recommended that the governance body should have such a power if mutual fund investors approve the termination, and the Draft Report has now recommended that the governance body should have the power to terminate unilaterally the fund manager in certain circumstances without the approval of mutual fund investors.

The Erlichman Report stated that "designing a governance regime is not a science but rather is an art" and the three divergent proposals concerning the power to terminate the fund manager indicate that, as an art, there is not a clear right answer. We believe, however, that for

⁶⁴ *Striking a Balance: A Framework for Regulating Mutual Funds and their Managers* (March 1, 2002).

the reasons set out in the Erlichman Report, the governance body should not have the power to terminate the manager but rather the alternative mechanism described in the Erlichman Report be relied upon, namely that the board can report matters to the CSA or to the securityholders of the mutual fund or, in appropriate circumstances, call a meeting of mutual fund securityholders to vote on the issues. This reporting power and the power to call a meeting of mutual fund securityholders, together with the publicity engendered if the report is made to the securityholders or the securityholder meeting is called and the threat of action by the CSA if the report is made to the CSA, should in most cases provide sufficient incentive for the board and the manager to work together and resolve any issues.

17.3 Recruiting Qualified Mutual Fund Directors

The Draft Report recommended that the process by which potential directors of mutual fund governance bodies are identified and nominated be expanded so as to include a broader range of potential directors.

We concur with this recommendation of the Committee, which was first voiced in the Erlichman Report in response to criticisms that there would not be a sufficient number of qualified individuals to become board members. In this regard, the Erlichman Report stated on pages 162 to 163 as follows:

“Another criticism is that the Canadian mutual fund industry will not be able to find enough well qualified individuals to become board members. With respect to qualifications, I believe that board education programs sponsored by the manager or by a trade organization like IFIC could bring new board members a long way up the requisite learning curve. As to the number of individuals required, I recommend below that the same individuals could be board members of all funds in the mutual fund complex. It may be the case that it will be difficult to find ‘high profile’ individuals to become board members, but I do not believe that high profile individuals would necessarily make the best mutual fund board members. Individuals who have had business experience in or outside the mutual fund area could have the appropriate background to become board members, while board education programs could teach board members what they need to know about the mutual fund business. It is key, however, that the individuals have integrity and take their roles seriously.”

The Draft Report further recommended that the majority of directors be independent of the management company.

We also concur with this recommendation of the Committee. We refer you to the following extract from page 164 of the Erlichman Report:

“I recommend that the board should consist of at least three individuals, of whom at least a majority and preferably at least two-thirds are independent of the manager. The definition of what constitutes an ‘independent’ member should be modeled on the Dey Report’s definition of ‘unrelated’ director rather than on the complex and detailed rules used in the *Investment Company Act of 1940*. As stated in the ICI Best Practices Report, having at least two-thirds of the directors of every investment company board being independent ‘will help assure that independent directors control the voting process, particularly on matters involving potential conflicts of interest with the fund’s investment adviser or other service providers.’”

17.4 How the Independent Governance Body Will Look

The Draft Report recommended that the mutual fund governance body should have certain characteristics, including: independence from the manager; a majority of independent directors; the right to retain counsel and other independent advisers; and the right to set its compensation and establish the obligation of each member to disclose annually all fees received from the fund and all affiliated funds.

In general, we concur with these recommendations of the Committee. We believe that the most controversial of these recommendations are: when and if there should be a right to terminate the mutual fund manager; whether there should be a cap on the number of funds for which any one independent governance body is responsible; and whether the governance body should have the right to set its own compensation.

We already have given you our views on whether the independent governance body should have the right to terminate the mutual fund manager.

With respect to there being a cap on the number of funds for which any one independent governance body is responsible, the Erlichman Report stated that there are various reasons why there should not be a restriction on the same people becoming members of the board of all of the mutual funds in a mutual fund family or a mutual fund complex. In particular, on page 173 the Erlichman Report quoted from a 1997 article that appeared in the *Journal of Financial Economics*:

“In rebuttal, others have suggested that the use of a common board of well-paid directors is beneficial for fund shareholders. The use of the same directors across multiple

boards creates economies of scale and scope in oversight due to the development of specialized monitoring skills. Being gatekeepers of many funds' contracts can enhance the directors' bargaining power. By sitting on many boards, independent directors develop a stronger relationship with independent counsel. Finally, higher compensation could be the reward for better oversight skills, which could be signaled to potential customers.”

The Erlichman Report added (on pages 173 and 174) that, should different individuals be required for the board of each mutual fund, there also are practical and logistical issues of finding sufficient numbers of qualified individuals to become members of the board and of having to hold separate board meetings of each mutual fund.

Finally, on page 174, the Erlichman Report quoted then SEC Chairman Levitt as follows:

“There have been questions raised in the press and in the courts about whether simply serving on multiple boards or portfolios compromises a director's independence. Recent court decisions say it doesn't. And I am inclined to agree.”

Accordingly, in our view, as the Erlichman Report suggested, there should not be a cap on the number of funds for which a governance body is responsible. Let each governance body determine the number of funds which it will oversee.

With respect to the right of the mutual fund governance body to set its own compensation, this is part of the broader question of who should set salaries and approve expenses and who should pay for salaries and expenses. In this regard, we again quote from pages 165 and 166 of the Erlichman Report:

“The salaries and expenses of the board members, including the expenses of professional advice that the board or that the independent members reasonably require to carry out their duties, must be borne either by the manager or by the funds themselves. I do not believe that there is a 'right' answer as to what party should bear these expenses. In the U.S., the expenses are borne by the mutual funds. There is some merit to arguments from the Canadian mutual fund industry that if boards are mandated by the CSA, the boards are being established for the benefit of the fund securityholders and accordingly the expenses associated with the board should be borne by the securityholders. The contrary view, however, is that the

expenses related to having boards of mutual funds are merely an additional cost of doing business and the manager should absorb these expenses as the price for entering into the mutual fund management business. At this time, I suggest that competition in the marketplace should determine who pays the board's fees and expenses, provided that who pays is adequately disclosed to investors. *No matter who pays the fees and expenses associated with the board, however, it is important in order to ensure the independence of independent members that their salaries should be determined by the board itself (although the manager and the board jointly could set the salary levels in the first instance).*" [emphasis added]

Accordingly, we concur that in order to ensure the independence of mutual fund board members, it is best that their salaries should be determined by the board itself.

17.5 Functions of the Governance Body

The Draft Report recommended that it is important to identify certain fundamental responsibilities of the mutual fund governance body. The Committee believes these responsibilities should include, at a minimum, overseeing the establishment and implementation of policies related to conflict of interest issues; monitoring fund performance, fees, expenses and their allocation; ensuring compliance with investment goals and strategies; reviewing the appointment of the auditor; and approving changes to investment goals and strategies and approval of material contracts.

This recommendation of the Committee philosophically agrees with that set out in the Erlichman Report, which stated on pages 166 and 167 as follows:

"The board, similar to a board of directors of a corporation, should have the general responsibility to supervise the management of the business and affairs of the mutual fund in order that decisions affecting the mutual fund are made in the best interests of the securityholders of the mutual fund. The board should have oversight responsibilities and should not micro-manage. The board need not have a detailed list of specific duties, although certain minimum responsibilities should be established. The minimum duties could include: (i) evaluating the performance of the manager in various categories, including providing an adequate level of service to securityholders and in producing acceptable investment returns for the mutual fund, before and after expenses, in comparison to

appropriate benchmarks that take into account the mutual fund's risk profile; (ii) reviewing the financial statements of the mutual fund; (iii) checking that the mutual fund is following its investment objectives; (iv) monitoring the manager's compliance with the mutual fund's compliance plan (described later in this Part VII under the heading '4. Recommendations Regarding a Compliance Plan'); and (v) making decisions on behalf of a mutual fund whenever conflict of interest issues arise between the mutual fund and any other party.

In addition to the specified minimum duties, the board should have flexibility to determine what else it should do to fulfil its broader general mandate."

The Draft Report goes further than the Erlichman Report, however, in several respects, which we believe the Committee should reconsider. In particular, the Draft Report indicates that the responsibilities of the governance body would include "ensuring compliance with investment goals and strategies." While we believe that the investment goals and strategies are part of the fundamental bargain made by the mutual fund manager and the investor and, therefore, that it is a proper role for the governance body to monitor whether such goals and strategies are being complied with, we do not believe that it is the responsibility of a governance body to "ensure" compliance with such goals and strategies. The board's function in this regard should be oversight and monitoring only. The difference between "ensure" and "oversight and monitoring" is important because it ultimately ties into potential liability of members of the independent governance body. Assuming the function is "oversight and monitoring" rather than "ensuring", we suggest that the governance body also should have the benefit of a legislated "due diligence defence" as well as a legislated "business judgement rule", both of which are recommended in the Erlichman Report.

Whether the governance body should have the responsibility to approve fundamental changes to the fund or its investment objectives or, rather, whether such approval should be required by the securityholders of the mutual fund, is another important issue. Investors purchase securities of a specific mutual fund because they wish to obtain a return on their invested funds based upon the investment objectives and strategies described in the prospectus of the mutual fund. Accordingly, we suggest that it is a complex issue whether the governance body should have the unilateral right to approve a change in such a fundamental matter as investment objectives of a mutual fund. If the governance body does have this right, can investors who disagree with the fund's proposed change of investment objectives exit the fund without the payment of any fees? Similarly, should investors have the right to exit in this manner if they disagree with other fundamental changes that the governance body proposes to approve? These are but some of the many issues that should be considered if the Committee still

recommends that the governance body have the power to approve fundamental changes to the mutual fund without securityholder approval.

17.6 Should There Be Registration of Mutual Fund Managers?

The Draft Report recommended that mutual fund managers should be subject to independent oversight of their capital adequacy, personnel proficiency and standards of business practice. The Committee believes that this oversight can be conducted by the independent governance body.

We agree with the Committee’s recommendation that mutual fund managers should be subject to independent oversight of their capital adequacy, personnel proficiency and standards of business practice. We do not agree, however, that this oversight should be conducted by the independent governance body.

We do not believe that prospective members of independent governance bodies will wish to have this oversight responsibility (which ultimately can translate into additional potential liability to board members). Adding this responsibility to board members will make it more difficult to recruit them. In addition, in order to fulfil these duties and responsibilities, prospective board members will require much additional knowledge, training and resources and to devote significant additional time and personal commitment.

The Erlichman Report considered this issue and ultimately concluded that the oversight function should be conducted by the securities regulator through the registration process rather than by the independent governance body. We quote from page 178 of the Erlichman Report:

“The manager of a mutual fund is typically the promoter of the fund and as such is the entity which causes the fund to be established and on an on-going basis has the responsibility (together with the trustee of a mutual fund trust and the board of directors of a mutual fund corporation) for operating the mutual fund. Accordingly, the manager is a very important, and perhaps the most important, entity in ensuring the viability of the mutual fund.

In considering whether Australian mutual fund managers should be registered, the ALRC [Australian Law Reform Commission] stated as follows in the ALRC Report:

‘Licensing is an effective way of imposing and monitoring the controls that the Review recommends for scheme operators. ... Licensing will enable the regulator to screen

out insolvent companies, those that do not have the required level of capital and those that do not have adequate compliance measures. Licensing provides a means of monitoring the operations of schemes [i.e. mutual funds] and imposing any necessary changes to the scheme's operation through licence conditions. It will also provide the ASC [Australian Securities Commission] with information about the industry which is particularly important for the purpose of surveillance. The Review recommends that all scheme operators should be licensed. It should be an offence for any person other than a court appointed temporary scheme operator or the administrator or liquidator for a scheme to operate a collective investment scheme or to issue interests in a collective investment scheme without a license.' ”

The Erlichman Report continued as follows on pages 180 and 181:

“Registration of a mutual fund manager should give the CSA the jurisdiction and power to inspect and monitor the operations of the mutual fund manager even if the manager is not registered as a dealer or as an adviser, thereby providing the CSA with another tool to assist them in trying to ensure that the interests of the mutual fund securityholders are being looked after adequately. The 1969 Mutual Funds Report has an interesting paragraph which is stated in a different context, but I believe the thought also is applicable in the context of the mutual fund manager:

‘8.65 *Regulatory systems often tend to weigh most heavily on the organizations for which they are least needed, namely those which are operated on an ethical basis and make it a policy to comply not only with the letter but also with the spirit of applicable rules. Other organizations, those for which the regulations are often designed, might take a more cavalier attitude towards them; reliance on a strict interpretation of the letter of the law, by contrast with conscientious adherence to its spirit, can result in completely different methods of operation. Only by effective enforcement can the disparity be rectified. With regulations of the type*

proposed in this chapter and with most of the recommendations in this report, *effective enforcement can only be attained with an adequate system of inspection*. Compliance with many of the procedures proposed in this report could be confirmed only by personal inspection, and problems in other aspects of operations can be detected in that way before they develop into crises.’ [emphasis added]”

Accordingly, we believe that the oversight of the manager’s capital adequacy, personnel proficiency and standards of business practice is a proper role for the regulator.

We also believe, however, that registration of a mutual fund manager should be required only in one province and that the other Canadian jurisdictions accept the registration and attendant oversight of that manager by the securities regulator with which the manager has been registered. Registration with only a single jurisdiction will reduce the administrative burdens and costs on the mutual fund industry.

17.7 Rulemaking Authority

The Draft Report recommended that subsection 143(31) of the Act should be amended, as required, to give the Commission the necessary authority to address mutual fund governance reform through its rule making power.

We concur with this recommendation of the Committee.

PART 6 ENFORCEMENT

Enforcement Provisions

We are generally in agreement with the proposals made by the Committee in the Draft Report. We have not made reference to those proposed revisions with which we agree. In each case that we have disagreed with the recommendations in the Report, we have suggested alternative amendments that we believe would achieve the objectives identified by the Committee.

Administrative Fine

We agree that the Commission should have the power to order payment of an administrative fine; however such a fine may not be appropriate in all circumstances.

In particular, it does not make any sense to impose an administrative fine on a reporting issuer where the conduct complained of has been found to have harmed the shareholders of the issuer. An obvious example is a fine imposed on a reporting issuer for making a misrepresentation in a continuous disclosure document that caused members of the public to acquire shares in the issuer and had the effect of inducing existing shareholders to retain their holdings. The practical effect of such an order would be in effect to penalize the innocent shareholders of the issuer.

An administrative fine could be an effective penalty if levied against a registered dealer. We have observed, however, that the proposed amendments do not take into account the possibility that a respondent member of a self-regulatory organization could be subject to an administrative fine for the same conduct before the Investment Dealers Association or Market Regulatory Services Inc. In addition, a single violation occurring simultaneously in more than one Canadian jurisdiction could subject a respondent to an administrative fine imposed by more than one Commission.

Investigation Costs

Pursuant to section 127.1 of the Act, a respondent in a section 127 proceeding is already responsible for the costs of the investigation. This is similar to provisions in the by-laws of the IDA⁶⁵ and Market Regulatory Services Inc. The quantum of these costs, is imprecise and approximate because the investigative staff is comprised of Commission employees who do not keep accurate records of the amount of time spent on any given matter. Respondents ought only to be responsible for the proportion of the actual salary costs to the Commission attributable to the prosecution as well as actual out of pocket expenses such as photocopying, court reporting expenses, expert and other witness fees. Accordingly, we propose that the investigation cost provisions of the Act be amended (i) to clarify that an unsuccessful respondent is only accountable for actual provable costs and disbursements by Commission Staff and (ii) to provide that such costs be subject to assessment by a respondent. By instituting such a procedure, investigative staff and enforcement counsel would have incentive to keep adequate records of the time that is spent on each matter.

Costs to Successful Respondent

In addition to clarifying the cost structure, the Act should be amended to give the Commission the discretion to award costs on an appropriate scale to successful respondents. Under the current regime, many respondents who might otherwise be inclined to contest proposed proceedings before the Commission are under significant financial pressure to settle because of the legal costs involved in defending a contested hearing. This financial pressure would be exacerbated if an administrative fine becomes an available remedy to the Commission.

⁶⁵ Investment Dealers Association Rule Book 2001 By-law 20 ss. 20.25(f).

Prior to the development of arbitral authority on the point before the Commission, counsel for a respondent will not be able to provide a sound estimate of his or her client's potential financial exposure on account of administrative fines. Due to these unquantified financial contingencies, a respondent may be inclined to admit to violations of Ontario securities law or conduct contrary to the public interest despite an honest belief that an arguable defence exists. In our view, extracting admissions in such circumstances is contrary to the public interest. If the Commission were given the discretion to award costs, there would be more contested hearings which would advance the development of the arbitral jurisprudence. More importantly, this proposed amendment would foster a greater sense among market participants that the hearing process before the Commission is fair and balanced.

Disgorgement of Profits

(a) Issues

In our submission, the Committee should reconsider its recommendation that the Act be amended to provide the Commission with the powers to award the disgorgement of profits by a respondent in a section 127 proceeding. As the Committee has recognized in its report, the disgorgement of profits can give rise to complex substantive and procedural issues relating to the determination of entitlement and the quantum. The adjudication of these issues before the Commission will inevitably involve the consideration of expert accounting and valuation evidence and complex legal submissions concerning the rights of third parties. In our view, given the limited resources available to the Commission's Enforcement Branch, the lengthy process of adjudicating restitution claims could adversely impact the timely prosecution of other Enforcement matters.

More importantly, the determination of restitution issues by the Commission will affect the rights of non-parties to the proceedings (those claiming entitlement to restitution). Procedural fairness would require that each potential claimant be notified of the hearing and given the right to participate. Under the existing Act, any claimant would be entitled to appeal a decision of the Commission affecting his or her rights under section 9 of the Act as an "interested person". On such an appeal, an appellate court will likely not grant any significant curial deference as is normally granted to decisions of the Commission⁶⁶ because regulatory tribunals such as the Commission are not presumed to have specialized expertise in the adjudication of restitution claims or the determination of entitlement. This would particularly be the case if the determination of the restitution claims would involve complex legal and equitable tracing issues.

⁶⁶ *Pezim v. British Columbia (Superintendent of Brokers)* (1994), 114 D.L.R. (4th) 385; *Committee for Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)*, [2001] S.C.J. No. 38; *Canada (Director of Investigation and Research, Competition Act) v. Southam Inc.*, [1996] S.C.J. No. 116; *Ross v. New Brunswick School District No. 15*, [1996] S.C.J. No. 40.

Moreover, if the Commission is given the power to award restitution at the request of Staff, difficulties could arise from the conflict between the enforcement objectives of the Commission and the interests of individual security holders that have suffered loss as the result of the conduct of a market participant. The objectives of individual investors are normally served by the imposition of specific remedies accruing to their benefit to the exclusion of prospective orders made to protect other members of the public from the conduct of a market participant in the future. This axiom is consistent with the reasoning in *Mithras*⁶⁷ as recently affirmed by the Supreme Court of Canada in *Asbestos*.⁶⁸

For example, a respondent might well make a settlement proposal whereby he or she agrees to make full restitution to investors on the condition that no restriction be imposed on his or her market activities in the future. In the context of the settlement discussions, the respondent might say that if Staff of the Commission insists on regulatory orders that will impede his or her future trading activities, then the respondent will fund his or her defence out of the funds that would otherwise be available for restitution. It may well be the case that the respondent is judgment proof and the funds would come from sources that would not be available if a restitution order were made. This would be a perfectly legitimate strategic position for the respondent to take. In these circumstances the interests of individual restitution claimants will conflict substantially from the interests of the Staff of the Commission. The injured investors who would never invest with the respondent in the future would favour the adoption of the settlement. If Staff of the Commission apply the principles articulated in *Mithras*, (as Staff should) it would have to reject the proposal even if it means that there is nothing available for investors at the end of the day. If a compromise of these interests were ultimately arrived at, the eventual result might be a resolution that inadequately addresses the public interest on a prospective basis and which also provides inadequate restitution to investors.

(b) Amendment to Section 128 is the Solution

The goals that the Committee has identified respecting disgorgement of profits could be achieved, and the above scenario avoided, if section 128 of the Act were amended to permit *any* interested party to bring an application for a restitution order.

This alternative would achieve the deterrent effect of restitution orders without adding to the burdens on Staff of the Enforcement Branch, complicating the adjudicative process before the Commission or compromising the settlement process. Section 128 of the Act already provides the Superior Court with the power to award restitution to investors if it is found that a

⁶⁷ *Re Mithras Management Ltd.* (1990), 13 O.S.C.B. 1600.

⁶⁸ *Committee for the Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)*, [2001] 2 S.C.R. 132.

respondent in a section 128 proceeding has not complied with Ontario securities law. As the Committee has noted in the report, the Commission has rarely used this section.⁶⁹

Such amendment is in keeping with the objectives of section 128 of the Act since much of the relief available under subsection 128(3) is designed to provide specific relief for the benefit of security holders that have suffered injury as a result of the conduct of a market participant. Among these remedies are orders granting rescission of transactions relating to trading in securities, damages and restitution as well as other orders concerning corporate governance akin to those available pursuant to the oppression remedy provisions of corporate law statutes. The central difficulty with section 128 is that currently only the Commission itself is entitled to make application to the court under this provision.

If a section 128 proceeding brought by aggrieved investors were to follow the successful prosecution of a section 127 proceeding before the Commission, it is likely that such a proceeding case would be resolved, or a settlement reached, in short order. In particular, although the authorities are not completely settled on the point, it now appears to be the case that the Commission's reasons for decision are admissible in evidence in subsequent civil proceedings provided that the parties and issues are the same.⁷⁰ Accordingly, allowing aggrieved investors to bring such proceedings would allow the Commission and interested parties to expend their resources in a fashion more closely aligned to their respective interests.

Cease Trading Powers

(a) Cease Trading Powers Should Not Include Purchases

We do not agree that the definition of "trade" for the purposes of the cease trading provisions of subsection 127(1) should be amended to include purchases of securities. In this regard we note that it is not an accident that the current Act excludes the purchase of securities from the definition of "trade".

It is clear that the Legislature gave some consideration to the exclusion of "purchases" in paragraph (a) of the definition of trade. Under the predecessor legislation to the

⁶⁹ The Committee referred to the *Sides* decision. The decision to apply to the court under section 128 resulted from the fact that the then existing remedies available under section 127 were inadequate to address the conduct complained of because at the time the Commission did not have the power to prohibit a respondent from acting as an officer, director or promoter of an issuer. With respect to another case brought under section 128, *O.S.C. v. Gilbert* (1996), 19 OSCB 3590, the section 128 application was brought for a similar reason, namely, to prohibit the respondent from acting as a market participant, which remedy was otherwise not available, except under section 128.

⁷⁰ See the decision in *Hill v. Gordon-Daly et al.* (2001), 56 O.R. (3d) 388 (Div. Ct.). Note that leave to appeal from this decision to the Court of Appeal for Ontario has been granted. See also contra, *Moyes v. Fortune Financial Corp.*, [2002] O.J. No. 1660 (unreported decision of the Superior Court of Ontario).

current Act (which was enacted in 1978) there was no express exclusion for “purchases” in the definition of trade. The prior definition was as follows:

“Trade” or “trading” includes,

- i any sale or disposition of or other dealing in or any solicitation in respect of a security for valuable consideration, whether the terms of payment be on margin, instalment or otherwise, or any attempt to do one of the foregoing,

.....

- iv. any act, advertisement, conduct or negotiation directly or indirectly in furtherance of the foregoing;

There is authority that even under the prior legislation, trading does not include purchasing. In *Prudential Trust Co. Ltd. v. Forseth*⁷¹, the Supreme Court of Canada held that a similar provision of the Saskatchewan *Security Frauds Prevention Act*⁷² did not apply to the purchases as opposed to sale of certain mineral right securities.

The policy reason for this exclusion from the definition of trade (and the expanded definition in the “insider trading” provisions) is that a purchaser who does not engage in any act in furtherance of a trade by a seller, other than a purchaser purchasing on the basis of material undisclosed information, is very unlikely to be able to engage in conduct that is contrary to the requirements of Ontario securities law or the public interest.

(b) Proposal Regarding Prohibition on Ownership of Securities

Despite the above, we recognize the concern that an individual who has been found by the Commission to be unsuitable as a market participant could continue to engage in conduct that is harmful to the public interest if he or she acquires (either alone or through associates or affiliates) a sufficient number of voting securities to materially affect the control of a reporting issuer or a registrant. In our submission, the objects of the Act would be better served if the Commission were given the power to prohibit any person or company or anyone acting under the person or company’s direction or control from holding more than 5 percent of the voting securities of any issuer.

⁷¹ [1960] S.C.R. 210 (S.C.C.)

⁷² *R.S.S. 1940, c. 287.*

In a material respect, this proposal is more onerous than what has been proposed by the Committee because it would, in certain circumstances, impose an obligation on the respondent to dispose of his or her existing positions in any issuer. Our proposal would also be more effective in certain circumstances where the existing cease trade powers are imposed. In certain circumstances, a cease trade order has the unfortunate effect of entrenching a person or company who the Commission has determined ought to be removed from the capital markets in his or her position effectively to control an issuer by prohibiting him or her from selling.

While our proposal may not address insider trading violations, the Commission would have the power effectively to prohibit the person from becoming or remaining an insider of any issuer. The insider trading issue could also be addressed by appropriate compliance orders.

Privity Requirement for Civil Liability for Insider Trading

We do not agree that it would be necessary or desirable to delete the existing privity requirement in the civil liability provisions respecting insider trading. The gravamen of section 134 of the Act is to remedy the damages resulting from inequality of information between specific purchasers and vendors of securities in the secondary market. Although it may be sheer “happenstance” that a given plaintiff happened to be on the other side of the transaction with the insider or tippee, it would make little sense to award compensation to a purchaser or seller who traded in a security with a vendor or purchaser who did not have knowledge of undisclosed material information. Awarding damages to all parties who acquired or sold securities over a given period allow persons who had not been harmed in any way by any act of the defendant to receive compensation. In this regard, it could be said that it was mere happenstance that such persons happened to be in the market purchasing or selling during the relevant period. Moreover, the measure of damages provided for in subsection 134(6), if unchanged, would require that a defendant pay more than the actual profit realized or loss avoided; damages would be payable for securities the defendant neither bought nor sold. From the perspective of the defendant, damages would no longer be compensatory but would, in effect, be punitive.

We agree with Professor Anisman’s observation that it is difficult for investors to demonstrate the direct relationship required by section 134 of the Act. In our view, this would be easily remedied if the Act were amended to permit a plaintiff to apply to the Commission for an order requiring a defendant’s registered dealer to disclose relevant trading data regarding the identity of the clients who executed trades at certain times and also requiring the TSX to disclose relevant trading data. The Act could also provide that a representative plaintiff in a proposed class proceeding could apply to the Commission for an order requiring the TSX and dealers who have acted for other potential claimants to disclose relevant information regarding their clients so that these clients could have the opportunity to participate in the class proceeding.