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Comments on proposed National Policy 51-201

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by John Kaiser, editor Kaiser Bottom-Fishing Report

I am concerned about the implications of the proposed Disclosure Standards as outlined in National Policy 51-201 with regard to the potential liability created when a corporation provides access to unpublished information in the form of oral or written communications. As an analyst for the Kaiser Bottom-Fishing Report, an independent newsletter that depends on subscription revenue for income, I frequently seek additional information from company officials beyond what the company has published in regulatory filings or as technical reports available on the corporate web site. The subject companies are of a speculative nature that ranges from technology development to mineral exploration. The service I provide to my subscribers involves articulating the company's project and assessing the evidence supporting the projected outcome and the strategy adopted by the company to pursue its goal. I generally bring to the table an analytical framework based on knowledge and experience which allows me to judge the failure/success potential of the project. My subscribers use these "outlook" commentaries to help them develop specific investment strategies. Sometimes in response to the analysis itself, and sometimes simply because of general market conditions, an immediate market reaction develops which results in a significant price movement up or down depending on the negative or positive tone of the "outlook". Sometimes my commentaries create controversy, though no market movement happens until after new information is generated and disclosed by the company that confirms the outlook. In all cases a situation exists where a select group of investors, my subscribers, are able to trade on the basis of restricted access to conclusions that are at least partly based on information selectively disclosed to me. The disclosure comes in the form of conversations with company insiders, field trips, technical reports, and one-on-one office visits. I have never been in a position where non-public information has been disclosed to me that would clearly have a significant affect on the market, either because it is entirely unexpected or differs sharply from expectations already priced into the market. The type of information I typically obtain is subtle and often requires a rich interpretative context to be meaningful in any way. When this actually happens, I find that an "immaterial" but "non-public" fact has "material" implications with regard to my understanding of the company's outlook. It is conceivable that my publication of this analysis to a restricted audience could directly result in market activity that creates significant price movement. What concerns me is the definition of "materiality" as outlined in 4.3.3: "a fact is material when it (i) significantly affects the market price or value of a security; or (ii) would reasonably be expected to have a significant effect on the market price or value of a security". The market liquidity of the kind of public companies my analysis targets is generally low with limited coverage from competing analysts. As a result "significant price movements" attributable to an analyst's comments are much more likely than is the case with more widely covered and liquid securities.

I am concerned that the materiality of non-public information can be established retroactively through measurement of market activity attributable to investors reacting to an analyst's observations that include non-public information. This may not have emerged as a problem under the "tipping" provisions, but may become so once the policy spotlight is put on the relationship between management, analysts and their clients/subscribers. The SEC's Regulation Fair Disclosure addresses the possibility of the "mosaic effect", where an analyst obtains the missing piece that enables him to put the puzzle together, by restricting the definition of materiality to whether or not a "reasonable investor" in possession of the non-public information would expect widespread knowledge of this information to have a market moving effect. Regulation FD is based on the common sense notion that non-public information is material if it carries sufficient context to make the potential for a profitable trade obvious to an investor without requiring specialized knowledge. As I understand Regulation FD, it does not affect a situation where I as the analyst provide an interpretative context to generate a speculative conclusion that still has a degree of uncertainty, but not as much as the same conclusion not supported by an "argument" that includes non-public information. The value of an analyst lies in his ability to provide a prognosis about the future, not an autopsy of what happened. Investors pay attention to analysts not because they provide a consensus, but because they uniquely claim to spotlight an inefficiency in the market's assessment of the likelihood of an outcome. An investor's willingness to act on the analyst's prognosis hinges on both the perceived plausibility of the argument and faith in the credibility of the analyst. Because both factors are subjectively variable, the reaction of the analyst's audience is unpredictable. As the proposed National Policy 51-201 is written, it appears to legitimize the initiation of regulatory or civil action against a company and analyst simply because the analyst's audience reacted in such a way as to significantly affect the market price of a stock. It would be possible to construct an after-the-fact argument that general disclosure of the non-public information would not have allowed a buying opportunity to exist for the analyst's audience to exploit. This creates the absurd possibility that market activity driven by any combination of forces could become the measure of materiality for what by themselves are relevant but immaterial facts.

If National Policy 51-201 allows market activity to create after-the-fact definitions of materiality, we can expect two undesirable consequences. One is the "chilling effect" where companies no longer discuss projects nor provide analysts access to detailed information, with the result that markets are left to operate in a climate of minimalist disclosure that undermines the market's role as a capital allocation mechanism and turns it into a gambling mechanism. The other undesirable consequence is that analysts continue to have selective access to non-public information, but avoid communicating this circumstance by presenting conclusions without supporting arguments. This has the undesirable effect that an analyst is transformed from a researcher, who backs up his conclusions with evidence and reasoning that are subject to his audience's independent scrutiny, into a crystal ball gazing guru whose forecasts can only be followed blindly. The rise of celebrity analysts has further negative consequences in that such "magically" successful analysts become self-fulfilling prophets who rely less and less on research, and eventually have an arbitrary, distorting influence on capital allocation. If analysts do not have access to detailed non-public information, nor protection from retroactively defined materiality, they will not only fail to play a productive role in capital markets, but will end up playing a destructive role. The inevitable demise of celebrity analysts, as we are witnessing in the fallout from the recent dot-com mania, undermines the credibility of analysts as a group.

National Policy 51-201 also fails to address the mosaic effect where "materiality is in the mind of the beholder". The impetus for Regulation FD came from a practice where companies gave "guidance" to a select group of market professionals on upcoming "information flow events" whose market price implications were clear cut. In the speculative arena of technology development and mineral exploration there is no room for guidance regarding results, but there is enormous room for detailed disclosure of "inputs" which rarely reveal a definitive outlook for results, but which allow shrewd investors to tailor their expectations. Because an analyst or newsletter writer publishes to a restricted audience, a paper trail exists which would make it easy to demonstrate the causal sequence behind benefits captured by the restricted audience. A knowledgeable third party would be able to identify any non-public information that is key to the analyst's conclusion. The stage is set for litigation that charges the analyst with benefiting from selective disclosure.

As an example, consider the case of the Tli Kwi Cho diamond pipe, discovered in 1993 and bulk sampled in 1994. Based on limited disclosures the market developed high expectations that were shattered when the bulk sample results were released. Overnight nearly a billion dollars in market capitalization evaporated as investors abandoned diamond companies. The results were a surprise even to the operator who had full control of detailed data. This data foretold the disappointment, but only if interpreted by somebody with an intimate understanding of the nature of diamond deposits. At the time I lacked the technical knowledge required to properly interpret this data, but if I had access to the micro diamond data today, I would arrive at a fairly negative conclusion about the bulk sample outcome. The market as a whole might not believe me, though individuals who did would make substantial profits. A similar case actually occurred in 1999 when I obtained non-public information that three large stones represented 75% of the value of a diamond parcel recovered by Winspear in a mini bulk sample. Management believed this fact to be non-material, but as later results proved, it was very material. Even after I published my negative assessment of the outlook, both management and the market disagreed with my prognosis. In the Winspear case the Vancouver Stock Exchange, which had access to professional diamond experts, forced the company to make a formal disclosure. The result was that the stock price never reached the levels that would have been plausible if this three stone fact was not the case. Diamond exploration is today still a poorly documented process with unreliable disclosure practices. As an analyst it is my goal to get access to as much detailed information as possible so that I can apply the analytical method I believe to be appropriate. The situation is ripe for an analyst to obtain selectively disclosed information that management does not believe to be material, but which enables the analyst to generate well-supported conclusions, which, if not circulated beyond his restricted audience, can lead to substantial trading benefits. When these conclusions are negative, and subsequently born out by results, the new selective disclosure policy could be invoked by angry investors claiming that the analyst and his clients had an unfair advantage.

My recommendation is that National Policy 51-201 eliminate the retroactive definition of a material fact (4.3.3. (i)) and acknowledge that a non-public fact can be immaterial by itself, but have market-moving materiality when plugged into an interpretative framework. I also strongly urge that section 6.9.2 (electronic communications) be strengthened to establish detailed information as publicly disclosed by making it passively available on the web site. No analyst should have access to technical reports, business plans, maps, drill logs and other detailed reports unless this information is accessible to anybody. The exception would be where a confidentiality agreement has been signed, but this exception is irrelevant because there is no reason whatsoever for an analyst to sign such an agreement. The current definition of disclosure relies heavily on the process of "pushing" information at a broad audience. It does not make sense to "push" detailed information which has no materiality for the average investor. Such voluminous documents should be simply available for downloading by anybody interested in it. This accessibility would alleviate the complaint that in the absence of selective disclosure there is no useful role left for analysts to play. It is an analyst's duty to spend time and effort turning raw information into meaningful conclusions. Most investors have neither the time, skill nor will to grapple with detailed information. That is what analysts get paid to do. Online availability of detailed information would also curtail a common abuse in the speculative arena where management does not communicate with analysts deemed to be unfriendly. If passive publishing of non-material information to a web site receives stronger endorsement from National Policy 51-201, it would encourage management to engage with analysts in complex discussions about the company's projects without fear that a minor detail could achieve material proportions if it completes the puzzle for the analyst. It is my experience that corporate executives and analysts have a pretty good sense of what information is untouchable. In mineral exploration this tends to be specific numbers such as assays expected from completed exploration work. Far more important is the construction of interpretative contexts, which requires information that is often detailed and subtle. A typical discussion between an analyst and management aims to create a better understanding of the project and its supporting data. It is not our goal to obtain material inside information, because we understand perfectly well that possession of such information compromises our ability to communicate to our audiences. A research analyst's priority is communicating with his audience, be it his employer's clients or his subscribers. A good analyst is one who backs up conclusions with supporting evidence and arguments whose coherence and plausibility the audience can judge. A bad analyst is one who simply provides conclusions the audience must either trust or ignore. In the speculative arena analysts have too often achieved celebrity status by being in the right place at the right time. The new selective disclosure standards policy should encourage argument supported analysis and discourage "trust me" conclusions that masquerade as analysis.

With regard to communications to a potential private placee, it is patently unfair to provide any information not "generally disclosed". A private placement is usually at a discount to the market and frequently includes a bonus in the form of a warrant. A private placement often occurs at a price and time where the size of the placement far exceeds the amount of stock an investor could hope to accumulate in the open market without driving the stock price higher. To have access to a private placement is already a privilege. To give the investor access to non-public information is to give an extra advantage. A good analyst's access to non-public information is visible because it forms part of his published argument. In contrast, a placee never "publishes" his reliance on non-public information, and consequently can never be unequivocally accused of benefiting from selective disclosure. All documents provided to potential placees such as an offering memorandum should be available on the company's web site for anybody to access.

Thank you,

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