IN THE MATTER OF THE SECURITIES ACT
R.S.O. 1990, c. S.5, AS AMENDED

- and -

YBM MAGNEX INTERNATIONAL INC.
HARRY W. ANTES
JACOB G. BOGATIN
KENNETH E. DAVIES
IGOR FISHERMAN
DANIEL E. GATTI
FRANK S. GREENWALD
R. OWEN MITCHELL
DAVID R. PETERSON
MICHAEL D. SCHMIDT
LAWRENCE D. WILDER
GRIFFITHS MCBURNEY & PARTNERS
NATIONAL BANK FINANCIAL CORP.
(formerly known as First Marathon Securities Limited)

Panel:	Howard I. Wetston, Q.C.	-	Vice-Chair (Chair of the Panel)
	Derek Brown	-	Commissioner
	Robert W. Davis, FCA	-	Commissioner

[1] This case raises serious questions with respect to the meaning of materiality in the prospectus and timely disclosure provisions of the *Securities Act* (the "Act"). A basic tenet of securities law is that disclosure is generally limited to *material* matters. Confronted by the dilemma of what should be disclosed to the public, the respondents relied on the concept of materiality as the cornerstone for disclosure. YBM's key disclosure documents did not, we find, contain full, true and plain disclosure of all material facts. YBM also failed to disclose a material change in its affairs forthwith. While disclosing good news with little hesitation, its practice was to restrict the disclosure of bad news.

[2] YBM's disclosure leads the reader to believe that the risks faced by YBM were no greater than the inherent risks faced by any company operating in Eastern Europe at that time. We find this to be incorrect. YBM was subject to company-specific risks. An investor in YBM's securities had the right to know what specific risks were presently threatening the issuer. Disclosure continues as the main principle for protecting investors, ensuring fairness in the trading markets and enhancing investor trust.

[3] Despite a hearing which took over 124 hearing days to complete, this case is not about organized crime, money laundering or whether the respondents believed YBM was not a real company. It is about the disclosure of risk. Materiality is reinforced as the standard for such disclosure in securities markets by taking into account the considerations associated with the exercise of judgement and reasonable diligence.

First Allegation

[4] Staff's first allegation is that YBM Magnex International Inc. ("YBM") filed a preliminary prospectus dated May 30, 1997 and a final prospectus dated November 17, 1997 that failed to contain full, true and plain disclosure of all material facts relating to the securities offered. Specifically, staff allege that YBM failed to disclose the mandate, information obtained by and findings of a special committee of its board of directors (the "Special Committee"). The respondent directors and officers are alleged to have authorized, permitted or acquiesced in YBM's failure to make full, true and plain disclosure. The respondent underwriters are alleged to have signed certificates to prospectuses which, to the best of their knowledge, information, and belief did not contain full, true and plain disclosure.

[5] The essence of what is engaged in this case is the disclosure of risk. Were the risks faced by YBM fully, truly and plainly disclosed as simply general business risks associated with activities in Eastern Europe? Were the concerns simply those expressed by the media and government authorities generally concerning companies doing business in Eastern Europe and, particularly, Russia? If not, was YBM uniquely subject to material risks that were not disclosed?

[6] Disclosure in securities markets encourages investing and therefore growth. Disclosure protects investors, aids in ensuring that securities markets operate in a free and open manner and ensures a security will nearly correspond to its actual value. Too much disclosure or information overload can be counter-productive. The boundaries are identified by the concept of "material facts". The definition appears straightforward but its assessment is nuanced.

[7] The materiality assessment in this case involves a consideration of whether material facts respecting the mandate, information obtained by and findings of the Special Committee were omitted from the disclosure documents. Would the disclosure of such information translate into market gains or losses? In our opinion, the critical question is whether certain undisclosed facts contained in the Special Committee Report would have revealed that YBM was, at the time, exposed to risks that would reasonably be expected to have a significant effect on the value of YBM's securities if disclosed.

[8] One should not lose sight of the forest for the trees by assessing the materiality of individual facts piecemeal when the broader factual context suggests a risk faced by an issuer. Some facts may be material on their own, while others may only be material in the context of other facts. Common sense must prevail; the broader factual context, or total mix, must not be overlooked when the risk

facing the company is a current one.

[9] To summarise, the parts of the AIF and the rest of the prospectus that dealt with risks other than the “special” risks connected with Eastern Europe plainly disclosed both the existence of a risk and the factual basis for the risk. The sections on Eastern Europe were considerably more opaque in describing the precise risks facing YBM and the factual basis for those risks.

[10] We are of the opinion that, when taken together with other facts, there was sufficient confirmation of the aspects of the U.S. Government’s investigation into YBM to assess whether these facts are material within the meaning of the Act.

[11] In our view, when the omissions which are material on their own and the omissions which in isolation may not appear to be material are considered together, the evidence indicates that YBM was subject to a set of risks specific to itself. These risks were not disclosed. The AIF told the investing public that the mandate, information obtained by and findings of the Special Committee were connected to only general concerns expressed in the media and by government authorities that related to all companies doing business in Eastern Europe.

[12] No doubt, the facts and information unearthed by the Special Committee presented YBM with very difficult disclosure decisions. Having chosen to proceed with a public offering, which required full, true and plain disclosure of all material facts, the obscure disclosure contained in the AIF was unsatisfactory. It did not provide investors with the opportunity to adequately inform themselves regarding the specific risks facing YBM.

[13] At a minimum, we believe some disclosure regarding what YBM knew about the U.S. investigation and less muddled disclosure regarding the purpose of the Special Committee would have better informed investors about the risks facing YBM.

[14] We recognize that in fostering high standards of fitness and business conduct we must not overly constrain the ability of the officers and directors to make rational business decisions and take measured risks. Risk taking is in the spirit of commercial activity and in the hope of greater economic reward. Risk taking is accommodated, not hampered, by care and diligence.

[15] We think it best to consider the reasonableness of the respondents’ diligence and their belief from the perspective of a prudent person in the circumstances. This necessarily entails both objective and subjective considerations including their degree of participation, access to the information and skill.

[16] The Special Committee was independent of management, but was not without a manifest conflict of interest. Mitchell chaired the Special Committee and was very active as YBM’s co-lead underwriter. Mitchell took a number of positive steps through his work as Chair of the Special Committee towards uncovering facts that could have had an adverse economic impact on the business. However, the risks at issue left little margin for error. Mitchell had considerable skill, access to the most information and extensive participation in the offering, the investigation of the facts, their

materiality and their disclosure. He developed a belief in the legitimacy of the business. However, that did not in our view justify a reasonable basis for his belief that YBM made full, true and plain disclosure of all material facts. Consequently, a defence of due diligence is unavailable to him.

[17] Mitchell, as an underwriter, was largely compensated based upon a direct drive compensation scheme. Clearly, First Marathon and Mitchell would benefit if YBM completed the Crucible acquisition and the offering. Simply put, Mitchell was in a conflict of interest. We do not view the conflict of interest as a matter of intention or lack of good faith on his part. Rather, it compromised both his time and judgement.

[18] Davies was the only outside director who had a personal visit from the FBI in April 1996. Davies did not discuss this visit or the likely subject matter with the board or its counsel. Having heard his testimony, we are of the opinion that having regard to his skill and business experience, he failed to act prudently. We must consider his belief that there were no material facts omitted. A director's belief cannot be considered reasonable when he is aware of circumstances of such a character, so plain, so manifest, that a person with any degree of prudence would not have acted in this manner.

[19] Schmidt, unlike Mitchell and Davies, did not have any information that other directors did not have or did not share with the board. His belief in the legitimacy of the business and no managerial improprieties was not unreasonable. He admittedly gave more weight to these factors than to other risks that YBM might face. He clearly could have done more on the Special Committee and he should have. Nevertheless, he had no knowledge of any facts not known to the directors generally and to Mitchell and Davies more specifically.

[20] While we believe Peterson could have done more, we have concluded that Peterson acted reasonably based on his involvement in the matter, his skill and his access to information in the circumstances. Accordingly, his due diligence defence is available to him, but just barely. We are of the view that Peterson brought a unique perspective to the board. His professional reputation as testified to by Mr. Michael Wilson, Mr. David Beatty and Mr. John Tory, and his experience in many other public company boards, was not in any way equalled by any other director. He had unique access to counsel to the Special Committee, whom he supported as counsel both to YBM and the Special Committee. He was appointed to add to the prestige and status of YBM. While Peterson meets the legal test of due diligence, the panel remains disappointed that he did not offer more insight and leadership to the board in these circumstances.

[21] Antes and Greenwald brought different skills to the YBM board than the other directors. Skill is that proficiency that comes from training and experience. They did not have the public company or business experience of other YBM directors. They relied on the members of the Special Committee to fulfill the duties assigned to them. For all their involvement in identifying and recommending the acquisition of Crucible, Antes and Greenwald had no material role in the financing. They relied on counsel for the drafting of disclosure that was to comply with Ontario securities law. Legal advice must be considered in the context in which it was given, and in this context, given their level of

experience and skill, it was reasonable for Antes and Greenwald to rely on counsel. They did not participate in the drafting of the AIF, the preliminary prospectus or the final prospectus, and did not participate in any of the meetings with staff. Accordingly, their belief as to full, true and plain disclosure is justified in the circumstances of the case. Therefore, a due diligence defence is available to both Antes and Greenwald.

[22] Gatti had no experience in such matters. He relied on the Special Committee. He relied on the experience of underwriters and securities lawyers for the issuer and underwriters. While Gatti knew a great deal, the Special Committee knew more. The disclosure at issue was not financial disclosure. The Special Committee was independent of management. As such, his reliance was in good faith and honest in the circumstances. It was clear that Gatti was subordinate to Bogatin and to the decisions of Mitchell and Wilder. What should he have done? In our opinion, in such circumstances an engaged CFO should communicate directly with the board of directors of the company. In conclusion, we find that, at the relevant time, Gatti had a reasonable belief that the prospectus disclosure was true and that no material facts were omitted. In the circumstances of this case, we find that Gatti has proved his due diligence, but just barely.

[23] The reasonableness of First Marathon's belief can only be assessed in the context of the collective knowledge of First Marathon. National Bank acknowledges that Mitchell should not have been permitted to have been involved in investment banking functions in this financing. The investigation undertaken by the underwriters in this case was extensive. A significant shortcoming of Jones' investigation on behalf of First Marathon, however, was that he was unaware of all the facts that Mitchell was.

[24] In addition to these failures to communicate, the evidence suggests other shortcomings in First Marathon's due diligence process. Most notably, the process was not complete at the time First Marathon agreed that the preliminary prospectus could be filed. It is unclear how First Marathon could certify to the best of its knowledge, information and belief given the circumstances. We recognize the commercial reason for proceeding in this manner, but the desire to get on with the Crucible acquisition was simply too high-risk at this stage. First Marathon was a sophisticated and experienced underwriting firm. Unlike the officers and directors of YBM, conducting public offerings was First Marathon's lifeblood. Moreover, First Marathon, through Mitchell's involvement with YBM, was more knowledgeable than the typical underwriter. While clearly not the guarantor of full, true and plain disclosure, the underwriter is a gatekeeper. There can be little doubt that First Marathon exerted significant efforts to investigate YBM. We do not believe it sought to deliberately mislead investors. However, given its knowledge, access to information, involvement and skill, we do not find that National Bank has established that the belief that the prospectus contained full, true and plain disclosure was justified. Accordingly a defence of due diligence is unavailable.

[25] While GMP was less knowledgeable regarding the mandate, information obtained by and findings of the Special Committee, it was not completely uninformed. While not a guarantor of YBM's disclosure, McBurney understood that a diligent investment banker would be expected to "drill down" on sensitive issues and agreed that his experience as both a securities lawyer and investment banker

would help him in identifying sensitive areas of a company's business. Why did GMP possess the limited knowledge that it did? It is clear that GMP relied upon Mitchell and First Marathon. McBurney knew that Mitchell's dual role had the potential for conflict. In principle, we see no reason why one member of an underwriting syndicate cannot or should not rely on another, but where a co-lead underwriter falls down in the conduct of its due diligence, the other co-lead may have to bear the risk of its reliance. We believe that GMP understood that its reliance on First Marathon was subject to certain risks given Mitchell's roles.

[26] There is no doubt that GMP, along with the other respondents, drew great comfort from the audit by Deloitte & Touche LLP (U.S.) ("D&T") which, by all accounts, was an exceptional measure to institute in the midst of a prospectus offering. However, GMP also relied on First Marathon's flawed investigation. GMP was fully aware of those risks. If it was not, it should have been. GMP should have taken certain steps that would have been consistent with its role as a co-lead underwriter. Accordingly, we find that a defence of due diligence is unavailable to GMP.

[27] Mr. Greenspan, on behalf of GMP, seeks a stay of these proceedings pursuant to subsection 23(1) of the *Statutory Powers Procedure Act*, wherein a tribunal may make an order to prevent an abuse of process. The allegation is one of misconduct against staff counsel of the Commission. The facts herein fall short of the high standard for a finding of an abuse of process and a stay of proceedings. It is not the clearest of cases in which the fairness of this hearing or its integrity has been impaired. The request to stay is denied.

Second Allegation

[28] Staff's second allegation is that YBM failed to comply with its continuous disclosure obligations by not issuing forthwith a press release that disclosed the substance of a material change in the affairs of the company. Specifically, YBM should have disclosed that D&T had advised YBM on or before April 20, 1998 that it would not perform any further services for the company, including the rendering of an audit opinion in respect of the company's 1997 financial statements, until YBM had completed an in-depth forensic investigation that addressed specific concerns to D&T's satisfaction. The members of YBM's audit committee, its Chief Executive Officer, Chief Financial Officer and Chief Operating Officer are alleged to have authorized, permitted or acquiesced in YBM's failure to comply with those continuous disclosure obligations.

[29] An issuer is obliged to disclose material changes. That enhances the fairness of the market. The definition of material change acts as a brake on premature and undesirable disclosure. The concept of material change, like that of material fact, requires an exercise of judgement. If the decision is borderline, then the information should be considered material and disclosed. In our opinion, a supercritical interpretation of the meaning of material change does not support the goal of promoting disclosure or protecting the investing public; sections 1.1 and 2.1 of the Act.

[30] The requirement for an annual audit by an independent auditor is intended to provide the public

with an independent and objective check on the fairness of the presentation of the company's financial position at fiscal year end. That information is not only crucial to investors in the secondary market but also to an issuer's ability to raise capital. An auditor, while not a guarantor of financial statement accuracy, assumes a special role vis-à-vis the public. There was no disagreement with respect to the crucial role of auditors in public companies.

[31] There was also no disagreement that YBM faced a serious risk if it did not file its audited financial statements by May 20, 1998 or obtain an exemption from the filing deadline. Failure to file on time or obtain an exemption would result in the issuance of a cease trade order against YBM's securities.

[32] The concerns presented to Mitchell and Antes on April 19 which led to the audit suspension and the request for a forensic investigation were extraordinary in nature. D&T was concerned about (a) the validity of transactions, (b) whether counterparties to YBM's agreements were legal entities, and (c) organized crime and the possible cover-up of the flow of money. Given the events of April 19 and 20, as informed by earlier events, the emergence by April 20 of the risk regarding the filing deadline and likely cease trade order constituted a material change. The press release was issued approximately 18 days after notice of the audit suspension was provided. This was not forthwith, particularly in light of the ten day period set out in subsection 75(2) of the Act.

[33] Although Mitchell believed it was possible that D&T would still render an audit opinion, this was highly improbable. D&T expressed doubt that the necessary investigation could be completed in time for the filing deadline. Its concerns were fundamental in nature and involved the validity of millions of dollars in transactions and the legal existence of counterparties to the transactions. His belief in these circumstances, including his reliance on legal advice, was not reasonable.

[34] As with Mitchell, we find that as of April 20, Antes ought to have known that YBM likely would not get its audit opinion in time and that, as a consequence, the shares of the company would be cease-traded. Regardless of his relative lack of experience in the capital markets, he was an active member of the Audit Committee, was knowledgeable of the issues and had reason to challenge the legal advice.

[35] We agree that Antes could not be expected to know the nuances between an audit, a high-risk audit and a forensic investigation. But that is not the issue. The issue is one of prudence and common sense, particularly where D&T did not want to deal with management. His belief had to be reasonable, and as with Mitchell, the basis for that belief was too slim. We find that Antes did not have a reasonable basis for believing on April 20 that a material change had not occurred.

Sanctions

[36] Section 127 is a regulatory provision, the purpose of which is neither remedial nor punitive. It is protective and preventative, intended to be exercised to prevent likely future harm to Ontario's

capital markets. *Erikson* confirms the principle of both specific and general deterrence in section 127 public interest cases. General deterrence should deter others from similar misconduct and hopefully improve business standards. The sanction imposed should reflect the Commission's assessment of the measures necessary to achieve these objectives. Moreover, there must be an appropriate relationship between the seriousness of the violation and the sanctions selected to achieve compliance with the law. We do not view the conduct of the individual respondents who answered the allegation as deceitful. However, while not deceitful, we have found that certain respondents, in the circumstances, failed to satisfy prospectus and timely disclosure duties under the Act.

[37] Sanctions are contained in the Commission's order dated June 27, 2003 effective July 2, 2003.