Submission on Insider Trading Task Force (ITTF) Proposals: Prevention, Detection and Deterrence

NATIONAL BUSINESS LAW SECTION
CANADIAN BAR ASSOCIATION

February 2004

TABLE OF CONTENTS

Submission on Insider Trading Task Force (ITTF) Proposals: Prevention, Detection and Deterrence

PREFACE

The Canadian Bar Association is a national association representing 38,000 jurists, including lawyers, notaries, law teachers and students across Canada. The Association's primary objectives include improvement in the law and in the administration of justice.

This submission was prepared by the National Business Law Section of the Canadian Bar Association, with assistance from the Legislation and Law Reform Directorate at the National Office. The submission has been reviewed by the Legislation and Law Reform Committee and approved as a public statement of the National Business Law Section of the Canadian Bar Association.

Submission on Insider Trading Task Force (ITTF) Proposals: Prevention, Detection and Deterrence

I. INTRODUCTION

The Insider Trading Task Force (ITTF) published, in November 2003, a report entitled *Illegal Insider Trading in Canada: Recommendations on Prevention, Detection and Deterrence* (the Report). The Report has 32 recommendations for changes relating to illegal insider trading in Canada. The National Business Law Section of the Canadian Bar Association (the CBA Section) welcomes the opportunity to present its views on the proposals by the ITTF.

This is the second submission by the CBA relating to the Report. The first submission dealt with the recommendations on service providers in section 3.1.2. This submission relates to the remainder of the ITTF report.

The objective of the ITTF is stated in the Report as "evaluating how best to address illegal insider trading (emphasis added) on Canadian capital markets". The identification of a legitimate regulatory issue is typically the rationale for changes in the regulatory framework. The mandate of the ITTF was to:

1. identify means of reducing the risk of illegal insider trading occurring such as by promulgating best practices for dealers, issuers and service providers to limit the leakage of inside information;

2. increase the ability of regulators to detect illegal insider trading when it occurs, such as by addressing offshore and nominee account issues and by coordinating the regulation of equities with their derivatives; and

3. increase the success of deterrence efforts through:

    - better coordination among regulatory agencies,
    - ensuring the laws are adequate, and
    - improved enforcement mechanisms and penalties.

II. PREVENTION – EXEMPTION FOR MUTUAL KNOWLEDGE OF MATERIAL INFORMATION (SECTION 3.2.4)

Although the CBA Section agrees that it is possible for insiders to structure abusive transactions to fall within the "mutual knowledge" exemption from the insider trading prohibition, we believe that exemption should continue to apply to some transactions between insiders and the issuer. For example, the exemption has been interpreted as permitting a senior officer with knowledge of undisclosed material information about the issuer to exercise a stock option (since both the officer and the issuer would "know" the inside information) as long as the officer did not sell the shares before the relevant information was disclosed. If the exemption were limited in the manner suggested by Recommendation #13, officers may be forced to allow an unexercised stock option to expire if they had knowledge of material information not yet disclosed or sufficiently disseminated.

The CBA Section believes it would be punitive to force an officer of an issuer to allow an "in the money" option (which forms part of the officer's compensation) to expire without exercising it. However, there may in fact be circumstances in which an option holder with knowledge of undisclosed material information could inappropriately make use of undisclosed material information by exercising stock options which are about to expire. For example, if the option exercise price was significantly above the market price for the shares and the undisclosed material information was favourable, it would

be inappropriate for the insider (who would be prohibited from making market purchases) to acquire shares by exercising options with the expectation that the market price would rise above the option exercise price once the favourable information is disseminated. Therefore, limits on the manner in which the "mutual knowledge" exemption from insider trading must be carefully considered.

III. DETECTION – DATA MINING (SECTION 4.1.2)

While the CBA Section supports Recommendation 16 calling for increased electronic data base development and integration, there is some concern that such matters should be undertaken thoughtfully and not on an ad hoc basis. The current strain on market participants in dealing with regulatory issues, including federal initiatives relating to money laundering and anti-terrorism, and market regulatory initiatives relating to T+1, put tremendous strain on resources (human and financial) and may inhibit a thoughtful process if the demands become intolerable. Regulatory priorities need to be established. This also applies to Recommendation 18 in 4.2.2 – Detection of Insider Trading by Nominee and Offshore Accounts.

IV. DETECTION – COMPLAINTS/TIPS (SECTION 4.1.4)

The rationale and the resulting Recommendation 17 are not necessarily linked. The CBA Section agrees that public education is appropriate and within the purview of the authority of the securities regulatory authorities. We do not agree that "encouraging more complaints and tips" should underlie public education. If the objective of getting more complaints and tips were not met, we would continue to support the educational process.

V. DETERRENCE (SECTION 5.0)

Throughout the Report, there is a palpable undercurrent of frustration on the part of regulators with their perceived inability to root out and successfully sanction enough of the illegal insider trading activity that they believe occurs in Canada. Nowhere is this frustration more evident than in the section of the Report that deals with deterrence.

In approximately four pages, the Report proposes to reinvent, in a radically different form, the basis for liability for insider trading in Canada. While some of the concepts may be worthy of further discussion, in the CBA Section's view the recommendations in the Report are premature and unjustified.

VI. DETERRENCE – PROVINCIAL LAW - "INFORMATION CONNECTION" VS. "PERSON CONNECTION" (SECTION 5.1.3)

As the Report points out, the essential definition of illegal insider trading in all provinces is that no insider or person or company in a special relationship with a reporting issuer, with knowledge of a material fact or material change that has not been generally disclosed, may sell or purchase securities of the reporting issuer. Similarly, no such person may disclose a material fact or change to another person, other than in the necessary course of business. The Report breaks down this common approach into two basic elements:

- the "information connection" test, defined by possession of inside information; and

- a "person connection" test, requiring either some connection or relationship to the issuer or, alternatively, obtaining the material information from a person in a special relationship with the issuer.

The Report proposes to eliminate the "person connection" test, leaving only an "information connection" test. The Report phrases the new standard of liability as follows: "no person with knowledge of insider information may sell or purchase securities of an issuer". The Report frankly concedes that "this approach does not require that the person with knowledge of such information hold any position with the issuer or have knowledge of the source or owner of information".

In the CBA Section's view, this would be a tectonic shift in the landscape of insider trading. It would have the effect, presumably unintended, of rendering quasi-criminal a wide range of ordinary market behaviour. The existing formulation of the law premises liability on the basis that the person trading on the inside information knows, or ought to know, that it has been derived from an inside source. That knowledge, combined with evidently material information, provides the rationale for the imposition of sanctions. The offence contains a subjective element of knowledge (watered down to a degree by the "ought to have known" standard).

By comparison, the proposed formulation would largely remove any subjective element. If information is objectively material, undisclosed and true, then any trading on the basis of that information would be illegal. The Report refers to the circumstances of an "accidental insider", who has learned information in a special circumstance such as "overhearing a conversation ... finding confidential documents in a rubbish bin, receiving a fax sent to a wrong number, etc.". One would expect these "special circumstances" to be rare. On the other hand, trading on the basis of market rumours or "hot tips", received from sources apparently unconnected to the issuer in question, is likely not uncommon. On a pure "information connection" approach, a person trading on a market rumour or such a "hot tip" would be liable if it turns out, simply, that the information contained in the rumour or tip were true.

In response to the concern regarding "accidental" insiders (but without reference to the broader issue of market rumours), the Report cites with approval the March 2003 Report of the Emerging Markets Committee of IOSCO, entitled *Insider Trading - How Jurisdictions Regulate It*. That study is primarily a survey of the regulatory regime in a number of jurisdictions (but, interestingly, not Canada). While a reading of the Report may suggest that IOSCO proposed an "information connection" test alone, that is not the case. The IOSCO study discussed the definition of an "insider", noted the differing approaches in various jurisdictions, and discussed the strengths, weaknesses and rationales for those regimes. The conclusions of the IOSCO study are not prescriptive, but rather form a checklist of issues which IOSCO believes should be addressed in the formulation of insider trading regimes. For example, it concludes that in formulating a definition of an "insider", "the following issues should be addressed", and lists five questions, each beginning with "whether ...".

In that context, the IOSCO study makes the comment, repeated in the Report, that "obviously, broad definitions of insider trading can be criticized if innocent people, without knowledge of the confidentiality and materiality of information, are subject to criminal penalties. However, the behaviour of such investors generally indicates whether they had knowledge that they were trading on inside information". That excerpt cross-references a fuller discussion, in the context of regimes that require a specific intent. The study notes that "although proving a defendant's intent presents difficulties in some cases, the difficulties are not insurmountable." It then sets forth examples of clearly suspicious behaviour from which a trier of fact could easily infer a knowing misuse of inside information. The IOSCO study, read in its entirety, does not conclude that an "information connection" test is the preferred alternative.

Our fundamental objection to the Report's proposal in this regard is, simply, that it could subject to prosecution persons engaging in conduct, which Canadian society does not, in our view, generally agree should be criminal. The Report arguably recognizes

that fact, in passing. In its later discussion of sanctions, it notes that "longer terms of imprisonment will be difficult to justify, especially if the offence is reformulated on the 'information connection' only approach". We believe that statement is a tacit recognition of the risk of wrongful convictions if only an "information connection" test is adopted.

Going back to our example of a person trading on a market rumour: by definition, a person who hears a market rumour and proceeds to trade on the basis of the rumour, is doing so in the belief that the rumour is true but not yet publicly disclosed, and that accordingly there is a profit to be made (or loss avoided). Several studies have shown that stock prices tend to move up in advance of major corporate announcements. It is difficult not to conclude that at least in some cases there has been a "leak" of material non-public information. In the age of internet chat rooms and online accounts, leaked information can move quickly, and far from its original source. Adopting an "information connection" test alone could render every person liable, regardless how distant from the issuer or insider, who trades on the basis of a leak (in its form as a rumour) for which they, personally, had neither responsibility nor knowledge of its source. This seems to be an unwarranted extension of liability. In our submission, the existing formulation, common to all provinces, with both an "information connection" and a "person connection", is preferred. It contains the elements of intent, and a nexus with the source of the inside information, which together justify the imposition of criminal liability.

VII. DETERRENCE - FEDERAL LAW - CRIMINAL DETERRENT (SECTION 5.1.4)

The Report discusses Bill C 46, which was passed by the House of Commons but died on the order paper in November 2003. Bill C 46 would establish new federal criminal offences of illegal insider trading and tipping, in the *Criminal Code*. The CBA had not

yet commented on Bill C 46 (which contains provisions beyond those relevant to insider trading). If similar legislation is introduced in the new session of Parliament, the CBA may comment more fully on it. Our reference here is solely in the context of its discussion in the Report.

As with the proposals concerning provincial law, the Report proposes a fundamental shift in the federal approach to insider trading. The federal approach, as reflected in Bill C 46, is to create an indictable offence of insider trading largely premised on the existing provincial model of the "knowing use" of inside information by a person in a special relationship with an issuer. The proposed offence would criminalize specific conduct, using both an "information connection" and a "person connection" test.

The Report notes two different approaches to enforcement action against persons who trade with knowledge of inside information: "specific conduct"; and "market abuse and fraud". It notes that "the specific conduct approach is firmly entrenched in Canadian provincial legislation". It notes that the criminal model in the United States, by comparison, is based on a broader approach, rooted in concepts of "market abuse and fraud". The report concludes, with very little discussion, that the federal government should reconsider the approach in Bill C 46 and adapt "the United States model" to the Canadian context. While this is easy to say, we believe it would be very difficult to accomplish and the merit of such a radically different approach in Canada has not been demonstrated.

The U.S. experience with insider trading enforcement is not, with respect, one that Canada should seek to emulate. It is a largely judge-made body of law, based on general prohibitions against the "employment of manipulative and deceptive devices" (Rule 10b-5), and notions of fiduciary duty markedly different from those in Canada. For much of the modern age, the boundaries of insider trading in the U.S. have been unclear. Without the direction of specific criminal provisions, debate in the U.S. courts

has swirled around notions of "duty" and discussions of underlying theories of liability (the so-called "classical theory" and the "misappropriation theory"). It is noteworthy that, as recently as 1997, the U.S. Supreme Court concluded that a partner in a law firm retained on a potential tender offer would be liable for trading the target's securities with knowledge of that retainer (*SEC v. O'Hagan*). To a Canadian observer, it is surely surprising that such a conclusion was unclear until the Supreme Court weighed in.

The Report seems at pains to "provide a sufficient distinction between the provincial and proposed federal offence". It notes that adopting a U.S. approach "would distinguish the federal offence from quasi-criminal provincial offences". The need and rationale for such a distinction is not clear. One suspects that the unspoken rationale is in the reference to successful proceedings and the statement that "U.S. authorities also have obtained more convictions during the comparable period".

In summary, the CBA Section believes that the fundamental shift proposed by the Report, to "the model in the United States" is at odds with the universally accepted approach across Canada, and its benefits have not been justified.

VIII. DETERRENCE - SANCTIONS, REMEDIES AND ENFORCEMENT PRACTICES (SECTION 5.1.5)

The CBA Section agrees that provincial securities legislation should be amended to provide uniformity among provinces, including for administrative penalties, enforcement orders and compliance orders.

IX. DETERRENCE - ENFORCEMENT PRACTICES (SECTION 5.2)

The CBA Section also agrees with the Report's recommendation that the Integrated Market Enforcement Teams might be adapted as a forum to consolidate expertise with respect to, and enforcement activity in relation to, insider trading laws.