

# A PROPOSAL FOR THE ENHANCEMENT OF CANADIAN (ONTARIO) INSIDER TRADING REGULATION

by:

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## ABSTRACT

This paper intends to identify and make recommendations on the direction of how Ontario should reform its insider trading regulations. To support the arguments and recommendations, the insider trading laws and regulations in Ontario, the United States and the United Kingdom will be compared and examined from a statutory and enforcement perspective.

## INTRODUCTION

In the modern securities market, insider trading is often viewed in a negative light as a violation of securities law and an immoral activity. Nevertheless, the media and investing public often fail to realize that there are two types of insider trading. The first form, in which corporate insiders trade on disclosed information and report them to the regulators, is legal. The second form, the trading by corporate insiders on material, non-public information, is illegal and restricted under current securities regulation. This paper focuses only on the second form.

The province of Ontario<sup>2</sup> is currently rife with insider trading. In a report, the Bank of Canada referred to “large-scale evidence of insider trading and reporting violations, based on a study of stock buyback programs and insider trading around significant news announcements.”<sup>3</sup> Meanwhile, a study has identified that “profits made by corporate insiders in Canada prior to the announcement of acquisitions are the highest among 52 countries studied,”<sup>4</sup> many of which include developing countries with only nascent securities regulation. Not only does such rampant insider trading deter investors from venturing into the market, it also increases risks faced by existing investors, driving up the cost of equity and lowering the valuation of equity issues. Clearly, something must be done to remedy this crisis.

In addition to the competence of Ontario’s securities regulator, another important factor for successfully curbing insider trading lies in the parameters in which regulators operate in policing different schemes used by traders aware of material non-public information. In a report titled “Illegal Insider Trading in Canada: Recommendations on Prevention, Detection and Deterrence”, the Insider Trading Task Force commissioned by the Canadian Securities Administrators noted that Ontario’s (and Canada’s) securities regulators face a heavy burden of proof when taking actions against insider trading.<sup>5</sup> Thus, they recommend updating Ontario’s insider trading regulation based on the approaches in the United States or the United Kingdom.

The objective of this paper is to identify the direction of how Ontario should reform its insider trading regulation – both from a statutory and enforcement perspective. Parts I, II and III of this paper will discuss, respectively, the insider trading laws and regulations in Ontario, the United States and the United Kingdom. Part IV will critically examine the United States and British models of regulation and recommend whether Ontario should adopt one or both of them fully, partially, or not at all. Part V will compare and contrast the efficacy of insider trading enforcement between Ontario and the United States, and discuss why Ontario’s securities regulator – the Ontario Securities Commission (“OSC”) – must strengthen its current enforcement tactics against insider trading in order to best take advantage of any improvements in its insider trading regulation.

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<sup>2</sup> The focus solely on Ontario securities regulation in Canada owes to the fact that securities markets are provincially regulated and the province of Ontario contains Canada’s largest securities market. As a result, this paper will not discuss federal regulation of insider trading under the Criminal Code of Canada, or securities regulations from other provinces in Canada.

<sup>3</sup> DAVID LONGWORTH & DONNA HOWARD, SUBMISSION OF THE BANK OF CANADA TO THE TASK FORCE 5 (2006) (submission by the Bank of Canada to the Task Force to Modernize Securities Regulation in Canada).

<sup>4</sup> THE WISE PERSONS’ COMMITTEE TO REVIEW THE STRUCTURE OF SECURITIES REGULATION IN CANADA, IT’S TIME 27 (2006). *Accord* Arturo Bris, DO INSIDER TRADING LAWS WORK?, 11 EUROPEAN FINANCIAL MANAGEMENT 267, 287 (2005) (showing that Canadian markets, with an average daily abnormal turnover of 35.18%, gives rise to the largest insider trading profits amongst 52 countries).

<sup>5</sup> INSIDER TRADING TASK FORCE, ILLEGAL INSIDER TRADING IN CANADA: RECOMMENDATIONS ON PREVENTION, DETECTION AND DETERRENCE 37-38 (2003) (the Task Force was established by the provincial securities regulators of Ontario, British Columbia, Alberta and Quebec).

## PART I - OVERVIEW OF INSIDER TRADING REGULATION IN ONTARIO

### A. Introduction

In Ontario, insider trading on material non-public information is defined and restricted explicitly by Sections 76(1), 76(3) and 76(5) of the Ontario Securities Act (“OSA”). Tipping, a related offence, is restricted by Section 76(2). Defences to insider trading and tipping are also defined in Sections 76(4) and Sections 175(1) to 175(5).

Before 1965, Ontario regulation of insider trading was originally based upon common law. However, the restrictions and inconsistencies in common law doctrine<sup>6</sup> provided challenges to effectively deter insider trading. To transcend the bounds of common law, the province adopted recommendations from the *Report of the Attorney General’s Committee on Securities Regulation in Ontario* (“Kimber Report”) to regulate insider trading under the OSA<sup>7</sup>. The rationale behind enacting such regulation, as noted by the Kimber Report, is to protect investors through a free, open and efficient securities market with “prices thereon based upon the fullest knowledge of all relevant facts among traders. Any favour which tends to destroy or put in question this concept lessens the confidence of the investing public in the market place, and is, therefore, a matter of public concern.”<sup>8</sup>

### B. Circumstances Leading to Insider Trading Liability

Section 76(1) No person or company in a special relationship with a reporting issuer shall purchase or sell securities of the reporting issuer with the knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed.<sup>9</sup>

This clause prompts a number of factors which would lead to insider trading liability – namely, 1) undisclosed material facts or changes, 2) lack of general disclosure, 3) lack of dissemination and 4) knowledge – if the person or company is a “special relationship person” or a “tippee”.

#### 1) Undisclosed Material Facts or Changes (i.e. Materiality)

A “material fact” or “material change” is defined in National Instrument 51-102 as a fact/change in the issuer’s “business, operations, or capital that would reasonably be expected to have a significant effect on the market price or value of the securities.”<sup>10</sup>

The OSC delved further into the meaning of “materiality” in *Donnini*, 25 O.S.C.B. 6225 (2002) and defined it as “it can be expected that a reasonable investor would consider the disclosure [of the material fact or change] a factor in making an investment decision.”<sup>11</sup> Furthermore, the OSC also established a probability / magnitude test for forward-looking material facts or changes which “affect the probable future of the company.”<sup>12</sup> Under the test, the materiality of such a fact or change “depends on the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company’s securities.”<sup>11</sup>

#### 2) Lack of General Disclosure and 3) Lack of Dissemination

National Policy 51-201 (“NP 51-201”), Section 3.5(2) stipulates that information has been generally disclosed and effectively disseminated if the information has been disseminated in a manner calculated to effectively reach the marketplace and that public investors have been given a reasonable amount of time to analyze the information.<sup>13</sup> Should the insider trade before meeting these two conditions, he runs the risk of potentially triggering insider trading liability. The OSC has, in

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<sup>6</sup> DAVID JOHNSTON & KATHLEEN DOYLE ROCKWELL, CANADIAN SECURITIES REGULATION 257 (4<sup>th</sup> ed. 2006), *see also* Percival v. Wright, [1902] 2 Ch. 421 (Eng.) (an early English case ruling that a director owed no duty to a shareholder and thus is under no obligation to disclose material information before to trading).

<sup>7</sup> *See* JOHNSTON & ROCKWELL, at 248.

<sup>8</sup> REPORT OF THE ATTORNEY GENERAL’S COMMITTEE ON SECURITIES LEGISLATION IN ONTARIO ¶2.02 (1965).

<sup>9</sup> Ontario Securities Act, R.S.O. 1990, c. S.5, § 76 (1).

<sup>10</sup> National Instrument 51-102 *Continuous Disclosure Requirements*, 27 O.S.C.B. 3443, § 1.1.

<sup>11</sup> *Donnini*, 25 O.S.C.B. 6225 (2002) ¶ 130.

<sup>12</sup> *Id.* ¶ 131.

<sup>13</sup> National Policy 51-201 *Disclosure Standards*, 25 O.S.C.B. 4497, § 3.5.

Connor, II O.S.C.B. 149 (1976) suggested that insiders should wait one full trading day after the release of the material information before trading.<sup>14</sup>

#### 4) Knowledge

Originally, insider trading liability would only apply if the trader has knowledge of the undisclosed non-public information, and knowingly uses it when trading. However, it has since been argued that a proof of “use” would create an insurmountable burden upon the OSC – prompting its elimination from the OSA<sup>15</sup>. Current provincial securities legislation only requires knowledge of material non-public information to impose insider trading liability. This effectively places insider trading within the realm of strict liability offences, and gives rise to the limited defence of a material mistake of fact.<sup>16</sup>

#### “Special Relationship Person” or “Tippee”

According to OSA Section 1(1), a director or officer of a reporting issuer or its subsidiaries, or anyone (including the issuer itself) with a beneficial ownership of more than 10% of the reporting issuer’s voting securities, qualifies as an insider<sup>17</sup>. Section 76(5)(a) to (d) extends this by defining a person in a “special relationship” with an issuer as an insider, affiliate or associate of: the issuer, any party proposing to make a take-over bid, reorganization, amalgamation or merger with the issuer, any party engaging or proposing to engage in any business or professional activity on behalf of the issuer, and any person who learned of the material fact or change whilst being in a prior “special relationship” with an issuer<sup>18</sup>. Meanwhile, “tippee” status is defined as the following:

Section 76(5)(e) a person or company that learns of a material fact or material change with respect to the issuer from any other person or company described in this subsection, including a person or company described in this clause, and knows or ought reasonably to have known that the other person or company is a person or company in such a relationship.<sup>19</sup>

The last clause in this definition “knows or ought reasonably...relationship” points to a “person connection” regulatory paradigm. One must not trade if one receives material information that is not generally available to the market from a person or company that one knows or ought reasonably to have known to be in a special relationship with a reporting issuer. In addition, a person who receives material, non-public information from a tippee as defined under Section 76(5)(e) is also a tippee and must not trade.<sup>20</sup> Taken at face value, such a definition would encompass anyone (even a bystander) who becomes privy to inside information given he/she is aware or ought to be aware that the source of the information is in a special relationship with the issuer. However, proving such a connection requires the OSC to trace through the flow of information from the tipper to the tippee – an arduous process that requires significant resources and manpower.

Naturally accompanying Section 76(5)(e) is the definition of the tipping offence:

Section 76(2) No reporting issuer and no person or company in a special relationship with a reporting issuer shall inform, other than in the necessary course of business, another person or company of a material fact or material change with respect to the reporting issuer before the material fact or material change has been generally disclosed.<sup>21</sup>

A tippee can also be a tipper should he or she be in a special relationship with a reporting issuer and informs another person or company of a material, non-public, fact or change.<sup>22</sup> In addition, the tipping offence would continue to apply even if the tippee does not know that the tipper is in a special relationship with the reporting issuer<sup>23</sup>. It also does not matter what the intentions of the tippee are. The tippee may trade, or may do nothing. The offence is committed as long as a special relationship person shares a material, undisclosed fact or change, other than in the necessary course of business, with another

<sup>14</sup> Connor, II O.S.C.B. 149 (1976).

<sup>15</sup> JOHNSTON & ROCKWELL, *supra* note 6, at 272.

<sup>16</sup> See R. v. Fingold (1999), 89 O.T.C. 249.

<sup>17</sup> Ontario Securities Act, R.S.O. 1990, c. S.5, § 1 (1).

<sup>18</sup> Ontario Securities Act, R.S.O. 1990, c. S.5, § 76 (5)(a) – (d).

<sup>19</sup> Ontario Securities Act, R.S.O. 1990, c. S.5, § 76 (5)(e).

<sup>20</sup> JOHNSTON & ROCKWELL, *supra* note 6, at 269.

<sup>21</sup> Ontario Securities Act, R.S.O. 1990, c. S.5, § 76 (2).

<sup>22</sup> See MARY G. CONDON ET AL., SECURITIES LAW IN CANADA – CASES AND COMMENTARY 433-477 (4<sup>th</sup> ed. 2006).

<sup>23</sup> See *id.*

person of company. As described below, this restriction against tipping closely mimics American and British regulations against selective disclosure.

### C. DEFENCES TO INSIDER TRADING LIABILITY

The common law, Sections 76(4) and 175(1) of the OSA, as well as NP 51-201 provide a range of defences to insider trading liability. Such defences are outlined below:

#### 1) *Reasonable Belief in General Disclosure*

Section 76(4) No person or company shall be found to have contravened subsection (1), (2) or (3) if the person or company proves that the person or company reasonably believed that the material fact or material change had been generally disclosed.<sup>24</sup>

As noted in the clause above, the onus is on the accused person or company that he or she had such a reasonable belief.<sup>25</sup> However, the Ontario Court of Appeal, in *Green v. Charterhouse Grp. Canada Ltd.*, 12 O.R. 2d 280 (1976), held that a limited disclosure of relevant information would only result in an inadequate disclosure.<sup>26</sup>

#### 2) *No Knowledge*

Section 175(1) A person or company that purchases or sells securities of a reporting issuer with knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed is exempt from subsection 76 (1) of the Act and from liability under section 134 of the Act, where the person or company proves that,

(a) no director, officer, partner, employee or agent of the person or company who made or participated in making the decision to purchase or sell the securities of the reporting issuer had actual knowledge of the material fact or material change; and

(b) no advice was given with respect to the purchase or sale of the securities to the director, officer, partner, employee or agent of the person or company who made or participated in making the decision to purchase or sell the securities by a director, partner, officer, employee or agent of the person or company who had actual knowledge of the material fact or the material change,<sup>27</sup>

This defence applies primarily to corporate defendants and is unavailable to individuals with actual knowledge.<sup>28</sup> In addition, it is also important for corporate defendants to implement reasonable policies and procedures (i.e. Chinese Walls or information barriers) to prevent insider trading contraventions by their staff:

Section 175(3) In determining whether a person or company has sustained the burden of proof under subsection (1), it shall be relevant whether and to what extent the person or company has implemented and maintained reasonable policies and procedures to prevent contraventions of subsection 76 (1) of the Act by persons making or influencing investment decisions on its behalf and to prevent transmission of information concerning a material fact or material change contrary to subsection 76 (2) or (3) of the Act.<sup>29</sup>

#### 3) *Acting Without Using the Information*

A defence is available under Section 175(2) if the insider proves that their purchase or sale was entered into as an agent to a specific unsolicited order, as an automatic dividend reinvestment plan, share purchase plan or other similar automatic plan entered into before the insider had knowledge, or as a fulfillment of a legally binding obligation entered into before the insider had knowledge.<sup>30</sup> Although there is no case law on this area, a forward (or other types of obligatory) derivative contract entered into before the insider has knowledge of material non-public information would likely fall under the “similar automatic plan” bucket above.

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<sup>24</sup> Ontario Securities Act, R.S.O. 1990, c. S.5, § 76 (4).

<sup>25</sup> JOHNSTON & ROCKWELL, *supra* note 6, at 274.

<sup>26</sup> *Green v. Charterhouse Grp. Canada Ltd.* (1976), 12 O.R. 2d 280 (Can.).

<sup>27</sup> OSA General Regulations, O. Reg. 1015, § 175(1).

<sup>28</sup> JOHNSTON & ROCKWELL, *supra* note 6, at 276.

<sup>29</sup> OSA General Regulations, O. Reg. 1015, § 175(3).

<sup>30</sup> OSA General Regulations, O. Reg. 1015, § 175(2).

#### 4) Reasonable Mistake of Fact

This defence is available under case law since insider trading is a “strict liability” offence. In *Fingold*, the Ontario Court of Justice (General Division) equated this defence with “due diligence” and established that the court should “assess the credibility of the defendant and determine whether he has discharged on the onus on him to establish a reasonable mistake of fact on a balance of probabilities.”<sup>31</sup> Nevertheless, the court did warn that “once the prosecution has established objectively that it was a material fact the likelihood of the defendant raising a defence of reasonable mistake of fact successfully is quite remote.”<sup>32</sup>

#### 5) Tipper Disclosed Information in the “Necessary Course of Business”

NP 51-201, Section 3.3, explains the rationale behind this defence as to not “unduly interfere with a company’s ordinary business activities.”<sup>33</sup> Communications with, for example, vendors, employees, lenders, counsel, auditors, underwriters, unions, parties to negotiations, government agencies and regulators, and credit rating agencies are grouped under this defence.<sup>34</sup> Exceptions are also granted if the communication is used to effectuate a take-over bid or private placement. However, in *Royal Trustco Ltd. v. Ontario (Securities Commission)* 42 O.R. 2d 147 (1983), the Ontario High Court of Justice held that the disclosure of material non-public information in defence of a take-over bid does not qualify as under a “necessary course of business.”<sup>35</sup>

#### 6) Tippee Unaware that Tipper was a Special Relationship Person

This defence stems naturally from a contradiction to the “knows or ought reasonably to have known that the other person or company is a person or company in such a relationship” requirement in Section 76(5)(e) of the OSA.

## PART II – OVERVIEW OF INSIDER TRADING REGULATION IN THE UNITED STATES

### A. Introduction

Unlike its Canadian counterpart, insider trading regulation in the United States was not explicitly defined or restricted by any statute or rule until the implementation of SEC Rule 10b5-1 in 2000. Nevertheless, Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) and SEC Rule 10b-5, as noted below, are typically invoked by the Department of Justice, the SEC and private plaintiffs in charges of insider trading.

#### Section 10 -- Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange -

- b. To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.<sup>36</sup>

#### Rule 10b-5 -- Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- a. To employ any device, scheme, or artifice to defraud,
- b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

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<sup>31</sup> R. v. Fingold (1999), 89 O.T.C. 249. (Can.).

<sup>32</sup> *Id.*

<sup>33</sup> National Policy 51-201 *Disclosure Standards*, 25 O.S.C.B. 4497, § 3.3.

<sup>34</sup> JOHNSTON & ROCKWELL, *supra* note 6, at 277.

<sup>35</sup> *Royal Trustco Ltd. v. Ontario (Securities Commission)* (1983), 42 O.R. 2d 147 (Can.).

<sup>36</sup> 15 U.S.C. § 78j (2010).

in connection with the purchase or sale of any security.<sup>37</sup>

## B. Circumstances Leading to Insider Trading Liability in the United States

In *Chiarella v. United States*, 445 U.S. 222 (1980), the United States Supreme Court (“Supreme Court”) established a model of insider trading liability based on the notion of a fiduciary relationship between the insider and the shareholders of the corporation.

In short, the Supreme Court held that “one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so,”<sup>38</sup> and that such a duty to disclose is created when “the other [party] is entitled to know [the information] because of a fiduciary or other similar relation of trust and confidence between them.”<sup>39</sup> Furthermore, the Supreme Court justified this new model by arguing that, by preventing the breach of fiduciary duty, it “guarantees that corporate insiders, who have an obligation to place the shareholders’ welfare before their own, will not benefit personally through fraudulent use of material, non-public information.”<sup>40</sup>

### *Tipping Offence and Tippee Status:*

Building on the new fiduciary duty model in *Chiarella*, the Supreme Court, in *Dirks v. SEC*, 463 U.S. 646 (1983), defined a new tippee liability theory, under the framework that:

“a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material non-public information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been breach.”<sup>41</sup>

The court in *Dirks* then argued that the tippee’s duty to disclose or abstain is “derivative from that of the insider’s duty”<sup>42</sup>. Furthermore, the court noted that the tippee assumes an insider duty to the shareholders not because he receives insider information, but rather because it has been made available to him improperly.<sup>43</sup>

However, this raises an important requirement to establishing the tipper’s liability: the tipper (or insider) must have first breached his liability to the shareholders by “benefit[ing], directly or indirectly, from his disclosure.”<sup>44</sup> Such benefit may be inferred through, for example, a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, an intention to benefit the particular recipient, or when an insider makes a gift of confidential info to a trading relative or friend.<sup>45</sup> In contrast, “absent some personal gain [to the tipper], there has been no breach of duty to stockholders . . . [and] there is no derivative breach [by the tippee].”<sup>46</sup>

In short, by trading on material, non-public information knowingly acquired from a tipping insider, a tippee breaches his derivative fiduciary duty to the shareholders of a corporation and may find himself liable for insider trading under Section 10 (b). Ignoring its fiduciary duty underpinnings, the aforementioned reasoning closely resembles the OSA Section 76(5) definition of a “tippee” – one who trades on material non-public information knowing that the tipper is in a “special relationship” with the reporting issuer.

The framework above also defines the tipping offence as when an insider “breaches his fiduciary duty to the shareholders by disclosing the information to the tippee”<sup>47</sup>, subject to a personal benefit test of “whether the insider personally will benefit, directly or indirectly, from his disclosure”.<sup>48</sup> Such a formulation of the tipping offence differs from its Ontario counterpart, as Section 76(2) of the OSA does not employ any personal benefit test.

### *Constructive Insiders*

Footnote 14 of *Dirks* fills a regulatory gap in *Chiarella* by including a number of associates of the issuer under the insider banner. In the footnote, the court argues that outsiders may become fiduciaries of the shareholders if they have entered into a

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<sup>37</sup> 17 C.F.R. § 240.10b-5 (1976).

<sup>38</sup> *Chiarella v. United States*, 445 U.S. 222, 227 (1980).

<sup>39</sup> *Id.* at 227.

<sup>40</sup> *Id.* at 230

<sup>41</sup> *Dirks v. SEC*, 463 U.S. 646, 660 (1983).

<sup>42</sup> *Id.* at 659.

<sup>43</sup> *Id.* at 660.

<sup>44</sup> *Id.* at 662.

<sup>45</sup> *Id.* at 664.

<sup>46</sup> *Dirks*, 463 U.S. at 666.

<sup>47</sup> *Id.* at 660.

<sup>48</sup> *Id.* at 662.

special confidential relationship with the issuer and are given access to information solely for corporate purposes.<sup>49</sup> Such persons, referred to as “temporary, constructive, or quasi-insiders”, are subject to the “disclose or abstain” rule applicable to the original corporate insiders as defined in *Chiarella* and to tippees as defined above.<sup>50</sup>

In summary, the *Chiarella* model and the *Dirks* Footnote 14 model place all corporate insiders (i.e. directors, senior management and substantial shareholders) and other temporary insiders who owe a fiduciary duty to the shareholders (i.e. legal counsel, auditors, credit agencies) within the grasp of insider trading liability. Thus, they cover a subset of the persons covered under the special relationship definition in the OSA. Similarly, *Dirks* defines a tipping offence that targets a more restrictive subset of recipients than the OSA, and establishes tippee liability if the tipper receives a benefit from his tipping.

### *SEC’s Attempts at Reversing Chiarella and Dirks*

Since *Chiarella* and *Dirks*, the SEC has promulgated Rule 14e-3 and Regulation FD to, in effect, reverse the two Supreme Court decisions in selected circumstances.

Six months after the Supreme Court’s decision on *Chiarella*<sup>51</sup>, the SEC enacted Rule 14e-3 to make it unlawful for a person other than a bidder or a prospective bidder (“bidder”), once that bidder has “taken substantial steps to commence a tender offer”, to purchase or sell the security being sought after (“target”) if the person possesses material non-public information obtained from the bidder, the issuer of the target, or any other person acting on behalf of such a bidder or target<sup>52</sup>. It also makes it unlawful for any person<sup>53</sup> in possession of material, non-public information relating to a tender offer that has been knowingly obtained from any of the above persons, to communicate the information to any other individual.<sup>54</sup> A defence is available for non-natural persons (in particular, multi-service financial institutions) who have enacted information barriers restricting the buying and selling of the target’s security, and/or preventing the access of information related to the tender offer<sup>55</sup>.

In the tender offer context, Rule 14e-3 effectively removes the *Chiarella* requirement that a breach of fiduciary duty must be present in an insider trading or tipping offense.<sup>56</sup> It has also stood up against the Supreme Court’s scrutiny. In *United States v. O’Hagan* (1997) (to be discussed in far greater detail below), a 7-2 majority acknowledged the difficulty the SEC faces in proving a breach of fiduciary duty in the tender offer context and that the rule is “a proper exercise of the SEC’s prophylactic power under S 14(e).”<sup>57</sup>

Meanwhile, in 2000, the SEC enacted Regulation FD (Fair Disclosure)<sup>58</sup> to outflank *Dirks* and its personal benefit test and establish liability for selective disclosure by insiders.

Thus, Regulation FD forbids corporate insiders from disclosing material non-public information to a select group of recipients (“enumerated persons”) without simultaneous (if the initial disclosure is intentional) or prompt (if the initial disclosure is non-intentional) public disclosure<sup>59</sup>. This rule is primarily targeted against securities analysts (who comprise of

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<sup>49</sup> “corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant working for the corporation... The basis for recognizing the fiduciary duty is not simply that such persons acquired non-public corporate information, but rather that they have entered into a special confidential relationship to the conduct of the business of the enterprise and are given access to information solely for corporate purposes.”

*Id.* at 655 n.14.

<sup>50</sup> “When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee.” *Id.* at 655 n.14.

<sup>51</sup> HAROLD S. BLOOMENTHAL, *SECURITIES LAW HANDBOOK* 809 (2<sup>th</sup> ed. 2007).

<sup>52</sup> Rule 14e-3(a), 17 C.F.R. § 240.14e-3(a) (1980).

<sup>53</sup> Includes an officer, director, employee or advisor of the bidder or target, or any other persons in possession of such information.

<sup>54</sup> BLOOMENTHAL, *supra* note 50, at 810.

<sup>55</sup> Rule 14e-3(b), 17 C.F.R. § 240.14e-3(b) (1980).

<sup>56</sup> JAMES D. COX ET AL., *SECURITIES REGULATION – CASES AND MATERIALS* 914 (5<sup>th</sup> ed. 2006).

<sup>57</sup> *United States v. O’Hagan*, 521 U.S. 642, 676 (1997).

<sup>58</sup> 17 C.F.R. § 243.100 (2000).

<sup>59</sup> The basic rule prohibiting selective disclosure, Rule 100, is summarized by the SEC as follows:

“Under this rule, whenever:

- (i) an issuer, or person acting on its behalf,
- (ii) discloses material non-public information,
- (iii) to certain enumerated persons [(1) broker-dealers, (2) investment advisers or institutional investment managers, (3) investment companies and certain companies excluded from the definition of an investment company, (4) associated persons of those with (1) or (2) above and affiliated persons of those in (3) above, and (5) holders of the issuer’s securities whom it is reasonably foreseeable that such person will trade on the basis of the information],

a majority of enumerated persons) who may previously have been able to obtain material, non-public information one step ahead of the general public in conference calls or private meetings with management.

While extremely popular with small retail investors, Regulation FD has caused concern amongst securities analysts that it would discourage management from providing guidance regarding earnings forecasts.<sup>60</sup> In particular, the Regulation's failure and inability of case law<sup>61</sup> to clearly define "materiality" has given rise to concerns that management would be unwilling to disclose any information under fear that such information would be classified as "material" by the SEC. In return, the SEC stated under the Regulation's adapting release that "an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a 'mosaic' of information that, taken together, is material."<sup>62</sup> Meanwhile, there shall be no liability when "the issuer discloses immaterial information whose significance is discerned by the analyst."<sup>63</sup> Furthermore, the SEC clarified that a "failure to make a public disclosure required solely by Rule 100 will not be deemed a violation of Rule 10b-5"<sup>64</sup>, unless the selective disclosure is made under circumstances that meet the *Chiarella* breach of fiduciary duty and *Dirks* personal benefit tests. The regulation is also inapplicable to selective disclosure made in connection with an offering registered under the Securities Act.<sup>65</sup>

In summary, Regulation FD achieves the same effect as the tipping offence under Section 76(2) of the OSA, though the recipients must be enumerated persons. The Regulation does not impose any duties upon the enumerated persons themselves, and tippee liability remains in the realm of the decision set forth in the *Dirks* judgement.

### C. Ramifications of *US v. O'Hagan* - The Misappropriation Theory

*United States v. O'Hagan*, 521 U.S. 642 (1997) is viewed by most commentators as a cornerstone of insider trading regulation in the United States. James H. O'Hagan, a partner at the law firm Dorsey & Whitney, learned of confidential information regarding a possible tender offer by his firm's client, Grand Met PLC, for the target company Pillsbury Madison. He then purchased Pillsbury stocks and call options prior to the tender offer, and sold them after announcement of the offer, earning over \$4.3 million in the process. He was then charged with 57 counts of securities fraud under Section 10(b) and Rule 10b-5, fraudulent trading under Section 14(e) of the Act and Rule 14e-3(a), federal mail and wire fraud, and money laundering.<sup>66</sup> The trial court convicted O'Hagan on all counts, but the Court of Appeal of the Eighth Circuit reversed all convictions.<sup>67</sup> The prosecution appealed, and the Supreme Court granted certiorari.

Since O'Hagan, who never worked on the tender offer, was not in a fiduciary relationship with Pillsbury's shareholders, the prosecution faced a major difficulty establishing insider trading liability under the *Chiarella* fiduciary model. As a result, reasoning that "securities laws are not framed to pick up only those violations that are covered by common law fraud", but a range of "deceptive devices", the prosecution advocated the "misappropriation theory."<sup>68</sup> The government argued that by "[maintaining] a pretence of loyalty to the principal while secretly converting the principal's information for personal gain", O'Hagan, an "unfaithful agent", deceived and breached his fiduciary duty to his principal.<sup>69</sup> Since the misappropriator of information could only realize the value of the inside information in the securities market, his deceptive breach was thus "in connection with" his purchase and sale of securities.<sup>70</sup> The fulfillment of the "deception" and "in connection with" requirements led to a violation of Section 10(b).

The Supreme Court, in a 6-3 majority, agreed with the prosecution that a violation of Section 10(b) and Rule 10b-5 may be predicated on the misappropriation theory, reversed the Eighth Circuit's decision and remanded for further proceeding.<sup>71</sup>

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(iv) the issuer must make public disclosure of that same information:

- (a) simultaneously (for intentional disclosures), or
- (b) promptly (for non-intentional disclosures)."

Selective Disclosure and Insider Trading, Securities Exchange Act Release No. 7787, 65 Fed. Reg. 51,716 (August 24, 2000), at Pt.II.B, 2000 [hereinafter *Final Release*].

<sup>60</sup> BLOOMENTHAL, *supra* note 51, at 865.

<sup>61</sup> The best guidance in defining materiality under case law stems from *TSC Industries Inc. v. Northway Inc.*, 426 U.S. 438 (1976), where material information is defined as "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision," *id.* at 449.

<sup>62</sup> *Final Release*, *supra* note 59, at Pt.II.B.2.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at Pt.II.A.4.

<sup>65</sup> *Id.* at Pt.II.B.6.a.i

<sup>66</sup> BLOOMENTHAL, *supra* note 51, at 804.

<sup>67</sup> *United States v. O'Hagan*, 92 F.3d 612, 628 (8<sup>th</sup> Cir. 1996).

<sup>68</sup> Micah A. Acoba, *Insider Trading Jurisprudence After United States v. O'Hagan: A Restatement (Second) of Torts §551(2) Perspective*, 84 Cornell L.R. 1356, 1391 (1999).

<sup>69</sup> *Id.* at 1393.

<sup>70</sup> *Id.* at 1394.

<sup>71</sup> *United States v. O'Hagan*, 521 U.S. 642, 678 (1997).

The majority agreed that the misappropriation theory fulfilled the deception requirement under Section 10(b), in that “a fiduciary who ‘[pretends] loyalty to the principal while secretly converting the principal’s information for personal gain dupes’ or defrauds the principal.”<sup>72</sup> The majority also noted that “if the fiduciary discloses to the source that he plans to trade on the non-public information, there is no “deceptive device and thus no Section 10(b) violation”<sup>73</sup> – “full disclosure forecloses liability under the misappropriation theory.”<sup>74</sup>

The majority also believed that the condition of “in connection with the purchase or sale of a security” is satisfied “because the fiduciary’s fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide.”<sup>75</sup>

The majority then discussed the policy rationale behind the misappropriation theory. Noting that a misappropriator “gains his advantageous position through [deceiving] the source of the information and simultaneously harms members of the investing public,”<sup>76</sup> trading on misappropriated information “undermines the integrity of, and investor confidence in, the securities markets”<sup>77</sup>. While recognizing informational disparity as “inevitable in the securities markets”, the majority also warned that “investors likely would hesitate to venture their capital in a market where trading based on misappropriated non-public information is unchecked by law.”<sup>78</sup> Thus, the misappropriation theory serves to “insure honest securities markets and thereby promote investor confidence.”<sup>79</sup>

#### D. Introduction of SEC Rule 10b5-1

In a bold attempt to formulate the misappropriation theory and to establish insider trading liability while the insider is aware of material non-public information, the SEC introduced Rule 10b5-1 in October 2000. The rule first directly formulates the misappropriation theory in *O’Hagan*<sup>80</sup>, then establishes that a person may be liable for insider trading if he or she trades while “aware” (or of “knowing possession”) of material non-public information in breach of a direct, indirect or derivative fiduciary duty<sup>81</sup>. The SEC believes that this shall better “[protect] investors and the integrity of the securities markets” than a “use” standard, “as it reflects the common sense notion that a trader who is aware of inside information when making a trading decision inevitably makes use of the information.”<sup>82</sup>

The rule then lists the affirmative defences available to avoid liability under paragraph b): In short, a person must demonstrate that before becoming aware of the material non-public information, he had entered into a binding contract to purchase or sell the security, provided instructions to another person to execute the trade for his account, or adopted a written plan for trading securities (collectively referred to as a “plan”).<sup>83</sup> Such a plan must have either i) expressly

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<sup>72</sup> *Id.* at 653.

<sup>73</sup> *Id.* at 655.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.* at 656.

<sup>76</sup> *Id.*

<sup>77</sup> *O’Hagan*, 521 U.S. at 658.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> Paragraph (a):

The “manipulative and deceptive devices” prohibited by Section 10(b) of the Act and Rule 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material non-public information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material non-public information.

Rule 10b5-1(a), 17 C.F.R. § 240.10b5-1(a) (2000).

<sup>81</sup> Paragraph (b):

Subject to the affirmative defenses in paragraph (c) of this section, a purchase or sale of a security of an issuer is “on the basis of” material non-public information about that security or issuer if the person making the purchase or sale was aware of the material non-public information when the person made the purchase or sale.

Rule 10b5-1(b), 17 C.F.R. § 240.10b5-1(b) (2000).

<sup>82</sup> *Final Release*, *supra* note 59, at Pt.III.A.2.

<sup>83</sup> Paragraph (c)(1)(i)

specified the amount, price and date for the purchase or sale of securities, ii) provided a formula or algorithm for determining the amount, price and date, or iii) did not permit the person to exercise any subsequent control, provided that any other person with such control was not aware of material non-public information when doing so<sup>84</sup>. The person must also demonstrate that the purchase or sale of securities occurred according to the plan,<sup>85</sup> provided that the plan has not been altered or deviated, and that the person has not entered into a corresponding or hedging transaction. Finally, the plan must have been entered into in good faith and not in an attempt to skirt the requirements of Rule 10b5-1.<sup>86</sup>

Paragraph (c)(2) provides an affirmative defence to non-person entities (i.e. corporations) to liability under paragraph (b). In essence, it provides a defence if the individual who traded on behalf of the entity is not aware of material non-public information, or if the entity has enacted such schemes as “Chinese Walls” (preventing flow of material non-public information) or “Grey-Lists” (restrictions on trading on securities from certain firms) amongst its staff<sup>87</sup>.

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Subject to paragraph (c)(1)(ii) of this section, a person's purchase or sale is not "on the basis of" material non-public information if the person making the purchase or sale demonstrates that:

- A. Before becoming aware of the information, the person had:
1. Entered into a binding contract to purchase or sell the security,
  2. Instructed another person to purchase or sell the security for the instructing person's account, or
  3. Adopted a written plan for trading securities;

Rule 10b5-1(c)(1)(i)(A), 17 C.F.R. § 240.10b5-1(c)(1)(i)(A) (2000).

<sup>84</sup> Paragraph (c)(1)(i)(B)

The contract, instruction, or plan described in paragraph (c)(1)(i)(A) of this Section:

1. Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold;
2. Included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
3. Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material non-public information when doing so; and

Rule 10b5-1(c)(1)(i)(B), 17 C.F.R. § 240.10b5-1(c)(1)(i)(B) (2000).

<sup>85</sup> Paragraph (c)(1)(i)(C)

The purchase or sale that occurred was pursuant to the contract, instruction, or plan. A purchase or sale is not "pursuant to a contract, instruction, or plan" if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities.

Rule 10b5-1(c)(1)(i)(C), 17 C.F.R. § 240.10b5-1(c)(1)(i)(C) (2000).

<sup>86</sup> Paragraph (c)(1)(ii):

Paragraph (c)(1)(i) of this section is applicable only when the contract, instruction, or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this section.

Rule 10b5-1(c)(1)(ii), 17 C.F.R. § 240.10b5-1(c)(1)(ii) (2000).

<sup>87</sup> Paragraph (c)(2):

A person other than a natural person also may demonstrate that a purchase or sale of securities is not "on the basis of" material non-public information if the person demonstrates that:

- i. The individual making the investment decision on behalf of the person to purchase or sell the securities was not aware of the information; and
- ii. The person had implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material non-public information.

## E. Comparison between O’Hagan, Rule 10b5-1 and Ontario Insider Trading Regulation

### A. US Provisions in Agreement with Ontario Regulation

A number of Rule 10b5-1 provisions have direct similarities in the Canadian system. The “awareness” standard in paragraph (b) closely resembles the “knowledge of” requirement under Section 76(1) of the OSA. Both standards see a mere awareness or knowledge of material non-public information as adequate in imposing insider trading liability.

The affirmative defences under paragraph (c)(1) – that a purchase or sale was made pursuant to a binding contract, prior instructions or written plan that has been entered before the trader had knowledge of material non-public information – are congruent with the defences provided under Sections 175(2)(b) and (c) of the OSA, which permits purchase or sale pursuant to some “automatic plan” or “legally binding obligation”<sup>88</sup> “prior to the acquisition of knowledge of the material fact or material change”<sup>89</sup>. Paragraph (c)(1) goes into greater depth by requiring that the plan either specify the amount, price and date of the transaction, include a formula or algorithm for determining the price, or restrict any exercise of influence to persons who are not aware of material non-public information. While Sections 175(2)(b) and (c) may not have included such specific requirements for its automatic plans, it is highly unlikely that the OSC would consider any less rigorous plan, or any plan which permits modification by a special-relationship person, as “automatic”.

Meanwhile, the affirmative defences under paragraph (c)(2) are equivalent to those under Sections 175(1) and 175(3) of the OSA. Both are only available to non-natural persons (companies or other entities), and either require the trader to have no knowledge of material non-public information, or that the entity to have implemented “reasonable policies and procedures” to prevent insider trading violations (i.e. Chinese Walls, grey lists). An important distinction, however, is that the defences under Section 175(3) are partial and only serve as evidence that the entity has sustained the burden of proof under Section 175(1). Meanwhile, paragraph (c)(2)(ii) provides a complete defence when “reasonable policies and procedures” are implemented. Nevertheless, since both defences lead to the same objective – that individuals trading on behalf of the entity are unaware of material non-public information – there is no pressing need to replace the more rigorous Ontario standard with its 10b5-1 counterpart.

### B. US Provisions in Disagreement with Ontario Regulation

The *Chiarella* fiduciary and the O’Hagan misappropriation (together referred to as the “fiduciary duty”) theories cover a large subset of OSA “special relationship persons”. Traders who did not breach or have no fiduciary duty with the information source and tippees who were tipped by tipplers who did not receive a personal benefit remain outside of the “fiduciary duty” theory’s reach. Nevertheless, the two sets of regulations diverge significantly in their formulation of insider trading liability. The American “fiduciary duty” theory relies on finding a deceptive breach in the fiduciary link between persons on the information flow (issuer → insider/tipper (information source) → misappropriator/tippee). Meanwhile, Ontario’s “special relationship” formulation requires two findings – a flow of inside information from the issuer to the ultimate trader, and evidence that each tippee is aware that his/her tipper is a special relationship person.<sup>90</sup> Fiduciary relationships play no part in Ontario insider trading regulation. Given the higher burden faced by regulators when proving the existence of a fiduciary duty between individuals, it may be argued that Ontario regulators face fewer obstacles when compared to their American counterparts.

## PART III – OVERVIEW OF INSIDER TRADING REGULATION IN THE UNITED KINGDOM

Insider trading is regulated in the United Kingdom under both the Criminal Justice Act of 1993 (“CJA”)<sup>91</sup> and the Financial Services and Markets Act 2000 (“FSMA”).<sup>92</sup> Since this paper only discusses civil regulation in Ontario, discussion regarding British regulations is restricted to the civil regulations under the FSMA. The FSMA is also the primary weapon

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These policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the person has material non-public information, or those that prevent such individuals from becoming aware of such information.

Rule 10b5-1(c)(2), 17 C.F.R. § 240.10b5-1(c)(2) (2000).

<sup>88</sup> *Supra* note 29.

<sup>89</sup> *Supra* note 30.

<sup>90</sup> INSIDER TRADING TASK FORCE, *supra* Note 3, at 39.

<sup>91</sup> Criminal Justice Act, 1993, c. 36, §.61(1) (section delineating criminal law on insider trading).

<sup>92</sup> Financial Services and Markets Act, 2000, c. 8, § 1(1).

used by the British regulatory agency – the Financial Services Authority (“FSA”) – in prosecuting insider trading given the overly high standards required by the CJA.<sup>93</sup>

The current formulation of British insider trading regulation is primarily based on the requirements of the European Commission’s Market Abuse Directive (“MAD”), implemented on July 1, 2005.<sup>94</sup> In particular, Section 118 of the FSMA directly regulates three types of the misuse of information (behaviour based on information not generally available to market users)<sup>95</sup> – Section 118(2) insider dealing, Section 118(3) improper disclosure, Section 118(4) misuse of information (legacy, catch-all offence). Section 118(2) insider dealing and Section 118(3) improper disclosure are very similar to the corresponding OSA regulations on insider trading – both regulate insider trading by prohibiting a specific list of activities (or the “specific conduct” approach).

#### A. Market Abuse and Insider Dealing

Section 118(1) of the FSMA defines market abuse. It was introduced in 2005 in light of the implementation of MAD:

##### Section 118

(1) For the purposes of this Act, market abuse is behaviour (whether by one person alone or by two or more persons jointly or in concert) which--

(a) occurs in relation to--

(i) qualifying investments admitted to trading on a prescribed market,

(ii) qualifying investments in respect of which a request for admission to trading on such a market has been made, or

(iii) in the case of subsection (2) or (3) behaviour, investments which are related investments in relation to such qualifying investments, and

(b) falls within any one or more of the types of behaviour set out in subsections (2) to (8).<sup>96</sup>

Insider trading, or insider dealing, is defined under Section 118(2) of the FSMA:

##### Section 118(2)

The first type of behaviour is where an *insider* deals, or attempts to deal, in a qualifying investment or related investment *on the basis of inside information* relating to the investment in question. (emphasis added)<sup>97</sup>

The *italicized* terms are the most contentious terms of this section and are further defined in Section 118B of the FSMA. The term “insider” is defined as follows:

##### Section 118B

For the purposes of this Part an insider is any person who has inside information--

(a) as a result of his membership of an administrative, management or supervisory body of an issuer of qualifying investments,

(b) as a result of his holding in the capital of an issuer of qualifying investments,

(c) as a result of having access to the information through the exercise of his employment, profession or duties,

(d) as a result of his criminal activities, or

(e) which he has obtained by other means and which he knows, or could reasonably be expected to know, is inside information.<sup>98</sup>

The FSA, in its Market Abuse Rulebook (“MAR”), views that a person could be “‘reasonably expected to know’ that information in his possession is inside information if a normal and reasonable person in the position of that person would both (a) know that the person from he received it is an ‘insider’, and (b) know that it is inside information”.<sup>99</sup> This guidance reveals that the FSMA’s definition of insider covers not only tippees, but also the bystander who becomes privy to inside information, knows that his information is material and non-public, and knows that the information source

<sup>93</sup> ALASTAIR HUDSON, *SECURITIES LAW* 782 (1<sup>st</sup> ed. 2008).

<sup>94</sup> *Id.* at 780.

<sup>95</sup> MICHAEL BLAIR ET AL., *FINANCIAL SERVICES LAW* 393 (2<sup>nd</sup> ed. 2009).

<sup>96</sup> Financial Services and Markets Act, 2000, c. 8, § 118(1) (The terms “qualifying investments” and “related investments” are not defined within the Act. The term “Investment”, however, is defined in § 22 and Sch.2 to the Act).

<sup>97</sup> Financial Services and Markets Act, 2000, c. 8, § 118(2).

<sup>98</sup> Financial Services and Markets Act, 2000, c. 8, § 118B.

<sup>99</sup> MAR 1.2.8E

is an insider of the company. Similar to the OSA, a natural defence also exists if the tippee does not and could not reasonably be expected to know that the information source is an ‘insider’.

The definitions of insider and the clause “reasonably expected to know” form the core of the current British “person connection” regulatory paradigm on insider trading. Apart from including traditional corporate insiders (directors, senior management and substantial shareholders, etc) and constructive/temporary insiders (auditors, lawyers, underwriters, etc), it also includes any “outsider” who obtained inside information and knows, or could reasonably be expected to know, that it is inside information.

Meanwhile, MAR 1.2.9 indicates that the insider specified by Section 118B(a) to (d) “does not need to know that the information concerned is inside information.”<sup>100</sup>

“Inside information”, on the other hand, is defined by Section 118C(2) of the FSMA:

#### Section 118C

(2) In relation to qualifying investments, or related investments, which are not commodity derivatives, inside information is information of a precise nature which—

- (a) is not generally available,
- (b) relates, directly or indirectly, to one or more issuers of the qualifying investments or to one or more of the qualifying investments, and
- (c) would, if generally available, be likely to have a significant effect on the price of the qualifying investments or on the price of related investments.<sup>101</sup>

A number of critics have argued that the phrase “not generally available” may be construed to include information obtained from securities research. This, in turn, will “chill” the market’s incentive to research for information and analyze securities.<sup>102</sup> In light of this, the FSMA contains a safe harbour for information obtained from such research:

#### Section 118C

(8) Information which can be obtained by research or analysis conducted by, or on behalf of, users of a market is to be regarded, for the purposes of this Part, as being generally available to them.<sup>103</sup>

The phrase “on the basis of” is not defined explicitly under the FSMA. However, the MAR indicates that a person’s behaviour would be ‘on the basis of’ inside information where information is the reason for, or a material influence on, a decision to deal or attempt to deal.<sup>104</sup>

### *B. Improper Disclosure*

Introduced in 2005 in light of MAD, the second type of market abuse, improper disclosure, aims to achieve the objectives of Section 76(2) of the OSA and SEC Regulation FD – to prohibit issuer selective disclosure of material non-public information. Like OSA Section 76(2), it may also be used to prohibit tipping by corporate insiders or outsiders aware of such information. Improper disclosure is defined under Section 118(3) as “where an insider discloses inside information to another person otherwise than in the proper course of the exercise of his employment, profession or duties.”<sup>105</sup> A suggested acid test for the proper course of the exercise of his employment, profession or duties is whether or not the disclosure was part of the approved procedure on the market in question.<sup>106</sup>

Similar to Section 76(2) and Regulation FD, it does not matter whether the recipient of the information intends to disseminate the information, to profit from the information, or to do nothing at all. Meanwhile, echoing Regulation FD, the MAR also points out that “selective briefing of analysts by directors of issuers or others who are persons discharging managerial responsibilities”<sup>107</sup> is an example of improper disclosure.

### *C. Misuse of Information*

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<sup>100</sup> MAR 1.2.9

<sup>101</sup> Financial Services and Markets Act, 2000, c. 8, § 118B.

<sup>102</sup> HUDSON, *supra* note 93, at 803 – 804.

<sup>103</sup> Financial Services and Markets Act, 2000, c. 8, § 118C.

<sup>104</sup> MAR 1.3.4E.

<sup>105</sup> Financial Services and Markets Act, 2000, c. 8, § 118(3).

<sup>106</sup> HUDSON, *supra* note 93, at 790.

<sup>107</sup> MAR 1.4.2E.

The third type of market abuse, misuse of information, is a pre-MAD legacy offence that served the function of prohibiting insider dealing and improper disclosure before 2005.<sup>108</sup> Currently, it serves as a catch-all provision to regulate activities that may not be classified under insider dealing or improper disclosure. It is defined under Section 118(4) of the FSMA:

#### Section 118

(4) The third is where the behaviour (not falling within subsection (2) or (3))—

- (a) is based on information which is not generally available to those using the market but which, if available to a regular user of the market, would be, or would be likely to be, regarded by him as relevant when deciding the terms on which transactions in qualifying investments should be effected, and
- (b) is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market.<sup>109</sup>

The term “regular user” is defined, in relation to a particular market, as “a reasonable person who regularly deals on that market in investments of the kind in question.”<sup>110</sup> According to the MAR, a regular user would take the following factors into account in determining whether information is relevant:

- Extent to which the information is reliable
- Whether the information is new or fresh
- Whether any future developments will lead to a disclosure or announcement when they actually occur
- Whether there are any other material information which is already generally available to inform users of the market.<sup>111</sup>

Meanwhile, according to the MAR, a regular user would regard behaviour as failing to meet the expected standard if

- (1) The relevant information has to be disclosed in accordance with any legal or regulatory requirement
- (2) The relevant information is routinely the subject of a public announcement although not subject to any formal disclosure requirement
- (3) The behaviour is based on information relating to possible future developments...that will become a type within (1) or (2).<sup>112</sup>

The FSA has also, in a number of cases, adopted appropriate professional standards as the expected standard.<sup>113</sup>

The provisions of this pre-MAD legacy offence differ from those of the post-MAD insider dealing and improper disclosure offences in a variety of ways. Firstly, the pre-MAD concept of “relevant information not generally available” is wider in scope than the post-MAD concept of “inside information.” In particular, there is no requirement that the information would “likely to have a significant effect on the price of the qualifying investments or on the price of related investments”.<sup>114</sup> Secondly, the post-MAD provisions require some specified action (i.e. dealing, disclosing), while the pre-MAD provisions simply requires “behaviour”.<sup>115</sup> Thirdly, the legacy offence does not attempt to define or designate an “insider” – as long as the behaviour satisfies the requirements under (4)(a) and (4)(b), it constitutes a misuse of information. This represents a pure “Parity of Information” and “Information Connection” insider trading regulatory paradigm. The lack of an insider requirement also allows the FSA to prosecute corporate insiders, constructive insiders, outsiders who breach their fiduciary duty to the information source, or outsiders who have no fiduciary duty to the information source but falls under the provisions of (4)(a) and (4)(b), for market abuse for their misuse of information.

The term “based on” in the provision above has been further defined by the Financial Services and Markets Tribunal (an independent body which hears references arising from decision notices issued by the FSA) in *Arif Mohammad v. FSA*, FSMT Case 037 (2005). The tribunal noted that “for conduct to be based on inside information it must be one of the reasons for the dealing...[but] need not be the only reason for the dealing.”<sup>116</sup>

#### PART IV – MODELS FOR STRENGTHENING ONTARIO’S REGULATIONS

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<sup>108</sup> BLAIR, *supra* note 95, at 382.

<sup>109</sup> Financial Services and Markets Act, 2000, c. 8, § 118(4).

<sup>110</sup> Financial Services and Markets Act, 2000, c. 8, § 130A(3).

<sup>111</sup> MAR 1.5.6.

<sup>112</sup> MAR 1.5.7.

<sup>113</sup> BLAIR, *supra* note 95, at 415.

<sup>114</sup> *Supra* note 101.

<sup>115</sup> *Supra* note 97.

<sup>116</sup> *Arif Mohammad v. FSA*, FSMT Case 037 (2005).

The insider trading regulation strategies in the US and the UK provide a number of models for modifying Ontario's insider trading regulation. Primary differences in insider trading liability under them are listed in Table 1 in the appendix.

The following two sub-sections will critically examine these models, and analyze whether Ontario should adopt them fully or partially, or not adopt them at all. The evaluation criteria are simple – any new regulation should be fair and unambiguous, yet flexible enough to reasonably reduce the burden of proof currently faced by the OSC in proving an insider trading violation.

#### A. United States

The decisions of the landmark cases *Chiarella*, *Dirks* and *O'Hagan* have constructed insider trading liability under the framework of fiduciary duty. Instead of defining insider trading under specific activities, this “fiduciary duty” approach allows the SEC and the courts to flexibly adapt its arguments to each situation. Furthermore, this approach encapsulates insider trading and tipping under securities fraud and thereby attaches a victim to the trader's or tipper's actions. This effectively counters the common argument that insider trading and tipping are victimless crimes and thus should not be policed.<sup>117</sup>

Its flexibility, however, is also one of its weaknesses. Critics of the “fiduciary duty” approach have argued that the regulatory theories laid down in *Chiarella* and *O'Hagan* are both “underinclusive” and “overinclusive.”<sup>118</sup> Since insider trading liability hinges on the trader's breach or derivative breach of fiduciary duty to the shareholders (*Chiarella*) or to the information source (*O'Hagan*), there would be no liability if the trader has no such fiduciary duty or if the trader discloses his intention to trade based on material non-public information. In *SEC v. Switzer*, 580 F. Supp. 756 (W.D. Okla. 1984), a bystander who traded based on material non-public information he overheard cannot be charged with insider trading since he owed no fiduciary duty to the shareholders or to the information source, as the latter was unaware that Switzer overheard his conversation.<sup>119</sup> Meanwhile, in *Jensen v. Kimble*, 1 F.3d 1073 (10th Cir. 1993) and *McCormick v. Fund American Companies Inc.*, 26 F.3d 869 (9th Cir. 1994), the inside traders avoided insider trading liability by “explicitly inform[ing] the other part[ies] of [their] failure to disclose [material, non-public information.]”<sup>120</sup> Since these traders have disclosed their failure to disclose, they cannot be charged with insider trading under S 10(b) of the Exchange Act as they have not deceived anyone (note: this stems from the “deceptive device” requirement under that section of the Act).

Conversely, the fiduciary duty requirement has also been viewed as overinclusive, or overly expansive, in its reach. A strict reading of “deceptive device” under S 10(b) of the Exchange Act, along with the argument in *O'Hagan* that the securities trade “consummates” the deception, reveal that only a simple case of deception is needed to establish insider trading liability under the “fiduciary duty” approach. Consequently, a trader who has no knowledge of material non-public information, but has facilitated his trade with an act of deception or deceptive breach of fiduciary duty to shareholders or his source of information, may be charged with insider trading. Prakash points out two scenarios, and provides an example for each, in which this may occur:

1) “[A]n individual can trade on misappropriated non-material, non-public information and still be found liable if her trade consummates a deception”<sup>121</sup>

Example: An accounting firm has a rule that prohibits its staff from trading on any information gleaned from its clients. If a staff secretly trades after becoming aware of some non-material, non-public information, he commits an act of deception against his firm (the information source) and can be charged with insider trading under the misappropriation theory – even if the information was non-material and non-public.

2) “One may trade on purely public information and still be liable”<sup>122</sup>

Example: A broker violates his firm's policy by secretly executing personal trades based on public information using a brokerage service other than that provided by his firm. Since this constitutes an act of deception in connection with a securities transaction, the broker is liable for insider trading under the ruling in *O'Hagan*. Note that, however, the broker has not misappropriated any information – he was trading based on public information.<sup>123</sup>

Prakash then points out that the government or private parties “could declare that liability attaches whenever someone engages in undisclosed trading that deceptively . . . breaches a fiduciary duty”<sup>124</sup>. This removes the need to prove that the

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<sup>117</sup> JOHNSTON & ROCKWELL, *supra* note 6, at 280.

<sup>118</sup> Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 Columbia L.R. 1491, 1498 (2000).

<sup>119</sup> *SEC v. Switzer*, 580 F.Supp. 756, 766 (W.D. Okla. 1984).

<sup>120</sup> *Jensen v. Kimble*, 1 F.3d 1073, 1078 (10th Cir. 1993).

<sup>121</sup> Prakash, *supra* note 118, at 1537.

<sup>122</sup> *Id.* at 1538.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.* at 1545.

trader was aware of material non-public information, and makes the government or the private party's case significantly easier to prove.<sup>125</sup> Although such a situation is unlikely, it remains a possible danger to innocent traders who have no intention to trade on material non-public information. In addition, since Rule 10b5-1 is promulgated on the basis of *Chiarella*, *Dirks* and *O'Hagan*, it is also susceptible to the aforementioned problems.

Cox et al. have raised questions as to how the misappropriation theory may be applied to misappropriators who tip instead of trade. In this case, the misappropriator's breach occurs before the trading, and hence may not be congruent with the *O'Hagan* observation that a fraud is "in connection with" a purchase or sale when the breach "coincides" with the trading.<sup>126</sup> The Second Circuit, in *United States v. Falcone*, 257 F.3d 226 (2d Cir. 2001), has dismissed this question by arguing that the "O'Hagan's requirement that the misappropriated information 'ordinarily' be valuable 'due to its utility in securities trading' appears to be a more generally applicable factor in determining whether Section 10(b)'s 'in connection with' requirement is satisfied."<sup>127</sup> It remains to be seen whether the same standard would be applied in the other circuits or in future Supreme Court rulings.

Furthermore, within the context of the *Falcone* decision, should the 'personal benefit' test articulated under *Dirks* be applied to the tipping misappropriators?<sup>128</sup> The courts are split on this question. Some courts (the First Circuit in *SEC v. Sargent*, 229 F.3d 68 (1<sup>st</sup> Cir. 2000) and the District Court for the Southern District of New York in *SEC v. Willis*, 777 F. Supp. 1165 (S.D.N.Y. 1991)) have argued that the 'personal benefit' test is only applicable in cases where there is a fiduciary duty to disclose to shareholders whose shares are being traded. Going even further, the Second Circuit, noting that the misappropriation theory is rooted under a "business property protection" rationale, ruled in *United States v. Libera*, 989 F.3d 586 (2d Cir. 1993) that it was not even necessary for the misappropriating tipper to know that his breach would lead to the trading by the tippee. However, the Eleventh Circuit, in *SEC v. Yun*, 327 F.3d 1263 (11<sup>th</sup> Cir. 2003), noted that throwing out the 'personal benefit' test is absurd and would "impose liability more readily for tipping than trading . . . undermin[ing] the Supreme Court's rationale for imposing the benefit requirement in the first place: the desire that a tip rises to the level of a trade."<sup>129</sup>

Meanwhile, the application of the misappropriation theory for cases involving multiple layers of tippee trading (or "remote tippee" trading) also lacks sufficient case law guidance. In *SEC v. Musella*, 678 F. Supp. 1060 (S.D.N.Y. 1988), the District Court for the Southern District of New York ruled that several policemen who traded based on material, non-public information received from another officer, who in turn received the information from a law firm employee (the policemen had no knowledge regarding the identity of the source) were still liable under the misappropriation theory since they have made a "conscious and deliberate choice" to not ask their tipper about the source and that they "at the very least . . . should have known that fiduciary duties were being breached."<sup>130</sup> Whether such an argument would be accepted by other courts is crucial, as many "modern" insider trading cases involve a web of tipplers and tippees who may only have scant knowledge of the initial breach of fiduciary duty by the source of the information.

In addition to the "fiduciary duty" regulation strategy, the SEC's formulation of Rule 14e-3 has also come under intense scrutiny. Major criticism levelled against Rule 14e-3 points to the fact that it is only applicable to tender offers. In *Switzer* noted above, the bystander would have triggered liability under Rule 14e-3 should the transaction on which he based his trade was a tender offer instead of a merger.<sup>131</sup> Meanwhile, in *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991), the defendant was criminally convicted under Rule 14e-3 based on solely the fact that he knowingly traded based on material, non-public information related to a tender offer obtained from an insider source. However, since his tipper did not obtain a personal benefit from his communication of material, non-public information, Chestman was not liable under Rule 10b-5.<sup>132</sup> Nevertheless, the unfairness in the application of the law is glaringly evident across these two cases – the conviction of Chestman and the exoneration of Switzer depended solely on the nature of the deal underlying their trades – and blatantly runs against the principles of securities regulation to treat similar market participants fairly.

In summary, the state of constant flux and uncertainty surrounding US insider trading regulations makes it an entirely unsuitable candidate for adoption in Ontario. Nonetheless, it must be noted that the "fiduciary duty" regulation strategy has allowed the SEC to launch over 391 insider trading actions in the period between 1995 and 2005 – substantially more than any other developed country.<sup>133</sup> This is likely a testament to the SEC's prowess in enforcing insider trading regulation, to be further explored in Part V below.

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<sup>125</sup> *Id.*

<sup>126</sup> COX ET AL., *supra* note 56, at 906.

<sup>127</sup> *United States v. Falcone*, 257 F.3d 226, 233 (2d Cir. 2001).

<sup>128</sup> COX ET AL., *supra* note 56, at 906.

<sup>129</sup> *SEC v. Yun*, 327 F.3d 1263, 1278-1279 (11<sup>th</sup> Cir. 2003).

<sup>130</sup> *SEC v. Musella*, 678 F. Supp. 1060, 1063 (S.D.N.Y. 1988).

<sup>131</sup> Marc I. Steinberg, *Insider Trading, Selective Disclosure, and Prompt Disclosure*, 22 U. Pa. J. Int'l Econ. L. 365, 644 (2000).

<sup>132</sup> Steinberg, *supra* note 131, at 646.

<sup>133</sup> UPTAL BHATTACHARYA, ENFORCEMENT AND ITS IMPACT ON COST OF EQUITY AND LIQUIDITY OF THE MARKET 155 (2006) (a report commissioned by the Task Force to Modernize Securities Legislation in Canada).

## B. United Kingdom, Post-MAD

The United Kingdom market abuse provisions regarding insider dealing and improper disclosure are very similar to the corresponding OSA regulations. The insider dealing offence under Section 118(1) of FSMA is almost equivalent to that under Section 76(1) of the OSA. Both mandate that insiders (or special relationship persons) may not trade on the basis of inside information. However, while the FSA must prove that the insider has been materially influenced by the inside information (and would not have traded otherwise) in order to satisfy “on the basis of”, the OSC merely has to prove that the insider is aware of the inside information. Although the FSA’s standard of proof is lower than that for a “use” of the inside information (which proved to be extremely difficult to prove in Ontario in the past), it is still higher than that of the OSC’s “awareness” requirement and may pose a difficulty in combating insider trading.

The FSMA definition of the term “insider” is also equivalent to the OSA definition of “special relationship person”. Although the two definitions are not “equal” (the FSMA definition lacks a clause extending the definition to a “prior special relationship”, and the OSA definition lacks a clause extending to “criminal activities”), they both contain catch-all phrases (Section 118B (e), Section 76(5)(e)) that identify a person as an insider/special relationship person if he: (a) knows that the person from he received the information from (i.e. “tipper”) is an insider/special relationship person, and (b) knows that it is inside information. Naturally, these catch-all phrases provide a defence if the person is unaware that the tipper is an insider/special relationship person. Both definitions also point towards a “person connection” paradigm – anyone, regardless of their occupation or fiduciary relationship with the issuer or the source of the information, can be caught under the insider/special relationship person umbrella if they meet the requirements in Section 118B or Section 76(5).

The FSMA definition of the term “inside information” in FSMA Section 118C(2) is also equivalent to the OSA definition of a material fact or material change in NP 51-201. Both definitions require the information to have a significant effect on the price of the security, to relate to a particular issuer, and to not be disclosed or disseminated. One difference remains – the OSA does not contain a safe harbour for information that is derived through research or analysis. However, given the vibrant atmosphere of securities research and analysis in Ontario, it appears that the province’s regulatory paradigm has not chilled the market’s incentive to perform research. As a result, it is not necessary for Ontario to adopt this safe harbour.

The FSMA’s definition of improper disclosure is almost identical to the “tipping” offence under Section 76(2) of the OSA, albeit with a different focus. The FSMA’s definition is aimed at selective disclosure, while the OSA is aimed at tipping. Nevertheless, either definition can be used to police selective disclosure or tipping. Furthermore, improper disclosure or tipping may be construed under the FSMA or OSA regardless of the intentions of the tippee – the mere sharing of material non-public information by the tipper is enough to trigger the offence.

Unfortunately, the post-MAD regulations in the United Kingdom are as ineffective as the OSA’s regulations in curbing insider trading. The FSA’s own research shows that informed trading took place prior to 28.7% of takeover announcements of 2007, up from 24% in 2000.<sup>134</sup> Meanwhile, only three market abuse disciplinary actions were successfully concluded (i.e. resulted in a Final Notice) between 2006 and August 2008.<sup>135</sup> Echoing the opinion of the Insider Trading Task Force, this may have been the result of the “person connection” (i.e. identifying parties to the information flow) required by the post-MAD FSMA and the OSA in defining an “insider” or a “special relationship person”. Such a connection is, according to the task force, difficult to prove and may have impeded the pursuit of insider trading actions.<sup>136</sup> Thus, Ontario should not adopt the post-MAD regulatory strategy in the United Kingdom as it presents no improvement over the existing strategy in the province.

## C. United Kingdom, Pre-MAD

As mentioned above, the pre-MAD insider trading offences in the United Kingdom are defined by the legacy “misuse of information” offence. This very generally-worded offence is aimed at catching any undesirable behaviour that is “based on information deemed relevant by a regular user when deciding the terms on which transactions in qualifying investments should be effected.” As a result, it differs significantly from the Ontario and post-MAD UK regulatory strategies as it does not require a troublesome “person connection” burden of proof. As long as the person is acting on the basis of some material non-public information, and this act is considered to be a failure of the standard of behaviour reasonably expected of the person in his position in the market, the offence is satisfied. Such an “information connection” proof frees up the regulators from attempting to decipher the link between tippers and tippees in a suspected case of tipping and insider trading, or from determining the fiduciary relationships between parties to a flow of information.

Meanwhile, the regular user test is a point of contention. On one hand, it frees up regulators from trying to fit a myriad of insider trading behaviour into a static set of defined prohibited activities. On the other hand, this flexibility also gives the regulator an extraordinary amount of control over what is relevant information, and what is a failure of standard behaviour.

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<sup>134</sup> BLAIR, *supra* note 95, at 442.

<sup>135</sup> *Id.*

<sup>136</sup> INSIDER TRADING TASK FORCE, *supra* Note 3, at 39.

Although, as noted above, the MAR provides extensive guidance as to factors (listing rules, professional standards, etc) affecting the “regular user” in his decisions, most of such factors would only apply to clear-cut cases (i.e. director purchasing shares ahead of announcing a gold discovery). However, more ambiguous scenarios (i.e. the bystander scenario in *Switzer*) may generate inconsistencies in ruling – especially when regulators are increasingly influenced by public and political pressure. Consequently, any Ontario adoption of the regular user test must be handled so that a common, defined set of “relevant information” and “substandard behaviour” is used for every situation. In fact, current Ontario regulation already performs this adequately – NP 51-201 and OSA Sections 76(1), (2) clearly delineates the criteria for, respectively, relevant information and failure of standard behaviour. There is thus little reason to change Ontario’s regulation in these two specific areas.

The term “based on”, again, requires the FSA to prove that the trader has been materially influenced by the inside information (and would not have traded otherwise). Since this applies a higher standard of proof than current Ontario regulations, this element of the misuse of information offence should not be applied.

Perhaps not surprisingly, the pre-MAD regulatory strategy in the UK performs better than the post-MAD regulatory strategy. Between 2000 and 2004, the FSA successfully concluded (*note*: instead of initiated) 27 disciplinary actions for market abuse/misconduct and imposed total financial sanctions of £40 million.<sup>137</sup> As noted above, this higher rate of success probably owes to the ease in proving the “information connection” in the pre-MAD strategy.

Summarizing the above findings, it can be seen that Ontario’s current insider trading regulation is not inferior to those of the US or the UK. In fact, it is in a number of ways superior to the US and the UK regulations. Nevertheless, it is recommended that the province should change its definition of a “special relationship person” from one determined through a “person connection” to one determined through an “information connection”. Specifically, Ontario should modify Section 76(5)(e) of the OSA to bring any person who becomes aware of a material, not generally disclosed, fact or change under the umbrella of “special relationship persons”. Other changes are not necessary as they would not improve the current regulatory strategy. They would only increase the OSC’s burden of proof, or would introduce new problems to the province’s insider trading regulations.

While the “fiduciary duty” regulatory strategy in the United States has proven to be a very potent weapon against insider trading (as indicated by the large numbers of SEC actions since its introduction), transplanting the entire model of issuer-insider/source of information-tippee fiduciary duty to Canada may prove challenging. Not only will such a change require a re-write of Ontario’s current legislation on insider trading, corporations and market investors must also incur additional costs to deal with such a large “fix” in their legal compliance requirements. Furthermore, the various “underinclusions”, “overinclusions” and complexities of the “fiduciary duty” and misappropriation theories may introduce new ambiguity into Ontario insider trading regulations – something that is not desirable given its need for reform. Furthermore, the unfairness inherent in Rule 14e-3 means that it should certainly not be adopted in Ontario.

Of course, the proposed change to the definition of a “special relationship person” is not meant to be a panacea for all the ills and woes of Ontario’s current regulations. Instead, it should serve as a “performance-enhancing drug” for the province’s regulators by granting them wider parameters when policing insider trading violations.

## PART V – EFFICACY OF ENFORCEMENT

As noted above, the SEC has been able to launch 391 insider trading cases from 1995 to 2005. In contrast, the OSC launched a meagre 11 insider trading cases during the same period.<sup>138</sup> Scaled by the number of listed firms, Bhattacharya (2006)’s study, commissioned by the Task Force to Modernize Securities Regulation in Canada, found that the SEC prosecuted 20 times more insider trading violations than the OSC, while exacting 17 times more in fines.<sup>139</sup> This trend has continued through the recent years – despite significant market downturns in 2008, the OSC did not commence any illegal insider trading proceedings.<sup>140</sup> Meanwhile, the SEC commenced 61 insider trading proceedings in the same year.<sup>141</sup> Echoing the evidence noted in Part IV above, the FSA’s performance was also dismal – only three cases of market abuse were successfully concluded between 2006 and 2008. Although the United States does possess the largest and most sophisticated capital markets in the world, the number of insider trading actions in the UK and Ontario – home to the world’s second and seventh largest stock exchanges – are disproportionately small. Such an observation is telling – despite the regulatory hurdles it faces in proving insider trading violations, the SEC has been much more vigorous in enforcing the regulations than the OSC or the FSA. The situation in Ontario is particularly worrying, as the province has recently seen a surge of M&A deals involving high-growth, early-stage resource & energy firms. The resultant amplification of stock price volatility makes it particularly attractive to trade ahead of the market using material, non-public information.

<sup>137</sup> BLAIR, *supra* note 95, at 441.

<sup>138</sup> BHATTACHARYA, *supra* note 133, at 155.

<sup>139</sup> *Id.* at 156.

<sup>140</sup> Martin Middlestaedt, A world of difference on insider trading prosecutions, *The Globe and Mail*, March 14, 2011, <http://www.theglobeandmail.com/globe-investor/a-world-of-difference-on-insider-trading-prosecutions/article1941863/>.

<sup>141</sup> SEC, SPOTLIGHT ON INSIDER TRADING, (June 1, 2011), <http://www.sec.gov/spotlight/insidertrading.shtm>.

Nevertheless, before we commence our discussion on how the OSC may step up its game against insider trading, we must examine whether the OSC should do so in the first place. The answer to this question from financial research is a resounding yes. Bhattacharya and Daouk (2005)'s study shows, "both theoretically and empirically, that sometimes no security law may be better than a good security law that is not enforced,"<sup>142</sup> and that insider trading prohibitions may satisfy these conditions. Their study also shows that the cost of equity actually increases in nations, which have enacted insider trading laws, but do not enforce them.<sup>143</sup> This in return would undervalue the equities in the nation and make it harder for firms to raise equity capital. Although this result holds only in emerging markets, and does not seem to significantly affect the Canadian market, the increasing number of Chinese, African and South American resource and energy issuers and market participants on the Toronto Stock and Venture Exchanges makes this result a potential threat to the exchanges' position as healthy and fair markets.

### *SEC's Enforcement Tactics*

As the statistics above show, the SEC is a prime example of how securities regulators should enforce insider trading law. With a staff of 1100 in its enforcement division, the SEC diverts significant attention to the policing of insider trading and has accordingly developed a large arsenal of weapons for the detection of suspicious trading and the identification of the corresponding traders.<sup>144</sup> The SEC also coordinates actively with the exchanges, various other regulatory agencies, the FBI and the Justice Department in the detection and prosecution of illegal insider trading. Sophisticated computer analysis dedicated to link up traders with their history of personal networks and connections, enabling the identification of all persons who both traded and had some contact with the source of the information. In order to encourage whistleblowing, the SEC was also granted authority from 1988 to 2010 to pay bounties to persons who provide information leading to the imposition of a civil penalty on a person for insider trading, with the informant eligible to receiving up to 10% of the penalty collected.<sup>145</sup> In 2010, the SEC also announced a new "cooperation policy", where the Commission, in exchange for information that provides "material assistance" to its law enforcement efforts, will consider lesser sanctions in appropriate cases.<sup>146</sup> As such, the SEC Enforcement Division has been receiving hundreds of thousands of complaints and tips from market participants each year.<sup>147</sup>

### *OSC's Enforcement Record*

The OSC's current enforcement regime is clearly lacking in vigour when compared to that of the SEC. As of late 2010, the Canadian newspaper *Globe and Mail* reported that the OSC's insider trading team, already the largest of the 3 specialized investigation units within its enforcement department, is only composed of 14 individuals.<sup>148</sup> Its status as a provincial regulator (unlike the SEC, which is a national regulator) also prevents it from engaging in actions across provincial borders. The same *Globe and Mail* report also cites cases where the police have been reluctant to cooperate with the OSC on enforcing securities laws, citing other priorities.<sup>149</sup> Unlike the SEC, the OSC also fails to quickly dispatch cases to the courts or administrative tribunals – as a prior Chairman of the OSC noted "Canadian cases are often allowed to drag on to the detriment of all parties."<sup>150</sup> Meanwhile, although the OSC has a "credit for cooperation" policy similar to that of the SEC in place since 2002,<sup>151</sup> the lack of any potential rewards for whistleblowers makes it less likely for whistleblowers to sound alarms on insider trading.

Nevertheless, after years of public complaints of blatant insider trading ahead of major corporate deals, the OSC has finally taken action to step-up its insider trading enforcement efforts. 2010 saw the introduction of the OSC's new in-house

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<sup>142</sup> BHATTACHARYA, *supra* note 133, at 152.

<sup>143</sup> *Id.*

<sup>144</sup> SEC, TESTIMONY CONCERNING SECURITIES LAW ENFORCEMENT IN THE CURRENT FINANCIAL CRISIS BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES (March 20, 2009), <http://www.sec.gov/news/testimony/2009/ts032009ebw.htm> .

<sup>145</sup> Rescission of Rules Pertaining to the Payment of Bounties for Information Leading to the Recovery of Civil Penalties for Insider Trading, Securities Exchange Act 1934, Release No. 62921 (September 21, 2010).

<sup>146</sup> Policy Statement Concerning Cooperation by Individuals in Investigations and Related Enforcement Actions, Securities Exchange Act 1934, Release No. 61340 (January 19, 2010).

<sup>147</sup> SEC, *supra* note 144.

<sup>148</sup> Janet McFarland, On the hunt for illegal insider trading, *The Globe and Mail*, February 25, 2011, <http://www.theglobeandmail.com/globe-investor/on-the-hunt-for-illegal-insider-trading/article1915227/> .

<sup>149</sup> *Id.*

<sup>150</sup> Mittlestaedt, *supra* note 140.

<sup>151</sup> OSC, OSC STAFF NOTICE 15-702 CREDIT FOR COOPERATION (June 28, 2002), [http://www.osc.gov.on.ca/en/SecuritiesLaw\\_sn\\_20020628\\_15-702.jsp](http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20020628_15-702.jsp).

detection platform, which aim to detect the webs of personal connections in a manner similar to that of the SEC.<sup>152</sup> The OSC intends to use it to aid in their attempt to crack down on tipping and trading by tippees. Meanwhile, in March 2011, a new OSC chairman has suggested that the Commission adopt SEC style settlements to speed up case flow, and expand its current cooperation policy to encourage more people to come forward to the Commission and settle cases.<sup>153</sup> However, unless additional resources are poured into expanding the OSC's personnel ranks and maintain its infrastructure on detecting insider trading, it is unlikely that such settlements and cooperation policies would be helpful in curbing insider trading. As long as the OSC remains (and/or retains a public impression as) a toothless tiger in catching illegal insider trading, inside traders and tippees have no reason to fear possible persecution and, likewise, would not surrender themselves to the authorities. Informants also see no incentive to submit complaints or tips absent any financial rewards for his/her deeds.

### *Improving Public Impression of the OSC – Crack Down on Hedge Fund Insider Trading*

Assuming adequate resources are available, the OSC may attempt to quickly bolster its reputation as an enforcer by emulating the SEC in the latter's recent priority in policing insider trading by hedge funds. Since the mid-2000s, the SEC and Congress have been alarmed by studies that show hedge funds are responsible for engaging in widespread insider trading ahead of M&As.<sup>154</sup> Studies have also revealed that hedge funds are primarily responsible for "dramatic spikes in trading volume ahead of the announcement of corporate transactions".<sup>155</sup> Furthermore, unusual spikes in credit default swap fees and option trading volumes (typical instruments traded by hedge funds) ahead of major M&A and leveraged buyout transactions have also been tied to confidential meetings between bidders and company management that were subsequently disclosed – strongly suggesting that tipping and insider trading were responsible for these spikes.<sup>156</sup> The SEC has suggested that hedge fund managers are encouraged to commit insider trading by four major incentives: 1) intense competition amongst hedge fund managers (who charge much higher fees compared to other investment vehicles) in boosting their returns to attract more investors, 2) the hedge fund industry's prior lack of regulatory oversight (particularly in the debt and derivative markets), which has led to a lack of the information barriers that such oversight would normally spawn in larger financial institutions, 3) the hedge fund managers' close connections with company management, who in turn may be investors or investees of the fund, and 4) the far less transparent nature (as compared to equities) of the securities that hedge funds participate in (distressed debt offerings, OTC derivatives, etc).<sup>157</sup>

The SEC's actions against hedge fund insider trading have taken on two primary fronts: 1) "classic" insider trading and 2) insider trading with regards to "Private Investment in Public Entities" ("PIPE") offerings.<sup>158</sup> The first form of insider trading has received substantial news in the market (with the recent case of Raj Rajaratnam's Galleon Asset Management and its relationship with former Goldman Sachs director Rajat Gupta receiving significant public spotlight). The SEC's success in prosecuting Rajaratnam adds onto its string of successful hedge fund insider trading cases. *Guttenburg*<sup>159</sup> involved a hedge fund manager serving as a tippee link between two insider trading schemes, "passing on illegal tips and tainted others' trading wherever he went – like the hedge-fund equivalent of a contagious virus" over a 5 year period<sup>160</sup>. Another case, *Tom*, involved a hedge fund manager trading on information received from an investor of his own fund.<sup>161</sup>

The second form of insider trading under scrutiny involves PIPEs, which serve as a form of financing by companies that may be unable to obtain capital through public means. Since such offerings involve public entities issuing shares to private investors, they result in a dilutive effect on the entities' shares and a drop in their prices. Hence, this represents an opportunity for hedge funds aware of material, non-public information regarding the PIPE to earn a profit by shorting on the entities' shares ahead of the announcement of the private offering. In two separate civil actions, *Langley Partners L.P.*<sup>162</sup> and *Joseph J. Spiegel*<sup>163</sup>, the SEC alleged four hedge fund managers who engaged in "naked" short selling of the PIPE issuers' not-yet-registered stocks in Canada, later covering their naked short positions with the PIPE shares once they became registered.<sup>164</sup> In a further violation of securities regulation (Section 5 of the Exchange Act), the hedge fund managers also

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<sup>152</sup> McFarland, *supra* note 145.

<sup>153</sup> Janet McFarland, New OSC chief pledges more jail terms for securities offenders, The Globe and Mail, March 9, 2011, <http://www.theglobeandmail.com/report-on-business/new-osc-chief-pledges-more-jail-terms-for-securities-offenders/article1830621/>.

<sup>154</sup> Linda Chatman Thomsen et al., *Hedge Funds: An Enforcement Perspective*, 39 Rutgers L.J. 541, 553 (2008).

<sup>155</sup> *Id.* at 577.

<sup>156</sup> *Id.* at 577 n.207.

<sup>157</sup> Thomsen, *supra* note 154, at 555.

<sup>158</sup> *Id.* at 581.

<sup>159</sup> SEC v. Guttenberg, Litigation Release No. 20,022 (Mar. 1, 2007).

<sup>160</sup> Thomsen, *supra* note 154, at 586.

<sup>161</sup> SEC v. Tom, Litigation Release No. 19,729 (June 15, 2006).

<sup>162</sup> SEC v. Langley Partners, L.P., Litigation Release No. 19,607 (Mar. 14, 2006).

<sup>163</sup> SEC v. Spiegel, Litigation Release No. 19,956, 89 SEC Docket 2167 (Jan. 4, 2007).

<sup>164</sup> BARRY W. RASHKOVER ET AL., SEC ENFORCEMENT AND EXAMINATIONS CONCERNING HEDGE FUNDS 5 (2008).

attempted to conceal their conduct by engaging in deceptive trading techniques, including wash sales and matched orders, which created the impression that they were covering the short positions with open market purchases (instead of the stocks issued through the PIPE).<sup>165</sup>

While the OSC may not yet have the technical resources and manpower to tackle sophisticated insider trading by hedge fund managers, the two PIPE cases above show that hedge fund managers in the United States are using Canada as a safe haven to conduct such illegal activities. Hence, it would not be surprising for an unethical Canadian hedge fund manager, not far behind his US counterparts in sophistication, to also exploit the same gap in regulatory enforcement.

However, the impression amongst investors of the “incompetence” of the OSC also provides the Commission with a perfect opportunity to strike.

As a start, the OSC should begin probing hedge fund managers for red flags that would serve as incentives to insider trading. A report by Sidley Austin (to hedge fund managers, to warn them of possible traps in compliance) has noted a number of potential red flags:

- The lack of an ethical tone from the top
- The lack of a Chief Compliance Officer, who is sufficiently experienced, compensated and empowered to compel others to adhere to the firm’s compliance policies and procedures.
- The lack of information barriers between those potentially aware of material, non-public information, such as technological and physical walls between different groups of portfolio managers, and/or a list of securities that a portfolio manager is prohibited from trading once he/she becomes aware of material, non-public information.
- The existence of “consultant information aggregators” hired by the hedge fund. These aggregators provide paths to experts in various industries, where the experts may in fact be employees of public companies the hedge fund invests or is interested in investing in. An important area of concern is whether these experts are providing material, non-public information to the hedge fund, a possible indication of which is if they receive over-generous compensations for their services.
- Frequent sharing of information by non-affiliated portfolio managers over conferences or “idea-dinners”
- “Value added” or “strategic” investors, often senior managers or directors of public companies the hedge fund invests or may invest in<sup>166</sup>

Such a probe may give rise to multiple red flags, upon which the OSC may further investigate to uncover strands of evidence, if any, leading to findings of insider trading or tipping. Even if the results of the probe were inconclusive, the OSC would have demonstrated to the Canadian investing public that it is prepared to tackle insider trading with the same vigour as its American counterpart.

## CONCLUSION

The curbing of illegal insider trading is a crucial pre-requisite to a healthy, modern capital market. Despite being the seventh largest in the world, Ontario’s securities market has been beset by rampant insider trading. This is not the result of unsound regulation – Ontario’s insider trading law, besides its requirement for evidence of a “person connection” between the trader and the source of information, permits its regulators to pursue violators at least as dexterously their counterparts in the US or the UK. Nevertheless, in light of the SEC’s robust enforcement record against insider trading, the OSC’s own record is an everlasting reminder of how strong regulations can be rendered ineffective by poor enforcement. Fortunately for Ontario’s market participants, a turnaround is achievable. By pushing for a relaxation of the “person connection” requirement, by allocating more personnel and resources to enforcement, and by taking the fight to Bay Street’s most surreptitious members – hedge funds, the OSC stands to capitalize on its current momentum to establish itself as a strong and effective police of illegal insider trading in Ontario’s securities markets.

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<sup>165</sup> Thomsen, *supra note 154*, at 592.

<sup>166</sup> RASHKOVER ET AL., *supra note 164*, at 20-26

TABLE 1): SUMMARY OF INSIDER TRADING LIABILITY UNDER ONTARIO, US AND UK REGULATIONS

	<b>Ontario</b>	<b>US</b>	<b>UK (Post-MAD)</b>	<b>UK (Pre-MAD)</b>
<b>Regulatory Strategy</b>	Person Connection – must show the flow of information from the issuer to the trader/tippee	Fiduciary-duty Connection – must show a breach (or derivative breach) of duty by the tipper and tippee to his/her source of information	Person Connection – must show the flow of information from the issuer to the trader/tippee	Information Connection – only required to show the trader’s mere knowledge of material inside information
<b>Insiders</b>				
Insider (i.e. directors, management, employees)	Liable for trading and/or tipping (treated in the same bucket as Special Relationship Persons)	Liable for trading. Liable for tipping if subject to a personal benefit from the tippee, or if in relation to a tender offer (regardless of personal benefit)	Liable for trading and/or tipping	Liable for trading and/or tipping
Other Special Relationship Persons/Quasi-insiders (i.e. accountants, underwriters, consultants)	Same as above	Same as above	Same as above	Same as above
<b>Tippees and “Outsiders”</b>				
First-level tippee	Liable for trading and/or tipping if tippee is aware that the source of information is a special relationship person with the issuer	Liable for trading and/or tipping if the tipper has breached his/her fiduciary duty to the issuer, and/or if the tipping is relation to a tender offer.	Liable for trading and/or tipping if tippee is aware that the source of information is an insider and that the information is non-public and material.	Liable for trading and/or tipping
Multi-level tippee	Liable for trading and/or tipping if tippee is aware that the source of information is a tipper.	Liable for trading and/or tipping if the tipper has breached his/her fiduciary duty to the issuer, and/or if the tipping is relation to a tender offer.	Liable for trading and/or tipping if tippee is aware that the source of information is a tipper.	Liable for trading and/or tipping
Misappropriator	Liable for trading and/or tipping.	Liable for trading and liable for tipping if relation to a tender offer. Liability for tipping under other circumstances under dispute.	Liable for trading and/or tipping.	Liable for trading and/or tipping
Bystander (no relationship to issuer or any other tipper)	Liable for trading and/or tipping if tippee is aware that the source of information is a tipper.	Generally not liable for trading or tipping, unless in relation to a tender offer.	Liable for trading and/or tipping if tippee is aware that the source of information is a tipper.	Liable for trading and/or tipping