



SECURITIES

M A T T E R S

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Impending OSC Legislation: Civil Liability for Secondary Market Disclosure

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Increasing Investor Protection and Escalating Continuous Disclosure Requirements for Public Issuers

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BACKGROUND & STATUS

Civil liability for secondary market disclosure essentially means that more investors will now be able to hold companies legally responsible, and directors, officers and other influential persons personally liable, for the accuracy and completeness of the ongoing information provided to the public. Efforts towards implementing this regime in Canada have been ongoing for many years now. Such investor protection is seen by many to be extremely important since over 90% of all shares are bought and sold in the secondary market. A similar regime has been in place in the United States for decades.

The Ontario legislature has now passed legislation that will amend their *Securities Act* to create a continuous disclosure liability regime.¹ However, the sections of that legislation on civil liability for secondary market disclosure do not come into force until proclamation by the Lieutenant Governor, which is currently still pending. Legal representatives of the Ontario Securities Commission (OSC) anticipate these sections will be proclaimed into force as soon as some necessary amendments to the Regulations have been made, including definitions for certain key terms. This process is underway and the Ontario government is working to finalize and approve these required amendments. Thus, there will very soon be civil liability for secondary market disclosure.

Once the legislation is proclaimed, it will provide investors with a statutory right to sue public companies and other key parties (such as officers, directors, control persons and experts). The right to sue will arise when there is false or misleading information (misrepresentations), or when material changes are not disclosed, in statements or documents issued by public companies to investors on an ongoing basis. Relevant materials include the company's annual and quarterly financial statements, press releases, and other public oral statements and comments. This means

that public issuers and their key personnel are going to have to adopt and follow much more stringent procedures and controls in relation to the disclosure of information.

Civil liability already exists in the primary market—where shares are made available to the public based on information contained in a formal disclosure document, like a prospectus. The *Ontario Securities Act* already gives investors the right to sue if the information in the formal document is false or misleading.

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Similar legislation creating civil liability for continuous disclosure has also been passed in British Columbia, and is also pending proclamation. Currently, there is no pending legislation in any other jurisdiction in Canada, but it is likely just a matter of time. The Ontario and British Columbia legislation both clearly contemplate that comparable legislation will be enacted in the other provinces and territories of Canada. Further, this type of legislation is part of the overall push towards uniform securities regulation across Canada.

SUMMARY OF THE LEGISLATION

A. Basis for Liability: Investors Right to Sue

There are essentially three main areas of misconduct that will provide investors with a right to sue:

1. Misrepresentations in documents released or in public oral statements made by an Issuer, or by a person or company with actual, implied or apparent authority to act or speak on the Issuer's behalf as to the business or affairs of an Issuer.

2. Misrepresentations in documents or public oral statements by “influential persons” relating to the business or affairs of an Issuer, or a person or company with actual, implied or apparent authority to act on behalf of an influential person.
3. Failure of the Issuer to make timely disclosure of a material change.

The legislation defines “misrepresentations” as “misleading or untrue statements”, which are statements that a person or company knows, or should know, are misleading or untrue (in a material respect and in light of the circumstances), or statements missing facts that are required to be stated to make the statements not misleading, and that would reasonably be expected to have a significant effect on the market price or value of a security.

Notably, plaintiffs need not prove they relied on a misrepresentation or failure to make timely disclosure.

B. Who Is Entitled To Sue?

Potential plaintiffs include any person or company (investor) acquiring or disposing of a publicly traded issuer's securities during a time when a misrepresentation or non-disclosure was left uncorrected. Thus, the violation period only ends when the issuer corrects its disclosure or discloses the material change.

C. Who Can be Sued?

Although the type of violation dictates which persons can be sued, the list of potential defendants is quite long. It includes:

1. **Responsible Issuers** – meaning a reporting issuer in Ontario or any other issuer with publicly traded securities who has a real and substantial connection to Ontario;
2. **Influential Persons** – including Control Persons, promoters, insiders, or investment fund managers;
3. **Directors or officers** – of a responsible issuer or an influential person; and

4. **Experts** – including accountants, auditors, appraisers, engineers, financial analysts, and lawyers. However, there is one carve-out or exception from the category of “experts” for approved rating organizations under National Instrument 44-101.

D. Liability Standards

The legislation makes a major distinction between misrepresentations in “*core documents*” and misrepresentations in “*non-core documents*” or in “*public oral statements*” (note definitions immediately below). Thus, the legislation sets out two liability standards, which vary according to the type of disclosure at issue.

The legislation provides strict liability for misrepresentations in *core documents* and for failures of issuers, investment fund managers, and their respective officers, to make timely disclosure of material changes. This means

that there is no requirement on the part of the plaintiff to prove any mental state or motive on the part of the defendant. Simply, if a misrepresentation is proven to exist, the onus then shifts to the defendant to establish a defence in order to avoid liability.

Plaintiffs have a greater burden to prove liability for misrepresentations or failures to disclose a material change in *non-core documents* and in *public oral statements*. Even if misrepresentation or failure to disclose is proven, the onus still remains on the plaintiff to prove that the defendant: (1) had knowledge of the misrepresentation or omission, (2) deliberately avoided acquiring knowledge, or (3) engaged in gross misconduct.

Notably, plaintiffs need not prove that they relied on a misrepresentation or failure to make timely disclosure, in either *core* or *non-core documents*.

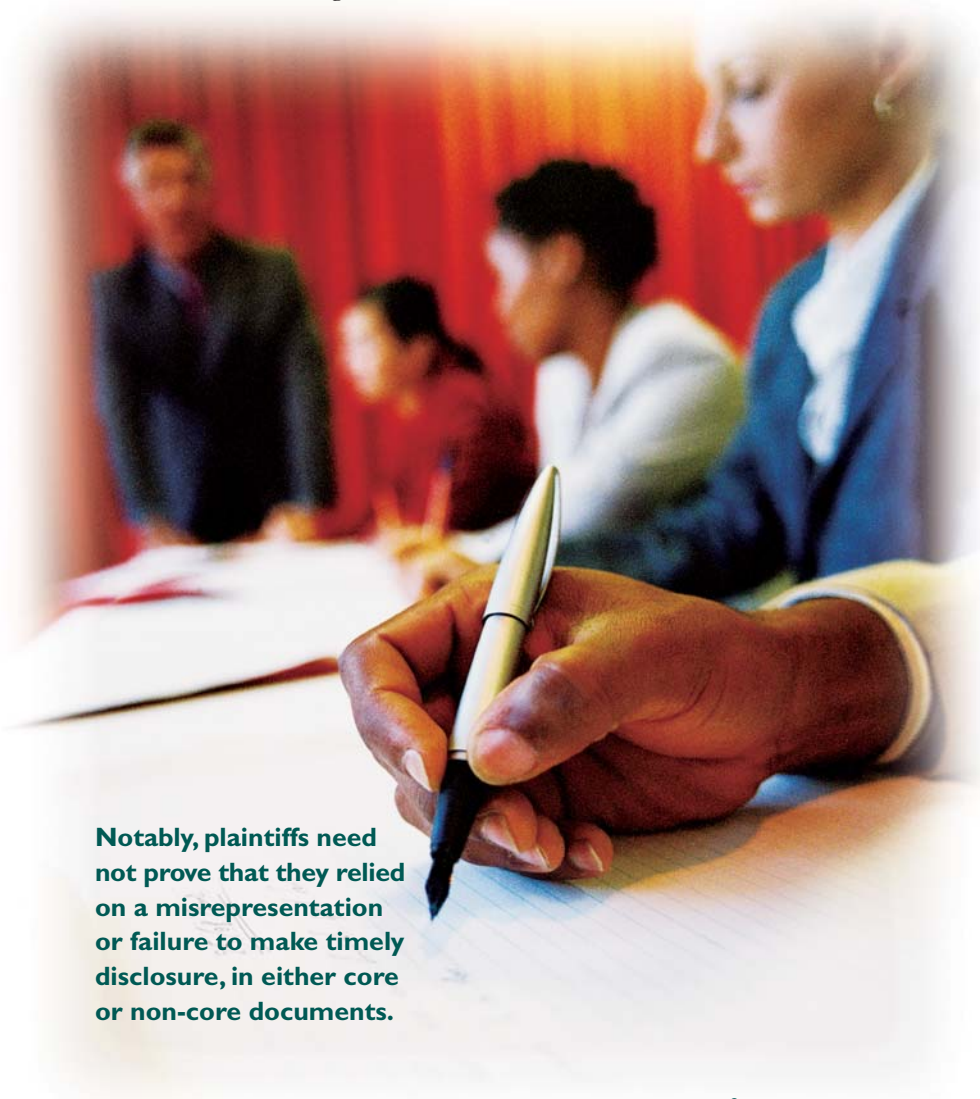
Relevant definitions:

- ▶ “*Core documents*” are generally formal documents required to be filed by issuers, such as prospectuses, take-over bid circulars, issuer bid circulars, directors’ circulars, rights offering circulars, management’s discussion and analysis (MD&A), annual information forms (AIFs), information circulars, and annual and interim financial statements.
- ▶ “*Non-core documents*” very broadly include any written communication, which may or may not be filed or required to be filed with the Commission, which contains information that would reasonably be expected to affect the market price or value of securities of the issuer.
- ▶ A “public oral statement” is defined to mean an oral statement made in circumstances in which a reasonable person would believe that information contained in the statement would become generally disclosed.

E. Defences

The legislation provides numerous defences to the defendant, which if proven, would prevent recovery by a plaintiff. In other words, if a defendant can prove certain circumstances existed, then the defendant will not be held liable for failure to make timely disclosure or for making misrepresentations. Briefly, the defences include the following:

1. **Plaintiff Had Knowledge** – of the misrepresentation or material change when he/she sold or purchased the security.
2. **Reasonable Investigation (Due Diligence)** – if the defendant conducted or caused to be conducted a reasonable investigation and the defendant had no reasonable grounds to believe there was a misrepresentation or that failure to make timely disclosure would occur. For this defence, there are several factors set out in the legislation that must be considered by the Court, such as: the knowledge, experience, function, role and responsibility of the person; the existence, if any, nature of, and reasonableness of reliance on any disclosure compliance system; any applicable



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professional standards; and the period of time within which disclosure was required.

3. **No Authority Defence (for public oral statements and for defendants other than the speaker)** – if the person who made the statement did not have implied or actual authority to speak on behalf of the Issuer.
4. **Confidential Disclosure** – in a confidential filing with the Commission, provided the defendant is able to show, among other things, a reasonable basis for making disclosure on a confidential basis.
5. **Safe Harbour for Forward-Looking Information (FLI)** – provided the defendant can prove it had a reasonable basis for making the forecast or projection, used reasonable cautionary language as to the FLI, and identified material factors or assumptions relied on.

6. **Reasonable Reliance on Experts** (reports, statements or opinions) – if the defendant did not know, and had no reasonable grounds to believe, that there had been a misrepresentation in the information provided by the expert.

7. **Defence for Experts** – if there was no consent provided by the expert for release of the information or a withdrawal of the expert's consent.

8. **Inadvertent Release of Documents** (for documents other than those required to be filed with the OSC) – if the defendant had no knowledge or reasonable grounds to believe that document would be released.

9. **Derivative Information or Republication** – if the defendant was merely repeating a misrepresentation that was also contained in a document filed by someone else, provided the republication expressly references the

source of the information and the defendant does not know or have reasonable grounds to believe it was repeating a misrepresentation.

10. **Corrective Action** (for defendants other than the Issuer) – if, upon becoming aware of a misrepresentation or failure to disclose, the defendant promptly notified the board of the Issuer, and, if no correction or subsequent disclosure was made, the defendant promptly and in writing notified the OSC.

11. **Independent Intervening Cause** – a defendant is not liable for any portion of damages caused by an unrelated change in market price.

E Calculation of Damages

The calculation of damages will be governed by detailed calculations set out in the legislation. Basically, damages will be based on the difference between the value of the securities (acquired or disposed of) at a time when the

public disclosure record of the issuer was inaccurate, and the value of the securities after the disclosure was corrected. The calculations also depend on whether or not the plaintiff mitigated its loss by resale or repurchase, and if so, when such mitigation was done—“on or before the 10th trading day” after the wrong was corrected, or “after the 10th trading day” from when the wrong was corrected. The calculation must also take into account the effect of hedging or other risk limiting transactions.

G. Liability Limits

The amount of damages payable will be subject to upper limits or caps on liability provided in the legislation, depending on the nature of the defendant.

The maximum liability for Responsible Issuers and Influential Persons (other than individuals) will be the greater of 5% of their market capitalization (as defined in the regulations) or \$1 million.

Directors and officers of Influential Persons and Responsible Issuers, Influential Persons who are individuals, and other persons making a public oral misrepresentation would face maximum individual liability of \$25,000 or 50% of their compensation (cash and deferred compensation such as options) received from the issuer and its affiliates in the 12 months preceding the misrepresentation or failure to make timely disclosure.

Experts will be liable for up to the greater of \$1 million or the amount of revenue earned by the expert or its affiliates from the responsible issuer during the preceding 12 months.

The legislation provides for other general limits on the amount of damages payable. For example, the liability limits will have national application. This means Courts are to deduct damages assessed in other related actions in Ontario and other provinces and territories in Canada under comparable legislation and amounts paid to settle those actions.

H. Exception to Liability Limits

The liability limits outlined above will not apply to defendants, other than responsible issuer, if a plaintiff proves the person or company authorized, permitted or acquiesced in the making of misrepresentation or failure to make timely disclosure while knowing it was misrepresentation or failure to make timely disclosure.

I. Allocation of Liability

One feature of the legislation beneficial to defendants is that violators will only be liable in proportion to their degree of fault. This is different than liability for primary market disclosure and is intended to be a safeguard mechanism to prevent targeting of only “deep pocket” defendants.

However, the relative protection of proportionate liability can be lost if it is proven that the defendant authorized, permitted or acquiesced in making the misrepresentation or failure to make timely disclosure while knowing it to be misrepresentation or failure to make timely disclosure. If this occurs, then the whole amount of damages assessed in the action may be recovered from that defendant.

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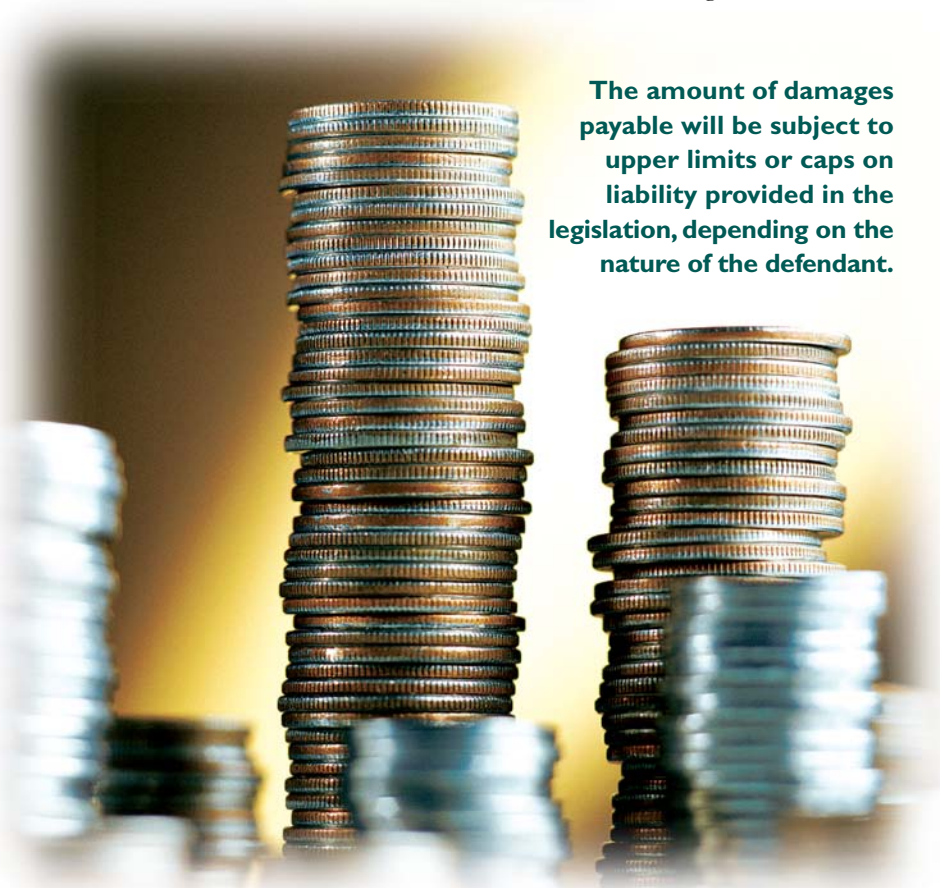
J. Procedural Safeguards for Potential Defendants

Some members of the legal community fear that this new legislation will open the floodgates in Canada to class actions against public issuers, their major shareholders, officers and directors and various professionals. However, in addition to the provisions establishing a regime of proportionate liability, the legislation has some important procedural safeguards and controls in order to avoid frivolous, coercive and unmeritorious litigation.

Most important is the screening mechanism of required court leave for potential lawsuits. All plaintiffs must obtain leave of the Court to start a proceeding. In order to do so, the court must be satisfied that (a) the action is being brought in good faith, and (b) there is a reasonable possibility of success. This is a fairly high hurdle for plaintiffs to overcome.

There are also restrictions on settlement, as no proceeding can be stayed, discontinued, settled or dismissed for delay without court approval. Finally, the legislation provides loser-pays cost rules, meaning the prevailing party will be entitled to costs of the litigation.

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K. Other Procedural Matters

A few other procedural matters of note are the following:

OSC Intervenor Status and Public Notifications:

The Commission must be notified by plaintiffs of all applications for and granting of leave, and the Commission has the right to intervene in any proceeding. Further, plaintiffs must promptly issue a news release once it has been granted leave to commence a proceeding.

Limitation Periods: No proceeding can be commenced more than three years after the date on which the relevant document was released, the date on which the public oral statement was made, or the date on which the requisite disclosure was required to be made. In addition, no proceeding can be commenced more than six months after the issuance of a news release disclosing that a plaintiff has obtained leave to commence an action.


Not an Exclusive Remedy: The rights provided in this legislation are meant to be an addition to all the other remedies available at law.

WHAT ISSUERS SHOULD DO NOW TO MINIMIZE THEIR EXPOSURE

In light of the impending nature of this legislation both in Ontario and British Columbia, all public issuers would be wise to immediately consider several matters in the interests of minimizing exposure. Generally, the ability to establish a proper defence to an action brought by a plaintiff under this new legislation will depend on whether issuers have implemented appropriate controls and procedures for disclosure of information. Thus it is recommended that all public issuers follow the guidelines below, largely as found in TSXtra Online Newsletter, Vol.4, Issue 1, "Ready for Civil Liability?" In addition, Issuers will want to ensure that their insurance coverage for directors and officers is adequate to deal with the implications of this impending legislation.

A. Fully Comply with the TSX Timely Disclosure Policy [found in Section 406-423.3 of the TSX Company Manual]

The TSX requires issuers to immediately disclose material information, both material changes and material facts, through an approved news wire service. Issuers can best ensure they comply with timely disclosure of a material change by following these disclosure rules.



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B. Adopt and Adhere to a Written Disclosure Policy

When deciding whether there is liability, courts are required to consider whether the issuer had a suitable disclosure compliance system or policy in place. Thus, issuers must design, adopt and adhere to appropriate disclosure policies and procedures. Directors will be held responsible to ensure that suitable policies and procedures are adopted, and they have an ongoing responsibility to monitor compliance.

Policies should:

- ▶ describe the process for reviewing public disclosures (including news releases),
- ▶ identify who is responsible for the process, and
- ▶ outline the circumstances in which a material change has occurred.

All issuers should review any existing disclosure policies to ensure they are current, that the policies address the required elements and that they are being followed.

C. Plan Public Oral Statements

All issuers should carefully plan, and even fully script where possible, any public presentations and oral statements by spokespersons. In addition, a record of public oral statements should be kept to aid in identifying and quickly rectifying any misrepresentations or failures to disclose.

Footnotes

¹Bill 198, now the *Budget Measures Act, 2002*, passed on December 9, 2002, which contains the main provisions, and Bill 149, now the *Budget Measures Act (Fall), 2004*, passed on December 16, 2004, which contains further and mostly technical amendments.

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