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### SANCTIONS AGAINST INSIDER TRADING: A PROPOSAL FOR REFORM

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*This article reviews Canadian legislative penal, civil and administrative sanctions against insider trading. It notes the limitations on these sanctions as a means of deterring insider trading. It then proposes a reform of the law which would allow Securities Commissions to bring civil actions on behalf of persons who have traded either with insiders or when insiders have traded.*

*Dans cet article l'auteur passe en revue les sanctions pénales, civiles et administratives imposées par la loi pour les activités de dirigeant. Il souligne que ces sanctions ont un effet limité quand il s'agit de décourager ce genre d'activité. Il propose donc une réforme du droit qui permettrait aux commissions de valeurs mobilières de lancer une action civile au nom des personnes qui ont passé une transaction soit avec le dirigeant soit au moment où le dirigeant passait sa transaction.*

#### Introduction

In spite of its being prohibited, it is a common perception that there is in fact a great deal of insider trading. The perception is borne out by empirical studies that indicate substantial insider trading in advance of the public announcement of significant events with respect to securities issuers.<sup>1</sup> Concern for the lack of enforcement of the prohibition has taken

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<sup>1</sup> See, e.g., E.F. Fama, L. Fisher, M. Jensen and R. Roll, *The Adjustment of Stock Prices to New Information* (1969), 10 *International Economic Review* 1; F.K. Reilly and E.F. Drzycinski, *Short-Run Profits from Stock Splits* (1981), *Financial Management* 64 (showing evidence of stock price increases in advance of the announcement of a stock split).

on a relatively high profile in recent years. In the United States the highly

Insider trading may also explain stock price increases prior to the announcement of takeovers or mergers; see, e.g., G. Mandelker, Risk and Return: The Case of Merging Firms (1974), 1 J. of Fin. Eco. 303; A.J. Keown and J.M. Pinkerton, Merger Announcements and Insider Trading Activity: An Empirical Investigation (1981), 36 J. of Fin. 855; but see G.A. Jarrell and A.B. Poulsen, Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation (1989), 5 J. of Law, Eco. & Org. 225, suggesting that much of the pre-bid increase in price may be due to market anticipation rather than insider trading. Trading by insiders has been linked to pre-announcement periods; see, e.g., J.H. Lorie and V. Neiderhoffer, Predictive and Statistical Properties of Insider Trading (1968), 11 J. of L. & Eco. 35.

There is also evidence of profits from insider trading based on studies of insider trading reports. See, e.g., J. Jaffe, Special Information and Insider Trading (1974), 47 J. of Bus. 410; J. Jaffe, The Effect of Regulation Changes on Insider Trading (1974), 5 Bell J. of Eco. and Mgmt. Sci. 93; J.E. Finnerty, Insiders and Market Efficiency (1976), 31 J. Fin. 1141; H.N. Seyhun, Insiders Profits, Costs of Trading and Market Efficiency (1986), 16 J. of Fin. Eco. 189; H.N. Seyhun, The Information Content of Aggregate Insider Trading (1988), 61 J. of Bus. 1; D.J. Fowler *et al.*, A Preliminary Examination of Insider Trading in Canada (paper delivered at the Canadian Association of Administrative Sciences Annual Conference (1977), pp. 189-194); J.B. Baesel and G.R. Stein, The Value of Information: Inferences from the Profitability of Insider Trading (1979), 14 J. Fin. & Quant. Ana. 553; but see M.S. Rozeff and M.A. Zaman, Market Efficiency and Insider Trading—New Evidence (1988), 61 J. Bus. 25; D. Givoly and D. Palmon, Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence (1985), 58 J. of Bus. 69; M.H. Lee and H. Bishara, Securities Regulation and Market Efficiency (1985), 5 Intl. Rev. of L. & Eco. 247, suggesting insiders make little or no profit on their reported trades. Insiders also appear to earn profits on trading timed to correspond to announcements such as forecasts of annual earnings; see, e.g., S.H. Penman, Insider Trading and the Dissemination of Firms' Forecast Information (1982), 55 J. Bus. 479; J. Elliot, D. Morse and G. Richards, The Association Between Insider Trading and Information Announcements (1985), 15 Rand J. Econ. 521. R. Heinkel and A. Kraus, The Effect of Insider Trading on Average Rates of Return (1987), 20 Cdn. J. of Eco. 588, found evidence of profitable insider trading for stocks traded on the Vancouver Stock Exchange, but found that insider portfolio performance did not outperform outsider portfolio performance on average.

This apparent extensiveness of insider trading may be due in part to lack of enforcement of insider trading sanctions. The lack of enforcement is referred to in R.L. Simmonds, Penal Liability for Insider Trading in Canada: Commission des Valeurs Mobilières du Québec v. Blaikie (1988), 14 C.B.L.J. 477, at p. 477; F.H. Buckley, How to do Things with Inside Information (1977-78), 2 C.B.L.J. 343, at p. 344, noting the relative paucity of significant Canadian decisions on insider trading. As noted by Simmonds, the only cases of any note are *Green v. Charterhouse Group Canada Ltd.* (1976), 68 D.L.R. (3d) 592, 12 O.R. (2d) 280 (Ont. C.A.); *Re Danuke* (1981), 2 O.S.C. Bull. 31C; *Re Connor*, [1976] O.S.C. Bull. 149 and *Re Royal Trustco Ltd. and Ontario Securities Commission* (1983), 148 D.L.R. (3d) 301, 42 O.R. (2d) 147 (Ont. Div. Ct.). See also *Kaiser Resources and Robert C. Stanlake* (1981), 1 O.S.C. Bull. 13C and *NIR Oil Ltd. v. Bodrug* (1984), 23 B.L.R. 52 (Alta. Q.B.), *aff'd* (1985), 18 D.L.R. (4th) 608 (Alta. C.A.). In British Columbia, when action was taken against two directors of Greenwell Resources Ltd., it was suggested, on the representations of a former Superintendent of Brokers and a former director of corporate investigations, that it was thought to be the first time the provincial securities regulators had acted in a case of illegal insider trading; see "Two directors of Greenwell Resources facing insider-trading charges in B.C.", *Globe & Mail*, Report on Business, Aug. 3rd, 1988, p. B4.

publicized actions against Dennis Levine<sup>2</sup> and Ivan Boesky,<sup>3</sup> as well as numerous other actions pursued by the Securities Exchange Commission,<sup>4</sup> followed the enactment of the Insider Trading Sanctions Act of 1984<sup>5</sup> and an increased enforcement effort against insider trading by the Commission.<sup>6</sup> More recently, concern in the United States has focused on the need to provide a statutory definition of insider trading as well as the need to further augment enforcement against insider trading, resulting in the enactment of the Insider Trading and Securities Fraud Enforcement Act of 1988.<sup>7</sup> The enforcement activity with respect to insider trading in Canada has not been as extensive and dramatic as it has been in the United States. However, the cases of *Commission des valeurs mobilières du Québec v. Blaikie*<sup>8</sup> and *R. v. Bennett*<sup>9</sup> drew attention to and raised concerns with respect to insider trading.

Although there has been considerable debate as to whether insider trading should be prohibited,<sup>10</sup> the current law in North America reflects

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<sup>2</sup> *SEC v. Levine*, No. 86-3726 (S.D.N.Y., 1986).

<sup>3</sup> *SEC v. Boesky*, No. 86-8767 (S.D.N.Y., 1986).

<sup>4</sup> A number of these actions are summarized in T.A. Levine and A.G. Mathews, Government Enforcement Activities Involving Insider Trading Abuses (1987), 19 Inst. or Sec. Reg. (vol. I) 409.

<sup>5</sup> 98 STAT 1264.

<sup>6</sup> See H.R. No. 98-355, Sept. 15, 1983, pp. 5-6, noting that the SEC had made the prosecution of insider trading a priority and that it had brought more cases in the past four years than in all previous years combined.

<sup>7</sup> 102 STAT 4677. See H.R. No. 100-910, Sept. 9, 1988. See also the Insider Trading Proscriptions Act of 1987, Bill S. 1380, 100th Congress, 1st Session. See also, Report of the Task Force on Regulation of Insider Trading (1985), 41(1) Bus. Law 223.

<sup>8</sup> (1988), *Société Québécoise d'Information Juridique*, Judgment no. 88-636 (Que. Ct. Sess.) (commented on by Simmonds, *loc. cit.*, footnote 1).

<sup>9</sup> (May 12, 1989, file B06477C2, Provincial Court of B.C.).

<sup>10</sup> This question has been extensively debated. A very abbreviated list of the literature on this debate includes, for example, H. Manne, *Insider Trading and The Stock Market* (1966); H. Manne, *Insider Trading and the Law* (1970), 23 Vand. L. Rev. 547; F.H. Easterbrook, *Insider Trading as an Agency Problem*, in J. Pratt and R. Zecharauser (eds.), *The Agency Relationship* (1984); D.W. Carlton and D.R. Fischel, *The Regulation of Insider Trading* (1983), 35 Stan. L. Rev. 857; R.A. Schotland, *Unsafe at any Price: A Reply to Manne, Insider Trading and the Stock Market* (1967), 53 Virg. L. Rev. 1425; V. Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws* (1979), 93 Harv. L. Rev. 322; D.S. Karjala, *Statutory Regulation of Insider Trading in Impersonal Stock Markets*, [1982] Duke L.J. 627; S. Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts* (1982), 68 Virg. L. Rev. 117. The available empirical evidence has yet to resolve this debate; see Easterbrook, *ibid.* In the author's view the arguments and evidence on insider trading are equivocal with respect to whether it should be prohibited. The author remains ambivalent on the point and simply accepts, for the purposes of this article, that the policy of prohibiting insider trading, as reflected in the current law, will continue.

a policy of deterring insider trading and compensating "victims"<sup>11</sup> of it.<sup>12</sup> Insider trading is generally prohibited and civil remedies are provided to compensate for losses incurred as a result of insider trading. The object of this article is not to reconsider whether the current policy is appropriate. Instead, it is assumed, for the purposes of this article, that:

- (i) it is desirable to deter insider trading;
- (ii) the activity is capable of being deterred;<sup>13</sup> and
- (iii) that it is desirable to "compensate" those who have incurred losses as a consequence of trading with or by others who had better access to and knowledge of inside information.<sup>14</sup>

This article reassesses the effectiveness of the current means of enforcing the prohibition against insider trading and proposes a reform to improve the effectiveness of the enforcement of the prohibition against insider trading. Briefly stated, the proposal is to allow Securities Commissions to bring civil actions on behalf of persons who have incurred losses in trades with insiders. Securities Commissions would use the amounts awarded to pay

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<sup>11</sup> It is not clear how the "victims" should be defined—see *infra*, footnote 14.

<sup>12</sup> It is often alleged that insider trading reduces the confidence of the investing public in the market. Deterrence of insider trading thus encourages investment by increasing the public's confidence in the market. See, for example, S.M. Beck, Of Secretaries, Analysts and Printers: Some Reflections on Insider Trading (1983-84), 8 C.B.L.J. 385, at p. 394, and Brudney, *loc. cit.*, footnote 10. Compensation could also conceivably promote confidence in the market by ensuring that investors who did incur losses as a consequence of insider trading, or the lack of information traded on by an insider, will be able to recover that loss.

<sup>13</sup> Although there may be a variety of motivations for insider trading, perhaps even including a perverse pleasure at taking advantage of others, it is assumed that the primary motivation for most insider trading is greed. Accordingly, removing the expectation of a gain from insider trading should deter most insider trading.

<sup>14</sup> There has been considerable debate as to whether anyone really loses as a consequence of insider trading; see, e.g., M.P. Dooley, Enforcement of Insider Trading Restrictions (1980), 66 Va. L. Rev. 1, at pp. 33, 36, 55, 68; H. Manne, Insider Trading and the Stock Market (1966), pp. 93-104; Comment, Insider Trading Without Disclosure—Theory of Liability (1967), 28 Ohio St. L.J. 472, at p. 477; Note, Insider's Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Shares (1969), 78 Yale L.J. 864, at p. 872; K.E. Scott, Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy (1980), 9 J. Legal Stud. 801, at pp. 807, 809; and see W.K.S. Wang, Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed and Who Can Sue Whom Under SEC Rule 10b-5? (1981), 54 So. Cal. L.R. 1217. Current securities legislation in Canada provides for an action for compensation by the person who traded with another person who had better access to insider information. This only compensates those who, by windfall, traded with the "insider". It does not compensate others who might not have traded had they known of the information. Thus, the group of persons who might be said to be deserving of "compensation" may be much broader than the group of persons who traded directly with persons having better access to and knowledge of inside information. The arguments and evidence with respect to whether anyone loses as a consequence of insider trading are equivocal. The author, in making the assumption noted in the text, simply accepts the policy of compensation reflected in the current legislation and assumes it is not likely to change in the near future.

for the costs of enforcement and to compensate those who have incurred losses due to insider trading.

The reform proposal is set out after arguing that the existing means of enforcing the prohibition against insider trading are not likely to be effective. Part I provides an overview of the criminal sanctions against insider trading in Canada and notes the inevitable reliance on circumstantial evidence in most insider trading cases and the consequent difficulties that the Crown faces in proving its case. It considers the impediments to obtaining a conviction when the circumstantial nature of insider trading cases encounters the criminal law burden of proof, the non-compellability of the accused and limitations on the laying of the charge. Part II considers the existing civil and administrative sanctions, and Part III proposes a reform empowering Securities Commissions to bring actions on behalf of persons incurring losses as a consequence of insider trading.

### *I. Penal Sanctions: Impediments to Enforcement*

Canadian Securities Acts attempt to deter insider trading, in part, through a penal sanction. The effectiveness of the sanction is constrained by the circumstantial nature of the evidence in insider trading cases coupled with the criminal law burden of proof. This Part sets out the elements which the Crown must prove to establish the offence, shows that the evidence available to establish certain elements of the offence will almost invariably be circumstantial, and notes the impediments to penal sanctions which, coupled with circumstantial evidence, are likely to make such sanctions ineffective.

#### *A. The Elements of the Criminal Offences*

Generally Canadian Securities Acts contain provisions prohibiting both trading on inside information and informing others of inside information. To obtain a conviction for trading on inside information under most Canadian Securities Acts the Crown must prove that:

- (i) the accused was in a "special relationship"<sup>15</sup> with the issuer of the securities;<sup>16</sup>

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<sup>15</sup> See *infra*, footnote 25.

<sup>16</sup> See the Securities Act, S.B.C. 1985, c. 83, s. 68(1)(a), as am., S.B.C. 1989, c. 78, s. 25 (hereinafter "B.C.S.A."); Securities Act, R.S.O. 1980, c. 466, s. 75(1), as am., S.O. 1987, c. 7, s. 7 (hereinafter "O.S.A."); The Securities Act, S.S. 1988, c. S-42.2, s. 85(3) (hereinafter "S.S.A."); The Securities Act, R.S.M. 1988, c. S50, s. 112(1) (hereinafter "M.S.A."); Securities Act, R.S.N.S. 1989, c.418, s. 82(1)(a) (hereinafter "N.S.S.A."); Securities Act, S.A. 1981, s. 119(2), as am. 1989, c. 19, s. 6 (hereinafter "A.S.A."). Sections 187 and 189 of the Quebec Securities Act, R.S.Q., c. V-1.1, as am. (hereinafter "Q.S.A.") provide a roughly corresponding approach.

The issuer of the securities must be a "reporting issuer". "Reporting issuer" is defined so as to include "persons" (broadly defined to include individuals, corporations, partnerships, trusts, etc.) who have issued securities which are publicly traded. See the definitions of

- (ii) the accused purchased or sold securities of the issuer;<sup>17</sup>
- (iii) the accused made the purchase or sale with knowledge of material information<sup>18</sup> concerning the affairs of the issuer;<sup>19</sup> and
- (iv) that the material information had not been generally disclosed.<sup>20</sup>

“reporting issuer”, “issuer” and “person” in the B.C.S.A., s. 1(1); O.S.A., ss. 1(1) 18, 28, 38; S.S.A., s. 2(1)(x), (hh), (qq); N.S.S.A., s. 2(1)(s), (ad), (ao); A.S.A., s. 1(t.1), (j), (o). See ss. 5 and 68 of the Q.S.A. for definitions of “reporting issuer” and “issuer”. Manitoba uses the term “corporation” (see M.S.A., s. 100) for the purposes of the insider trading provisions. The definition is similar to that of “reporting issuer” in other jurisdictions, but is limited to incorporated organizations or associations.

Newfoundland, Prince Edward Island and New Brunswick do not have provisions on insider trading in their respective Securities Acts. There are provisions in the New Brunswick Business Corporations Act, S.N.B. 1981, c. B-9.1, as am., S.N.B. 1983, c. 15, s. 15, and in The Corporations Act, S. Nfld. 1986, c. 12, as am., S. Nfld. 1987, c. 38, ss. 207-210, making insiders liable to compensate direct losses of others where they “make use of any specific confidential information”.

<sup>17</sup> See B.C.S.A., s. 68(1); O.S.A., s. 75(1); S.S.A., s. 85(3); M.S.A., s. 112(1); N.S.S.A., s. 82(1)(a); A.S.A., s. 119(2). See also s. 187 of the Q.S.A. For the purposes of the prohibition against insider trading in several of the Securities Acts a “security of the reporting issuer” is deemed to include a put, call, option or other right or obligation to purchase or sell securities of the reporting issuer or a security the market price of which varies materially with the market price of the securities of the reporting issuer. See, B.C.S.A., s. 68(1)(d), (e); O.S.A., s. 75(6); S.S.A., s. 85(2); M.S.A., s. 112(6); A.S.A., s. 119(1). S. 189.1 of the Q.S.A. is to similar effect.

<sup>18</sup> The legislation generally refers to “material facts” and “material changes”. A “material fact” is defined as:

... a fact that significantly affects, or could reasonably be expected to significantly affect the market price or value of those securities.

See B.C.S.A., s. 1(1). Similar or identical definitions (generally substituting “would” for the word “could”) can be found in other Securities Acts. See O.S.A., s. 1(1) 22.; S.S.A., s. 2(1)(z); M.S.A., s. 108(1); N.S.S.A., s. 2(1)(w); A.S.A., s. 1(1).

A “material change” is defined as:

... a change in the business, operations, assets or ownership of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer and includes a decision to implement that change made by

- (a) senior management of the issuer who believe that confirmation of the decision by the directors is probable, or
- (b) the directors of the issuer.

See B.C.S.A., s. 1(1). Similar or identical definitions can be found in other Securities Acts. See O.S.A., s. 1(1) 21.; S.S.A., s. 2(1)(y); M.S.A., s. 108(1); N.S.S.A., s. 2(1)(v); A.S.A., s. 1(k.1). The Q.S.A. uses the term “privileged information” which is defined in s. 5 as “any information not yet generally known that could affect the value or the market price of the securities of an issuer”.

<sup>19</sup> B.C.S.A., s. 68(1)(b); O.S.A., s. 75(1); S.S.A., s. 85(3); M.S.A., s. 112(1); N.S.S.A., s. 82(1)(a); A.S.A., s. 119(2). The Q.S.A., s. 187 uses the expression “having privileged information”.

<sup>20</sup> *Ibid.* This element is present in the definition of “privileged information” under the Q.S.A.

To obtain a conviction for informing another of inside information, the Crown must prove that:

- (i) the accused person was in a "special relationship" with the issuer;<sup>21</sup>
- (ii) the accused informed another person of material information<sup>22</sup> with respect to the issuer;<sup>23</sup> and
- (iii) the accused informed another person of the material information before it was generally disclosed.<sup>24</sup>

The definition of "special relationship", in general terms, attempts to cover both persons who have direct access to inside information and persons who obtain the information indirectly through an informer or chain of informers.<sup>25</sup> Those persons who have obtained information through an informer or chain of informers are colloquially referred to as "tippees".

<sup>21</sup> See B.C.S.A., s. 68(2), (3); O.S.A., s. 75(2), (3); M.S.A., s. 112(2); S.S.A., s. 85(4), (5); N.S.S.A., s. 82(1)(b); A.S.A., s. 119(3); Q.S.A., ss. 188, 189.

<sup>22</sup> See *supra*, footnote 17.

<sup>23</sup> See B.C.S.A., s. 68(2), (3); O.S.A., s. 75(2), (3); M.S.A., s. 112(2); S.S.A., s. 85(4), (5); N.S.S.A., s. 82(1)(b); A.S.A., s. 119(3); Q.S.A., s. 188.

<sup>24</sup> *Ibid.* This aspect is present in the definition of "privileged information" in s.5 of the Q.S.A.

<sup>25</sup> The definition of those having access to inside information (that is, in a "special relationship" with the reporting issuer) includes "insiders", "affiliates" or "associates" (see *infra*, footnote 79) of:

- (i) the reporting issuer;
- (ii) "persons" proposing to make a takeover bid, be a party to a reorganization, amalgamation, merger, arrangement or similar business combination with the reporting issuer, or proposing to acquire a substantial portion of the property of the reporting issuer.

It includes persons engaging or proposing to engage in any business or professional activity with the reporting issuer or with a person described in (ii) above. It also includes directors, officers or employees of the reporting issuer, of persons described in (ii) above, or of persons engaging or proposing to engage in business or professional activity with the reporting issuer or with persons described in (ii) above. It also includes any person who acquired knowledge of insider information while they were in any of the relationships described above. Further, it includes any person in the subsequent chain of persons who learned of material information that originated from any of the persons described above. See, generally, B.C.S.A., s. 3; O.S.A., s. 75(5); M.S.A., s. 112(5); S.S.A., s. 85(1); N.S.S.A., s. 82(3); A.S.A., s. 9. S. 189 of the Q.S.A. defines the persons to whom the prohibition applies in different terms but its scope is roughly the same.

"Person" is typically broadly defined to include individuals, corporations, partnerships, trusts, funds, associations, or any other organized group of persons, or the personal or legal representative of a person. See, *e.g.*, B.C.S.A., s. 1(1); O.S.A., s. 1(1)28; S.S.A., s. 2(1)(hh); A.S.A., s. 1(o); M.S.A., s. 1(1); N.S.S.A., s. 2(1)(ad).

"Take over bid" is generally defined as any offer to acquire outstanding voting or equity securities of a class made to a person in the province where the effect of the acquisition would result in the bidder owning or controlling twenty per cent or more of that class of securities. See B.C.S.A., s. 74(1); O.S.A., s. 88(1); S.S.A., s. 98(1)(j); A.S.A., 131(1)(j); M.S.A., s. 80(1); N.S.S.A., s. 95(1)(p).

To establish that a tippee accused of trading or informing was in a "special relationship" with the issuer, the Crown must prove that the accused:<sup>26</sup>

- (i) acquired knowledge of the inside information from a person having direct access to inside information or from a tippee of a person having direct access to inside information; and
- (ii) knew or ought reasonably to have known that the person communicating the knowledge was such a person.

The prohibitions with respect to informing typically permit the defence that the information was given in the necessary course of business of the reporting issuer.<sup>27</sup> There is a defence with respect to both the trading and informing offences that the person reasonably believed that the material information had been generally disclosed.<sup>28</sup>

<sup>26</sup> See B.C.S.A., s. 3(e); O.S.A., s. 75(5)(e); M.S.A., s. 112(5)(e); S.S.A., s. 85(1)(e); N.S.S.A., s. 82(3)(e); A.S.A., s. 9(e). The Q.S.A. covers tippees in s. 189(5), referring to persons having privileged information that, to the person's knowledge, was disclosed by the persons having access to privileged information as set out in s. 189(1) to (4). S. 189(6) refers to persons who acquired privileged information knowing it to be privileged information concerning a reporting issuer.

<sup>27</sup> B.C.S.A., s. 68(2); O.S.A., s. 75(2); M.S.A., s. 112(2); S.S.A., s. 85(4); N.S.S.A., s. 82(1)(b); A.S.A., s. 119(3); Q.S.A., s. 188(2).

<sup>28</sup> B.C.S.A., s. 68(4); O.S.A., s. 75(4); S.S.A., s. 85(6)(a); N.S.S.A., s. 82(1)(a); M.S.A., s. 112(4)(a); A.S.A., s. 119(a); Q.S.A., s. 187(1) and s. 188(1). Both M.S.A., s. 112(4)(b) and A.S.A., ss. 119(6)(b), provide the defence that the material fact or change was known or ought reasonably to have been known to the purchaser. The A.S.A. also provides for a series of defences with respect to trading on inside information such as that the person who made the trade did not have "actual" knowledge of the material information, acted on behalf of a person who did not have knowledge of the material information or that the purchase was pursuant to a legal obligation to do so (see A.S.A., s. 119(5)). The N.S.S.A. also provides the defence that the defendant did not make use of the material information in purchasing or selling the securities.

Given that these provisions carry criminal sanctions, it is likely that the accused's burden of proof is only such as to raise a reasonable doubt with respect to concluding that they could *not* have reasonably believed that the material fact or material change had been generally disclosed. If it required proof on a balance of probabilities of a reasonable belief that the information had been generally disclosed it would probably be considered contrary to s. 11(d) of the Canadian Charter of Rights and Freedoms, Constitution Act, 1982, Part I; see *R. v. Dubois*, [1985] 2 S.C.R. 350, (1985), 23 D.L.R. (4th) 503; *R. v. Oakes*, [1986] 1 S.C.R. 103, (1986), 26 D.L.R. (4th) 200; *R. v. Vaillancourt*, [1987] 2 S.C.R. 636, (1987), 47 D.L.R. (4th) 399; *R. v. Holmes*, [1988] 1 S.C.R. 914, (1988), 50 D.L.R. (4th) 680; *R. v. Whyte*, [1988] 2 S.C.R. 3, (1988), 51 D.L.R. (4th) 481. S. 68(4) of the B.C.S.A. requires the accused to prove "on the balance of probabilities" that he or she reasonably believed that the material fact or material change had been generally disclosed. This "reverse onus" provision is probably contrary to s. 11(d) of the Canadian Charter of Rights and Freedoms: see the cases noted above, especially *R. v. Oakes*, and the views of Dickson C.J.C. at pp. 132-133 (S.C.R.), 222-223 (D.L.R.). It might be said to be demonstrably justifiable under s. 1 of the Charter.



## B. *Circumstantial Evidence in Insider Trading Cases*

Whether the Crown is seeking a penal sanction against (i) an "insider" (hereinafter used broadly to refer to a person who has direct access to inside information)<sup>29</sup> for trading, or (ii) against an informer or tippee, the Crown will almost inevitably have to rely on circumstantial evidence to establish one or more of the elements noted above.

### (1) *Trading by an Insider*

Where it is alleged that an insider traded on inside information, the Crown may be able to obtain direct evidence with respect to most of the elements of the offence. For instance, the Crown will generally be able to obtain direct evidence from corporate records that the person is or was at the time an insider, affiliate, associate, director, officer or employee of the issuer. In the simplest case, the Crown should also be able to establish through direct evidence that the person traded, as well as the time of the trades. This may be obtained from the records of brokers and of stock exchanges. There may also be direct evidence of the material information if it has subsequently been disclosed in a material change report.<sup>30</sup> This would allow the Crown to establish the existence of material information and will provide evidence with respect to when the information became generally disclosed.

In the best of cases the Crown may only have to resort to circumstantial evidence to show that the accused knew of the material information. If the circumstantial evidence is strong enough the accused would then have to show that he or she either did not know of the material information or that he or she reasonably believed that the material information had been generally disclosed.

Thus, where an insider is alleged to have traded, the Crown may well be able to obtain direct evidence with respect to most of the elements of the offence. However, without an admission from the accused, circumstantial evidence will, at the very least, be required to show the accused knew of the material information.

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<sup>29</sup> For brevity the term "insider" is used in a broader sense than the definition given in Securities Act (see *infra*, footnote 61). In the sense it is being used here, it includes all the persons described *supra*, footnote 25, except for tippees.

<sup>30</sup> See the requirements for material change reports: B.C.S.A., s. 67; O.S.A., s. 74; S.S.A., s. 84; N.S.S.A., s. 81; A.S.A., s. 118; Q.S.A., ss. 73 and 74. National Policy No. 40 extends the application of these provisions to "material information" which consists of both "material changes" and "material facts" (see section D of the Policy Statement and see, *supra*, footnote 18, on the definition of "material change" and "material fact").

## (2) *Informing and Tippee Trading*

Where it is alleged that the accused informed another or that the accused is a tippee who traded, the Crown will have to prove, as in the case where an accused with direct access to inside information traded, that the informer was in a special relationship with the reporting issuer, that there was a material fact or material change that was not generally disclosed, and, with respect to a tippee trader, that the tippee bought or sold securities of the reporting issuer.<sup>31</sup> In addition, in the case of informing, the Crown must prove that the accused informed, and in the case of tippee trading, the Crown must prove that the tippee acquired knowledge of the inside information from an alleged informer.<sup>32</sup> This will require proof of a communication of the inside information by the informer to the tippee either at a meeting of the two or by some other form of communication such as by telephone.

Where, for example, the communication is by telephone, the Crown must prove:

- (i) the exact time and duration of the telephone call or calls in which the information was communicated;
- (ii) who made and who received the call or calls; and
- (iii) that the conversation during the call or calls included a communication of the material information.

Unless the Crown is blessed with an unusually cooperative tippee or informant who gives direct evidence with respect to these matters, the best the Crown can hope for, in most cases, would be to be able to establish that:<sup>33</sup>

- (i) there was a call from the place where the insider was at the time of the call; and
- (ii) the call was to the place where the tippee was at the time of the call.

The origin and destination of telephone calls and the time of telephone calls may be established from telephone company records of long distance calls.<sup>34</sup> However, it will generally not be clear that the informer made the call, that the tippee received the call, or that the conversation included a communication of the inside information. There may have been many persons who could have made the call from the place where the call was made and there may have been many persons who could have received the call at the place it was received. Moreover, there may also have been

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<sup>31</sup> See *supra*, Part I.A.

<sup>32</sup> *Ibid.*

<sup>33</sup> This was essentially the Crown's evidence of a communication in *R. v. Bennett*, *supra*, footnote 9.

<sup>34</sup> This was the source of the evidence of the timing of the telephone calls in *R. v. Benett*, *ibid.*

a number of outlets at either location to make or receive the call.<sup>35</sup> To establish that the call was made by the informer and received by the tippee could require the testimony of all persons other than the informer and the tippee at either location. With the potential for numerous calls made and received at each location, the possibility that many calls may have been placed between the two locations, faded memories and the potential for perjury, it will be very difficult to establish with direct evidence that the call was between the informant and the tippee.

Consequently, a number of inferences must be drawn to establish the communication of the inside information. It must be inferred that:

- (i) it was the informer who made the telephone call from the place where the insider was to the place where the tippee was;
- (ii) the tippee received that call; and
- (iii) the conversation during the call included a communication of the inside information.

With respect to the tippee, the further inference must be drawn that the tippee knew or ought to have known that the person communicating the information was in a special relationship with the issuer.

The Crown may be able to introduce several pieces of circumstantial evidence that would support the inferences that need to be drawn. For instance, the Crown may be able to introduce evidence indicating that the timing of trades and the time of the material information (or the time of the general disclosure of the material information) were exceptionally fortuitous, that the trading activity was inconsistent with a reasonably prudent investment strategy, that the trades were made with exceptional haste, that the disclosure of the information was unduly delayed, or that there was an ongoing personal or business relationship between the informant and the tippee.

If the informer or tippee introduces evidence to establish that he or she reasonably believed the information to have been generally disclosed then the Crown may also have to rely on circumstantial evidence for the contrary inference that the informant or tippee ought to have known from the conversation or the circumstances that the information had not been generally disclosed.

Thus, in the case of informing and in the case of trading by tippees, the Crown will have to rely on circumstantial evidence to prove several elements of the offences with respect to insider trading.

### (3) *Summary*

To obtain a conviction against insider trading or informing the Crown will have to rely on circumstantial evidence to support a number of inferences

<sup>35</sup> This was the problem with the telephone call in which Doman was alleged to have informed the Bennetts of the withdrawal of a takeover in *R. v. Bennett*, *ibid*.

required to establish elements of the offences. In the case of trading by an insider, the Crown may not have to rely as heavily on circumstantial evidence. However, where the Crown is seeking a conviction for informing or for trading by a tippee, the reliance on circumstantial evidence will be much greater.

### *C. Circumstantial Evidence and Related Impediments to Penal Sanctions for Insider Trading*

Successful enforcement of insider trading prohibitions through penal sanctions is impeded when the circumstantial nature of the majority of insider trading cases is coupled with the procedural hurdles of (i) a strict burden of proof, (ii) the non-compellability of the accused, and (iii) the specificity required in the laying of the information.

#### *(1) The Burden of Proof*

The burden of proof in a criminal case is proof beyond a reasonable doubt.<sup>36</sup> Given that proving offences with respect to insider trading cases will typically require reliance, to a large degree, on circumstantial evidence, this burden of proof will make it exceedingly difficult to obtain a conviction for either trading or informing on inside information.<sup>37</sup> A case based on circumstantial evidence will tend to leave considerable room for doubt. Only very strong circumstantial evidence will allow a conviction.

The consequence of this and other impediments to a criminal sanction is that the probability of obtaining a conviction is low. This, combined with the costs and difficulties associated with successfully identifying

<sup>36</sup> See, for example, *Woolmington v. D.P.P.*, [1935] A.C. 462, at pp. 481-482 (H.L.); *Manchuk v. The King*, [1938] S.C.R. 341, at p. 349, [1938] 3 D.L.R. 693, at p. 699; *R. v. City of Sault Ste. Marie*, [1978] 2 S.C.R. 1299, at p. 1316, (1978), 85 D.L.R. (3d) 161, at p. 174. Also see s. 11(d) of the Canadian Charter of Rights and Freedoms, *supra*, footnote 28, and see, for example, *Dubois v. The Queen*, *supra*, footnote 28, at pp. 357 (S.C.R.), 521-522 (D.L.R.) and *R. v. Oakes*, *supra*, footnote 28, at pp. 119-121 (S.C.R.), 212-214 (D.L.R.).

<sup>37</sup> Indeed, there may be an even greater burden of proof in cases based on circumstantial evidence. According to the rule in *Hodge's Case*, in a case based on circumstantial evidence, triers of fact must be satisfied "not only that those circumstances were consistent with [the accused's] having committed the act, but they must also be satisfied that the facts were such as to be inconsistent with any other rational conclusion than that the prisoner was the guilty person"; *Hodge's Case* (1838), 2 Lewin 227, at p. 227, 168 E.R. 1136, at p. 1137 (Assizes). The rule has been applied in numerous cases; see, e.g., *R. v. Macchione*, [1937] 1 W.W.R. 151 (B.C.C.A.); *R. v. Carey*, [1945] 3 W.W.R. 508, at p. 509 (B.C.C.A.); *R. v. Sherman* (1945), 62 B.C.R. 241 (B.C.C.A.); *R. v. Comba*, [1938] S.C.R. 396, at p. 397; *Lizotte v. R.*, [1951] S.C.R. 115, at pp. 132-133, [1951] 2 D.L.R. 754, at pp. 769-770; and followed in *R. v. Demetrio* (1926), 59 O.L.R. 249 (Ont. App. Div.), and *R. v. Jasey* (1940), 14 M.P.R. 571 (N.S.S.C.). However, in *R. v. Cooper*, [1978] 1 S.C.R. 860, (1977), 74 D.L.R. (3d) 731, the Supreme Court of Canada held that the "rule" in *Hodge's Case* should be rejected as an inexorable rule of law in Canada; see, at pp. 865 (S.C.R.), 735 (D.L.R.), per Laskin C.J.C., dissenting, and at pp. 881 (S.C.R.), 746 (D.L.R.),

incidents of insider trading and informing, makes the overall probability of enforcement against insider trading and informing very low. A very high penalty is needed to ensure that the expected penalty from engaging in insider trading<sup>38</sup> is sufficient to eliminate any expected benefit and thereby deter insider trading. This is the justification for a penalty of up to three times the profit obtained from the insider trading or informing.<sup>39</sup> However, this may have the perverse effect of raising the burden of proof, and thereby further lowering the probability of enforcement, since the court will be that much more concerned about the injustice of erroneously finding against the accused. It may be that the effect on the probability of enforcement is proportionately greater than the increase in the penalty with the result that the overall deterrent effect is actually lowered.

## (2) *Non-Compellability of the Accused*

In a criminal action the accused is not compellable as a witness.<sup>40</sup> This makes it that much more difficult to get direct evidence on the nature of the knowledge traded on or the nature of the information passed. Although an informer or tippee may not be entirely honest, if they could be compelled

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per Ritchie J. (with whom Martland, Beetz, and de Grandpré JJ. concurred): "It is enough if it is made plain to the members of the jury that before basing a verdict of guilty on circumstantial evidence they must be satisfied beyond a reasonable doubt that the guilt of the accused is the only reasonable inference to be drawn from the proven facts." The position now appears to be (and perhaps in practice has always been) not that there is a higher burden of proof but just that it is harder to meet the burden of proof with circumstantial evidence. As Phipson has put it (Phipson on Evidence (14th ed., 1990), p. 3, para. 1-04), in reference to "direct" and "indirect" evidence:

... the superiority of [direct evidence] is that it contains at most only one source of error, fallibility of assertion, while the latter has, in addition, fallibility of inference.

<sup>38</sup> The "expected" penalty is equal to the probability of successful enforcement times the penalty imposed in the event of successful enforcement.

<sup>39</sup> A penalty of up to the greater of \$1,000,000 and three times any profit made on trading or informing (and not less than the profit) can be obtained pursuant to B.C.S.A., s. 138(4)-(6); O.S.A., s. 118(4), (5); S.S.A., s. 131(6), (7). Under the Q.S.A., s. 204, a maximum fine of the greater of \$1,000,000 and four times the profit can be imposed, with a minimum fine of the greater of \$5,000 or two times the profit made. In other provinces the monetary penalties are less severe—see N.S.S.A., s. 109(1) (\$2,000 for individuals and \$25,000 for persons other than individuals). Imprisonment is also an available sanction—B.C.S.A., s. 138(1) (up to three years); O.S.A., s. 118(1) (up to two years); N.S.S.A., s. 129(1) (up to one year); S.S.A., s. 131(3) (up to two years); Q.S.A., s. 204 (up to two years).

<sup>40</sup> This is specifically provided for in some provinces—see Alberta Evidence Act, R.S.A. 1980, c. A-21, s. 4(3); Evidence Act, R.S.N.B. 1973, c. E-11, s. 5; Provincial Offences Act, R.S.O. 1980, c. 300, s. 47. Some provinces render the accused compellable—see, e.g., Manitoba Evidence Act, R.S.M. 1987, c. E150, s. 4. However, such provisions are likely to be found in violation of s. 11(c) of the Canadian Charter of Rights and Freedoms, *supra*, footnote 28. The B.C. Evidence Act, R.S.B.C. 1979, c. 116, does not state whether the accused is compellable. It was suggested in *Re Samwald and Mills* (1977), 4 B.C.L.R. 113 (B.C.S.C.) that the accused may be compellable by the Crown. However, this interpretation is unlikely to survive a challenge based on s. 11(c) of the Charter.

to testify one could at least cause the accused informer and tippee to respond to questions on these matters and bring into question the credibility of any competing explanations they offer.

Without being able to compel the accused the only way to get direct evidence would be through a wiretap or other similar interception of a private communication. Obtaining such evidence would require advance knowledge of a continuing process of informing and insider trading, so that insider trading subsequent to the events that led to the initial suspicions of insider trading could be pursued with the benefit of evidence from intercepted communications. Evidence from intercepted communications also involves the procedural complexities of obtaining an authorization to intercept communications and getting the evidence admitted.<sup>41</sup> It may also be very costly.

### (3) *Specificity in the Laying of the Information*

Insider trading may go on over a prolonged period. It may involve several trades based on information that is relatively insignificant when viewed in isolation. Nonetheless, the whole series of trades viewed together may indicate a pattern of trading (or of informing) on material inside information.

For instance, the issuer may be in the very initial stages of courting merger candidates or negotiating a purchase or sale of substantial assets. There may be only a small probability of a future transaction. Nonetheless, some trading may occur on the basis of information with respect to the potential transaction. As subsequent information either confirms or lessens the likelihood of the transaction, more trades may occur as persons trading on the inside information adjust their position in the security based on the current status of the inside information received coupled with other available information. Each bit of information may seem relatively immaterial in isolation. Each trade on the new information may be just a slight adjustment in a person's overall position in the security. However, a whole series of such trades viewed together may be quite substantial and may indicate a pattern of trading (or informing) on material inside information about the transaction or a series of transactions.

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<sup>41</sup> See the Criminal Code, R.S.C. 1985, c. C-46, ss. 184-196, as am., R.S.C. 1985, c. 27 (1st Supp.), ss. 24-28 and S.C. 1988, c. 37, s. 45.

An information may be quashed if it is not sufficiently specific.<sup>42</sup> Each count on an information must apply to a single transaction.<sup>43</sup> However, the offence of insider trading or informing may not be readily shown with respect to a particular trade but may be more consistent with a series of trades occurring over a prolonged period. This may impede the Crown in successfully prosecuting insider trading which involves a series of trades based on relatively immaterial information at each discrete stage but which is clearly material when considered as a whole.

#### D. Summary

The reliance on circumstantial evidence in insider trading cases, coupled with the burden of proof, the non-compellability of the accused and the limitations with respect to the laying of an information in criminal cases, makes the likelihood of successful enforcement of a criminal sanction in insider trading cases very low. Increasing the penalty to compensate for the low probability of enforcement may have the perverse effect of increasing the burden of proof and reducing the overall deterrent effect of the sanction.

Although penal sanctions for insider trading have not eliminated insider trading, they may have had some deterrent effect.<sup>44</sup> However, given the impediments to penal sanctions, they do not appear to hold much promise

<sup>42</sup> See, e.g., Offence Act, R.S.B.C. 1979, c. 305, s. 86(3); Provincial Offences Act, R.S.O. 1980, c. 300, s. 26(6). Dealing with a similar provision of the Criminal Code, R.S.C. 1985, c. C-46, s. 581(3), as am., R.S.C. 1985, c. 27 (1st Supp.), s. 118, Lamer J. noted, in *R. v. WIS Developments Ltd.*, [1984] 1 S.C.R. 485, at p. 493, (1984), 9 D.L.R. (4th) 661, at p. 669, that the policy behind these provisions requires that in order for an accused to be treated fairly:

... he must be able clearly to identify what he is alleged to have done wrong so that he may prepare his case adequately, and that at the outset of his trial or thereafter once the trial is over and at some other court, he must be able to argue that he has already been acquitted or convicted of the offence or that he comes within the protective principles set out in *Kienapple v. The Queen* (1974), 15 C.C.C. (2d) 524, 44 D.L.R. (3d) 451, [1975] 1 S.C.R. 729.

See also *R. v. Cote*, [1978] 1 S.C.R. 8, at p. 18, (1977), 73 D.L.R. (3d) 752, at p. 757 (per de Grandpré J.).

<sup>43</sup> See, e.g., Offence Act, R.S.B.C. 1979, c. 305, s. 13(1)(b); Provincial Offences Act, R.S.O. 1980, c. 400, s. 26(2).

<sup>44</sup> The existing provisions may well have had some deterrent effect. Having a penal sanction may send a signal to members of society that such behaviour is considered dishonest or immoral. This may deter insider trading or informing by some of the more noble members of society. Indeed, there is evidence that many business people are aware that insider trading is prohibited and consider it a serious matter; see E. Rosenbaum *et al.*, Corporate and Investment Attitudes Toward Insider Trading in Canada (1983-84), 8 C.B.L.J. 485. Perhaps the deterrent effect of the sanction has led to the results of more recent studies suggesting little or no profits made by insiders on reported trades; see Rozeff and Zamen, *loc. cit.*, footnote 1; Givoly and Palmon, *loc. cit.*, footnote 1; Lee and Bishara, *loc. cit.*, footnote 1.

for further deterrence of insider trading. Consequently, the focus should be on enhancing the deterrent effect provided by civil actions.<sup>45</sup>

## II. *Civil Actions by Securities Holders, the Reporting Issuer and the Securities Commission*

This Part examines the civil actions and administrative proceedings that can be taken with respect to insider trading. These civil actions and administrative proceedings are not likely to be a very effective deterrent to insider trading nor provide an effective means of compensation. The focus in this Part is on the civil actions provided for in Canadian Securities Acts. The provisions appearing in Company or Corporations Acts are somewhat outdated in terms of the development of insider trading legislation and have been found to impose substantial constraints on the enforcement of insider trading sanctions.<sup>46</sup>

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<sup>45</sup> The presence of a criminal sanction may affect the probability of the success of civil actions against insider trading. Firstly, although the burden of proof in civil actions is proof on the balance of probabilities, this is a very flexible standard; see, e.g., *Briginshaw v. Briginshaw* (1938), 60 C.L.R. 336 (Aust. H.C.); *Bater v. Bater*, [1951] P. 35, at p. 37 (C.A.); *Smith v. Smith and Smedman*, [1952] 2 S.C.R. 312, at pp. 331-332; *Reed v. Town of Lincoln* (1973), 39 D.L.R. (3d) 7 (Ont. H.C.). The burden may be affected by such factors as the seriousness of the allegation and the gravity of the consequences flowing from a particular finding. When a finding in a civil case carries with it implications of criminal wrongdoing then it is likely that the burden of proof will be higher. Thus the presence of a criminal sanction could increase the burden of proof in a civil action.

Secondly, a defendant in civil actions (and possibly other witnesses as well) may be able to refuse to testify on the basis of a privilege against self-incrimination. In Canada, the only formal protection against self-incrimination is the right of a person charged with an offence not to be compelled to be a witness in proceedings in respect of the offence (see s. 11(c) of the Canadian Charter of Rights and Freedoms, *supra*, footnote 28; see also, *supra*, footnote 40, with respect to provincial statutes providing a similar right) and the right of a witness not to have evidence given in any proceeding used to incriminate that witness in any other proceedings (except in a prosecution for perjury or for the giving of contradictory evidence; see s. 13 of the Canadian Charter of Rights and Freedoms). However, it may be possible for the privilege to be expanded under s. 7 of the Canadian Charter of Rights and Freedoms such that it provides a right to refuse to testify on the basis of self-incrimination, as has been recognized in England. The potential for such an expansion of the right was recognized in *Reference re Section 94(2) of the Motor Vehicle Act*, [1985] 2 S.C.R. 486, (1985), 23 C.C.C. (3d) 289. Although some courts have decided against the expansion of the right beyond that specifically provided in the Charter (see *R. v. Altseimer* (1982), 1 C.C.C. (3d) 7 (Ont. C.A.); *Thompson Newspapers v. Director of Investigation and Research* (1986), 30 C.C.C. (3d) 145 (Ont. C.A.); *R. v. Daigle* (1982), 32 C.R. (3d) 388 (Que. S.C.)), the right to remain silent was recognized in *R.L. Crain Inc. v. Couture and Restrictive Trade Practices Commission* (1983), 6 D.L.R. (4th) 478 Sask. Q.B.), and in *R. v. Woolley* (1988), 40 C.C.C. (3d) 531 (Ont. C.A.).

Thus the presence of the criminal sanction for insider trading may impinge upon the civil sanction by affecting the burden of proof and compellability of witnesses in civil actions.

<sup>46</sup> The words that create the most difficulties with the corporate statutory provisions are "makes use of specific confidential information"; see *infra*, footnote 47.



## A. Civil Actions by the Seller or Purchaser

### (1) *The Elements of Civil Actions by the Seller or Purchaser*

Canadian Securities Acts generally provide for an action for damages against a person trading on material inside information by the person with whom the trade was made.<sup>47</sup> As with the prohibition subject to criminal sanction, the elements that the plaintiff must show are:<sup>48</sup>

- (i) the defendant was in a "special relationship"<sup>49</sup> with the issuer;<sup>50</sup>
- (ii) the defendant purchased or sold securities of the issuer;
- (iii) the defendant made the purchase or sale with knowledge of material information about the issuer;<sup>51</sup> and
- (iv) that the material information had not been generally disclosed.

As in the prohibition subject to criminal sanction, there is a defence of reasonable belief that the material information had been generally disclosed.<sup>52</sup> There is an additional defence that the material information ought reasonably to have been known to the plaintiff.<sup>53</sup>

<sup>47</sup> See B.C.S.A., s. 119(2); O.S.A., s. 131(1); M.S.A., s. 113(1); A.S.A., s. 171(1); N.S.S.A., s. 142(1), (2); S.S.A., s. 142(1); Q.S.A., s. 226 (referring to ss. 187 and 189 with respect to the elements that must be proved). There are also provisions for such an action in most Canadian corporate law statutes (e.g., Canada Business Corporations Act, R.S.C. 1985, c. C-44, ss. 126-131; Company Act, R.S.B.C. 1979, c. 59, s. 153; Business Corporations Act, S.O. 1982, s. 138). These provisions generally require that the insider "make use of specific confidential information". Problems with proving this (see Simmonds, *loc. cit.*, footnote 1, Buckley, *loc. cit.*, footnote 1, and the cases cited, *supra*, footnote 1) probably make these provisions less likely to lead to a successful action. Consequently, the focus herein is on the provisions of provincial securities acts.

Common law actions against directors and officers are also possible. Although such actions have long been thought to be virtually impossible on the basis of a rather broad interpretation of *Percival v. Wright*, [1902] 2 Ch. 421 (Ch. D.) as authority for the proposition that directors and officers owe their fiduciary duties to the corporation and not to shareholders, more recent cases suggest that in some situations ("special facts") there may be a duty to shareholders; see, e.g., *Coleman v. Myers*, [1977] 2 N.Z.L.R. 225 (S.C., C.A.); *Dusik v. Newton* (1985), 62 B.C.L.R. 1 (B.C.C.A.) (*cf. Roberts v. Pelling* (1981), 16 B.L.R. 150 (B.C.S.C.)) and the *obiter* comments in *Nir Oil Ltd. v. Bodrug*, *supra*, footnote 1 (Alta. C.A.).

<sup>48</sup> *Ibid.*

<sup>49</sup> See *supra*, footnote 25.

<sup>50</sup> See *supra*, footnote 16, with respect to the definition of "reporting issuer".

<sup>51</sup> See *supra*, footnote 18, with respect to the definition of "material fact" and "material change" which together constitute "material information".

<sup>52</sup> See B.C.S.A., s. 119(2)(c); O.S.A., s. 131(1)(a); M.S.A., s. 113(1)(a); A.S.A., s. 171(2)(a); N.S.S.A., s. 142(1)(a), (2)(a); S.S.A., s. 142(1)(a); Q.S.A., s. 187(1). Applying the burden of proof in civil actions, the onus on the defendant in establishing this defence should be proof on the balance of probabilities rather than simply having to introduce a reasonable doubt as in a criminal action.

<sup>53</sup> See B.C.S.A., s. 119(2)(d); O.S.A., s. 131(1)(b); M.S.A., s. 113(1)(b); A.S.A., s. 171(2)(b) (s. 172(2) also provides the additional defences noted, *supra*, footnote 28, with respect to the penal provision for insider trading); N.S.S.A., s. 142(1)(b), (2)(b); S.S.A.,

Similarly, Canadian Securities Acts also generally provide that an action for damages can be brought against a person who informed another of the inside information.<sup>54</sup> The action can be brought by anyone who sold securities to or purchased securities from a person who obtained the inside information from the informer. The elements that the plaintiff must prove are again similar to those that the Crown must prove to obtain a conviction against an informer. They are that:<sup>55</sup>

- (i) the defendant was in a "special relationship" with the issuer;
- (ii) the defendant informed another person of a material information with respect to the issuer; and
- (iii) the information was given before the material information was generally disclosed.

The defences are the same as those with respect to an action against a person trading on inside information with the additional defence that the information was given in the course of business of the issuer.<sup>56</sup> In assessing the damages the court is to consider the difference between the price at which the plaintiff bought or sold the securities and the average market price over the twenty trading days after the general disclosure of the information.<sup>57</sup> In some jurisdictions the court is specifically empowered to apply any other measure of damages it considers relevant in the circumstances.<sup>58</sup>

## (2) *The Ineffectiveness of Civil Actions by Sellers or Purchasers*

The victims of insider trading will rarely choose to bring the civil actions provided for in the Securities Acts. There are several reasons for

s. 142(1)(b). No such defence is specifically set out in the Q.S.A. The N.S.S.A. also provides a defence that the defendant "did not make use of knowledge of" the material information in selling or purchasing the securities, see s. 142(1)(c), (2)(c). Again, the burden of proof for the defendant should be on the balance of probabilities rather than simply raising a reasonable doubt as in a criminal action.

<sup>54</sup> See B.C.S.A., s. 119(3); O.S.A., s. 131(2); M.S.A., s. 113(2); A.S.A., s. 171(3); N.S.S.A., s. 142(1), (2); S.S.A., s. 142(2); Q.S.A., s. 227 (with reference to ss. 188 and 189 as to what must be proved).

<sup>55</sup> *Ibid.*

<sup>56</sup> See B.C.S.A., s. 119(3)(d) to (g); O.S.A., s. 131(2)(d) to (g); M.S.A., s. 113(2)(d) to (g); A.S.A., s. 171(4); N.S.S.A., s. 142(1), (2); S.S.A., s. 142(2)(d) to (g); Q.S.A., s. 188(2). With respect to information given by a person in a special relationship with the reporting issuer, the B.C.S.A., s. 119(3)(f), also provides as a defence that the information was given in the course of business of the person in the special relationship with the reporting issuer. The O.S.A. provides that the disclosure must have been in the "necessary course of business" in order to establish the defence. The N.S.S.A. also provides a defence that defendant "did not make use of knowledge of" the material information in communicating knowledge of the material information; see s. 142(1)(c), (2)(c).

<sup>57</sup> See B.C.S.A., s. 119(7); O.S.A., s. 131(6); M.S.A., s. 113(6); A.S.A., s. 171(9); N.S.S.A., s. 142(6); S.S.A., s. 142(6). Sections 226 and 227 of the Q.S.A. simply refer to "the harm suffered".

<sup>58</sup> See B.C.S.A., s. 119(7); O.S.A., s. 131(6); N.S.S.A., s. 142(6).

this. Firstly, the potential plaintiff must be able to determine that there was a trade by someone in a "special relationship" (that is, a person having inside information)<sup>59</sup> with the reporting issuer. Insider trading reports may allow one to identify trading by some of the persons who have inside information.<sup>60</sup> However, these reports do not cover all persons who might have access to inside information.<sup>61</sup>

Secondly, it may be difficult for victims of insider trading to discover whether they actually traded with the person who had inside information. This may require access to records of the insider's broker.<sup>62</sup> Even with such access this would be a difficult and time consuming procedure. It is thus not one which most investors would pursue on the off chance that they may have been fortunate enough to trade with an insider.

Thirdly, the plaintiff must institute an action in which the costs will be very high. Although there is a lower burden of proof in a civil proceeding than in a criminal proceeding, a civil action, as the criminal action, is likely to be based on circumstantial evidence. Consequently, there is no guarantee of winning and thereby being able to recoup one's costs. Even if the plaintiff wins the case the full legal cost will generally not be recovered.

<sup>59</sup> See, *supra*, footnote 25.

<sup>60</sup> Monthly reports of insider trading must be filed by "insiders" of "reporting issuers". See B.C.S.A., ss. 70, 71; O.S.A., ss. 102, 104, 105; M.S.A., s. 109; A.S.A., ss. 147, 150; N.S.S.A., ss. 113, 116, 117; S.S.A., ss. 116, 117, 118; Q.S.A., ss. 89-103.

<sup>61</sup> The reports apply to "insiders", a term which is much narrower than "special relationship". "Insider" is generally defined as:

... where used in relation to an issuer,

- (a) a director or senior officer of the issuer,
- (b) a director or senior officer of a person that is itself an insider or subsidiary of the issuer,
- (c) a person whose control, or direct or indirect beneficial ownership, or a combination of that control and ownership, over securities of the issuer extends, not counting securities in respect of which he is acting as an underwriter in the course of a distribution, to securities carrying more than 10% of the voting rights attached to all that issuer's outstanding voting securities, or
- (d) the issuer itself, where it has purchased, redeemed or otherwise acquired any securities of its own issue, for so long as it continues to hold those securities.

See B.C.S.A., s. 1(1). Further, certain directors and senior officers are deemed to be insiders for the six month period preceding an acquisition by an issuer, or a reporting issuer, of another reporting issuer; see B.C.S.A., s. 2(2), (3). Similar provisions can be found in the Securities Acts of other provinces. See O.S.A., ss. 1(1)17, 1(8), 1(9); M.S.A., s. 108(1) (but the definition in the M.S.A. does not include directors and senior officers of persons owning securities carrying more than 10% of the voting rights); A.S.A., ss. 1(i), 8; N.S.S.A., ss. 2(8), 2(9); S.S.A., ss. 2(1)(w), 2(8), 2(9); Q.S.A., ss. 89-95.

<sup>62</sup> Brokers are generally required to maintain records such as trading blotters, orders, confirmations and so on through which one may be able to trace who traded and whom they traded with. See, e.g., B.C. Reg. 270/86, as am. by B.C. Reg. 306/88, ss. 27-39 and s. 80; O.S.A., s. 35 and R.R.O. 910/80, s. 101.

Thus, the victim of insider trading will generally only bring an action where the probability of an award of damages is high and where an award of damages is likely to be quite substantial.

If plaintiffs could act as a representative for a broader class of purchasers or sellers then they might be willing to institute an action even where they have incurred a relatively small trading loss. However, the current status of class actions in Canada makes this a very unlikely scenario. In their current state, class actions are unlikely where there will be damages in differing amounts and where one or more separate issues need to be determined with respect to each member of the class.<sup>63</sup> In a civil action for damages for insider trading, the damages are likely to be different for each trader since the trades of different potential plaintiffs will generally have been for different prices and involve different volumes of securities.<sup>64</sup> There will be separate issues with respect to each member of the class since the defendant will undoubtedly argue a right to be able to assert against each plaintiff the defence that the plaintiff knew or ought reasonably to have known of the material information.

In summary, while the statutory civil action goes a long way to overcome the strictures of the common law with respect to civil actions

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<sup>63</sup> See *Naken v. General Motors of Canada Ltd.*, [1983] 1 S.C.R. 72, (1983), 144 D.L.R. (3d) 385, which interpreted the former Ontario Rule 75 (R.R.O. 1980, Reg. 540). The current Ontario Rule 12.01 (O. Reg. 560/84) is essentially the same and there are similar rules in other provinces (see, e.g., B.C. rule 5(11); B.C. Reg. 310/76; Alta. rule 42 (Alta. Reg. 390/68)). The Supreme Court of Canada overruled the decision of the Ontario Court of Appeal ((1979), 21 O.R. (2d) 780) which would have allowed the class action in *Naken*, where the damages were defined such that they were the same for all members of the class, so long as the statement of claim was amended to ensure that the only separate issue with respect to each member of the class (whether the individual member of the class had relied on the misrepresentations in the defendant's advertising) was made an element of the definition of a member of the class (i.e., one was a member of the class if they had relied). Although it is possible to state a cause of action that will permit a class action to be brought under the existing rules (see, e.g., *Ranjoy Sales & Leasing Ltd. v. Deloitte, Haskins and Sells* (1984), 48 C.P.C. 26 (Man. C.A.)), it is generally difficult to do so, even with respect to investors claiming to be harmed as a class (see, e.g., *Cooper v. Kelly Peters & Associates Ltd.* (1987), 24 C.P.C. (2d) 40 (B.C.S.C.) and *Kripps v. Touche, Ross & Co.* (1986), 7 B.C.L.R. (2d) 105 (B.C.S.C.)), which stated that a class is appropriate where the members of the class are capable of clear and finite definition, the principal issues of fact and law are the same for all members, and there is a single measure of damage applicable to all members). See, generally, Ontario Law Reform Commission, Report on Class Actions (1982); Symposium: Class Actions Reform in Canada (1984), 9 C.B.L.J., at pp. 260-366; A. Roman, Class Actions in Canada: The Path to Reform? (1988), 7(4) *Advocates' Soc. J.* 28.

<sup>64</sup> The damages calculation should be one that could readily be reduced to arithmetic terms with the inputs being the price paid for the securities and the volume of securities traded with respect to each of the individual plaintiffs. In *Cobbold v. Time Canada Ltd.* (1976), 71 D.L.R. (3d) 629, 13 O.R. (2d) 567 (Ont. H.C.), a class action was approved where the damages to individual plaintiffs could be determined by an arithmetical calculation. However, it is not clear whether this approach has survived *Naken v. General Motors*, *supra*, footnote 63.

for insider trading,<sup>65</sup> it is a seldom used remedy in spite of the apparent presence of extensive insider trading activity.<sup>66</sup> Problems with respect to becoming aware that one was a victim of insider trading coupled with the risk of non-compensation for the cost of a civil action, make the statutory civil action very ineffective for either deterring insider trading or compensating those who have sold to or bought from others having inside information.

## B. *Defects in Actions by or on Behalf of the Reporting Issuer*

### (1) *Actions by or on Behalf of the Reporting Issuer*

The issuer of the securities traded can bring an action against an insider, affiliate or associate of the issuer where that person has either traded with knowledge of or informed another person of material information that has not been generally disclosed.<sup>67</sup> The issuer must show that the person was an "insider", "affiliate", or "associate" of the issuer, that the person either bought or sold securities with knowledge of inside information or informed another of the inside information, and that he or she did so before the information was generally disclosed.<sup>68</sup> The action is for an accounting to the issuer for any benefit or advantage received by the insider, affiliate, or associate or by the tippee.<sup>69</sup> The defences are a reasonable belief that the information had been generally disclosed,<sup>70</sup> and, with respect to informing, that the giving of the information was necessary in the course of business of the issuer.<sup>71</sup>

In the face of reluctance on the part of the reporting issuer to bring an action, the Securities Commission or a person who was a security holder at the time of the transaction or who is currently a security holder, can bring an application for leave to bring an action, or continue an action,

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<sup>65</sup> *Supra*, footnote 47, with respect to common law actions.

<sup>66</sup> See *supra*, footnote 1.

<sup>67</sup> See B.C.S.A., s. 119(5); O.S.A., s. 131(4); M.S.A., s. 113(4); A.S.A., s. 171(5); N.S.S.A., s. 142(4); S.S.A., s. 142(4). A roughly corresponding action is provided for in s. 228 of the Q.S.A. A similar action is provided for in most Canadian corporate law statutes—see *supra*, footnote 47.

<sup>68</sup> *Ibid.* Under s. 189 of the Q.S.A. the persons to whom an action for accounting applies is much broader.

<sup>69</sup> *Ibid.*

<sup>70</sup> B.C.S.A., s. 119(5); O.S.A., s. 131(4); M.S.A., s. 113(4); A.S.A., s. 171(6); N.S.S.A., s. 142(4)(c); S.S.A., s. 142(4); Q.S.A., ss. 187(1), 189.1. The N.S.S.A., s. 142(4)(d), (e) also provides the defence that the victim of insider trading knew, or ought reasonably to have known, of the material information, or the defence that the insider did not make use of knowledge of the material information.

<sup>71</sup> *Supra*, footnote 67. The Q.S.A. provision for accounting to the issuer does not make reference to the provision in s. 188 dealing with "disclosure" of privileged information. However, it does refer to s. 189.1 which prohibits "use" of privileged information. S. 189.1 does not specifically provide a defence with respect to giving information in the necessary course of business.

in the name of and on behalf of the issuer to enforce the duty to account.<sup>72</sup> In exercising its discretion to grant leave to bring an action, or continue an action, in the name of and on behalf of the reporting issuer, the court is to consider the best interests of the reporting issuer and its security holders, having regard to the potential benefit to be derived from the action by the reporting issuer and its security holders, and the cost involved in the prosecution of the action.<sup>73</sup> The court is also empowered to order the reporting issuer to pay all costs properly incurred by the person or Securities Commission commencing or continuing an action on behalf of the reporting issuer.<sup>74</sup>

## (2) *The Ineffectiveness of Actions by or on Behalf of the Issuer*

Actions by issuers will not be plagued to the same degree as actions by individuals with high costs of an action relative to the potential benefits. Nonetheless, actions by, or on behalf of, an issuer are likely to be an ineffective means of deterring insider trading or compensating the victims of insider trading.

### (a) *Ineffective Deterrence*

For the issuer, the benefits of sanctioning insider trading may not justify the cost to the issuer of monitoring and enforcing an accounting by insiders. It has been suggested that there are economies of scale in monitoring and enforcing sanctions against insider trading.<sup>75</sup> Thus, although the benefits of sanctioning insider trading may outweigh the costs of monitoring and enforcement when done on behalf of many issuers, the benefits may not outweigh the costs of monitoring and enforcement for individual issuers. Further, those in control of the issuer may be reluctant to take action against persons with whom they work, socialize or conduct business on a daily basis. Thus the issuer may not be inclined to bring an action for insider trading.

Individual security holders may also be reluctant to bring an action on behalf of an issuer. Although an order for costs to be paid by the issuer is available in a derivative action, this may not fully compensate

<sup>72</sup> See B.C.S.A., s. 121(1); O.S.A., s. 132(1); M.S.A., s. 114 (allows a security holder to apply for an order to have the Commission bring an action); A.S.A., s. 172(1); N.S.S.A., s. 143(1); S.S.A., s. 143(1); Q.S.A., ss. 229, 233.

<sup>73</sup> See B.C.S.A., s. 121(6); O.S.A., s. 132(6); s. 114 of the M.S.A. simply requires one to show reasonable grounds for believing that the corporation has a cause of action and has failed to commence or diligently prosecute it (Q.S.A., s. 231, is to similar effect); A.S.A., s. 172(8); N.S.S.A., s. 143(6); S.S.A., s. 143(6).

<sup>74</sup> See B.C.S.A., ss. 121(4), (5); O.S.A., ss. 132(4), (5); s. 114 of the M.S.A. simply provides that the court may make an order for commencing or continuing the action on such terms as the judge thinks fit; A.S.A., ss. 172(6), (7); N.S.S.A., ss. 143(4), (5); S.S.A., ss. 143(4), (5); Q.S.A., s. 232.

<sup>75</sup> See, e.g., Easterbrook, in Pratt and Zechauser, *op. cit.*, footnote 10.

the cost to an individual of bringing an action on behalf of the issuer. The legal costs covered by such an order would not, for instance, compensate for the time and effort expended by the individual in bringing the action. The accounting for the benefit to the insider in a successful action goes to the issuer and not the individual. Thus the benefits of the action are shared while some of the costs of the action may not be fully compensated. Consequently, individual security holders may be reluctant to bring an action on behalf of the issuer.

A Securities Commission may also be unable to bring an action. A Securities Commission must apply for leave to bring an action and leave is only granted where it is in the best interests of the issuer that the action be brought.<sup>76</sup> It is not clear that a reporting issuer would benefit from sanctioning insider trading. Indeed, it has been argued that allowing insider trading provides a form of compensation that aligns management and shareholder interests in a way that can not be replicated by other methods of compensation.<sup>77</sup> The issuer may also bear the costs of an action. In short, with the test of the best interests of the issuer, there may be grounds for not granting leave to a Securities Commission to bring an action.

An action by or on behalf of an issuer can only be taken against "insiders", "associates", or "affiliates" of the issuer who trade on or inform others of inside information.<sup>78</sup> This does not include persons engaged in a business or professional activity with the issuer, tippees of "insiders", "associates" or "affiliates" of the issuer or tippees of persons engaged in a business or professional activity with the issuer.<sup>79</sup> Thus an action by or on behalf of an issuer does not reach all trading on inside information.

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<sup>76</sup> See *supra*, footnote 73.

<sup>77</sup> See, e.g., Manné, *loc. cit.*, footnote 10; Easterbrook, in Pratt and Zechauser, *op. cit.*, footnote 10; Carlton and Fischel, *loc. cit.*, footnote 10.

<sup>78</sup> See *supra*, footnotes 67 and 68.

<sup>79</sup> "Insiders" typically include persons or companies that exercise direct or beneficial control over voting securities carrying 10% or more of the voting rights attached to all securities, and directors or senior officers of reporting issuers or of issuers who are insiders of reporting issuers; see *supra*, footnote 61.

An issuer is typically said to be "affiliated" with another issuer if one is the subsidiary of the other or each of them is controlled by the same person; see B.C.S.A., s. 1(2); O.S.A., s. 1(2); M.S.A., s. 1(2); A.S.A., s. 2; N.S.S.A., s. 2(2); S.S.A., s. 2(2).

"Associate" is typically defined to include an individual's spouse, living in the same residence, any partner of the "person", any trust in which the "person" serves as trustee or has a substantial beneficial interest, or any issuer in which the "person" beneficially owns securities carrying more than 10% of the voting rights attached to outstanding securities of the issuer; see B.C.S.A., s. 1(1); O.S.A., s. 1(1)(2); M.S.A., s. 1(1); A.S.A., s. 1(a.1); N.S.S.A., s. 2(1)(b); S.S.A., s. 2(1)(b).

These, broad as they may be, are much narrower than the concept of "special relationship" (see *supra*, footnote 25) and are clearly narrower than the range of persons who might have access to inside information.

The scope of Q.S.A., ss. 228, 187 and 189, is broader than just "insiders", "associates" and "affiliates".

If an action is taken by or on behalf of the issuer the remedy simply requires that the benefit obtained be paid to the issuer. However, the trader (or informer) may not be caught. Even if caught, it is possible that no action will be brought by or on behalf of the issuer. Consequently, the probability of having to disgorge the benefit of insider trading or informing will be slight. There will be a net expected gain from insider trading or informing. Thus a remedy of simply paying the benefit to the issuer will be an ineffective deterrent to insider trading.<sup>80</sup>

In summary, actions by or on behalf of issuers are an ineffective deterrent of insider trading. Issuers will be reluctant to monitor and sanction insider trading. Individual security holders will be reluctant to bring actions on behalf of issuers. Securities Commissions may not be able to get leave to bring actions on behalf of issuers. Not all insider trading will be affected by actions by or on behalf of issuers and, even for the insider trading that is covered by an action by or on behalf of an issuer, the remedy of accounting for the benefit received will be insufficient to deter that insider trading.

#### (b) *Ineffective Compensation*

A successful action will result in the benefit to the insider being returned to the issuer, thus accruing to the benefit of the issuer's security holders. However, the security holders at the time the award is made may not be the same as the security holders at the time of the trade on inside information. The compensation will thus not necessarily accrue to the persons who suffered the loss.

Further, although the remedy may compensate the security holders of the issuer as a whole, it does not directly compensate the individual security holders who traded. They may have arguably suffered a loss that is different and much greater than their proportionate share in the loss to the issuer. A compensation of the loss to the issuer is thus not an adequate compensation of their individual loss.

#### C. *Administrative Sanctions*<sup>81</sup>

##### (1) *Cease Trade Orders*

A Securities Commission may make a cease trade order against a person who has engaged in insider trading or informing.<sup>82</sup> A temporary

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<sup>80</sup> It should be noted, however, that there may be other deterrents for some insiders. Directors and officers, in addition to potential actions for damages and accounting, may, for instance, suffer a detrimental loss of reputation as a result of detection of insider trading.

<sup>81</sup> Other possible administrative sanctions not discussed in the text are the denial of exemptions (see, e.g., B.C.S.A., s. 144(1)(c); O.S.A., s. 124), or the suspension, cancellation of or restriction on registration for trading (see, e.g., B.C.S.A., s. 26; O.S.A., s. 26).

<sup>82</sup> See B.C.S.A., s. 144(1)(b); O.S.A., s. 123; M.S.A., s. 148(1); A.S.A., s. 165(1); N.S.S.A., s. 134; S.S.A., s. 134; Q.S.A., s. 265.



order can be made pending a hearing, or a cease trade order can be made for a longer period.<sup>83</sup>

A cease trade order may be a very effective way of deterring insider trading where a person who may become subject to the order holds a large portfolio of securities that may be affected or whose livelihood depends on continued trading privileges. Such an order may not be as effective for those persons whose livelihood does not depend on future trading privileges, or who do not hold many securities affected by the order. The order may not affect a person's ability to trade outside the jurisdiction (especially outside of Canada). In spite of these limitations, the order may have a substantial deterrent effect for many persons who would be in a position to inform or trade on inside information.

However, the cease trade order does nothing to compensate persons who traded with or at the time another person was trading on inside information. Thus the cease trade order does not overcome the defects of the other remedies for insider trading with respect to compensation.

### (2) *Prohibition from Acting as a Director or Officer*

In British Columbia, the Commission, where it is considered to be in the public interest, may order that a person resign from his or her position as a director or officer or prohibit a person from becoming a director or officer.<sup>84</sup> This may be an effective deterrent for a limited group of persons having access to insider information but barely begins to cover the full ambit of potential possessors of inside information. The sanction will also not provide compensation to victims of insider trading.

### (3) *Administrative Penalty*

In British Columbia, the Commission, after a hearing, may also apply an administrative penalty for a contravention of the Act.<sup>85</sup> The penalty is probably not sufficient to deter more substantial insider trading gains. It also does not compensate individual victims of insider trading.

## III. *A Proposal for Reform*

As demonstrated above, the existing means of enforcing the prohibitions against insider trading are plagued by a number of impediments. This Part sets out a reform proposal which would augment enforcement of the prohibitions against insider trading.

<sup>83</sup> See B.C.S.A., s. 144(2); O.S.A., s. 123(3); M.S.A., s. 148(2); N.S.S.A., s. 134(4); S.S.A., s. 134(3).

<sup>84</sup> See B.C.S.A., s. 144(1)(d) (which also allows the Superintendent of Brokers to make the order).

<sup>85</sup> See B.C.S.A., s. 144.1.

### A. *The Proposal*

As noted above, Securities Commissions can bring an action on behalf of the issuer for an accounting for profits.<sup>86</sup> However, Securities Commissions should also be entitled to bring an action against insiders and tippees who trade or inform, to obtain compensation on behalf of and to distribute it to "victims" of insider trading.<sup>87</sup> The burden of proof should be the civil action burden of the balance of probabilities. The defendant should be compellable as a witness, as in other civil actions. The damages should be measured in an amount greater than the profits or benefit received from insider trading or informing to ensure effective deterrence, given the probability that some insider trading or informing will go undetected or for which enforcement will be unsuccessful.<sup>88</sup> The funds so obtained should then be used to pay for the costs of investigations and to create a compensation fund for compensation of victims of insider trading.

The effectiveness of this approach would depend on the investigation efforts of Securities Commissions.<sup>89</sup> Securities Commissions should monitor insider trading, identifying unusual trading patterns and investigating by whom the trading was done. Actions should be taken where the expected damage awards exceed the expected costs of bringing the action. The Commission staff could then seek to identify and notify victims of insider trading of a claim on the compensation fund.<sup>90</sup>

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<sup>86</sup> See *supra*, Part II.B.

<sup>87</sup> "Victims" of insider trading may, for instance, be those persons who actually traded with the person who had access to inside information, or, may be, in the view of some commentators, anyone who traded while the information remained undisclosed (or any of other possible classes of persons harmed—see *supra*, footnote 14). The civil actions in current Canadian Securities Acts have adopted the former class of persons—see the provisions noted *supra*, footnote 47.

<sup>88</sup> The extent to which the award should exceed the profits would require a consideration of such factors as any benefits which insider trading may provide (see, e.g., the articles listed, *supra*, footnote 10), the significance of any detrimental effects of insider trading, the probability of successful detection and enforcement against insider trading, and the costs involved in providing that degree of success in detection and enforcement.

<sup>89</sup> It might be said that Securities Commissions would have nothing to gain by investigating insider trading violations and thus may not provide sufficient investigation efforts to make the approach effective. If so, the success of the approach may depend on the sense of public duty of Securities Commissions staff. If that sense of public duty proved to be inadequate, other administrative incentives might be provided to cause Securities Commissions to increase their investigation efforts. To the extent that funds need to be raised to pay at least some of the initial investigation costs a user fee charged against issuers, rather than funding out of general tax revenues, would probably be more appropriate.

<sup>90</sup> This might be done by directly identifying victims of insider trading or by a public notice to potential victims of a claim on the fund and a time period within which to make the claim.

## B. *Advantages of a Securities Commission Action on Behalf of "Victims" of Insider Trading*

There are a number of advantages of this approach over the existing means of enforcement. Firstly, the civil burden of proof and compellability of the defendant will make the probability of successful enforcement, and thus the deterrent effect, greater than that of the criminal sanction.

Secondly, it reduces the problem of low expected damage awards relative to the potential expected costs of bringing an action which deters actions by most victims of insider trading. Having the Commission bring an action on behalf of all the victims of insider trading will, in most cases, make the expected damage award much higher relative to the expected costs of bringing the action. More actions are likely to be taken, thereby increasing deterrence of insider trading.

Thirdly, it avoids the requirement with respect to actions on behalf of the issuer that the Commission show the action is in the best interests of the issuer. This avoids the hurdle to deterring insider trading encountered in actions by or on behalf of the issuer.<sup>91</sup>

Fourthly, having damages greater than the profit or benefit received will compensate for the probability that some insider trading will go undetected or for which the prohibition will be unsuccessfully enforced.

Fifthly, the potential for compensation would be improved because an action is more likely to be brought. The Commission is in a better position to identify insider trading and to investigate who traded and with whom they traded. Further, because the potential damage award to the Commission is more likely to justify the costs of an action, an action providing a fund for compensation is more likely to be brought than an action by an individual victim of insider trading.

Further, the scope of compensation might be expanded to be more consistent with promoting confidence in the market. The current approach to compensating persons who traded is limited to those persons who traded with the insider.<sup>92</sup> It does not compensate those who would not have traded had they known of the inside information. Allowing this latter group to have an action could lead to potentially enormous claims against the insider, amounting to many times any profit attained by the insider from trading on the information. The proposed representative action by the Commission could provide for damages in an amount that would improve deterrence without leading to the potentially enormous claims of all persons who traded without inside information. It could then allow claims on the fund, collected through actions by the Commission, by all persons who traded without access to the inside information. Although the fund would

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<sup>91</sup> It should not, however, preclude a claim by the issuer for compensation from the fund obtained by an award of damages to the Commission.

<sup>92</sup> See Part II.A.(1), *supra*.

not be sufficient to compensate fully all such persons, it would provide some compensation to those persons whose confidence in the market might be shaken due to trading by persons who have better access to information, rather than just compensating those who, by chance, traded with the insider.

Thus the proposed approach to enforcement against insider trading has advantages over existing approaches in terms of both deterrence and compensation.

This is not to say that the proposal will, or should, eliminate insider trading. Given the alleged benefits of insider trading and the costs of enforcement, something less than complete deterrence may be appropriate.<sup>93</sup> Further there are other problems with respect to enforcing prohibitions against insider trading such as the cost and effectiveness of methods of identifying insider trading and the difficulty of tracing who did the trading, especially where trading has been done by persons in other jurisdictions or where offshore numbered accounts have been used.<sup>94</sup> This proposal will not address these problems. However, addressing these problems will be of little or no use without sanctions that provide for effective deterrence and compensation.

### *C. Challenges Under the Canadian Charter of Rights and Freedoms*

It should be noted that the proposed reform could be subject to challenge under the Canadian Charter of Rights and Freedoms.<sup>95</sup> The proposed actions by the Commission, although arguably a substitute for separate civil actions by victims of insider trading, might be characterized as an attempt to charge a person with an "offence" without a presumption of innocence, thereby violating section 11(d) of the Charter, and to compel a person accused of an offence to testify, thereby violating section 11(c) of the Charter.<sup>96</sup>

Even if the proposed right of Securities Commissions to bring an action for an amount greater than the profits were characterized as an

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<sup>93</sup> See *supra*, footnote 10.

<sup>94</sup> See, e.g., D.L. Cleeton and P.A. Reeder, *Stock and Option Markets—Are Insider Trading Regulations Effective?* (1987), 27 Q.R. Econ. & Bus. 63, which notes a number of strategies for avoiding detection of insider trading. See also, Note, *Extraterritorial Enforcement of Rule 10(b)-5: Insider Trading in the International Equities Market* (1988), 12 Suffolk Transnat. L.J. 83, and D.L. McNew, *Blocking Laws and Secrecy Provisions: Do International Negotiations Concerning Insider Trading Provide a Solution to Conflicts in Discovery Rules?* (1989), 26 Cal. W.L.R. 103, discussing problems facing insider trading sanctions in an increasingly international securities market.

<sup>95</sup> *Supra*, footnote 28.

<sup>96</sup> See C.B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, [1985] Duke L.J. 960, at pp. 1012-1018, suggesting that the Insider Trading Sanctions Act of 1984 might be characterized as a criminal statute and thus subject to due process requirements. It is suggested, however, that the fact that the statute is not intended to provide compensation makes such a characterization more likely.

"offence", the lower burden of proof and compellability of the alleged insider to be a witness might be supported as demonstrably justifiable under section 1 of the Charter. Accepting, as we appear to have, that insider trading should be prohibited, it is arguable, on the basis set out in Parts I and II above, that such an infringement of Charter rights is necessary to effectively deter insider trading and compensate victims of insider trading.

### *Conclusion*

Penal sanctions provide an ineffective means of deterring insider trading, since they generally involve substantial reliance on circumstantial evidence which, coupled with the strict burden of proof, non-compellability of the accused and constraints on the laying of the information in criminal proceedings, makes the probability of enforcement very low.

Civil actions for damages by persons who traded with others having inside information are likely to be rare because of the risk of incurring substantial costs in bringing the action and the relatively low damages in most cases. Class actions which might overcome this problem are unlikely to occur in Canada given their current procedural limitations. Actions by reporting issuers are unlikely to occur where there are close ties between the alleged insider and the issuer. Actions brought by security holders or Securities Commissions on behalf of reporting issuers require leave of the court, based on the best interests of the reporting issuer and not the interests of the victims of insider trading or of society as a whole. When an action is brought by a reporting issuer or on behalf of a reporting issuer, the remedy of an accounting for the benefit received will not be sufficient to deter insider trading and will not compensate those who have incurred trading losses as a consequence of insider trading.

Given the impediments to enforcement of penal sanctions and the limitations of existing civil actions for both deterrence and compensation, the available civil remedies should be augmented to reinforce deterrence and compensation. To do this, it is recommended that Securities Commissions be empowered to bring an action on behalf of victims of insider trading.

With the civil burden of proof, compellability of the alleged insider or tippee, greater benefit/cost justification for actions by Commissions rather than by individuals and awards in excess of profits obtained, the degree of deterrence of insider trading should be substantially increased. The compensation fund so created would allow for a greater degree of compensation to the victims of insider trading.

Perhaps even this added mode of enforcement would not be an effective deterrent against insider trading. However, if the commitment to the prohibition of insider trading is genuine then a new approach, such as the one proposed herein, is needed given the limitations on the current modes of enforcement.