

**MARKET MORALITY: A DEVELOPMENTAL ANALYSIS
OF INSIDER TRADING LEGISLATION IN MANITOBA**

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CHAPTER I INTRODUCTION

There is an underlying philosophy in the capitalistic world that a good securities market is good for a country's economy. If securities legislation has a role in achieving this end, it must be designed not only to serve the purpose of reducing specific imperfections in a free and open capital market, but also to assure the efficient operation of the market in achieving long-run economic objectives.

In the securities industry, the phrase "insider trading" is generally used to denote purchases or sales of securities of a company effected by, or on behalf of, a person whose relationship to the company is such that he is likely to have access to material information concerning the company not known to the general public.¹ The Kimber Report stated:²

... [I]n our view it is improper for an insider to use confidential information acquired by him by virtue of his position as an insider to make profits by trading in the securities of his company. The ideal securities market should be a free and open market with the prices thereon based upon the fullest possible knowledge of all relevant facts among traders. Any factor which tends to destroy or put in question this concept lessens the confidence of the investing public in the market place and is, therefore, a matter of public concern.

The philosophy of the Kimber Report, in part, is that if security legislation is improved in the interests of investors, the securities industry will benefit from increased public confidence. To the extent that the securities industry becomes an effective and efficient part of the economy, the general public will benefit.

However, some commentators such as Henry G. Manne³ contend that allowing insiders to trade freely may be fundamental to the survival of the corporate system. Manne views such inside information as a valuable asset

1. **Report of the Attorney General's Committee on Securities Legislation in Ontario** (March 1965), (Kimber Report), Part II, para. 2.01.
 2. *Supra*, n. 1, at para. 2.02.
 3. H. G. Manne, **Insider Trading and the Stock Market** (Free Press 1966) 17.

that is about the only way the economy can truly compensate entrepreneurs. He believes that the key to technological progress is the innovator who can find a new way of doing things. The entrepreneur/innovator may make quite a comfortable salary as a corporate manager, but this is merely remuneration for the routine job. He realizes nothing directly for the imaginative breakthrough, except that he knows what has happened before the general public does. Manne feels that the surest way to induce favourable change is to allow the entrepreneur to trade on the information. He does admit that there is some loss for people who sell between the time insiders are cognizant of a significant event and the point at which the full market impact is reached. According to this view, the intelligent long-term investor has substantially no interest in preventing his company's executives from trading in the company's shares, though the short-term trader who is not on the inside may have. In the United States and Canada, it will become readily apparent that Manne's thesis is counter to the general thought of the role of the insider.

H.P. Crawford⁴ commented on the prevalent private sector attitude which spawned abuses:

... [It] seems to have been completely accepted in the securities industry that the use of confidential information to profit is fair game. In this respect a quote referred to by Professor Loss from a Securities and Exchange Commission annual report pertaining to the enactment of the Securities Exchange Act of 1934 in the United States is apt.⁵ The annual report states:

'Prior to the 1934 Act the financial community more or less accepted the fact that 'sure thing' speculation was part of the emolument for serving as a corporate officer or director. In addition, large stockholders exercise sufficient control over the destinies of their companies to enable them to acquire and profit from information not available to others. It was in order to bring these practices into disrepute and encourage the voluntary maintenance of proper fiduciary standards that section 16 was enacted.'

The objective of this paper is to provide the reader with a look at the developments and influences - common law, and American - which shaped the law relating to insider trading, culminating in the Kimber Report whose recommendations were enacted in the 1966 Ontario Securities Act. Specifically, the scope of Chapter II entails an examination of common law development and exposes injustices, deficiencies and rules of law that emerged. Chapter III consists of a discussion of the 1934 United States Securities Act and how the development of certain rules and court interpretations expanded the scope of the original legislation. In Chapter IV one encounters a discussion of the considerations and overwhelming influence of American legislation that resulted in the Kimber Committee's recommendations which in turn resulted in the aforementioned 1966 Act which served as a model in securities legislation for the federal and provincial governments to follow. Chapter V focuses on the present Manitoba statutory enactments pertaining to insider trading which are substantially identical to the 1966 Ontario Act and includes a discussion of the practical problems and interpretive impacts of both American and Canadian cases litigated in this area today.

The final chapters of the paper consist of an examination of new developments relating to insider trading both at the federal and provincial levels, and concluding remarks.

4. H. P. Crawford, "Insider Trading" (1965), 8 Can. B. J. 400 at 407.

5. 10 SEC Ann. Rep. 50 (1944); See L. Loss, *Securities Regulation* (2d ed. 1961) at 1037-8.

CHAPTER II THE COMMON LAW AND INSIDER TRADING

The principles of the law of Agency regulate, in most respects, the relationship of the company and its directors. This long established position was articulated by Cairns, L.J. in *Ferguson v. Wilson*:⁶

What is the position of the directors of a public company? They are merely agents of the company. The company itself cannot act in its own person, for it has no person: it can only act through directors, and the case is, as regards those directors, merely the case of principal and agent for whenever an agent is liable, those directors would be liable. When the liability would attach to the principal and the principal only, the liability is the liability of the company.

Directors are not only agents, but to some extent trustees, or in a position of trust.⁷ Furthermore, the phrase, "in a position of trust" describes the term "fiduciary" which connotes owning a duty of honesty in the utmost good faith to the person for whose benefit property is held. Agents, directors and trustees are but a few examples of fiduciaries although the standards may not always be the same for all categories.

*Keech v. Sandford*⁸ laid down the strict equitable rule regarding fiduciary responsibility. In that case, a lessor refused to grant a new term to the infant beneficiary, whereupon the trustee renewed for himself. King, L.C. held that the trustee might not have the lease, but must hold it on trust for the beneficiary notwithstanding that the landlord has refused to renew to the beneficiary and that the trustee had acted in utmost good faith. Today, the modern doctrine of corporate opportunity is simply an extension of Equity's old rule that a fiduciary must not use his position to appropriate for himself benefits which he ought to have acquired, if at all, for his principal.⁹ The insider trading legislation that will be examined in the subsequent Chapters is an example of the above doctrine in statutory form.

*Regal Hastings v. Gulliver*¹⁰ illustrates the principle that once it is found that the agent has used either his principal's property or his own position in order to make money for himself, it matters not that the principal has lost no profit and suffered no damages. In that case, the company owned one theatre and the directors decided to acquire two other with a view to selling the whole undertaking as a going concern. They formed a subsidiary company to take a lease of the other two theatres for this purpose. The owner of the theatres insisted on a personal guarantee from the directors unless there was a minimum paid-up capital. Since Regal was apparently only able to supply its subsidiary with part of the paid-up capital required, Regal's directors were encouraged to provide the balance and accordingly they and their friends did so. Shortly after the acquisition of the leases, the shares of Regal and its subsidiary were sold and the directors of Regal who subscribed for shares in the subsidiary made substantial profits on the sale. Although it was conceded that the directors had acted bona fide throughout and that their activity was in the best interests of Regal, they were nevertheless held liable to account for their profits to the company.

Professor Beck felt that the concept underlying the decision in *Regal Hastings* was that of use of the position of director, or use of knowledge that comes to a director by reason of his position to gain advantage for himself when the interests of the company call for protection.¹¹ It also

6. (1886), L. R. 2 Ch. App. 77 at 89.

7. L. C. B. Gower, *The Principles of Modern Company Law* (3rd ed. 1969) 516.

8. (1726), Sel. Cas. T. King 61, 25 E.R. 223.

9. S. M. Beck, "The Saga of Peso Silver Mines; Corporate Opportunity Reconsidered" (1971), 49 Can. Bar Rev. 80 at 92.

10. [1942] 1 All E.R. 378 (H.L.) (hereinafter referred to as *Regal Hastings*).

11. *Supra*, n. 9, at 107.

should be noted that during the course of their judgments each of the Law Lords gave approval to the broad general rule that a director cannot use his office to appropriate for himself an advantage that ought, in fairness, to belong to the corporation.

*Zwicker v. Stanbury*¹² brought the law enunciated in *Regal Hastings* into Canada. The case concerned the C.P.R. which had a large block of shares in the Lord Nelson Hotel Company. C.P.R. was no longer interested in its investment in that company. It wanted to be paid what was owing to it on the debentures and a mortgage, and was unconcerned as to whether it received anything for its shares. The president of the company was seeking to resolve the many problems of the Hotel Company and accordingly he sought the C.P. R.'s assistance. As a result, he learned that the C.P.R. was interested in liquidating its interests in the hotel. An arrangement was made whereby the company could be reorganized. The result would be to pay off the debentures, and the shares owned by the C.P.R. would be made available without cost to the then directors of the company so that they could continue the management of the company. Ultimately, Mr. Zwicker, a shareholder, brought an action and the Supreme Court decided that the shares formerly belonging to the C.P.R. should be surrendered to the company for cancellation. The effect of this decision was that the company per se did not benefit because no money reached it, and no profits were returned to it. However, all of the shareholders did benefit because the effect of the cancellation of the shares was that all of the remaining shares had an immediate increase in value. It would appear that this case, following *Regal Hastings*, stands for the proposition that directors will be made to account to the company for any profits which may result when their personal interests conflict with the interests of the company.

In *Peso Silver Mines Ltd. v. Cropper*¹³ the Supreme Court of Canada examined the limits upon the doctrine as enunciated in *Regal Hastings*. Cropper was one of a small group of men whose business it was to acquire, develop and promote new mining ventures. One of the companies formed by the defendant was the plaintiff company. The plaintiff's board of directors, which included the defendant at the time, was approached by a prospector who offered to sell some claims to the company. After an investigation and analysis of many factors including sufficiency of available funds and the state of the development of the claims themselves, the board rejected the offer. The defendant eventually obtained control of these claims. A sale of control of the plaintiff company was effected as the result of the defendant's effort to raise new capital for the plaintiff. One of the first acts of the new majority of the board was to demand that the defendant make a full disclosure of all his mining interests. Later, the board wanted a transfer of the shares and securities representing the claims which the defendant's own company had acquired. The board claimed that in both cases the defendant held a fiduciary relationship as a director of the plaintiff company and had acquired these additional properties only by reason of that office, secretly, without consent of the plaintiff and in conflict with his duties to the plaintiff.

The Supreme Court held that this individual director, who chose to contact the outsider after the board of directors had considered the new venture and rejected it, did not violate any duty to the company. Cartwright,

12. [1953] 2 S.C.R. 438.

13. (1966), 58 D.L.R. (2d) 1, aff'g 56 D.L.R. (2d) 117 (B.C.C.A.).

J., (as he then was), in delivering the judgment of the court, quoted Lord Greene M.R. from the unreported Court of Appeal judgment of *Regal Hastings*:¹⁴

To say that the Company was entitled to claim the benefit of those shares would involve this proposition: Where a Board of Directors considers an investment which is offered to their company and bona fide comes to the conclusion that it is not an investment which their Company ought to make, any Director, after that Resolution is to come to and bona fide come to, who chooses to put up the money for that investment himself must be treated as having done it on behalf of the Company so that the Company can claim any profit that results to him from it. This is a proposition for which no particle of authority was cited; and goes, as it seems to me, far beyond anything that has even been suggested as to the duty of directors, agents, or persons in a position of that kind.

The court was unable to say that, on the facts, the defendant obtained the interests in the claims solely by reason of the fact that he was a director of plaintiff company. There was no evidence that the offer to the plaintiff company was accompanied by any confidential information unavailable to any prospective purchasers or that the defendant as director had access to any such information by reason of his office. Finally, there were also affirmative findings of fact that the defendant and his co-directors acted bona fide with regard to the interests of the plaintiff company and that they used sound business judgment in rejecting the offer.¹⁵

Even if the above case has suggested outer limits of the *Regal Hastings* principle, directors may have to consider other aspects of their fiduciary role. Professor Gower has stated that:¹⁶

Directors are not permitted, either during or after their service with the company, to use for their own purposes anything entrusted to them for use on behalf of the company. This principle is not restricted to property in the strict sense; it also includes trade secrets and confidential information. This principle, it is submitted, should be wide enough to cover cases such as *Percival v. Wright*,¹⁷ in which directors have used confidential information (for example, knowledge of an impending dividend declaration or take-over bid) to speculate successfully in their company's shares. The fact that the company itself suffers no damage ought, on general principles, to be irrelevant. As yet, however, no company in this country has sought to recover from a director on this ground, and, since *Percival v. Wright*,¹⁸ it seems to have been generally assumed that speculations directors have *carte blanche* to utilize their inside knowledge in private speculations.

As the Kimber Report has indicated, an insider is a person who is in a position to have made available to him pertinent material information concerning the company's affairs which the general public would not have.¹⁹ The term "insider" is borrowed from the American terminology,²⁰ where officers, directors and controlling shareholders are considered to be the traditional insiders. This traditional approach has certain deficiencies which will be discussed *infra*.

The Kimber Report stated the existing law as to the liability of an insider to a person with who he has traded and the person most directly injured by the improper trading thusly:²¹

14. *Supra*, n. 13, at 8.

15. **But see** Beck, *supra*, n. 9 at 101 where he states, "There was ample evidence that Peso was in exactly the same position as the Regal Company — it wanted the property but could not finance its purchase. The company President testified to that effect when asked the question by the trial Judge."

16. *Supra*, n. 7, at 546.

17. [1902] 2 Ch 421. The directors purchased shares from their members without revealing that negotiations were in progress for a sale of the undertaking at a favourable price.

18. *Ibid*.

19. *Supra*, n. 1.

20. *Supra*, n. 7, at 155.

21. *Supra*, n. 1, at para. 2.22.

In the English case of *Percival v. Wright*²² it was held that no fiduciary relationship exists between a director of a company and its shareholders. The wide scope of this decision was qualified to a certain extent by the Privy Council in *Allen v. Hyatt*²³ where it was held that in certain special circumstances there is a fiduciary relationship. The extent to which *Allen v. Hyatt*²⁴ qualified *Percival v. Wright*²⁵ is uncertain. It is probably limited to a very narrow class of case in which the shareholder and the director meet virtually face-to-face and the director is put in a fiduciary relationship by the conduct of the parties. Even if *Percival v. Wright*²⁶ were judicially overruled²⁷ with the result that directors would then owe a fiduciary duty to the shareholders of the company of which they are directors, the courts would be unlikely to impose such duty on insiders other than directors, such as officers or principal shareholders; nor is it likely that a fiduciary relationship would be established by jurisprudence to assist a purchaser of securities from an insider if such purchaser was not at that time a shareholder of the company.

The common law therefore appears unable to help the ordinary purchaser of securities, seeking relief from the insider, and it was on this basis that the Kimber Report recommended that *Percival v. Wright*²⁸ be abolished by statutory enactment.

Furthermore, in *Regal Hastings* the House of Lords indicated that the directors would not have been liable to account for their profits had the transaction been ratified by the shareholders. The case law is rather perplexing as to whether the use by an insider of confidential information to profit constitutes a fraud on the minority which cannot be consented to or ratified by a majority of the shareholders.

On the other hand, the judgments in *Zwicker v. Stanbury*²⁹ indicate that the use of inside information by the directors could not have been consented to by a majority of the shareholders.

Upon reflection of the above common law deficiencies, it is not surprising that industry thought trading on inside information "fair game", and abuses were to be expected.

CHAPTER III

THE AMERICAN DEVELOPMENTS AND INFLUENCES ON INSIDER TRADING

The American courts have at various times adopted three different doctrines relating to insider trading. The "majority rule" holds that directors and officers of a corporation may deal at arm's length with the company's shareholders. Therefore, there is no obligation on the part of an insider buying shares to disclose information known only to him. An opposite extreme is the so-called "minority rule" which states that a director does have a fiduciary obligation to a shareholder. Under this rule, full disclosure of all relevant facts related to the fairness of the price must be made before the director buys or sells.

The "special facts" doctrine is an intermediate position. This rule states that a director must disclose information when he is dealing in his

22 *Supra*, n 17.

23 (1914), 17 D.L.R. 7 (P.C.)

24 *Ibid.*

25 *Supra*, n 17.

26 *Ibid.*

27 Crawford, *supra*, n 4, at 406 says, "The judicial overruling of *Percival v. Wright* would, because of the difficulties involved in tracing stock exchange transactions, not be of great significance in correcting abuses except in trading that takes place on almost a face-to-face basis."

28 *Supra*, n 17

29 *Supra*, n 12

company's securities if special circumstances exist to his knowledge. The rule seems to require some relationship between parties indicating a substantial danger of fraud.³⁰ Many cases granting relief under this doctrine involve a seeking out of the individual shareholder to induce a sale of his securities. However, note that only existing shareholders who sell shares to insiders receive any protection from this rule. The so-called special facts doctrine is without question the prevailing approach today in the United States, and as a practical matter has become equivalent to the minority rule.³¹

The Securities and Exchange Act of 1934 and regulations thereunder expanded significantly on the common law. This was a result of the attitude in the United States towards insider trading, which was to impose upon corporate management a high standard of responsibility to shareholders. For many years section 16 of the Act³² provided the main control over the corporate insider. In spite of its apparent advantages, section 16 probably did not have an appreciable effect on reducing the total amount gained by insiders as a result of their possessing inside information. There are two reasons for its deficiency. Firstly, the section has no effect on any attempt to make profits after the end of a six-month period.³³ Secondly, the coverage of this section is limited to specifically designated insiders trading in the securities of the corporations to which they bear the specified relationship.³⁴

The exchange of information to "tippees"³⁵ is left completely untouched by the section because it covers only immediate uses of information by insiders buying and selling securities.

Rule 10 b-5³⁶ also deals specifically with insider trading and has substantially expanded the common law duties of the insider:

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

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

30. **Strong v. Repide**, 213 U.S. 419 (1909).

31. L. Loss, **Securities Regulation** (2nd ed. 1961), at 1446-48.

32. 48 Stat. 896 (1934) 15 U.S.C. 78, (1964). Subsection 16(a) requires every person owning beneficially, directly or indirectly more than ten per cent of a class of equity security registered on a national securities exchange, or who is a director or an officer of the issuer of such security to file an initial report disclosing the amount of each class of the issuer's equity securities, whether or not registered which are beneficially owned by such person at the time a person becomes such a director, officer or beneficial owner after registration. Subsequently, each person must report any change in his beneficial ownership of the issuer's equity securities within ten days after the end of each calendar month during which any change occurs.

Subsection 16(b) states that profits realized by persons required to report by subsection 16(a), from the purchase and sale or sale and purchase of an equity security of the issuer within a period of less than six months enure to and are recoverable by or on behalf of the issuer, unless such security was acquired in good faith in connection with a debt previously contracted. The subsection allows a shareholder to initiate an action on behalf of the company, if the company fails to initiate an action itself after a demand has been made.

In order to succeed under the section the plaintiff need only show that during any six-month period, the insider sold corporate securities at a higher price than he had paid during the same period.

33. Since securities must be held for six months in order to qualify for capital gains treatment under the Internal Revenue Code, many corporate insiders, buying before disclosure of important information would hold them for the six-month period in any event and would therefore not violate the section.

34. In the present Manitoba Securities Act there has been an attempt to remedy this defect by virtue of paragraph 108(2) (a) "every director or senior officer of a company that is itself and insider of a corporation shall be deemed to be an insider of such corporation."

35. *Supra*, n 1, at para 2 12. "Persons not connected with the company, but connected in some manner with an insider, such as spouses, relatives, friends and business associates . . ."

36. 17 C.F.R. s 240 10 b-5 [1964]. Rule 10 b-5, the SEC anti-fraud rule was the result of the failure of subsection 17(a) of the Securities Act of 1933 to outlaw fraud perpetrated by the buyer of securities upon the seller.

- (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

It gives the SEC power to pass regulations defining and prohibiting the use of manipulation or deceptive devices in connection with the purchase or sale of any securities. The rule makes it unlawful for an insider, such as a majority shareholder, to purchase the shares of a minority shareholder without disclosing material facts affecting the value of the shares known to the majority shareholder by reason of his inside position.³⁷ It can be said that basically, Rule 10 b-5 is a codification of the "minority rule" doctrine previously discussed.

In the *Matter of Cady, Roberts and Company*,³⁸ the Commission held that the anti-fraud provisions of Rule 10 b-5 applied to a member of a brokerage firm who had sold common stock for his wife's account and for the discretionary accounts of customers on the basis of advance information. The material fact here was received from a salesman of the brokerage firm who was also a director of the company, pertaining to the reduction of the company's regular dividend. Even though the partner executing the transaction held no position with the company, the SEC indicated that he had received corporate information prior to the first public release and therefore like the insider, he had obligations of disclosing material facts to the person to whom he sold his shares.

In *Securities Act Exchange Comm. v. Texas Gulf Sulphur Co.*³⁹ the SEC brought an action in the form of a suit in a Federal District Court based on Rule 10 b-5 charging that thirteen officers, directors and employees of Texas Gulf had used inside information about the company's Timmins, Ontario, ore strike, for their own benefit or for the benefit of others, by trading in the stock before the public was informed of the true nature of the rich copper and zinc discovery. The Commission further claimed that the first press release that the company eventually issued at the instance of the N.Y. Stock Exchange, attempted to moderate the significance of the find. The SEC was concerned about trading that took place just prior to the release and the main issue at the trial level was how long the release had to be out before the knowledge of the insiders could be treated as no longer confidential. The Court ruled that the definition of "insiders" was not limited to officers, directors and controlling stockholders, but that it extended to employees who were in possession of undisclosed information. The submission by the SEC that insiders must wait a reasonable time after the publication of corporate news was rejected by the Court on the ground that it was up to the SEC and not the Court to determine what such a waiting period should be. On appeal it was held that Rule 10 b-5 was violated whenever assertions are made in a manner reasonably calculated to influence the investing public (e.g. by means of financial media), if such assertions are false or misleading or are so incomplete as to mislead, irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes.⁴⁰ The case was remanded to the District Court for a hearing and determination of appropriate remedies.

37. *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951). The case is the first judicial recognition of its applicability to insider trading in a private civil action under this section.

38. 40 S.E.C. 907 (1961).

39. C.C.H. Fed. Sec. L. Rep. 91, 805 (1966), August 19; 401 F. 2d 833 (1968).

40. *Supra*, n. 39.

The Merrill Lynch case is discussed in the 1969 Pitblado Lectures:⁴¹

The facts in this case have not been tested in Court. The respondent agreed to an injunction being issued but did not confess any wrongdoing . . . [T]hose facts are that the respondent ascertained certain information on the affairs of a company when acting on behalf of the company in the preparation of an underwriting. It is alleged the information was disclosed to certain clients of the defendant.

On those facts should there be any surprise that action would be taken? Our law has always prohibited an agent from disclosing information he receives about the principal's business in the course of performing his duties.⁴²

Through court interpretations the scope of the U.S. legislation has been widened, particularly that of Rule 10 b-5. The courts have defined the insider to include any person who has direct or indirect access to corporate information not available to those with whom he is dealing. They have also enlarged the group to whom the insider owes a duty to encompass not only the existing shareholders but also the outsider who buys shares. Finally, they have extended the insider's affirmative obligation to report material facts.

CHAPTER IV

THE KIMBER REPORT

Prior to 1966, the Ontario Securities Act was primarily a disclosure statute, that is, a statute intended to give "full, true and plain disclosure of relevant matters to potential buyers of securities."⁴³ Except through the control of broker-dealers and investment advisors through licensing requirements under the Securities Act, the control of market practices was left basically to the *Criminal Code*⁴⁴ or to common law.

In October of 1963 the Attorney General's Committee on Securities Legislation in Ontario (Kimber Report) was appointed to study and recommend legislation to remedy alleged abuses in the industry. The Kimber Committee submitted its report in March of 1965, following which The Securities Act, 1966⁴⁵ was enacted, and amendments to The Corporations Act of Ontario⁴⁶ were made. It is difficult to assess the impact that the collapse of two major financial institutions⁴⁷ had on the legislation at that time — probably a favourable one.

The Committee conducted a thorough study of the law in the United States and many of its recommendations were derived from The Securities and Exchange Act of 1934. The American approach adopted was to utilize two branches to guard against improper insider trading. Insiders were required to report all trading under the first branch and the second established a liability for certain types of insider trading.

With respect to the first branch, the enacted legislation provided that shareholders and other interested persons be informed currently of the market activity of insiders in the security of a company. The insider was required to report within 10 days of the end of the calendar month his transactions in the company's securities during the month.⁴⁸ It was felt that

41. J. R. Kimber, "A Second Look at Insider Trading" (1969) Pitblado Lect. 89, at 94.

42. *London Joint Stock Bank v. Simmons*, [1892] A.C. 201.

43. *Supra*, n. 1, see paras. 2.14-2.19 for discussion of deficiencies.

44. R.S.C. 1970, c. C-34, as am. S.C. 1971, ss. 338 and 340.

45. S.O. 1966, c. 142 in force May 1, 1967.

46. S.O. 1966, c. 28 s. 71(1) incorporated the reporting sections of The Securities Act, S.O. 1966, c. 142 s. 109, 110, 111 and 112.

47. Atlantic Acceptance Corporation and the Prudential Finance Corporation.

48. S.O. 1966, c. 142 s. 110.

the insider who knows that his trading will become public knowledge will be less likely to engage in improper trading, and such disclosure will also lead to greater investor confidence in the securities market.⁴⁹

Under the second branch, the insider as well as his associates and affiliated companies could be liable to persons who have suffered through the use of "specific confidential information" in a securities transaction. This was a double liability since the Act specified that insiders as well as associates and affiliated companies were also accountable to the company whose securities were the subject of the transaction.⁵⁰ In other words, both personal and corporate rights of action arose from the same wrongful act.

In contrast to the American legislation, the term "insider" was specifically defined in the Ontario legislation.⁵¹ An insider of a company under the Act was (1) any director or senior officer as defined, (2) any shareholder (excluding underwriters in the course of primary distribution) beneficially owning, directly or indirectly, equity shares of the company carrying more than ten percent of the voting shares of the corporation for the time being outstanding, or (3) any director or senior officer of a company which was itself an insider of the company. Therefore, in the definition, the function or office of the insider determined whether or not any individual was considered to be an insider. Only directors and professional advisors were not covered. The Committee felt that lesser employees or professional advisors would be subject to internal discipline by their superiors or by professional bodies respectively.⁵²

At that time the Kimber Report was criticized for excluding "tippees" from the liability provisions. Kimber has stated that the Committee concluded that legislation was not required, that the law could develop.⁵³ Crawford also defends this position by stating:⁵⁴

Although there may be some merit in such criticism perhaps the purpose of the Kimber Report in this area was to achieve a fair measure of equity without too great a loss of precision. As lawyers are well aware, the development of law in many circumstances consists of a struggle between predictability and equity. If you have predictability, that is, clear and precise rules, then you have to sacrifice a certain amount of equity. To include tippees in the liability provisions might well have, at this stage in the development of our law, created undue certainty as to the concept of improper trading; a concept at the moment in the embryonic stage of its evolution.

As previously mentioned, "upon becoming an insider, the insider must file a report within ten days of the month following his new status setting out his holdings,⁵⁵ and changes in these holding must be reported within 10 days of the month following the change.⁵⁶ The Commission is required to maintain these reports for public inspection and to publish a monthly summary of the new reports.⁵⁷ SEC officials claim the popularity of their

49. *Supra*, n. 1, at para. 2.04.

50. S.O. 1966, c. 142 s. 113(1).

51. As previously mentioned, section 16 of the Securities and Exchange Act sets out who is liable. However, the SEC also has Rule 3 b-2 which defines insider to mean, "a president, vice-president, treasurer, secretary, comptroller and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers. The Kimber Committee, not satisfied with the American rule, wanted executive officers to be included as insiders as above, but in addition wanted "the five highest paid employees of the company, other than the foregoing, whose direct remuneration paid by the company or its subsidiaries is at a rate in excess of \$20,000 per annum." The new legislation accepted the recommendation in part, by defining senior officer [s. 1(1) 29] and including it in the definition of insider (s. 108(2)(a)).

52. *Supra*, n. 1, at para. 2.08 and para. 2.09.

53. R. B. Cantlie et al., "The Manitoba Securities Act — Panel Discussion" (1969), Pitblado Lect. 65, at 80.

54. *Supra*, n. 4, at 410.

55. S.O. 1966, c. 142 s. 109(1) and (2), O. Reg. 101/67, s. 41, Form 14.

56. S.O. 1966, c. 142 s. 109(4), O. Reg. 101/67, s. 42, Form 15.

57. S.O. 1966, c. 142 s. 110.

"insider trading" reports is only exceeded by a pamphlet issued by another department on the care and feeding of infants.⁵⁸

Paragraph 2.26 of the Report⁵⁹ enunciated a course of action which the Committee would regard as improper:

An insider of a company who, in a transaction relating to the securities of that company is an insider, makes improper use of specific confidential information which might be expected materially to affect the value of those securities, shall be liable to compensate any person who directly suffers from his action in so doing unless that information was known or ought to have been known to such person, and shall also be accountable to the company for any direct benefit, received or receivable by him, resulting from any such transaction.

The above recommendation was substantially enacted in section 113 of the Ontario Securities Act.⁶⁰

The operative phrase of section 113 created a liability only when an insider "makes use of any specific confidential information for his own benefit or advantage that, if generally known, might reasonably be expected to affect materially the value of securities." The liability depended on whether the insider had acted improperly. A cause of action as given both to a person who has suffered direct loss, to recover his loss and to the company to obtain from the insider any benefit he received. The personal action was necessary because of the holding in *Percival v. Wright*.⁶¹ However, Professor Beck⁶² contends that even if the statute were silent as to a corporate right of action, one would exist, in addition to the personal right, by extension of the principles in *Regal Hastings*, particularly as recently elaborated by the Supreme Court of Canada in *Canadian Aero Services v. O'Malley et al.*⁶³ He supports his argument with two recent American decisions where a common law derivative action was allowed in the case of insider trading by directors⁶⁴ and by directors and "tippees".⁶⁵

In Britain, the Jenkins Report⁶⁶ would limit liability for improper trading to directors and recommended that a cause of action for improper trading should be given only to persons trading with the insider and not to the company. It is quite possible that the Jenkins Committee had in mind the existing fiduciary obligations of insiders to account to the company for their profits and felt that no statutory law was therefore required.⁶⁷

Crawford provides an interesting comment on the possible judicial interpretations of the word "improper" in section 113:⁶⁸

If the word "improper" is interpreted in the context of the existing fiduciary law then it may result in a jurisprudential development of strict liability. However, if the word "improper" is interpreted by the courts to require an examination of the motives of the taxpayer then an entirely different, but perhaps more equitable standard, may result.

58. J. S. Ziegel, *Studies in Canadian Company Law* (Vol. 1 1967) 440.

59. *Supra*, n. 1.

60. *Supra*, n. 45.

61. *Supra*, n. 17.

62. S. M. Beck, "The Shareholder's Derivative Action" (1974), 52 *Can. Bar Rev.* 159 at 178.

63. (1974), 40 D.L.R. (3d) 371 (S.C.C.).

64. *Diamond v. Oreamuno*, 248 N.E. 2d 910 (N.Y.C.A. 1969).

65. *Scheln v. Chasen*, 478 F. 2d 817 (2nd Cir. 1973).

66. Report of the (English) Company Law Committee (Cmd. 1962), Jenkins Report). The Report also recommended that the doctrine in *Percival v. Wright* be abolished.

67. *Supra*, n. 4, at 411.

68. *Ibid.*

The decision in *Green v. Charterhouse Group Canada Ltd. et al*,⁶⁹ which is discussed more fully in Chapter VI, appears to indicate that an Ontario court favours the latter interpretation.

Kimber felt that the key phrases in subsection 113(1) that have yet to meet the test of interpretation are "specific confidential information", "to affect materially the value", and "direct loss suffered".⁷⁰ Subsection 113 (2) limited the action to a two-year period following the completion of the transaction giving rise to the cause of action.

Section 114 of the Ontario legislation substantially enacted paragraph 2.29 of the Kimber Report.⁷¹ It allowed a shareholder who believed that a company had reasonable grounds for instituting an action under section 113, or who believed that the company was not diligently pursuing such an action once commenced, to apply to a judge of the High Court (Queen's Bench in Manitoba) for an order requiring the Ontario Securities Commission to commence or continue an action on behalf of the company. The section was enacted to offset, to some extent, the reluctance of fellow directors to pursue a guilty director by providing a procedure whereby a shareholder can take steps to require an action to be brought in the name of the company.⁷²

Finally, it must be noted that provisions of The Corporations Act⁷³ of Ontario dealing with insider trading are substantially identical with those of The Securities Act, 1966.⁷⁴

CHAPTER V

ANALYSIS OF PRESENT MANITOBA LEGISLATION

Insider trading legislation in Manitoba is enacted in Part II of The Companies Act,⁷⁵ sections 85-92, and in Part XI of The Securities Act,⁷⁶ sections 108-117. Furthermore, section 92 of The Companies Act states:

The regulations made under The Securities Act, 1968, respecting insider trading apply *mutatis mutandis* to the reports required to be made under section 86 and generally to the matters for which provision is made under section 85 to 91.

Upon examination of subsections 100(a) and 108 (b) of The Securities Act, and paragraph 85 (1) (e) of The Companies Act, it appears that the legislation does not apply to shareholders in private companies. These individuals are left to remedies available under the common law.⁷⁷

Sections 108 and 85 are the definition sections of The Securities Act and The Companies Act, respectively. Subsection 108(a) which corresponds to paragraph 85(1)(c) of The Companies Act defines:

(a) "capital security" means any share of any class of shares of a company or any bond, debenture, note or other obligation of a company, whether secured or unsecured;

69. [1973] 2 O.R. 677 (Ont. H.C.).

70. *Supra*, n. 41, at 91.

71. *Supra*, n. 1.

72. *Supra*, n. 41, at 90.

73. S.O. 1966, c. 28.

74. *Supra*, n. 45.

75. R.S.M. 1970, c. C160, as am. S.M. 1970, c. 10; 1971, c. 64; 1972 c. 54 (hereinafter referred to as The Companies Act).

76. R.S.M. 1970, c. S50, as am. S.M. 1970, c. 23; 1971, c. 31, 1972, c. 58 (hereinafter referred to as The Securities Act).

77. Ontario has eliminated the distinction between public and private companies which enables broader protection of the public under existing securities legislation.

The above definition of capital security is a departure from American legislation and the Kimber Report as it includes debt. Disclosure and prohibition of insider trading should be restricted only to equity securities such as required by subsection 16(a) of the Securities and Exchange Act and recommended by the Kimber Report.⁷⁸

Generally, the investment market is a more stable market subject to small fluctuations. The difference in rate of return to the more informed and the less informed becomes smaller in such a market. Under the American view and the Kimber view the public in general, and shareholders in particular, would gain little protection from insiders reporting on debt transactions. It is questionable whether adding debt to insider trading legislation is worthwhile. It is a concession to conservatism and the added protection may not justify the additional "red tape".

However, some would contend that there can be confidential information which would affect the value of a debt security. If a company, for example, which had been paying common share dividends regularly, had to skip a dividend, the rating of its bonds could drop and so could their value. Insider knowledge of such value indicators may well be reason enough to justify the inclusion of debt in insider reports. The difference between debt and equity shares in this respect is only one of degree.

Subsection 108(c) of The Securities Act and paragraphs 85(1)(e) and (f) of The Companies Act define "insiders" but exclude lesser executives, employees and professionals for reasons previously discussed in Chapter IV. The above legislation utilizes the function concept to define insiders. On the other hand, the access concept of defining insiders is embodied in Rule 10 b-5. The *Texas Gulf Sulphur*⁷⁹ case offers a compelling example why we must change the concept from one of function to one of access to confidential information.

In that case the appeal held that a company geophysicist trading on secret information violated Rule 10 b-5 and that a corporate insider cannot use material information to his own advantage. Our legislation would appear to exclude the geophysicist under the category of lesser executives, employees and professionals. On the other hand, it could be argued that the Canadian courts have shown a willingness to extend fiduciary duties to senior officers and employees. This notion was illustrated in *O'Malley*,⁸⁰ although the decision relates to corporate opportunity rather than specifically to insider trading.

With this suggested change in concept of defining an insider, "tippees" would be subject to liability, but only subject to double liability if they are employees of the company, e.g. an executive secretary, or individual in a fiduciary relationship with the company.

With respect to the above concepts, Professor Beck argues:⁸¹

A finding that the information was acquired by the fiduciary in his capacity as such has been essential to establish liability. It has been suggested that the law should not focus solely upon the capacity in which the information was acquired and that a broader concept of the directors' function is required to deal with the corporate opportunity problem. A director may acquire information otherwise than as a director and use it in a situation in which he commits a breach of duty. For example, a director of a mining company may have been given information in his capacity as a

78 *Supra*, n 1, at para 2 10

79 *Supra*, n 39

80 *Supra*, n 63

81 *Supra*, n 9, at 110-111

promoter and speculator in the mining industry without any reference to his membership on the board of any particular company. Yet the information may be valuable to that company and capable of exploitation by it, in which case the director's use of it may well constitute a breach of duty. He could not be said to have acquired the information in circumstances in which he had an obligation to transfer it to the company, yet he has acquired and used information which could have been used by the company and he ought to be held liable to account.

It has been suggested that the object of including among insiders, the five highest paid employees, was to prevent companies from exempting senior managers from reporting by the simple expedient of not giving them a title appropriate to their responsibility. However, suppose six of the highest paid employees of a company trade on inside information. Under the present function concept of definition, only the five highest paid employees would be liable under subsection 113(1) as defined in paragraph 1 (29) (ii) of The Securities Act, and under subsection 89(1) as defined in paragraph 85 (1)(f) of The Companies Act.

The remuneration and title indicators were utilized to give clear guidance to industry and yet be broad enough to encompass those members of management who had access to confidential information and took part in the formulation of corporate decisions. However, it appears that these indicators inherent in the function concept are deficient. The function concept is discriminatory and will not win any widespread public acclaim. Therefore, it is submitted that the access concept should be the test. The American jurisprudential experience indicates that it yields just and equitable results.

It is also submitted that the present "insider" definition be expanded to include professionals such as lawyers. Such persons are not immune from other laws due to their status and there appears to be no valid reason for granting immunity to professional people.

Subsections 111(1) and (2) of The Securities Act and subsections 88(1) and (2) of The Companies Act enunciate the penalties for failure of an insider to file a report and for filing a report containing false or misleading statements. Offenders are liable on summary conviction to a fine of not more than one thousand dollars. Other jurisdictions have, or are considering substantially increasing the penalties which are discussed in Chapter VI. An example should illustrate the concerns in this area. Suppose "A" is an insider who because of specific confidential information knows that the company is headed for bankruptcy and owns one thousand shares which are presently trading at \$20 per share. "A" knows that tomorrow the insolvency announcement will be made and his shares will be worthless. He can trade the shares today and be liable for \$20,000. to the purchaser and \$20,000 to the company plus a maximum \$1,000 fine - \$41,000., or he can retain his shares and lose \$20,000. but if "A" trades and is not discovered for two years which is quite possible, he is \$20,000. ahead. A penalty providing for an alternative jail sentence and changes to the limitation period discussed *infra*, may discourage "A" from trading in such a situation.

Assuming that liability has been found under subsection 113(1) of The Securities Act or subsection 89(1) of The Companies Act, what then is the measure of compensation to be awarded to the injured party? Consider the following example. Suppose our friend "A", an insider, has specific confidential information which he knows will cause the shares of the company to increase in value. "A" buys one thousand shares from "B" today at \$20 per share. Tomorrow this information is made public and

shares increase in value to \$40 per share. Two months later the shares reach \$60 in value for reasons other than "A" was aware of when he bought the shares and "B" brings an action under subsection 113(1) of The Securities Act or subsection 89(1) of The Companies Act. On the trial date the shares are worth \$80 per share. Has "B" lost anything at all? Perhaps he would have sold his shares anyway, or did he lose \$20, \$40 or \$60 per share? In *Brady v. Morgan*,⁸² the Ontario Court of Appeal held that the measure of damages was the best market price at which the shares were traded prior to the trial, which in this case would be damages of \$60 per share. The result could encourage speculating in damages with respect to the timing of the commencement of the action. Canadian legislators and securities commissions should consider codifying the calculations of quantum of damages as California has done in section 25502 of the 1963 California Securities Law.

Subsection 113(2) of The Securities Act and subsection 89(2) of The Companies Act deal with the limitation period and state that an action must be commenced only within two years after the date of completion of the transaction that gave rise to the cause of action. It appears reasonable to submit that after a stock transaction, a trader may not be cognizant of the fraud perpetrated upon him for many months. Perhaps in some of these instances the limitation period would operate to render an unjust result.

Under The Limitation of Actions Act,⁸³ in every case of concealed fraud, the cause of action shall be deemed to have arisen when the fraud was first known or discovered. The limitation period under The Securities Act and The Companies Act should be two years from the discovery of the cause of action, because as in fraud, the knowledge of the cause of action is peculiar to the defendant.

Under subsection 114(1) of The Securities Act and subsection 90(1) of The Companies Act, a shareholder may have to provide security for costs and incur considerable cost in pursuing such an application. These costs may deter applicants when one must also consider that he may not be in a position of assessing his possibilities of success until after a substantial portion of these costs have been incurred.

The Kimber Committee recognized possible abuse in the take-over situation but chose not to legislate.⁸⁴ Under the present legislation, insiders with knowledge of a take-over bid are liable if they trade in securities of their own company but are immune if they deal in the securities of the other party to the take-over. Rule 10 b-5 in the U.S. Securities Exchange Act checks abuse of this sort in the United States and Canadian governments would be wise to incorporate a similar provision in their laws.

CHAPTER VI

NEW DEVELOPMENTS IN CANADA

The Federal Government first enacted legislation dealing with insider trading in amendments to the *Canada Corporations Act*,⁸⁵ (Bill C-4) which received Royal Assent on October 7, 1970. Provisions contained therein were similar to those of the Ontario model.

82. [1967] 2 O.R. 680 (Ont. C.A.).

83. R.S.M. 1970, c. L150 s. 7.

84. *Supra*, n. 1, at para. 232.

85. S.C. 1969-70, c. 70.

However, a short time later more amendments to the *Canada Corporations Act*⁸⁶ were enacted. It appeared that the Federal Legislation had eclipsed the Ontario model by virtue of section 100, specifically subsections 100.1 - 100.6. Paragraph 100.3(1), Offence and Punishment, imposed a discretionary prison term not exceeding six months for failure to file an insider report as well as the discretionary maximum one thousand dollar fine. Paragraph 100.3(2) imposed similar discretionary punishments for filing false or misleading reports. The liability of an insider was enunciated under paragraph 100.4(1). Insiders under this section included "every person employed or retained by the company." This phrase illustrated the conceptual change from function to access to information in respect of defining insiders, and finally captured lawyers and accountants in the statutory net. Further under subsection 100.5 a shareholder, upon application to have an action instituted, was no longer required to provide security for costs.

On March 24, 1975 the *Canada Business Corporations Act*,⁸⁷ (Bill C-29), received Royal Assent. It contains legislation in Part X, sections 121-125, dealing with insider trading which expands upon the previous federal legislation. Under subsections 122(9) and (10) the maximum fine for not filing or filing insider reports containing false or misleading statements has been increased to five thousand dollars, as well as retaining the discretionary imprisonment provisos of the previous legislation. Subsection 125(1) continues to expand the definition of "insider" under the access concept to include "tippees" under paragraph 125 (1)(f), "a person who receives specific confidential information", who are subject to double liability under paragraphs 125(5) (a) and (b), which seems unduly harsh unless the insider holds a fiduciary relationship with the company. Finally, subsection 125(6) enunciates the limitation period under this legislation which is simply a restatement of the previous legislation with its inherent inequity.

In Ontario, The Securities Act, (Bill 98)⁸⁸ was introduced in the Legislature and received first reading on May 30, 1975. It contains major changes in a proposed new Securities Act. This Bill was drafted to reinforce the basic principles of present securities legislation to prevent fraudulent conduct in securities trading and to provide adequate and timely disclosure to the market. The Bill has been discussed in detail with representatives from the other provinces, and the Ontario government hopes that Bill 98 will find acceptance as a uniform provincial Securities Act.

The draft legislation is a revision of The Ontario Securities Act⁸⁹ with one of its purposes being the expansion of insider trading liability. This provision will be expanded to include trading of securities of an issuer with knowledge of a material fact or change that has not been generally disclosed. It will also be an offence to inform another person or company of that material fact or change.

Hopefully, Bill 98 will also implement the recommendations contained in Chapter 22 - Insider Trading, of The Report on Mergers, Amalgamations

86. R.S.C. 1970, c. C-32 as am. R.S.C. 1970, (1st Supp.) c. 10; S.C. 1970-71, c. 1.

87. S.C. 1974-75, C-33.

88. 29th Legislature, Ontario, 5th Sess. (1975), this legislation was first introduced in the 4th session of the Ontario Legislature as Bill 75. Examination of both drafts revealed that there were no substantive changes to the insider trading provisions between sessions.

89. *Supra*, n. 45.

and Certain Related Matters by the Selection Committee on Company Law (November, 1973):

1. Provisions of the Act and The Securities Act imposing Insider Trading liability should be extended to include professional advisers or consultants retained by the corporation and to employees of the corporation.
2. In the case of take-over bids and statutory amalgamations, legislation similar to section 100.1(5) of the *Canada Corporations Act* should be enacted to cover directors and senior officers who *trade with knowledge that a bid is about to be made* (emphasis added).⁹⁰
3. Both section 151 of the Act and section 114 of The Securities Act should be enlarged to give the Ontario Securities Commission the right to apply to the court for an *order requiring the Commission* to commence or continue an action on behalf of a corporation to enforce the liability of an insider (emphasis added).

In addition subsection 124(2) of Bill 98 states:

No proceedings under this Act shall be commenced before the Commission more than two years after the facts upon which the proceedings are based *first came to the knowledge* of the Commission (emphasis added).

Subsection 128 (1) of Bill 98 contains the ultimate definition of an insider under the "access" concept by incorporating the phrase, "Every person or company that sells or purchases securities. . . ."

The Bill has been called one of Canada's most researched and most debated pieces of legislation⁹¹ and still may be amended in its passage through the Ontario Legislature. However, I have been led to believe that once enacted, it is likely to be duplicated in most other provinces.

A recent development in the judicial area took place in *Green v. Charterhouse Group Canada Ltd. et al.*⁹² This was an action under section 113 of The Ontario Securities Act.⁹³ The plaintiff owned 80,000 shares of I company and had a buy-sell agreement with the defendant shareholders that he would offer his shares to them before selling to others. He became particularly anxious to dispose of the shares, and under the agreement, offered them to the defendants. Although in a vulnerable position, they accepted in order to prevent a sudden release of the shares on the market. A short time before the sale, the defendants were aware of a possible take-over of the company under which the value of the shares would materially increase. The plaintiff was notified in general terms of these negotiations. The take-over subsequently came about, and the shares rose in price. The plaintiff wished to be compensated.

The High Court of Justice dismissed the action. The Court held that to create liability under section 113 it must be established that the insider "makes use of any specific confidential information". The buy-sell agreement in this case established that the defendants did not make use of the information regarding a possible take-over. Their reluctance to purchase was further evidence of this fact. The Court felt section 113 applied only when the knowledge of the facts constituted specific confidential information, and relief from liability under the section was provided if such information was known or ought reasonably to have been known to the person suffering the loss. The defendants did not consider the prospects of a take-over bid at a later date to be a factor in their

90. (emphasis added) — in reference to discussion of these issues in Chapter V.

91. The Financial Post, June 14, 1975, 1.

92. *Supra*, n. 69.

93. *Supra*, n. 45.

purchase of the plaintiff's shares. Thus, the Court found that facts complained of did not constitute "specific confidential information", but were preliminary and uncertain.

CHAPTER VII

CONCLUSION

In conclusion, one may say that regulation does not breed market morality but merely sets standards of acceptable conduct. The legislation in this area has developed relatively quickly owing in part to the vital function that the securities market performs in allocating scarce capital resources amongst competing entities in our economy. It is sincerely hoped that Manitoba adopts the new Ontario model, which although perpetuating some injustices, goes far in alleviating some inequities previously discussed.

One must also remember that there is nothing in any of the legislation examined that prohibits an insider from trading in his company's securities. At the same time, it is recognized that management is always in possession of facts which are not available to the general public. The standard would then seem to be whether the insider has knowledge of facts which, if disclosed, can reasonably be expected to have a sharp and immediate impact on the securities. If there is a question in the insider's mind that he would have a distinct advantage over the public generally, because of undisclosed corporate information he possesses, he should not trade.

Our Canadian securities laws are designed to give us a free and open market and ensure that the rules are observed for the benefit of all. Securities will be more accurately valued and issuers will encounter a more favourable reception for their securities, both of which are functions of increased public confidence in the market. The country as a whole then benefits as more capital will be available to aid in economic growth.

EUGENE HRETZAY *