

## **Illegal Insider Trading in Canada: Recommendations on Prevention, Detection and Deterrence**

**November, 2003**

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## Executive Summary

Canada's securities regulators responsible for regulating insider trading combined in September 2002 to form the Insider Trading Task Force with the objective of evaluating how best to address illegal insider trading on Canadian capital markets. Illegal insider trading involves the buying or selling of a security while in possession of undisclosed material information about the issuer, and includes related violations such as 'tipping' information and securities trading by the person 'tipped'. It erodes investor confidence by causing investors to believe that insiders have an unfair advantage.

A series of recommendations is presented in the report, focussed on addressing illegal insider trading from three directions: prevention, detection and deterrence. The recommendations are made with the objective of increasing the effectiveness of current regulatory efforts to address illegal insider trading undertaken on Canadian equities and derivatives markets. They are made in the context of an international regulatory environment that is fast becoming intolerant of practices that have assisted illegal insider trading to occur, such as the use of offshore accounts to hide beneficial ownership. They also, however, are made in recognition of a regulatory environment that is becoming increasingly complex and costly for market participants. As a result, most of the recommendations should result in little or no cost to market participants. Those with a cost attached, such as enhancing surveillance detection technologies, should result in benefits that extend beyond the regulation of insider trading to significantly improve the ability to regulate market integrity in general.

Some of the major recommendations are as follows:

### Prevention

- issuers whose securities are listed for trading on Canadian markets be encouraged to:
  - adopt the best practices provided in the CSA's Disclosure Standards Policy and the CIRI Standards and Guidelines for Disclosure
  - only retain lawyers and accountants who have adopted best practices for information containment as developed by their professional associations
- OSFI develop regulations for the management of inside information received by banks during their credit or other relationships with issuer clients
- intermediaries be required to meet IDA-mandated best practices on information containment including maintaining records of persons solicited to participate in bought deals

- markers identifying trading by insiders be made available on a real-time basis to all investors
- guidelines be provided to market participants, and applicable legislative prohibitions enforced, for the appropriate time delay for trading by those with pre-announcement knowledge of inside information following the announcement of the material event

## **Detection**

- securities commissions mandate and coordinate the development of an electronic database of integrated trade and client data to improve the effectiveness of market regulators to detect and prove illegal insider trading
- “shell banks” and residents of any jurisdiction that does not have a satisfactory regulatory regime not be permitted to open accounts with Canadian dealers
- offshore financial institutions be permitted to open accounts with Canadian dealers only on the condition that they consent to identify on request the individual responsible for a trade (subject to a cost/benefit analysis)
- direct access to a marketplace be prohibited for residents of jurisdictions that do not have a satisfactory regulatory regime unless confidentiality protections are waived
- Canada’s market regulators (RS and the Mx) coordinate their regulation of equities and derivatives of those equities
- RS and the Mx work with regulators of other markets around the world to create a centralized international database that identifies the markets upon which equities and their derivatives trade as well as inter-market misconduct

## **Deterrence**

- the Federal Government pass Bill C-46, amended to apply the concepts underlying the U.S. criminal law approach to illegal insider trading
- the formation of a nationally integrated working group, including representation from the securities commissions, SROs and the RCMP, be considered to focus solely on illegal insider trading, including assisting in the implementation of this report’s recommendations.

## 1.0 Introduction

### 1.1 Insider Trading as a Violation

Illegal insider trading involves the buying or selling of a security while in the possession of undisclosed material information about the issuer of the security, and includes related violations such as ‘tipping’ information and securities trading by the person ‘tipped’. A principle of securities regulation in North America is that markets operate efficiently on the basis of timely and full disclosure of all material information. Laws that require timely disclosure of material information and prohibit insider trading in the absence of full disclosure support this principle. Trading on “inside information”, as defined in Appendix B, including illegal insider trading and related misconduct such as tipping, undermines this principle.

Various critics of the nature and extent of securities legislation in North America have taken the view that insider trading is an essentially victimless activity. However, trading on inside information, including illegal insider trading, does produce ‘victims’. They include:

- the investor, unaware of the inside information, who transacts with a person who knows of the inside information. The person with inside information benefits from this unequal and unfair relationship by the amount the transaction price would have differed had both sides had access to the same generally disclosed information.
- market participants in general. A market that permits those with inside information to benefit to a greater extent than others results in a market that is inherently unfair, to the detriment of those participants who have no inside information.
- the issuer and its shareholders. Illegal insider trading in the securities of the issuer represents a “misappropriation” of valuable information that is the property of the issuer and, indirectly, its shareholders. In addition, when a corporate insider is found to have engaged in illegal insider trading, the perception of the integrity of the issuer’s management is compromised as is the issuer’s corporate reputation and its attractiveness as an investment.
- in the specific instance of insiders of an issuer structuring their acquisition of securities from treasury with knowledge of inside information, the issuer’s shareholders may be victimized due to the resulting dilution of the value of their shareholdings if those treasury securities are issued at a price that is lower than would have applied had the information been disclosed. Equally, the issuer would be victimized as a result of being induced to issue undervalued securities.

- the Canadian economy to the extent that investors may avoid the Canadian securities markets due to perceptions of an unfair and poorly regulated marketplace. Canadian markets operate in a competitive international environment that generally accepts the need for not only efficient markets but fair markets. Prevalent trading on inside information results in investment capital avoiding that market and adversely impacts the market's liquidity and the cost and availability of capital. It also indirectly adversely impacts overall growth and employment in the economy.

Trading on inside information, especially illegal insider trading, can cause significant harm to the fairness and efficiency of Canadian capital markets. Even the perception that illegal insider trading is prevalent can cause harm. This is so because it undermines investor confidence in the fairness and integrity of capital markets.

## 1.2 Insider Trading Task Force

The regulatory structure in Canada to address illegal insider trading is depicted in the diagram below. The diagram includes all of the regulatory authorities involved in Canada in preventing, detecting and deterring illegal insider trading and summarizes the role each plays. The Insider Trading Task Force was established in September 2002 by these regulatory authorities, comprising the Ontario, British Columbia and Alberta Securities Commissions, the Commission des valeurs mobilières du Québec, the Investment Dealers Association of Canada, the Bourse de Montréal and Market Regulation Services Inc.

The Task Force was formed out of concerns among its participating securities regulators that:

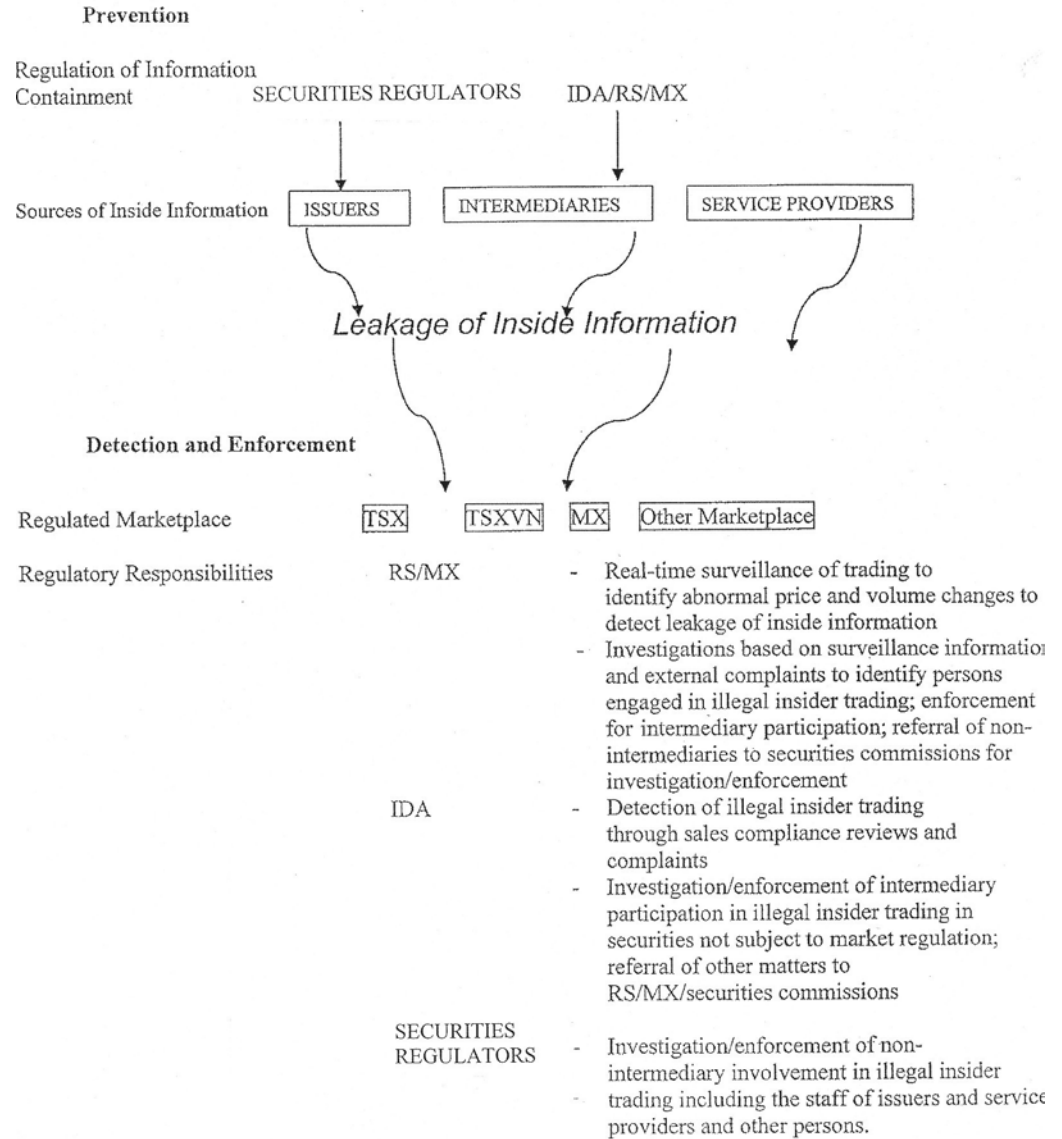
- there is a public perception that illegal insider trading is prevalent and increasing on Canadian markets, and
- although many suspected incidences of illegal insider trading are being identified through market surveillance, there have been few successful enforcement actions.

The mandate of the Task Force was to examine illegal insider trading in the Canadian marketplace in order to determine more effective means of addressing it, including:

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

# INSIDER TRADING TASK FORCE

## Regulatory Structure in Canada for the Prevention, Detection and Deterrence of Illegal Insider Trading



Note: "Securities Regulators" refers to the provincial and territorial securities commissions.



2. increasing the ability of regulators to detect illegal insider trading when it occurs, such as by addressing offshore and nominee account issues and by coordinating the regulation of equities with their derivatives; and
3. increasing the success of deterrence efforts through:
  - better coordination among regulatory agencies,
  - ensuring the laws are adequate, and
  - improved enforcement mechanisms and penalties.

### 1.3 Methodology

The review took place between February and June 2003 and included:

- a survey of market participants,
- discussions with staff at the OSC, BCSC, CVMQ, ASC, IDA and RS about regulatory processes, tools, best practices, challenges, and insight to regulation,
- inspection of relevant rules and policies of the IDA, RS and the Mx,
- review of all insider trading investigations open in Canada during calendar 2001 and 2002,
- interviews of staff at non-Canadian regulators, including the SEC, FSA, ASIC, NYSE and NASD, about regulatory processes, tools, best practices and insight to regulation,
- consultation with the ICAO, CBA, CIRI and the institutional subcommittee of the Compliance and Legal Section of the IDA about information containment,
- preparation of a bibliography of papers and articles on insider trading.

Some specific matters were beyond the scope of the project including:

- insider report filing obligations,
- the use of over-the-counter derivatives to carry out illegal insider trading,
- spread betting (i.e. bookmaking in changes in the value of securities),
- insider trading in debt securities, and
- independent benchmarking of Canadian market surveillance systems.

## 2.0 Quantifying the Issue

### 2.1 Incidence of Illegal Insider Trading

Economists have been presenting consistent empirical evidence of widespread insider trading on various markets around the world for over a decade. Economists define insider trading broadly as trading on inside information, being material facts or changes that have not been publicly disclosed through a media report or other official means of general dissemination. It is difficult, however, to determine how much of that trading would represent illegal insider trading as defined in Canada under provincial securities statutes.

The methodology used to date to quantify insider trading relies on identifying statistically abnormal changes in market price and volume before announcements of material events. These methods, however, are not sufficiently refined to do more than identify an apparent order of magnitude of trading on inside information, including for example speculative trading that derives from the leakage of inside information but does not meet the definition of illegal insider trading. Better analytical tools are becoming available and will over time yield more information about the nature and extent of illegal insider trading than traditional models are currently capable of doing.

Canadian markets are founded on the basis of fairness, which suggests that investors, whether insiders or not, should not be allowed to trade on inside information, however it was obtained. Market efficiency, the other central principle of market regulation, is directly tied to how quickly material information flows through the market and is incorporated into securities prices. Any trading on inside information that occurs on Canadian markets has a direct adverse impact on the fairness and efficiency of those markets and, as various academic research papers have concluded, consequently on market liquidity and the cost of capital.

Examples of proven illegal insider trading that has occurred over the past 15 years in Canada include: Russell J. Bennett, William R. Bennett and Harbanse S. Doman (approximately \$2.3 million in losses avoided from sales of Doman Industries Ltd. shares in 1988); Seakist Overseas Ltd., Michael G. de Groote et al (approximately \$16.5 million in net profits from the short sale of Laidlaw Inc. shares in 1991); Glen Harper (approximately \$3.6 million in losses avoided from selling shares of Golden Rule Resources Ltd. in 1997); and MCJC Holdings Inc. (unreported net profits from the sale of \$20.4 million in Corel Corporation shares in 1997).

Due to data limitations, it is currently very difficult to establish accurately the extent of insider trading, much less illegal insider trading, that occurs on Canadian markets. Nevertheless, academic research consistently evidences trading on inside information on markets around the world. There is no reason to believe that Canadian markets would not

also be victimized by these activities. With increased ease of access to offshore trading and the continued development of the options and single stock futures markets, illegal insider trading threatens to become more prevalent and profitable over time without strategies to mitigate the risk. The recommendations in this report are intended to result in a reduction in this risk by:

- decreasing the amount of inside information leakage through issuers, intermediaries and other service providers;
- improving the effectiveness of practices and procedures used to detect trading on inside information and, specifically, illegal insider trading; and
- increasing the credibility of the enforcement regime.

## 2.2 Cost of Regulating Insider Trading in Canada

The regulatory organizations in Canada who include within their mandates the responsibility for identifying, investigating and prosecuting illegal insider trading currently spend in aggregate approximately \$8.1 million annually on that regulation. This regulatory cost can be compared to the significant damage illegal insider trading can cause to Canadian capital markets. Nevertheless, the Task Force recognizes that the cost of regulating illegal insider trading should be proportionate to the risk. Risk criteria, in addition to “profits made from illegal insider trading”, could include:

- the incidence of illegal insider trading, including in securities not addressed by this report (as referred to previously under “Methodology”),
- the impact on market price,
- the incidence of illegal insider trading as a component of other serious violations such as manipulation and corporate accounting fraud, and
- a rating of the potential for negative economic consequences, for example on market liquidity, the cost of capital and the ability to attract investment capital to the Canadian marketplace.

A risk-based approach focuses on evaluating the risks of the conduct and the value of regulatory success in limiting the specific misconduct. It provides a supportable basis for determining the proportion of scarce resources to attack the problem of illegal insider trading. A risk-based approach is a relatively long-term initiative, requiring significant analysis and evaluation by all regulatory organizations concerned. In the meantime, the

recommended improvements are justifiable provided their cost is reasonable and proportionate to their value in increasing the efficiency and effectiveness of regulatory efforts to address illegal insider trading.

## 3.0 Prevention

Illegal insider trading can occur only when a person has access to inside information about an issuer that others do not, by virtue of some special relationship that person has with the issuer. That person can then use the information to personal advantage by buying or selling securities of the issuer before the information is generally disclosed to the public. To the extent that the flow of inside information is contained, the risk of illegal insider trading is lessened. Conversely, when information is disclosed in a timely manner, there is less risk that an individual can benefit from the information to the possible detriment of other investors.

Many individuals within issuers have access to inside information, as do service providers such as dealers, accountants, lawyers, bankers, technical specialists, analysts, actuaries and printers. This section reviews how issuers, dealers and other major service providers can best ensure that material information does not leak out prior to the information being generally disseminated. The section also reviews how best to ensure that issuers and those in possession of inside information meet the substance and intent of timely disclosure requirements. The objective of better information containment and timely disclosure practices is a reduced risk of illegal insider trading occurring.

### 3.1 Best Practices for Information Containment

#### 3.1.1 Issuers

The CSA in its National Policy 51-201 entitled *Disclosure Standards* articulates detailed best practices for issuers for disclosure and information containment as well as provides a thorough interpretation of insider trading laws. CIRI, a not-for-profit association of executives responsible for communications among public corporations, investors and the financial community, also has published a set of guidelines for best practices for issuers entitled *CIRI Standards and Guidance for Disclosure and Model Disclosure Policy – Second Edition 2003*. CIRI's set of best practices is consistent with and supports the CSA's Disclosure Standards Policy as well as TSX and TSXVN guidelines and requirements on disclosure.

The CSA and CIRI recommend that issuers adopt written disclosure policies to assist directors, officers and employees and other representatives in discharging timely disclosure obligations. Written disclosure policies also should provide guidance on how to maintain the confidentiality of corporate information and to prevent improper trading on inside information. The CSA and CIRI best practices offer guidance on broad issues including disclosure of material changes, timely disclosure, selective disclosure, materiality, maintenance of confidentiality, rumours and the role of analysts' reports. In

addition, guidance is offered on such specifics as responsibility for electronic communications, forward-looking information, news releases, use of the Internet and conference calls.

Adopting the CIRI and CSA best practices as a standard for issuers would assist issuers to ensure that they take all reasonable steps to contain inside information.

**Recommendation #1: Canadian equity marketplaces amend their timely disclosure policies to:**

- **recommend that issuers adopt the best practices provided in the CSA's Disclosure Standards Policy and the CIRI Standards and Guidelines for Disclosure; and**
- **emphasize (i) the responsibility of boards of directors and senior officers of issuers for compliance with best practices for information containment, as exemplified by the CSA and CIRI best practices, and (ii) where directors or senior officers fail to fulfil this responsibility, their suitability to act may be reviewed by the marketplace.**

A consistent concern raised by directors and officers of issuers is that, due to the complexity of the insider trading laws and associated requirements, it is difficult for them to understand how to meet their responsibilities in connection with information containment, timely disclosure and related trading restrictions. Educational activity directed to them would reduce the risk of illegal insider trading occurring by focussing on their obligations in these areas, as well as on the market integrity standards underlying insider trading restrictions, and the possible consequences of wrongdoing. Every new director and officer of an issuer is required to file a Form 4B with the exchange upon which the issuer is listed or with a provincial securities commission. A relatively simple means of ensuring that each of these directors and officers is provided with the information necessary to enable them to meet these obligations is to send each an information package upon their filing the Form 4B. The cost of preparing and sending the information package could be paid for out of various education funds accessible to the commissions and exchanges.

**Recommendation #2: The CSA, with the Canadian equities markets, develop a process whereby, upon receipt of a Form 4B, the director or officer is sent an information package that includes responsibilities and guidelines applicable to information containment, timely disclosure and insider trading restrictions, as well as background on the underlying market integrity standards and potential sanctions.**

## 3.1.2 *Service Providers*

It is the responsibility of the issuer, and its directors and senior officers, to take all reasonable steps to ensure the containment of inside information. Although issuers have the power to enforce best practices to contain inside information within their own organization, they are not in the same position to ensure that their service providers who have access to inside information also adopt best practices.

Issuers are permitted to disclose inside information to service providers, such as lawyers, accountants, dealers and bankers, if in the normal course of their employment, profession or duties. This exemption to the general prohibition on disclosing inside information relies on service providers being bound by their own regulations or codes of conduct to contain inside information. However, a review by the Task Force of provisions in the regulations or codes of conduct governing the major service providers found that specific requirements on containing inside information either do not exist (lawyers, accountants, banks) or were incomplete and inconsistently applied across the country (dealers). The absence of best practices on information containment for service providers weakens the effectiveness of efforts to reduce the incidence of illegal insider trading and tipping. It also makes it very difficult for issuers, in attempting to meet their obligations on information containment, to assess the adequacy of their service providers' information containment procedures. Standards would assist issuers to meet their obligation to minimize the potential leakage of inside information through service providers by providing issuers with a means to choose service providers that have adopted these standards.

### *(i) Lawyers*

Lawyers and their employees, including students, are often exposed to inside information in the course of acting for issuers. There are no national or provincial rules or practices for lawyers that address directly the containment of inside information. The Canadian Bar Association, as well as the provincial law societies, would be the appropriate entities to develop and obtain consensus on a set of national best practices for lawyers on containment of inside information obtained during the course of acting for issuers.

**Recommendation #3:**            **The CSA work with the CBA and the provincial law societies to develop substantive best practices for information containment for lawyers.**

**Recommendation #4:**            **Canadian equity marketplaces amend their timely disclosure policies to:**

- **recommend that issuers retain only lawyers who have adopted best practices on information containment; and**
- **emphasize (i) the responsibility of boards of directors and senior officers of issuers for compliance with best practices on information containment, as exemplified by using only lawyers who have adopted best practices on information containment and (ii) where directors or senior officers fail to fulfil this responsibility, their suitability to act may be reviewed by the applicable marketplace.**

**(ii) Accountants**

Professional accountants providing services to issuers in Canada consist of chartered accountants, certified general accountants and certified management accountants. Chartered accountants dominate the provision of audit and advisory services to issuers in Canada. Accountants and their employees, including students, gain access to inside information during the course of providing audit, tax, finance, investigation, insolvency, valuation and other advisory services to an issuer. As a result, there is the potential for misuse of such inside information.

There are currently no recognized best practices for accountants to follow for containment of inside information. The ICAO was asked to advise the Task Force on best practices for accountants.

In a written report, the ICAO explained that it mandates that all members govern themselves in accordance with the profession's rules of conduct. The rules of conduct state that a member of the ICAO shall not disclose any confidential information concerning the affairs of any client (including a former client, employer or former employer) except in certain circumstances. The exceptions are where a professional duty, legal or judicial process or law requires disclosure, where disclosure is necessary to defend the firm or where the client consents to disclosure. In addition, the member shall not use confidential information for personal advantage, the advantage of a third party or to the disadvantage of a client, without the consent of the client. The ICAO rules permit the use of confidential information with consent of the issuer client, however consent is irrelevant in the case of illegal insider trading.

The CICA provides guidance to accountants on complying with the profession's rules of conduct. They encourage accountants to consider implementing an internal policy regarding confidentiality, communicate the policy to personnel and at least annually have personnel confirm compliance with the policy. The CICA further recommends that the policy have detailed guidelines and examples depicting circumstances and the related



problems that could occur in practice. However, the implementation of such a policy is not mandatory and cannot be enforced.

The ICAO conducted a survey in 2003 to provide the Task Force with a summary of existing practices in information containment among the large accounting firms. The practices address issues such as risk management, hiring policies, confidentiality of client information (including former clients and non-clients), affirmation of and compliance with a policy on confidentiality, codes of ethics, written policy manuals, treatment of inside information, restricted lists and information barriers. The practices vary among firms and the ICAO did not identify best practices from the existing practices and, even if it had, the best practices would not be binding.

The CICA conducts research into current business issues and sets accounting and assurance standards. A collaborative effort on the part of the CICA and the provincial institutes is required to develop a set of national best practices for accountants on containment of inside information obtained during the course of performing audit and other services for issuers.

**Recommendation #5:                   The CSA work with the CICA and the provincial institutes of chartered accountants to develop substantive best practices for information containment for accountants.**

**Recommendation #6:                   Canadian equity marketplaces amend their timely disclosure policies to:**

- **recommend that issuers retain only accountants who have adopted best practices on information containment; and**
- **emphasize (i) the responsibility of boards of directors and senior officers of issuers for compliance with best practices on information containment, as exemplified by using only accountants who have adopted best practices on information containment and (ii) where directors and senior officers fail to fulfil this responsibility, their suitability to act may be reviewed by the applicable marketplace.**

**(iii)    Banks**

There is the potential for inside information to be disclosed as a result of a banking or other commercial-lending relationship. For example, an issuer may disclose to its banker that it requires an exemption from a loan covenant. This information may well be material information. However, not all banks have a process whereby the issuer is then

put on a restricted list. Restricted lists are effective tools for monitoring potential misuse of inside information by bank employees.

This is a regulatory gap that to date has not been fully addressed in Canada. In the United States, the issue has been the subject of recent consideration within the context of credit market participants (defined as institutions that (i) maintain loan portfolios (through origination, acquisition or both) or engage in other activities that generate credit exposures, (ii) may receive inside information in connection with these credit exposures or other activities and (iii) engage in credit-portfolio-management activities).

The normal business activities of credit market participants should trigger insider trading restrictions in some circumstances. As commercial lenders, credit market participants receive inside information from borrowers, both in connection with the origination or acquisition of loans and at subsequent stages, pursuant to standard reporting covenants in their loan agreements or in accordance with normal due diligence and related lending practices.

Credit market participants should have in place information controls and related policies and procedures appropriate to their business activities and organizational structures to control, limit and monitor the inappropriate dissemination and use of inside information. Such information controls may include (i) establishing a 'wall' to prevent access to inside information by persons having responsibility for the execution of, or the decision to execute, security-based transactions, (ii) 'need-to-know' policies to limit the dissemination of information within the firm, (iii) restricted lists, watch lists and trading reviews to help restrict, monitor or control transactions when the firm possesses inside information, and/or (iv) combinations of the foregoing.

OSFI oversees Canadian banks with a focus on safety, soundness and reputation.

**Recommendation #7:            The CSA request that OSFI develop regulations for the management of inside information received by banks during their credit or other relationships with issuers.**

***(iv)      Dealers***

Investment dealers facilitate the buying and selling of securities of issuers and are exposed to a great deal of inside information about issuers. In Ontario, the requirements for dealers to contain inside information are covered in OSC Policy 33-601, including the use of grey lists, restricted lists and information barriers. OSC policies are non-binding statements or guidelines intended to inform and guide those subject to Ontario regulation.

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Policy 33-601 states that the board of directors and senior officers of a registrant are responsible for ensuring that appropriate policies and procedures for the business activities of the registrant are adopted, maintained and enforced. A registrant of the OSC is encouraged to consider establishing written policies and procedures in the following areas:

- education of employees, including education about insider trading and ethical standards, what constitutes inside information, the legal consequences for breaches of the restrictions and ethical responsibilities of the registrant;
- containment of inside information, by limiting unauthorized transmission of inside information, such that the registrant should consider restricting access to areas that are in receipt of inside information, including the corporate finance area, and by designating departments as sensitive areas and separating those departments from others or, if restricting access to departments is not practical, then treating all of the departments as being 'behind the wall'. In addition, the registrant should assure the security of confidential information by restricting access to inside information, using code names in the place of proper names, keeping information in sensitive areas secure and ensuring electronic transmission of inside information takes place under adequate controls;
- restriction of transactions through the use of grey lists and restricted lists; and
- compliance policies and procedures to include monitoring and reviewing trading in registrants' accounts, monitoring and/or restricting trading in securities about which the registrant or its employees may possess inside information, monitoring, reviewing and/or restricting trading of all employees, requiring all employees to maintain accounts with the employer registrant only, requiring a senior officer to be responsible for the implementation and enforcement of policies and procedures and instituting a periodic review of the adequacy of policies and procedures.

A review of the compliance manuals of several major Canadian investment dealers found only one that included guidance for employees on best practices for information containment. At the request of the Task Force, the IDA developed a draft set of best practices for information containment by investment dealers modelled on OSC Policy 33-601. The IDA draft best practices detail the steps that dealers should take for information containment. Specifically, the IDA best practices address such safeguards as information barriers, grey lists and restricted lists to help ensure information containment. They were

developed on the basis that a common set of mandated best practices for information containment by dealers would not only assist to ensure fairness in the marketplace for investors but would also provide a standard for dealers to meet.

Neither the IDA's draft best practices nor OSC Policy 33-601 specifically deals with information containment within the context of private placements. In March 2003, a committee of investment dealers, composed of nine Vancouver-based firms that participate in retail offerings, developed a set of best practices for information containment in non-prospectus offerings. The Task Force endorses the work of the Vancouver dealer group.

The draft IDA best practices also do not specifically address the issue of information containment in the case of a "bought deal". At present there is no requirement that a dealer maintain records about those parties that have been solicited about potential interest in a bought deal. However, there is a risk that information, disclosed to potential participants who do not eventually take part in the bought deal, may be leaked thus providing an opportunity for illegal insider trading. The maintenance of records of contacts, including individuals and their relevant affiliations, would be of assistance in investigating suspected illegal insider trading.

**Recommendation #8:                    The IDA mandate best practices in information containment appropriate to the nature of a member's business, modelled on OSC Policy 33-601 and specifically addressing:**

- **private placements, as developed by the Vancouver dealer group, and**
- **bought deals.**

A review of the practices of the regulators reveals a patchwork approach in Canada to regulation of information containment by dealers. The IDA has primary responsibility in the area and reviews the practices of its members with respect to grey and restricted lists and information barriers as part of its sales compliance process. RS, as part of its trade desk compliance review function, reviews trading by dealers to ensure those with inside information are not trading on the basis of such information. As well, through its market surveillance functions, RS identifies any unusual trading patterns that may signal the leakage of inside information. The Mx also deals with information containment as part of its sales compliance reviews, through its market surveillance function and through its trade-desk review function. Finally, the TSXVN plays a role in regulating information containment by dealers, specifically addressing the requirements for information containment by a sponsor, required for an issuer to list its securities on the exchange.

There is some duplication in regulators' practices regarding review for information containment by dealers. At the same time, no one regulator fully covers all of the elements of Policy 33-601. A co-ordinated effort among regulators to fully review all of the elements identified in Policy 33-601, to avoid fragmented regulation in this area and to eliminate duplication would result in a more effective and efficient regulatory regime.

**Recommendation #9:**      **The IDA, RS, Mx and TSXVN form a committee to amend their procedures for the regulation of information containment by dealers to i) address the elements identified in OSC Policy 33-601, ii) eliminate duplication of effort and iii) rationalize the regulation of information containment.**

## 3.2 Timely Disclosure

### 3.2.1 *Timely Disclosure Policies*

Securities legislation in the majority of Canadian provinces and territories imposes a general timely disclosure obligation upon issuers. The rationale for timely disclosure is that all persons investing in securities must have equal access to information about issuers that may affect their investment decisions. Issuers are required to make immediate disclosure of material changes in their business, operations or capital by way of a news release. Subsequently a report explaining the material change must be filed with the appropriate securities commission. Securities regulators, however, encourage issuers to go beyond a narrow definition of what constitutes a material change to keep the marketplace advised about developments that may be relevant to investors and potential investors.

The CSA published NP51-201 Disclosure Standards in July 2002. NP51-201 describes the type of information that may be considered material to investors and that the CSA believes issuers should be disclosing on a timely basis.

Issuers that are listed on the TSX or TSXVN are subject to additional timely disclosure requirements. These issuers must make immediate disclosure not only of material changes in their business, operations or capital, but also of any material information whether or not that information constitutes a material change. Further, the TSX requirements provide that disclosure must be made upon the information becoming known to management or, in the case of information previously known, upon it becoming apparent to management that the information is material.

The TSX and TSXVN have written policies for issuers that deal with requirements for disclosure of material information on a timely basis. The TSX rules on timely disclosure are in Part IV of the TSX Company Manual, and the TSXVN rules are in Policy 3.3 of its Corporate Finance Manual. Both sets of rules detail the obligations of each of the

exchange's listed issuers for timely disclosure of material information. Compliance with these rules is required in order to continue meeting listing requirements on each exchange. Consistency between exchange policies would benefit both issuers and the public in standardizing information availability and the timeliness with which it is delivered. However, TSXVN issuers often require additional guidance and, as such, it is recognized that the TSXVN policy should have additional provisions as necessary.

The Task Force compared each exchange's timely disclosure rules to identify inconsistencies. The most significant are:

- each policy defines terms differently, such as "material information", "listed securities" and "issue". The exchanges should harmonize the use and definition of these key terms.
- both policies set forth a test for when an issuer must explain to the market the impact of external, political, economic and social developments on the issuer, but the tests are inconsistent. Both policies should use the "reasonably be expected" test.
- both policies should use the concept of "immediate disclosure" throughout. Both policies should refer to a list of events as "likely" to require immediate disclosure, with an additional provision indicating where TSXVN issuers "must make" immediate disclosure to reflect the different thresholds of materiality for more junior issuers.

The TSX and TSXVN have agreed to harmonize their timely disclosure policies to address these inconsistencies.

**Recommendation #10: TSXVN and TSX harmonize their timely disclosure policies.**

### 3.2.2 *Materiality*

One of the elements of the offence of illegal insider trading is that the information traded on must be material. Ontario's *Five Year Review Committee Final Report* (March 2003) provided a review of many areas of securities law, including the issue of materiality. The Committee concluded that there is considerable confusion about the difference between 'material fact' and 'material change' and the purpose for which each of these terms is used in securities legislation. Clarity on what constitutes materiality will not only assist regulators to enforce insider trading prohibitions but also will assist issuers to determine when disclosure is necessary. The Task Force endorses the following recommendations contained in the March 2003 Report:

1. The CSA study whether the current definition of 'material change' and timely disclosure reporting obligations should be amended to encompass:

- a broader scope of discloseable events;
  - itemized issuer-specific events requiring timely disclosure, similar to the SEC's Form 8-K approach; and
  - a requirement that agreements relating to the reported disclosure be filed as a schedule to the public report.
2. The existing 'market impact' materiality standard be changed for all purposes under securities legislation to a 'reasonable investor' standard.

The statutory definitions of material fact and material change, even if revised as recommended, leave open the issue that what may be material to an investor is not necessarily material to an issuer. For example, in a recent case in the United States, an investor allegedly sold securities with knowledge of an insider's sale of a significant block of securities. While the information may not necessarily meet the definition of a material fact or change for an issuer under provincial legislation, such information is arguably material information for investors that was not generally disclosed. In somewhat analogous circumstances, a recent Canadian case involved market speculation at the prospect of a take over bid that insiders knew would not occur. In that case, the market was trading on a rumour that was false and insiders sold during the speculative period. Again, in the circumstances, the fact that the take over bid would not occur was material information to the speculators but did not meet the definition of a material fact or change for the issuer under provincial legislation.

There is a relatively straightforward way to address these disclosure issues that does not require amending securities legislation to broaden the definition of material fact or material change. In accordance with UMIR, dealers are required to mark all insider trades at the time of entry and this information is available to RS in real time. These markers are currently not disclosed to the public. The disclosure of insider markers in real time to the public will level the playing field in respect of trading information that may be material to investors.

**Recommendation #11: RS amend UMIR to enable the disclosure of insider trading markers in real time to the public.**

### 3.2.3 *Generally Disclosed*

Provincial securities legislation prohibits trading on inside information until that information has been “generally disclosed”. Most market participants interpret general disclosure to occur upon the issuance of a news release disclosing the material information. However, the intent of the general disclosure provision is that market participants not only have equal access to the information by way of the news release but that they also have sufficient time to read and digest the information in order that they can make investment decisions taking the information into account. This is exemplified in U.S. regulations that consider dissemination of information complete only “when the public has assimilated the information in the disclosure”. It is also exemplified to some extent by the requirement of Canadian exchanges that issuers inform the market regulator prior to the announcement of a material event in order that trading in the securities can be halted pending the announcement. A halt lasts for, on average, approximately one hour after the announcement.

Because of the ongoing information advantage insiders and others in possession of inside information have, they should be prohibited from trading after the announcement of a material event until a sufficient time for the evaluation of the materiality of the event has passed. If a halt is not imposed by the market on which the securities trade, the prohibited trading period should be no less than the trading day upon which the material event is announced. Where a halt has been imposed, market analysis indicates that in some instances the average one hour halt may not be long enough for the significance of a material event to be fully digested by the market. The markets and RS should evaluate, and recommend to the securities commissions, the appropriate prohibited trading period after the halt is lifted for those who were in possession of the inside information. With that information, the securities commissions should clarify the meaning of “generally disclosed” under provincial securities legislation by providing guidelines on the minimum length of time those with prior knowledge of the inside information are prohibited from trading. The guidelines should be sufficiently clear to permit enforcement action to be taken against persons who trade after the issuance of a news release but before the news has been “generally disclosed”.

**Recommendation #12:**            **The CSA, with input from RS and the Canadian securities markets, clarify the legislative prohibition on persons in possession of inside information trading after the announcement of the event, but before there has been sufficient time to evaluate the materiality of the event, in order that the prohibition can be enforced.**



### 3.2.4 *Exemption for Mutual Knowledge of Material Information*

Under provincial legislation, a person is exempt from the insider trading prohibition where the person reasonably believed that the other party to the purchase or sale had knowledge of the material fact or change. A similar exemption exists for tipping. The ‘mutual knowledge’ exemption is also incorporated in the civil liability provisions. However, as the ASC pointed out in *Richard Harry Seto* (ASC, Feb.19, 2003), the legislation does not appear to address the harm that can occur when the parties to the transaction are the reporting issuer itself and an insider directing or causing the issuance of securities. The potential harm arises from the possibility that insiders can structure to their own benefit the acquisition of treasury securities at prices that do not reflect the price that would apply were the inside information generally disclosed. In such circumstances, other shareholders are harmed as a result of the issuer receiving proceeds from the sale of securities that do not reflect the market value of the securities that would have applied had the inside information been generally disclosed.

The ASC concluded in *Seto* that ‘*In the face of what appears to be a technical gap in the legislation and a very real prospect of public injury, if parties are to take advantage of this anomaly, we will continue to review the facts and circumstances of each case ... to determine whether the circumstances warrant the exercise of our public interest jurisdiction.*’ A better solution would be to limit the breadth of the exemption to exclude transactions between an insider and the issuer.

**Recommendation #13:**            **The CSA, through its USL Project, adopt a uniform approach for the exemption from the application of insider trading prohibitions when each party to the transaction has knowledge of inside information – the exemption should be limited to exclude transactions between an insider (or other persons in a special relationship) and the issuer.**

## 4.0 Detection

Illegal insider trading is detected through the use of market surveillance and data-mining systems, complaints and tips, dealer compliance efforts and inter-agency information-sharing. Recommendations are made in this part of the report to enhance the effectiveness of each of these detection methodologies. As well, the report looks in particular at the use of nominee and offshore accounts to engage in illegal insider trading and provides recommendations to improve regulatory success at identifying the involvement of these accounts. Finally, in recognition of the increased ease of access to trading on markets around the world, the report makes recommendations to increase the level of information-sharing and investigative coordination among regulators of both equities and derivatives markets.

### 4.1 Detection Processes

#### 4.1.1 Surveillance

Most illegal insider trading enforcement cases in Canada initially are detected through market surveillance systems that monitor trading on a same-day or next-day basis, looking for volume and price changes that are outside of 'normal' patterns. Equities markets in Canada are monitored by RS, an organization that is independent of these markets. The Mx provides surveillance of the derivatives market.

Derivative instruments such as options, futures and swaps are based on underlying assets such as equities and, in part, derive their value from those assets. Derivatives can be traded on an exchange or over-the-counter. OTC derivatives can be used to engage in illegal insider trading, including through monetization of stock options that is the subject of recent regulatory scrutiny in Ontario. However, the use of OTC derivatives to carry out illegal insider trading was beyond the scope of this report.

An independent assessment of the effectiveness of the insider trading surveillance systems of RS and the Mx also was beyond the scope of this report. However, this is an overview of their processes:

#### RS

The initial detection of possible insider trading at RS is through:

- the real-time IMM system that, using various electronic algorithms, issues alerts identifying unusual price or volume movements,

- communication with a market maker or other professional trader,
- communication with the issuer of the securities involved to determine the existence of any undisclosed material fact or change, and
- post-trade, pro-active reviews of unusual trading activity.

Upon detection, a review of trading activity typically covers a number of days prior to the date of issuance of material news. The review period can be extended if, for example, anomalies are identified on the price/volume trading chart for the previous several months.

## Mx

The initial detection of possible insider-trading cases at the Mx begins in the Market Monitoring department when suspicious trades are noticed or when a market specialist files a complaint with the Market Monitoring department. A file is prepared and a report is filed with the Market Surveillance department for further investigation. Analysts in Market Surveillance manually review option-trading patterns for a number of days prior to the news release and make a determination whether to initiate an insider-trading investigation. RS contacts the Mx when there are options on the underlying security that is the subject of an insider trading investigation.

Recommendations are made in section 4.3 of this report to increase the level of cooperation between RS and the Mx.

Surveillance of the markets in Canada for illegal insider trading, although performed on the equities markets electronically, based on the identification of unusual price and volume movements prior to a material announcement, does not include the use of specific insider trading alerts, including across market insider trading alerts.

**Recommendation #14: RS and the Mx evaluate the costs and benefits of enhancing their surveillance systems with electronic alerts to specifically identify insider trading.**

RS, as the regulator of Canadian equities markets, often will contact the issuer of securities to determine whether unusual price or volume movements in their securities may derive from undisclosed material information that has leaked into the marketplace. It is not an infrequent occurrence that the issuer responds with a “no material change” declaration to RS staff, or the issuer fails to return the telephone call, and a major announcement is made shortly thereafter. Although it may be legally correct that the information at that time was not yet material, in many instances it would assist the market regulator in evaluating ongoing trading to know the nature and negotiation stage of developing events. The failure to make full disclosure to RS staff in these circumstances

can adversely impact market integrity by delaying the regulator's understanding of market events in the context in which they are occurring, potentially resulting in illegal insider trading going undetected for some period of time.

Issuers should exercise responsibility for assisting in the prevention of illegal insider trading in their securities. However, the material change reporting requirement is currently the only one that can be enforced effectively. A greater incentive for issuers to keep the market regulator better informed, at least in relation to specific inquiries, would result from the development of an enforceable obligation of issuers to provide sufficient and timely notification to the market regulator of events that, although not technically material, may result in a material event. This enforceable obligation would alert RS staff to the significance of unusual price and volume movements as they occur and would lead to appropriate and more timely action being taken to ensure that the market is trading on the basis of equal information availability.

**Recommendation #15:**            **The CSA, RS and Mx develop an enforceable obligation of issuers to provide full disclosure of material and potentially material events to market regulators upon their request.**

#### **4.1.2 Data-Mining**

Current surveillance practices are hampered by the lack of data-mining capability. Data-mining entails reviewing trading for evidence of patterns that indicate an organized effort to avoid detection. These tools work best where client data (e.g. names, addresses, affiliates, subsidiaries) can be quickly and easily integrated with trade data to enable programs to be run electronically to identify these patterns. For example, programs run on integrated data are the only consistently effective way to identify the involvement of nominee and offshore accounts in illegal insider trading.

Currently, it is not feasible for data to be integrated market-wide without significant technological improvements to data collection and retrieval software currently in use. The CSA has in place an Industry Committee on Trade Reporting and Electronic Audit Trail Standards (TREATS). TREATS is mandated, among other things, to identify and discuss issues, options and recommendations regarding technology standards and an implementation plan for an electronic audit trail for orders and trades in securities. TREATS may be the appropriate means to initiate early development of the integrated trading and client information database needed to enhance insider trading detection capabilities.

**Recommendation #16:**            **The CSA, as a priority, coordinate the development of an electronic database integrating client data with data from trading conducted on Canadian equities and derivatives markets, in order to improve surveillance, data-mining and investigative capabilities.**

### **4.1.3 Insider Trading and Market Manipulation**

The indicia of illegal insider trading in illiquid securities often differ in comparison with illegal insider trading in more liquid securities. Particularly, illegal insider trading in illiquid securities is often linked to market manipulation.

Market manipulation is believed by some to be primarily a junior market problem. More accurately, however, it is the liquidity of the security and not the nature of the market that matters. It is more difficult to manipulate widely held and liquid securities. Manipulations often include insider trading, although the converse is not true.

A typical case of manipulation/insider trading involving securities of an illiquid issuer begins with the insiders issuing securities to themselves well in advance of a promotion. The promotion often includes leaks of information before a news release to start the market moving, and the insiders sell securities into the promotion. The manipulators are in possession of inside information about the issuer, i.e. that its securities are being manipulated, and take advantage of the inside information to trade. In effect, the promotion is part of a manipulation of which the insider trading is an integral component.

Insider trading is a relatively unsophisticated process where the key to avoiding detection is hiding beneficial ownership, keeping transactions small and timing trades. On the other hand, manipulation requires greater expertise and funding in order to move the share price of an issuer. Insider trading is a challenge to investigate, and manipulation investigations can be even more complex. However, manipulation cases are often easier to prove as they rely to a large extent on the analysis of readily available trading evidence, whereas insider trading cases usually rely on circumstantial evidence. Because it is usually easier to detect and prove manipulative trading, the detection and enforcement of illegal insider trading in illiquid securities often begins and ends with the detection and proof of manipulative trading.

### **4.1.4 Complaints/ Tips**

Canadian regulators report that few illegal insider trading investigations begin with complaints or tips, unlike the experience in the United States where complaints and tips from the investing public and the industry are significant sources of potential cases. It is not clear why American experience differs from Canadian experience, although the high-profile of illegal insider trading prosecutions in the United States may be a contributing factor. Certainly due to the higher profile of these cases in the United States, market participants are more aware of illegal insider trading, the harm to the market it causes and the consequences of engaging in it. In Canada, market education could fill part of this role.

IOSCO, in a March, 2003 Report of the Emerging Markets Committee entitled “*Insider Trading – How Jurisdictions Regulate It*”, emphasizes the need for educating market participants about why they should not engage in illegal insider trading. The Report states:

“The educational activity directed to them should be focused on promoting ethical rules and informing them about the possible consequences of wrongdoing (not only regarding sanctions that may be imposed by a supervisory authority or court, but also relating to the societal interests associated with the proper operation of markets). Market participants should be aware that insider trading is not acceptable behaviour, not only because a violator can be punished, but also because it impairs broader societal interests in the proper functioning of markets that support economic activities in the real economy. Training courses for investors, market participants and professional associations in the securities sector should stress that a necessary component of an effective civil society is the observance of ethical standards of behaviour in the marketplace, both in general terms and specifically relating to the use of inside information.”

The Task Force endorses these views. The result of such educational programs should be less risk of non-compliance and greater cooperation with regulatory authorities, including by way of complaints and tips. Funding could be provided from the various investor education funds available to the provincial securities commissions.

**Recommendation #17: Securities regulators encourage more complaints and tips by raising the profile of illegal insider trading in Canada through educational programs that provide market participants and the public with an understanding of how illegal insider trading and tipping happen and the harm they cause.**

## 4.2 Nominee and Offshore Accounts

### 4.2.1 *Incidence of Use*

Nominee and offshore accounts (as defined for purposes of this report in Appendix B) are used to conduct commercial activities and hold assets for a variety of legitimate purposes. However, these vehicles also may be used for illegal purposes including illegal insider trading, market manipulation and circumvention of disclosure requirements. The ability of regulators and law enforcement agencies to obtain information on beneficial ownership of nominee and offshore accounts on a timely basis will often determine the outcome of an investigation.

Illegal insider trading is seldom conducted in the name of the insider as the insider wishes to avoid detection and uses a nominee for that purpose. A nominee account can be represented to be resident in Canada or offshore. An offshore account may be utilized in combination with holding companies, international business corporations and trusts located in offshore financial centres. Offshore accounts especially are a barrier to the investigation of illegal insider trading because of the difficulty of obtaining information on a timely basis on beneficial ownership and flow of assets. They represent a means for sophisticated market players to avoid detection of their illegal insider trading activities. Without a consistently effective means of identifying the involvement of these accounts in insider trading and obtaining sufficient evidence to take disciplinary action against the beneficial owner of the account, the credibility of the regulatory regime suffers as do investors' perceptions of the market's fairness.

A survey of Canada's investment dealers conducted by securities regulators in Canada in 2001 found that Canadian brokerage firms were operating approximately 13,000 offshore brokerage accounts for their clients in 23 countries, approximately 3000 of which were in countries blacklisted by the FATF because of their secrecy laws and lack of regulation. Of these accounts, 2,647 were opened in the name of the beneficial owner and 353 in the name of various institutions and other entities where the beneficial owner was not fully disclosed. Of the 353 accounts, it was determined that the firm knew the beneficial owner for 211 of the accounts, leaving 142 outstanding for which beneficial ownership was unknown.

There were two hundred and eighty-nine insider trading matters open with the Commissions during 2001 and 2002. Of these, fifteen cases are known to have involved the use of offshore accounts and four cases are known to have involved the use of nominees. The offshore accounts identified by the commissions in illegal insider trading matters were in several jurisdictions with the largest numbers in United Kingdom dependencies, the Bahamas, and Switzerland.

The SROs (IDA, Mx and RS) are excluded from the above analysis because they refer insider trading cases to a commission, which results in double counting the nominee and offshore accounts in those referred cases. RS, due to its responsibility for undertaking surveillance of the Canadian equity markets, provided all but one of these referrals. The RS referrals with offshore accounts represented approximately 10% of all insider trading case referrals by RS. The number of referrals with offshore accounts involved is significant and likely understated.

Most persons who engage in illegal insider trading are not in a position, or do not have the financial sophistication and resources, to open an offshore account prior to trading on inside information. It is worth noting, however, that the number of these cases in Canada

is considerably lower than in the United States where regulators estimate that up to 25% of insider trading investigations involve offshore accounts.

## 4.2.2 Detection of Insider Trading by Nominee and Offshore Accounts

### (i) *Markers*

Currently, dealers who engage in trades for insiders and significant shareholders must identify those trades to RS and the Mx with a marker. The marker assists the market regulators to evaluate trading patterns for illegal insider trading. A nominee or offshore account used to hide beneficial ownership may deceive the dealer and result in a trade that, although conducted by an insider, is not identified by the marker. The development and implementation of an integrated data-mining capability for trade and client data will enhance the ability of market regulators to identify the participation in illegal insider trading by nominee and offshore accounts. However, pending the development of an integrated database, the addition of a marker for offshore accounts could assist RS and the Mx in evaluating the use of offshore accounts in apparent insider trading patterns.

**Recommendation #18:** **RS and the MX evaluate the costs and benefits of incorporating a marker for trades by offshore accounts.**

### (ii) *Red Flags*

The Task Force requested that RS and the IDA develop a set of ‘red flags’ for dealers to promote early detection of possible illegal insider trading, including when it is conducted through the use of nominee or offshore accounts. This information will be provided to IDA member firms to assist them to enhance their compliance review procedures.

**Recommendation #19:** **The IDA provide to its member firms a set of red flags for detection of possible insider trading, including where conducted through the use of nominee and offshore accounts, to assist them to enhance their compliance review procedures.**

### (iii) *International Information Sharing*

Improved cross-border cooperation with securities investigations, including more timely and comprehensive responses, would be of assistance in regulating illegal insider trading by offshore and nominee accounts. Particularly, some jurisdictions that meet the FATF’s recommended best practices for financial institutions in identifying beneficial ownership



do not make this information available for the purposes of securities investigations. Timely access to information on beneficial ownership is vital for effectively addressing the use of nominee and offshore accounts to engage in illegal insider trading. Securities commissions internationally have recognized this need and, through IOSCO, which represents a membership of more than 110 jurisdictions, recently have developed a Memorandum of Understanding concerning Consultation, Cooperation and the Exchange of Information. The MOU specifically addresses insider dealing and encompasses the agreement to share not only trading information but also any information that is related to trading, including banking information and information on beneficial ownership. The OSC, CVMQ, ASC and BCSC are members or associate members of IOSCO and are MOU signatories.

Prior to signing the MOU, member regulators must establish that they have the legal capability to meet its information sharing requirements. The intention is that member states, such as certain tax havens, with legal impediments to information sharing, amend their legislation to remove those barriers. As a result, obtaining signatories to the MOU is an ongoing process. As this process evolves, those jurisdictions unable to meet the terms and conditions of the MOU, as well as non-IOSCO member jurisdictions and those countries on the FATF's blacklist, likely would represent the jurisdictions from which Canadian securities regulators would be unable to obtain timely access to information on beneficial ownership.

#### ***(iv) Know Your Client (KYC) Requirements***

Experience in obtaining information on offshore accounts has improved since the tragic events of September 11, 2001, but delay, secrecy and inexperience of staff in some offshore jurisdictions can impede securities investigations. Better than attempting to determine beneficial ownership after the fact is to deter the use of offshore accounts, other than for legitimate purposes. One way to do so is by instituting and enforcing effective know-your-client requirements for investment dealers.

The IDA requirement for KYC is found in the IDA's Regulation 1300. The IDA requires all registrants to make a diligent and business-like effort to learn the essential financial and personal circumstances and the investment objectives of each client. The rule, in combination with other IDA by-laws, ensures that the client account documentation includes all material information about the client's status, and that it is updated to reflect any material changes to the client's status in order to assure suitability of investment recommendations.

Amendments to Regulation 1300 as approved by the IDA Board on June 22, 2003 require, other than for exempted persons including certain offshore financial institutions, that an investment dealer learn and verify the identity of the beneficial owner of all non-

individual accounts, including offshore accounts. If the identity of the beneficial owner cannot be obtained, the account cannot be opened. Where the offshore account holder is a “shell bank” or is located in a FATF blacklisted jurisdiction, the amendments also prohibit the opening of an account. The amendments respond to FATF recommendations issued on June 20, 2003 on best practices to address money-laundering. The amendments do not become effective until the expiration of a 30 day public comment period and further comment and approval by the CSA.

**Recommendation #20: The CSA approve the IDA’s revised Regulation 1300 that:**

- **prohibits accounts being opened where the account holder is a “shell bank” or located in a jurisdiction that does not have a satisfactory regulatory regime, and**
- **requires, other than for exempted persons including certain offshore financial institutions, learning and verifying the identity of the beneficial owner of the account.**

The proposed amendments do not apply to a foreign financial institution in a jurisdiction with a ‘satisfactory regulatory regime’. Canadian securities regulators have not provided guidance on jurisdictions that should not qualify for this exemption. The IDA has indicated that, at a minimum, countries on the FATF’s blacklist would not qualify. A more complete list would also include non-IOSCO members and IOSCO members who, after a reasonable period of time, have not signed the MOU previously discussed. Canadian regulators would use the list to determine both whether a jurisdiction has a satisfactory regulatory regime and, if not, the need for restrictions on offshore client brokerage accounts to address insider trading regulatory concerns.

**Recommendation #21: The provincial securities commissions, in consultation with the federal government and the IDA, use the list of IOSCO MOU signatories, once established, in addition to the FATF blacklist, to maintain a list of jurisdictions that do not have a satisfactory regulatory regime, and require that the IDA use that list to identify the offshore account holders to which account opening and related restrictions apply.**

**Recommendation #22:** To address the potential for illegal insider trading through offshore financial institutions, the IDA evaluate the costs and benefits of revising Regulation 1300 to require that members have at least the following account-opening condition for these offshore financial institutions:

- consent to identify on request, to the firm or to the appropriate Canadian regulator, the individual responsible for the trade.

Regulation 1300, other than for exempted persons, requires the identification of the beneficial owner of a non-individual account, including offshore accounts, prior to opening the account, and verification of ownership as soon as practicable or within six months. If the identity of the beneficial owner cannot be verified within the six month period, the account must be restricted after the expiry of the six month period to liquidating trades. The six month verification period was chosen to match the applicable period for securities dealers under federal money-laundering legislation. The potential consequence of the six-month verification period for insider trading regulation is that trading can occur for six months prior to verification of identity, providing an opportunity for illegal insider trading to occur and resultant profits to disappear before beneficial ownership is established.

**Recommendation #23:** The IDA consult with the federal government and IDA members to determine whether to retain a six month verification period or to revise Regulation 1300 to prohibit trading in an account until beneficial ownership of the account is verified or, alternatively, to require that assets accumulated in the account be retained in the account until beneficial ownership is verified.

TSX Rule and Policy 2-501 permit approved participant dealers to grant access to the TSX's order routing system to qualified domestic and offshore institutional and retail clients through order execution accounts (essentially accounts for which the dealer is not required to review orders for suitability). In effect, eligible clients are provided with direct access to the exchange's trading system. Proposed amendments to UMIR will require that "direct access" clients comply with certain UMIR provisions, including the requirement to conduct business on a marketplace openly and fairly in accordance with just and equitable principles of trade. Although this will provide RS with jurisdiction over Rule 2-501 client trading, its ability to regulate a client's compliance with UMIR, including for illegal insider trading, is severely restricted if the client resides in a secrecy

jurisdiction. The ability of such a client to withhold information from the regulator also is inequitable in relation to other direct access clients resident in non-secrecy jurisdictions. These same issues apply to subscribers to an ATS and to persons granted direct access to a QTRS.

**Recommendation #24:** **Direct access to a marketplace be prohibited for persons who do not reside in a jurisdiction with a satisfactory regulatory regime unless the person agrees in writing to make available to the market regulator on request all information, including bank account information, relating to trading conducted through that account.**

### 4.3 Inter-Market Insider Trading

Equities traded on Canada's equities markets, and their derivatives, can trade on various equities and derivatives markets around the world. Current technologies make access to trading on these markets relatively simple. As a result, the same or related parties can engage in patterns of illegal insider trading across markets. Effective detection of illegal insider trading requires that:

- market regulators know the markets upon which equities and their derivatives trade; and
- market regulators cooperate on detection and investigation of illegal inside trading involving securities that are inter-listed, or where a related security trades on one or more other markets.

There is no central database of information identifying the markets upon which an equity and its derivatives trade. The ISG is currently in the process of attempting to create such a database.

**Recommendation #25:** **RS and the Mx work with the ISG to develop and participate in a centralized international database that identifies the markets upon which equities and their derivatives trade.**

Through the ISG, as well, there is growing coordination of information-sharing and investigations among member market regulators. For example, the ISG has implemented an "unusual activity" database that members crosscheck to assist in identifying insider trading patterns and illegal inter-market insider trading. The database currently is used only by U.S. based markets.

**Recommendation #26:** RS and the Mx participate in the ISG’s “unusual activity” database to identify illegal inter-market insider trading.

Derivatives of the securities of approximately 78 TSX-listed issuers trade on the Mx. Greater coordination of detection and investigation between the Mx and RS, the market regulator for the TSX, would reduce the risk of inter-market illegal insider trading going undetected.

**Recommendation #27:** RS and the Mx coordinate their analysis of equities and derivatives to identify patterns of suspicious trading that involve related securities and establish formal procedures for ongoing communication.

## 5.0 Deterrence

Published academic research supports the position that the incidence of illegal insider trading will be reduced through the successful enforcement of insider trading laws with severe penalties. This part of the report considers, in section 5.1, the adequacy of current and proposed laws dealing with illegal insider trading and related misconduct in Canada, including the recent proposal by the federal government to create a criminal offence of illegal insider trading and tipping. Section 5.2 evaluates the effectiveness of current enforcement practices by Canadian securities regulators, including in comparison to other jurisdictions, and proposes a more coordinated enforcement model.

### 5.1 Insider Trading Laws

At present, illegal insider trading and related misconduct are addressed primarily under provincial securities legislation; there is no comparable offence under the *Criminal Code*. While the provincial legislation in this area is generally harmonized, recent initiatives of the CSA and federal government present opportunities to improve the overall regulatory framework.

First, in January 2003 the CSA published a ‘concept proposal’ for the USL Project to provide a national framework for securities regulation. The CSA proposal does not recommend changes to the law regarding insider trading and tipping but suggests greater harmonization of insider reporting obligations. Second, in June 2003 the federal government introduced Bill C-46 to Parliament. This Bill proposes to establish new *Criminal Code* offences of illegal insider trading and tipping.

Both the USL Project and Bill C-46 provide an opportunity for the CSA and federal government to establish a regulatory framework that effectively addresses illegal insider trading under criminal, quasi-criminal, administrative and civil processes, sanctions and remedies.

This section does not address the regulation by SROs of illegal insider trading and related misconduct. SROs generally regulate under contractually-based requirements for regulated persons to comply with applicable legislation and prohibitions against ‘conduct unbecoming’ and ‘conduct inconsistent with just and equitable principles of trade’.

#### 5.1.1 Approaches: Specific Conduct vs. Market Abuse and Fraud

In general terms, there are two different approaches to laws that provide the basis for enforcement action against persons who trade with knowledge of inside information. In

some jurisdictions, illegal insider trading and related misconduct are specifically prohibited through legislation that focuses on particular conduct. This specific conduct approach is taken in Canadian provinces, Australia, and in Part V of the United Kingdom CJA. Rule 14e-3 of the United States *Exchange Act* is comparable in that it deals specifically with transactions in securities on the basis of non-public information in the context of tender offers.

In other jurisdictions, illegal insider trading and related misconduct are included within a broad range of prohibited conduct. This broad approach is taken in Part VIII of the United Kingdom *Financial Services and Markets Act* (prohibiting ‘market abuse’), the CESR’s ‘Market Abuse’ Directive, section 17(a) of the United States *Securities Act* (prohibiting ‘fraud or deceit’ on a purchaser of securities), and section 10b and Rule 10b-5 of the *Exchange Act* (prohibiting ‘manipulative and deceptive devices’). The broad approach is justified, in part, on the basis that both manipulation and illegal insider trading harm the integrity of the market and are closely related.

The specific conduct approach is firmly entrenched in Canadian provincial legislation. This section discusses provincial legislation within that context and an appropriate approach for the proposed federal criminal legislation.

### **5.1.2 Rationale for Insider Trading Laws**

Various rationales provide the basis for laws in different countries addressing illegal insider trading and related misconduct. The most common are:

- equal access to information
- fiduciary duty
- property misappropriation
- market fairness and
- market efficiency.

The prohibition of illegal insider trading and related misconduct in provincial legislation is consistent with the rationales for securities regulation generally – investor protection, the fair and efficient operation of capital markets and fostering and maintaining public confidence in the markets. The insider trading prohibitions are intended to ensure the integrity of capital markets by preventing those who have an informational advantage from benefiting unfairly. As a result, those individuals who have access to inside

information are restricted from trading or informing others to the disadvantage of investors who do not have that same information.

The concerns that the insider trading prohibitions are intended to address were described by a recommendation set out in the *Report of the Attorney General's Committee on Securities Legislation in Ontario* – March, 1965 (the 'Kimber Report'). The *Kimber Report* states as follows:

*'In our opinion, it is not improper for an insider to buy or sell securities in his own company. Indeed, it is generally accepted that it is beneficial to a company to have officers and directors purchase securities in the company as they thereby acquire a direct financial interest in the welfare of the company. It is impossible to justify the proposition that an investment so made can never be realized or liquidated merely because the investor is an insider. However, in 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 marketplace and is, therefore, a matter of public concern.'*

The *Kimber Report* recommendations formed the basis for the insider trading provisions first introduced into securities legislation in Ontario and on which comparable legislation in other provinces was modelled.

### **5.1.3 Provincial Law - 'Information Connection' vs. 'Person Connection'**

Insider trading laws in Canadian provinces provide that no insider or person or company in a special relationship with a reporting issuer, with knowledge of a material fact or material change that has not been generally disclosed, may sell or purchase securities of the reporting issuer; similarly no such person may disclose such fact or change to another person, other than in the necessary course of business. This approach relies on an 'information connection' test, defined by possession of inside information, and an additional 'person connection' test. The 'person connection' test requires either some connection or relationship to the issuer or, alternatively, obtaining the material information from a person in a special relationship with the issuer. In the latter circumstance, the tippee must know or ought reasonably to have known at the time of acquiring the information that the source of the information was in a special relationship with the issuer. The 'person connection' test is not difficult to meet for insiders but



becomes more difficult to meet for persons who have knowledge of inside information having acquired that knowledge from persons in a 'special relationship' with the issuer.

An alternative to this approach depends on the 'information connection' test alone. That is, no person with knowledge of inside information may sell or purchase securities of an issuer. This approach does not require that the person with knowledge of such information hold any position with an issuer or have knowledge of the source or owner of information. The appeal of this approach is that it emphasizes the 'equal access to information' rationale for a prohibition against trading with inside information. It does not depend on a finding that a person was in a 'special relationship with an issuer' or any similar 'person connection'. From a perspective of market fairness, the prohibition appropriately applies to all persons who have unfair access to inside information. The 'information connection' approach has been the law in Australia since 1991. The United Kingdom *Financial Services and Markets Act* has followed a similar approach by proscribing 'market abuse' which includes behaviour based on information that is not generally available to the market.

IOSCO, in its March, 2003 Report of the Emerging Markets Committee referred to previously, states that:

"Best practice is that all the persons trading on inside information should be subject to sanctions. Obviously, broad definitions of insider trading can be criticized if innocent people, without knowledge of the confidentiality and materiality of information, are subjected to criminal penalties. However, the behaviour of such investors generally indicates whether they had knowledge that they were trading on inside information..."

The Report goes on to address the circumstances of an "accidental" insider, being "a person that neither has access to inside information, nor was tipped by a person who has access to such information, but learned inside information due to special circumstances". Special circumstances could include "... overhearing a conversation..., finding confidential documents in a rubbish bin, receiving a fax sent to a wrong number, etc." The Report indicates that the liability of such a person for trading on that information would depend on "their degree of knowledge and intent to trade on inside information generally" and that "... the behaviour of such investors generally indicates whether they had knowledge that they were trading on inside information."

The adoption of the 'information connection' model in Canada would not affect the statutory defence, in provincial securities legislation, that a person does not contravene the insider trading prohibition if the person proves on a balance of probabilities that, at the time of the purchase or sale, the person reasonably believed that the inside information had been generally disclosed. As well, the model would permit trading on information:

- that is ‘readily observable’, as the ‘information connection’ model is not intended to impose liability on persons who discover inside information that is not generally disclosed in a technical sense but is readily observable to anyone who happens upon or is looking for the information, or
- obtained through bona fide investigative research, in order to protect analysts, reporters and others who seek out and publish information from non-confidential sources about issuers.

Adopting the ‘information connection’ model will simplify the language of the prohibitions against trading with inside information. This approach will bring the prohibitions in line with the fundamental proposition that all persons trading on Canadian marketplaces should do so with the fullest possible knowledge of material information. Enforcement action will not be dependent on proof of a special relationship with an issuer.

**Recommendation #28:**     **The CSA, through its USL Project, consider the adoption of a uniform ‘information-connection’ approach to replace the current more complex model.**

#### ***5.1.4 Federal Law - Criminal Deterrent***

In June 2003 the Federal Government introduced Bill C-46 to Parliament; this Bill proposes to establish new offences of illegal insider trading and tipping as section 382.1 of the *Criminal Code*.

A requirement for a mental element, sometimes referred to as an element of fault, is an essential component of criminal liability. This is a constitutional requirement protected under section 7 of the Charter as a ‘principle of fundamental justice’. The minimum fault requirement may be demonstrated by proof of a positive state of mind such as intent, recklessness, or wilful blindness.

Among the challenges of criminalizing insider trading in Canada is to define an offence that does not run afoul of the principles of fundamental justice. It must contain the requisite element of fault and not impose so high a burden on the Crown that it will be incapable of proof. The recently proposed section 382.1 requires ‘knowing use’ of inside information by what is, in effect, a person in a special relationship with an issuer. In substance, this is a provincial quasi-criminal offence with a mental element of ‘knowing use’. However, the experience with other insider trading enactments has been that ‘knowing use’ type language results in an ‘insurmountable evidentiary obstacle’. An alternative approach would be to establish an offence generally based on the American model or the United Kingdom model.

The criminal model in the United States derives from the Exchange Act, particularly section 10b and Rule 10b5, and court opinions that have interpreted these enactments. This model is based on the broad approach outlined in section 5.1.1. It relies on two complementary theories, each addressing purchases or sales of securities on the basis of inside information. These are the ‘classical theory’ and the ‘misappropriation theory’. Illegal insider trading in the United States refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, non-public information about the security. The ‘classical theory’ targets a corporate insider's breach of duty to shareholders with whom the insider transacts; it applies not only to officers, directors and other insiders, but also lawyers, accountants and others who temporarily become fiduciaries to a corporation. Insider trading violations may also include ‘tipping’ such information, securities trading by the person ‘tipped,’ and securities trading by those who misappropriate such information. The ‘misappropriation theory’ is designed to protect the integrity of the securities markets against abuses by ‘outsiders’ to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders.

Concepts of ‘fiduciary duty’ (and to whom a duty is owed) differ between the United States and Canada. However, this is not a fundamental objection to the adaptation of the ‘classical theory’ to the Canadian context. In any event, the ‘misappropriation theory’ does not require a fiduciary duty to shareholders – it requires a duty to the source of the inside information and that concept is understood in Canadian law.

The United Kingdom model in Part V of the CJA is based on the specific conduct approach outlined in section 5.1.1. Illegal insider dealing occurs when an individual, who has information as an insider, deals in securities that are price-affected in relation to the information. The ‘dealing’ may involve either a securities transaction on a regulated market or an off-market transaction effected through a professional intermediary. Like the American approach, the CJA does not require proof that a defendant used inside information. Instead, an insider has a defence if the accused shows that he or she would have done what was done if he or she had not had the information. Like the Canadian provincial offences, the prosecution must satisfy a ‘person connection’ and an ‘information connection’ test.

While the United Kingdom approach is not limited by fiduciary or misappropriation principles, it is similar to the provincial quasi-criminal approach and, therefore, would not provide a sufficient distinction between the provincial and proposed federal offence. In addition, convictions for insider dealing under the CJA and its predecessor legislation have been low. In the last 10 years there have only been 17 successful convictions. By contrast, adopting the U.S. approach would distinguish the federal offence from the quasi-criminal provincial offences. U.S. authorities also have obtained more convictions

during the comparable period. Another advantage of the American approach is consistency throughout the North American market.

By adapting the United States model to the Canadian context, the Federal Government will avoid the challenges of a ‘knowing-use’ requirement (as proposed in Bill C-46) and, in terms of substantive content, satisfy Charter requirements.

**Recommendation #29: The Federal Government re-consider the approach in Bill C-46 and look to the model in the United States (with changes as required for the Canadian legal environment) to avoid the difficulties with a ‘knowing use’ requirement and, in terms of substantive content, satisfy Charter requirements.**

### *5.1.5 Sanctions and Remedies*

Research by the Task Force included a review of the sanctions and remedies available in proceedings under Canadian, U.S., U.K. and Australian law. Depending on the governing legislation, sanctions may be imposed by courts or securities commissions.

#### Courts

Under provincial legislation, which is not uniform, courts may impose compliance orders (including, in B.C. for instance, disgorgement orders and civil penalties), monetary fines and imprisonment. Monetary penalties may be imposed in B.C. for illegal insider trading or tipping. The amount of the penalty is the money obtained or losses avoided as a result of the contravention. In Alberta, the civil court may award damages to the issuer or to those defrauded in the amount obtained as a result of the contravention. In quasi-criminal proceedings, courts in various provinces may impose fines ranging from \$1,000,000 to \$5,000,000, or a multiple of the profits (whichever is greater), and imprisonment of between 3 to 5 years. In Australia, courts may impose fines and imprisonment for up to 5 years. In the United States, courts may impose civil penalties (including disgorgement), officer/director bars, fines, imprisonment and injunctions. Civil penalties may be imposed under section 21A of the Exchange Act for illegal insider trading or tipping; the penalty is to be determined by the court in light of the facts but may not exceed three times the profit gained or loss avoided. In criminal proceedings, the court may impose fines as high as \$5,000,000 (for an individual) and imprisonment may be up to 20 years. In the U.K., courts may impose imprisonment not exceeding 7 years.

Based on this review, it appears that the general structure of sanctions and remedies in Canada, although not uniform, is comparable to the structures in the countries reviewed. However, the maximum term of imprisonment available under provincial legislation is

clearly significantly less than under U.S. and, to a lesser extent, U.K. legislation [Note: Bill C-46 proposes a maximum prison sentence of 10 years]. As well, the monetary penalty available from the civil courts in Canada is significantly less severe than the multiple gain/loss avoided monetary penalty that can be imposed by U.S. courts in civil proceedings. In Canada, the multiple gain/loss avoided fines may only be imposed in quasi-criminal proceedings.

## Securities Commissions

Under provincial legislation, which is not uniform, securities commission regulatory proceedings may impose administrative penalties, cease trade orders, compliance orders and officer/director bars. Administrative penalties range from \$100,000 to \$1,000,000 (for individuals) and \$500,000 to \$1,000,000 (for corporations). In the United States, the SEC may impose monetary penalties of up to \$100,000 (for individuals) and \$500,000 (for corporations) and cease and desist orders. Sanctions under U.S. and provincial legislation are comparable.

At least three significant points derive from this review of sanctions and remedies:

1. Sanctions and remedies vary between provinces and a greater degree of consistency is appropriate. This has already been recognized by the CSA's USL Project that notes that the USL should harmonize the types of enforcement orders that may be made by securities commissions. Some provinces do not grant their commissions the power to order a monetary administrative penalty or to obtain compliance orders (including disgorgement or restitution orders) from the courts. These sanctions and remedies are significant options for securities regulators. Disgorgement and restitution orders, in particular, ought to be a civil alternative (with a lower standard of proof) to the monetary fines that may be imposed for quasi-criminal offences.
2. There is a difference among provinces in the maximum penalties available. In its USL Project 'concept proposal', the CSA suggests uniformity for the penalties available from provincial courts, but that administrative penalties need not be identical in all jurisdictions. This approach is suggested on the basis that jurisdictions with larger markets and issuers may need a higher maximum in order to have a meaningful enforcement power. However, as insider trading takes place on national markets, the residence of the insider should not determine the amount of an administrative penalty. Uniform administrative penalties still provide sufficient flexibility for commissions to impose sanctions that fit the circumstances of each case.
3. With the enactment of the Sarbanes-Oxley Act in the United States, there is now a more substantial gap between the maximum term of imprisonment under U.S.

securities legislation and provincial securities laws. The current sanctions under provincial legislation (with a maximum term of imprisonment between 3 - 5 years) appear to be at the upper end of sanctions for quasi-criminal offences. Longer terms of imprisonment will be difficult to justify, especially if the offence is reformulated on the “information connection” only approach. More severe sanctions should be left to the federal criminal law.

**Recommendation #30: Provincial securities legislation be amended to provide uniformity among provinces, including for administrative penalties, enforcement orders and compliance orders.**

**Recommendation #31: The proposed criminal sanctions under Bill C-46 be approved.**

## 5.2 Enforcement Practices

### 5.2.1 Investigation Techniques

The work of the Task Force included gathering and comparing information from securities regulators in Canada, Australia, the United States and the United Kingdom on enforcement of prohibitions on illegal insider trading to assess best practices and identify gaps in Canadian processes. As part of this process, the Task Force reviewed all insider trading cases open at securities regulators in Canada in 2001 and 2002 in order to gain insight into the nature and results of enforcement activity. On-site interviews of staff were undertaken at each of the following regulators:

Canada BCSC, ASC, OSC, CVMQ, RS

United States SEC, NASD, NYSE

United Kingdom FSA

Australia ASIC

The comparison found that, in general, enforcement practices in Canada are similar to those in other jurisdictions. Differences identified resulted in a number of recommendations for improved enforcement techniques. Details of these recommendations have not been provided in this report. The recommendations involve means of increasing the coordination and integration of regulatory efforts to address

illegal insider trading, including enhanced case assessment criteria, integrated procedures for quickly addressing and fast-tracking insider trading cases and specialized training.

## **5.2.2 IMETS**

The federal government, as part of its efforts to coordinate and strengthen enforcement against capital markets fraud, including illegal insider trading, is in the process of creating Integrated Market Enforcement Teams (IMETS) in Toronto, Vancouver, Montreal and Calgary dedicated solely to investigating capital markets fraud cases. The intention is for the IMETS to work closely with Canadian securities regulatory authorities, including the securities commissions and the SROs, particularly to identify capital markets cases to pursue. The IMETS, in combination with the proposed Criminal Code offences of insider trading and tipping, will represent an additional enforcement route that should be included in a coordinated and integrated regulatory approach to illegal insider trading.

Previous recommendations in this section of the report have emphasized the need for a coordinated and integrated approach across securities regulatory organizations to address illegal insider trading effectively. These recommendations include the development and enhancement of case assessment criteria, integrated procedures for quickly addressing and fast-tracking insider trading cases and specialized training. These criteria, procedures and training, once the IMETS are operational and the Criminal Code has been amended, should be expanded to encompass potential criminal enforcement and IMETS criteria, procedures and staff training.

Criminal enforcement of illegal insider trading will be one end of an enforcement continuum that starts with identification of possible illegal insider trading by the market regulator and its assessment for referral and subsequent investigation by a securities commission or IMET. The report's recommendations to increase the effectiveness of enforcement would be implemented most efficiently and effectively if consolidated in one nationally integrated group focussed on, and accountable for success in, enforcing insider trading laws. The IMETS, as proposed to be national in scope, could easily be adapted to such a purpose.

An effective process within the IMETS structure to address illegal insider trading would incorporate securities commission and SRO participation, most likely as a subgroup of the IMETS, in case assessment, using assessment criteria that would identify insider trading cases best suited to criminal enforcement under the Criminal Code, quasi-criminal enforcement under provincial securities legislation or administrative disciplinary action under provincial securities legislation or SRO rules. This IMET subgroup for illegal insider trading ideally would be the recipient of insider trading case referrals and would assess each for retention for criminal investigation and prosecution. As a national,

integrated and accountable group focussed solely on illegal insider trading, it would also provide a means to assist in administering and ensuring implementation of the other recommendations made in this report. In that connection, for example, it could participate in the development and initiation of a national training program for investigating and prosecuting illegal insider trading, the development of appropriate benchmarks to measure the success of the report's recommendations, coordination of additional research into the incidence of illegal insider trading on Canadian capital markets and promotion of the development of better detection tools.

**Recommendation # 32:**        **The CSA, in consultation with IMETS participants, consider recommending that a nationally integrated subgroup of the IMETS be formed to focus solely on illegal insider trading, including:**

- **receipt and assessment of insider trading cases;**
- **criminal investigations and prosecution; and**
- **assisting in administering implementation of this report's recommendations.**



## *Appendix A – Summary of Recommendations*

		Page Ref.	Implementation
<b>Prevention</b>			
1	<p>Canadian equity marketplaces amend their timely disclosure policies to:</p> <ul style="list-style-type: none"> <li>• recommend that issuers adopt the best practices provided in the CSA’s Disclosure Standards Policy and the CIRI Standards and Guidelines for Disclosure; and</li> <li>• emphasize (i) the responsibility of boards of directors and senior officers of issuers for compliance with best practices for information containment, as exemplified by the CSA and CIRI best practices, and (ii) where directors or senior officers fail to fulfil this responsibility, their suitability to act may be reviewed by the marketplace.</li> </ul>	11	TSX  TSX VN
2	<p>The CSA, with the Canadian equities markets, develop a process whereby, upon receipt of a Form 4B, the director or officer is sent an information package that includes responsibilities and guidelines applicable to information containment, timely disclosure and insider trading restrictions, as well as background on the underlying market integrity standards and potential sanctions.</p>	11	TSX  TSX VN  CSA
3	<p>The CSA work with the CBA and the provincial law societies to develop substantive best practices for information containment for lawyers.</p>	12	CSA

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4	<p>Canadian equity marketplaces amend their timely disclosure policies to:</p> <ul style="list-style-type: none"> <li>• recommend that issuers retain only lawyers who have adopted best practices on information containment; and</li> <li>• emphasize (i) the responsibility of boards of directors and senior officers of issuers for compliance with best practices on information containment, as exemplified by using only lawyers who have adopted best practices on information containment and (ii) where directors or senior officers fail to fulfil this responsibility, their suitability to act may be reviewed by the applicable marketplace.</li> </ul>	13	<p>TSX</p> <p>TSX VN</p>
5	<p>The CSA work with the CICA and the provincial institutes of chartered accountants to develop substantive best practices for information containment for accountants.</p>	14	<p>CSA</p>
6	<p>Canadian equity marketplaces amend their timely disclosure policies to:</p> <ul style="list-style-type: none"> <li>• recommend that issuers retain only accountants who have adopted best practices on information containment; and</li> <li>• emphasize (i) the responsibility of boards of directors and senior officers of issuers for compliance with best practices on information containment, as exemplified by using only accountants who have adopted best practices on information containment and (ii) where directors and senior officers fail to fulfil this responsibility, their suitability to act may be reviewed by the applicable marketplace.</li> </ul>	14	<p>TSX</p> <p>TSX VN</p>
7	<p>The CSA request that OSFI develop regulations for the management of inside information received by banks during their credit or other relationships with issuers.</p>	15	<p>CSA</p>

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8	<p>The IDA mandate best practices in information containment appropriate to the nature of a member's business, modelled on OSC Policy 33-601 and specifically addressing:</p> <ul style="list-style-type: none"> <li>• private placements, as developed by the Vancouver dealer group, and</li> <li>• bought deals.</li> </ul>	17	IDA
9	<p>The IDA, RS, Mx and TSXVN form a committee to amend their procedures for the regulation of information containment by dealers to i) address the elements identified in OSC Policy 33-601, ii) eliminate duplication of effort and iii) rationalize the regulation of information containment.</p>	18	IDA RS MX TSX VN
10	<p>TSXVN and TSX harmonize their timely disclosure policies.</p>	19	TSX TSX VN
11	<p>RS amend UMIR to enable the disclosure of insider trading markers in real time to the public.</p>	20	RS
12	<p>The CSA, with input from RS and the Canadian securities markets, clarify the legislative prohibition on persons in possession of inside information trading after the announcement of the event, but before there has been sufficient time to evaluate the materiality of the event, in order that the prohibition can be enforced.</p>	21	CSA

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13	<p>The CSA, through its USL project, adopt a uniform approach for the exemption from the application of insider trading prohibitions when each party to the transaction has knowledge of inside information – the exemption should be limited to exclude transactions between an insider (or other persons in a special relationship) and the issuer.</p>	22	CSA
	<p><b>Detection</b></p>		
14	<p>RS and the Mx evaluate the costs and benefits of enhancing their surveillance systems with electronic alerts to specifically identify insider trading.</p>	24	RS MX
15	<p>The CSA, RS and Mx develop an enforceable obligation of issuers to provide full disclosure of material and potentially material events to market regulators upon their request.</p>	25	CSA RS Mx
16	<p>The CSA, as a priority, coordinate the development of an electronic database integrating client data with data from trading conducted on Canadian equities and derivatives markets, in order to improve surveillance, data-mining and investigative capabilities.</p>	25	CSA
17	<p>Securities regulators encourage more complaints and tips by raising the profile of illegal insider trading in Canada through educational programs that provide market participants and the public with an understanding of how illegal insider trading and tipping happen and the harm they cause.</p>	27	CSA

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18	<p><b>RS and the MX evaluate the costs and benefits of incorporating a marker for trades by offshore accounts.</b></p>	29	<p><b>RS</b></p> <p><b>MX</b></p>
19	<p><b>The IDA provide to its member firms a set of red flags for detection of possible insider trading, including where conducted through the use of nominee and offshore accounts, to assist them to enhance their compliance review procedures.</b></p>	29	<p><b>IDA</b></p>
20	<p><b>The CSA approve the IDA’s revised Regulation 1300 that:</b></p> <ul style="list-style-type: none"> <li>• <b>prohibits accounts being opened where the accountholder is a “shell bank” or located in a jurisdiction that does not have a satisfactory regulatory regime, and</b></li> <li>• <b>requires, other than for exempted persons including certain offshore financial institutions, learning and verifying the identity of the beneficial owner of the account.</b></li> </ul>	31	<p><b>CSA</b></p>
21	<p><b>The provincial securities commissions, in consultation with the federal government and the IDA, use the list of IOSCO MOU signatories, once established, in addition to the FATF blacklist, to maintain a list of jurisdictions that do not have a satisfactory regulatory regime, and require that the IDA use that list to identify the offshore accountholders to which account opening and related restrictions apply.</b></p>	31	<p><b>ASC</b></p> <p><b>BCSC</b></p> <p><b>CVMQ</b></p> <p><b>OSC</b></p>
22	<p><b>To address the potential for illegal insider trading through offshore financial institutions, the IDA evaluate the costs and benefits of revising Regulation 1300 to require that members have at least the following account-opening condition for these offshore financial institutions:</b></p> <ul style="list-style-type: none"> <li>• <b>consent to identify on request, to the firm or to the appropriate Canadian regulator, the individual responsible for the trade.</b></li> </ul>	32	<p><b>IDA</b></p>

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23	<b>The IDA consult with the federal government and IDA members to determine whether to retain a six month verification period or to revise Regulation 1300 to prohibit trading in an account until beneficial ownership of the account is verified or, alternatively, to require that assets accumulated in the account be retained in the account until beneficial ownership is verified.</b>	32	<b>IDA</b>
24	<b>Direct access to a marketplace be prohibited for persons who do not reside in a jurisdiction with a satisfactory regulatory regime unless the person agrees in writing to make available to the market regulator on request all information, including bank account information, relating to trading conducted through that account.</b>	33	<b>TSX</b>
25	<b>RS and the Mx work with the ISG to develop and participate in a centralized international database that identifies the markets upon which equities and their derivatives trade.</b>	33	<b>RS MX</b>
26	<b>RS and the Mx participate in the ISG’s “unusual activity” database to identify illegal inter-market insider trading.</b>	34	<b>RS MX</b>
27	<b>RS and the Mx coordinate their analysis of equities and derivatives to identify patterns of suspicious trading that involve related securities and establish formal procedures for ongoing communication.</b>	34	<b>RS MX</b>
	<b>Deterrence</b>		
28	<b>The CSA, through its USL Project, consider the adoption of a uniform ‘information-connection’ approach to replace the current more complex model.</b>	39	<b>CSA</b>

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29	<p>The Federal Government re-consider the approach in Bill C-46 and look to the model in the United States (with changes as required for the Canadian legal environment) to avoid the difficulties with a ‘knowing use’ requirement and, in terms of substantive content, satisfy Charter requirements.</p>	41	FED. GOV’T
30	<p>Provincial securities legislation be amended to provide uniformity among provinces, including for administrative penalties, enforcement orders and compliance orders.</p>	43	CSA
31	<p>The proposed criminal sanctions under Bill C-46 be approved.</p>	43	FED. GOV’T
32	<p>The CSA, in consultation with IMETS participants, consider recommending that a nationally integrated subgroup of the IMETS be formed to focus solely on illegal insider trading, including:</p> <ul style="list-style-type: none"> <li>• receipt and assessment of insider trading cases;</li> <li>• criminal investigations and prosecution; and</li> <li>• assisting in administering implementation of this report’s recommendations.</li> </ul>	45	CSA

## Appendix B – Definitions

ASC	Alberta Securities Commission
ATS	Alternative Trading System
ASIC	Australian Securities & Investments Commission
BCSC	British Columbia Securities Commission
Bought deal	An entire issue of securities bought from the issuer by an investment dealer, frequently acting alone, for resale to its clients
CBA	Canadian Bar Association
CESR	Committee of European Securities Regulators
Charter	Canadian Charter of Rights and Freedoms
CICA	Canadian Institute of Chartered Accountants, of which the members are the provincial institutes of chartered accountants
CIRI	Canadian Investor Relations Institute
CJA	United Kingdom <i>Criminal Justice Act</i> of 1993.
CSA	Canadian Securities Administrators composed of the thirteen provincial and territorial securities regulatory



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	authorities
CVMQ	Commission des valeurs mobilières du Québec
Dealer	An investment dealer that is a member of the IDA
Derivative	An instrument such as a future, option or swap, whose value is based on underlying assets such as securities. A derivative derives its value from the underlying asset. Derivatives can be traded on an exchange such as the Mx or over the counter (OTC).
Exchange Act	The United States <i>Securities Exchange Act</i> of 1934 and related Rules
FATF	Financial Action Task Force is an inter-governmental body whose purpose is the development and promotion of policies, both at national and international levels, to combat money laundering
Five Year Review Committee Final Report (March 2003)	The report produced by an independent committee established by the Ontario provincial government to review the regulation of securities under the Ontario Securities Act and by the OSC and to recommend improvements
FSA	Financial Services Authority of the United Kingdom
Generally disclosed	Information has been generally disclosed if (a) the information has been disseminated in a manner calculated to effectively reach the marketplace; and (b) public investors have been given a reasonable amount of time to analyze the information
Grey list	A list of securities selected for special surveillance by a

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	<p>registrant. Issuers on the list are often takeover targets, companies planning to issue new securities, or stocks showing unusual activity. Trading is not prohibited by the dealer but is subject to close scrutiny by the firm's compliance department. Also known as a 'watch list'.</p>
ICAO	<p>Institute of Chartered Accountants of Ontario, a self-regulatory organization</p>
IDA	<p>The national self-regulatory organization and representative of dealers that regulates the activities of investment dealers in terms of capital adequacy and conduct of business other than for trading activities on regulated equities and derivatives marketplaces in Canada</p>
IMM	<p>The RS 'Intelligent Market Monitoring' system that tracks volume and price data</p>
Inside information	<p>Material fact or material change that has not been generally disclosed</p>
Insider trading	<p>A prohibited activity defined in provincial securities legislation as the purchase or sale of securities of a reporting issuer (including trading puts, calls and options) by a person in a special relationship with a reporting issuer who knows of material information with respect to that issuer, which information has not been generally disclosed. Note that insider trading, as a proscribed activity, varies from jurisdiction to jurisdiction.</p>
IOSCO	<p>International Organization of Securities Commissions, of which the OSC and CVMQ are ordinary members, and the BCSC and ASC are associate members.</p>
ISG	<p>The Intermarket Surveillance Group, which has the objective of providing a framework for the sharing of</p>

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	information and the coordination of regulatory efforts among securities and commodities markets and market regulators in North America, Europe and Asia to address intermarket trading abuses and to develop best practices
Issuer	A company whose securities trade on a stock exchange or other marketplace
ITTF	Insider Trading Task Force
KYC	Know your client, also referred to as 'enhanced due diligence' in the United States
Manipulation	Intentional interference with the free forces of supply and demand on the marketplace including conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities
Material change	Where used in relation to the activities of an issuer, 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.
Material fact	Where used in relation to securities issued or proposed to be issued, means a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of such securities
Material information	Collectively refers to 'material facts' and 'material changes', both of which are based on a market-impact test
MOU	Memorandum of Understanding that describes a formal process for information sharing between regulators

# INSIDER TRADING TASK FORCE

Mx	Bourse de Montréal Inc., an exchange that specializes in options
Nominee account	An account where the legal owner of the securities, as far as the issuer and its share registrar are concerned, is the nominee who can be an individual or legal entity. However, a third party has the 'beneficial interest' in the securities (i.e. the securities are really owned by the third party who is entitled to all income and capital gains arising from the investment). The discussion and recommendations concerning nominee accounts in this report relate to their use to engage in insider trading while concealing the true ownership of the securities acquired or sold.
Offshore account	A brokerage account at a Canadian dealer for which the accountholder, often a nominee financial institution, trust or holding company, is resident outside Canada in a jurisdiction whose laws applicable to non-residents effectively allow non-resident beneficiaries of brokerage accounts in their jurisdiction of domicile to avoid disclosure in that jurisdiction. Typically, the jurisdiction is one where income and inheritance taxes do not exist, where there are no currency exchange controls, and where bank and corporation secrecy laws significantly impede inquiries into the ownership of securities, companies and bank accounts.
OSC	Ontario Securities Commission
OTC	Over-the-counter market
Person in a special relationship	Such persons include, but are not limited to (a) insiders as defined under securities legislation, (b) directors, officers and employees of the issuer, (c) persons engaged in professional or business activities for or on behalf of the issuer, (d) anyone (a tippee) who learns of material information from someone that the tippee knows or should know is a person in a special relationship with the issuer

# INSIDER TRADING TASK FORCE

Private placement	The sale of securities by an issuer from treasury under an exemption from prospectus disclosure to a limited number of buyers, participated in by a dealer as underwriter or agent
QTRS	Quotation and Trade Reporting System
Restricted list	A list, compiled by a registrant, of issuers about which the registrant has inside information. Trading and research is restricted.
RS	Market Regulation Services Inc.
SEC	United States Securities and Exchange Commission
Secrecy jurisdiction	A country that shields the identity of beneficial owners of investments from securities regulators
SRO	Self-regulatory organization, specifically for the purposes of this report being the IDA, RS and the Mx
Tipping	A prohibited activity defined in provincial securities legislation - when a person or company in a special relationship with a reporting issuer informs, other than in the necessary course of business, anyone of a material fact or a material change (or privileged information in Québec) before that material information has been generally disclosed. .
TSX	Toronto Stock Exchange
TSXVN	TSX Venture Exchange
UMIR	Universal Market Integrity Rules, governing trading on

# INSIDER TRADING TASK FORCE

	Canadian equity markets and administered and enforced by RS
United States Securities Act	The United States <i>Securities Act</i> of 1933 and related Rules
USL	Uniform Securities Law project of the CSA
Watch list	A list of securities selected for special surveillance by a registrant. Issuers on the list are often takeover targets, companies planning to issue new securities, or stocks showing unusual activity. Trading is not prohibited by the dealer but is subject to close scrutiny by the firm's compliance department. Also known as a 'grey list'.