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INSIDER TRADING

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INSIDER TRADING

INTRODUCTION AND BACKGROUND

Insider trading has been described as the purchase and sale of securities of a corporation by a person with access to confidential information about the corporation that can materially affect the value of its securities and that is not known by other shareholders or the general public.

Trading by insiders *per se* is not illegal; most laws governing the issue allow insiders to trade in the securities of corporations with which they have a connection, provided they do not possess material confidential information about the corporation. Insider trading is proscribed, however, when the insider possesses material confidential information or uses such information for his or her benefit when trading in the securities of the corporation.

There are a number of reasons why improper insider trading is regulated. Without regulation, insiders could use important inside information to their own advantage and to the disadvantage of outside investors. This could damage the corporation's reputation and, more important, reduce confidence in the securities market in general.

This note discusses the insider trading provisions of the *Canada Business Corporations Act* (CBCA).

JURISDICTION TO ENACT LAWS RELATING TO INSIDER TRADING

Both the federal and provincial governments have jurisdiction to enact laws relating to insider trading. Provincial jurisdiction is based on the authority to enact laws relating to property and civil rights, while federal jurisdiction is based on the authority of the federal Parliament to create and regulate federal corporations.

At the provincial level, insider trading is regulated under provincial corporations laws and securities statutes. Companies incorporated federally under the *Canada Business Corporations Act* (CBCA) are also subject to the insider trading provisions found in that statute. The result is a certain amount of overlap and duplication.

The overlap and duplication of the federal and Ontario insider trading requirements were the subject of a Supreme Court of Canada decision in the early 1980s. In *Multiple Access Ltd.* v. *McCutcheon*,[(1)] the provisions of the Ontario *Securities Act* allowing compensation for loss suffered as a result of insider trading were held to apply to a federally incorporated corporation, even though the corporation was subject to similar insider trading requirements under federal law. The majority of the Court held that the insider trading provisions of both the *Canada Corporations Act*[(2)] and the Ontario *Securities Act* were valid. Writing for the majority, Dickson, J. concluded that the impugned provisions of the *Canada Corporations Act* had a general corporate purpose and a rational, functional connection with company law.

> Providing safeguards against the malfeasance of the managers is strictly within what might properly be called the constitution of the company. The proper relationship between a company and its insiders is central to the law of companies and, from the inception of companies, has been regulated by the legislation sanctioning the company's incorporation.... [T]he impugned provisions of the *Canada Corporations Act* are directed at preserving the integrity of federal companies and protecting the shareholders of such companies; they aim at practices, injurious to a company or to shareholders at large of a company, by persons who, because they hold positions of trust or otherwise are privy to information not available to all shareholders.[(3)]

The majority of the Court went on to find that the relevant sections of the Ontario *Securities Act* were also a valid exercise of provincial jurisdiction over property and civil rights

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(1) *Multiple Access Ltd*. v. *McCutcheon et al.* (1982), 138 D.L.R. (3d) p. 18 (SCC).

(2) The *Canada Corporations Act* was the predecessor to the *Canada Business Corporations Act*.

(3) *Multiple Access Ltd.* v. *McCutcheon et al.*, p. 15.

and that these provisions did not "sterilize the functions and activities of a federal company nor ... impair its status or essential powers."[4]

Thus, the majority found that insider trading provisions have both corporate law and securities law aspects. Because they considered these aspects to be of roughly equal importance, the majority felt that one did not have to prevail over the other.

The minority of the Court (three judges) took a different view, however. They concluded that the provisions of the Ontario *Securities Act* were constitutionally valid, being directed to regulating the holding and trading of securities in Ontario. The central concern of securities legislation, they observed, was not the constitution of the corporation but rather the regulation of trading in the corporation's securities.[5] On the other hand, they held that the federal insider trading provisions were not essential to the constitution of a federal corporation, or to its functional aspects and were therefore invalid.[6]

INSIDER TRADING -- *CANADA BUSINESS CORPORATIONS ACT*

Insider trading provisions were first introduced at the federal level in 1970 as part of the *Canada Corporations Act* and subsequently carried over into the CBCA in 1975.

Found in Part XI of the Act, the insider trading provision of the CBCA, for the most part, deal with insiders of "distributing corporations." A "distributing corporation" is defined as a corporation whose shares have been part of a distribution to the public, remain outstanding, and are held by more than one person.

Under section 126(1), an "insider" is defined as a director or officer of a distributing corporation, a distributing corporation that purchases or otherwise acquires its own shares (except a redemption of redeemable shares) or shares issued by an affiliate, or a person who beneficially owns more than 10% of the shares of a distributing corporation or who exercises control or direction over more than 10% of the votes attached to shares of such a corporation.

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(4) *Ibid.*, p. 19.

(5) *Ibid.*, p. 45.

(6) *Ibid.*, p. 48-49.

There are three main components of the provisions: requirement for insider reporting, speculative trading prohibitions, and civil liability.

A. Requirement to File Reports

A person is required to send a report to the Director under the CBCA within 10 days after the end of the month in which he or she becomes an insider of a distributing corporation. Additional insider reports are required within 10 days following the end of the month in which there is any change in the person's interest in the securities of a distributing corporation.

A person who, without reasonable cause, fails to file an insider trading report is subject to a maximum fine of $5,000 and/or to imprisonment for a term of up to six months (section 127).

B. Prohibition against Speculative Trading

The CBCA prohibits insiders from selling shares that they do not own or have a right to own (short selling) and from buying or selling a call option or put option in respect of a share of a distributing corporation of which they are insiders (section 130). Insiders can sell shares they do not own, however, provided they own other shares that are convertible into the shares sold, or they own an option or right to acquire the shares sold.

C. Civil Liability

Under subsection 131(4) of the CBCA, insiders (as defined in section 131(1)) who make use of specific confidential information for their own benefit in connection with a transaction in the securities of a corporation (whether distributing or non-distributing) are liable to compensate anyone who suffers a direct loss as a result. They are also accountable to the corporation for any direct benefit or advantage they receive.

INSIDER TRADING DISCUSSION PAPER

In February 1996, Industry Canada released a Discussion Paper on insider trading.[7] The paper looked at whether the CBCA insider trading provisions were still needed and, if so, what changes could be made. It outlined the three following approaches:

- eliminating the CBCA insider trading requirements in their entirety and leaving the regulation of insider trading to the provinces;
- eliminating only the insider reporting provision of the CBCA and leaving the collection of such information to provincial securities statutes;
- maintaining the CBCA insider trading requirements while harmonizing them with provincial requirements.[8]

At the outset, the Discussion Paper considered the argument that, because of the similarity between provincial securities laws and the CBCA insider trading provisions, the latter impose an unnecessary regulatory burden and should therefore be repealed.

Proponents of maintaining the CBCA provisions argue that these uphold a base level of regulation for CBCA corporations and that their repeal would eliminate only a small amount of duplication.

Recommending that the CBCA provisions be continued, the Discussion Paper went on to examine their three principal elements.

A. Filing Reports

The first element consists of the reporting provisions. While making no recommendation as to whether these provisions should be maintained, the Discussion Paper

(7) Industry Canada, Canada Business Corporations Act, Discussion Paper, *Insider Trading*, February 1996.

(8) *Ibid*., p. 6.

noted that duplicative filings could be eliminated if the Director under the CBCA were to exempt those who reported trades under provincial laws from having to file under the CBCA.

The Paper also examined a number of ways in which the reporting requirements could be changed, such as decreasing the time within which insiders must report trades or declare that they have become insiders and increasing the penalties for violating the insider trading provisions.

As mentioned earlier, the CBCA reporting provisions require that insider reports be filed within 10 days of the end of the month in which the person becomes an insider or makes a trade. Some provinces provide for disclosure to take place earlier, within 10 days of the persons's becoming an insider or making a trade. The Discussion Paper recommended that, if the CBCA insider reporting requirements were to be maintained, the time allowed for insiders to report trades or declare that they had become insiders should be decreased to within 10 days of the person's becoming an insider or making the trade.(9)

B. Speculative Trading

The Discussion Paper also examined the speculative trading provisions that prohibit insiders from short selling (selling shares that they do not own or have a right to own), buying and selling certain call options, and buying and selling a call option or a put option in respect of a share of the corporation or any of its affiliates. Violations of these prohibitions are subject to a summary conviction offence with a maximum fine of $5,000 and/or imprisonment for up to six months.

The Discussion Paper recommended that these provisions be maintained and amended.

C. Civil Liability

The civil liability provision makes liable those who, in connection with a transaction in a security of a corporation, and for their own benefit or advantage, make use of confidential information that, if generally known, might reasonably be expected to affect materially the value of the securities. This provision applies to both public and private

(9) *Ibid*., p. 14.

corporations. Two categories of persons can assert a claim against an insider: any person who has suffered a direct loss and the corporation itself.

Insider trading liability provisions are also found in provincial securities legislation. While it can be argued that having civil liability provisions in both the CBCA and provincial securities legislation may be duplicative, the Discussion Paper pointed out the jurisdictional advantage of the CBCA (investors across Canada can challenge the actions of an insider of any CBCA corporation) and the statute's potential for a broader class of plaintiffs. The Discussion Paper recommended that the civil liability provision be maintained and amended where necessary.

D. Penal Liability

Finally, the Discussion Paper examined whether the CBCA should contain a penal liability provision for improper insider trading. Noting that provincial securities legislation does contain such a provision, the paper pointed out that its absence from the CBCA makes the trading provision of that law more difficult to enforce. Moreover, it is argued that a penal provision would, in the event of a successful prosecution, assist those undertaking a civil action.

The Discussion Paper recommended the addition to the CBCA of a penal liability provision prohibiting improper insider trading and wrongful communication of material confidential information. The provision would be limited to securities of distributing corporations. The maximum penalty would be two years in jail and/or $1,000,000 or three times the profit made, whichever was greater.(10)

RECOMMENDATIONS OF THE STANDING SENATE COMMITTEE ON BANKING, TRADE AND COMMERCE

The Standing Senate Committee on Banking, Trade and Commerce examined the CBCA insider trading provisions in its 1996 report *Corporate Governance*.(11)

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(10) *Ibid*., p. 52.

(11) Senate of Canada, Standing Senate Committee on Banking, Trade and Commerce, *Corporate Governance*, August 1996.

The Committee did not see a need to repeal these provisions but noted that, where duplication and overlap existed, the Director under the CBCA should use individual and blanket exemptions to reduce the burden of duplicate filings.

Of the Discussion Paper's proposals for modernizing the insider trading provisions, the one most widely discussed before the Committee was that dealing with the time for filing insider trading reports. A number of witnesses argued for earlier disclosure of insider trading, some even suggesting that reports should be filed on the day a transaction was completed. Although favouring more timely disclosure, others suggested that it might be difficult for some institutions to report trades on a same-day basis.

The Committee supported earlier disclosure of insider activities and recommended that the time given for insiders to report trades or declare that they had become insiders should be decreased to within 10 days of the person's becoming an insider or making a trade.(12) The Committee also recommended that this time period be prescribed by regulation rather than in the CBCA itself. This would allow for more timely updating of the provisions and make it easier to harmonize time frames with provincial requirements.(13)

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(12) *Ibid*., p. 56.

(13) *Ibid*.