# CANADIAN SECURITIES LITIGATION OUTLOOK

Trends to Watch for Capital Markets Participants

2017 UPDATE

Cassels

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# OUR SECURITIES LITIGATION TEAM

The securities litigators at Cassels have extensive experience advocating on behalf of market participants including issuers, advisors, directors, officers and shareholders in high stakes civil and regulatory disputes. Litigators on our versatile team have been recognized by *Lexpert*, *Chambers Global*, *Best Lawyers in Canada* and *Martindale-Hubbell*, and are complemented by leading practitioners from our corporate securities group.

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# TRENDS TO WATCH FOR CAPITAL MARKETS PARTICIPANTS

As we enter the final quarter of 2017, the Cassels securities litigation team is pleased to share our latest analysis of securities litigation developments from the past 12 months and trends to watch in 2018.

In our feature piece, we review implications and lessons learned from three key M&A decisions, ranging from the court's role in approving plan of arrangement transactions to the power of regulators to review and unwind private placement transactions in the context of hostile take-over bids and contested proxy contests. Cassels represented parties in all of these proceedings, before the Yukon Supreme Court and Court of Appeal, the Ontario Securities Commission and the British Columbia Securities Commission.

We also examine how to protect confidential information in the context of eroding deal team privilege protection, the implications of increased cooperation and sharing of information among securities regulators, the importance of robust insider trading compliance protections in the face of recent successful insider trading prosecutions in Canada and US, recent developments in Canadian securities class actions, and the use of no contest and other creative settlement agreements by market participants to resolve concurrent civil and regulatory proceedings.

Please feel free to contact any member of the Cassels securities litigation team for further discussion of these trends and their impact on market participants. We will also continue to report on new developments as they happen.

# 1 CHANGE OF CONTROL TRANSACTIONS: HEIGHTENED SCRUTINY AND INTERVENTION

Three recent decisions will have an enduring impact on transactions affecting corporate control, including merger and acquisition transactions and proxy contests, with significant implications for corporations, their officers, directors and external advisors.[1]

In *InterOil v Mulacek*,[2] the Yukon Court of Appeal refused to approve the US$2.3 billion ExxonMobil acquisition of InterOil by way of plan of arrangement due to a flawed corporate governance process and inadequate shareholder disclosure. In *Re Dolly Varden Silver Corporation and Hecla Mining Corporation*[3] and *Re Eco Oro Minerals Corp*,[4] Canadian securities commissions applied heightened scrutiny to potentially tactical equity financings, allowing a highly dilutive private placement transaction in the context of a hostile takeover bid in one instance and unwinding a private placement in the context of a proxy contest in another.

These decisions demonstrate a heightened focus on corporate governance, shareholder disclosure and fairness, and on the roles of courts and securities commissions as gatekeepers in scrutinizing corporate control transactions. Most importantly, these recent decisions suggest a potentially fundamental shift in the level of business judgment deference accorded to target boards.

## GATEKEEPER FOR ARRANGEMENT TRANSACTIONS

The *InterOil* decision confirmed that court approval is an important and meaningful requirement in arrangement transactions to protect shareholders.[5] This decision marked the first time a Canadian court has blocked a significant transaction at the arrangement approval stage. The proposed multi-billion dollar ExxonMobil acquisition of Interoil was the result of a second unsolicited superior bid, was approved and recommended by the board as financially fair based on a fairness opinion of a global investment bank, was at a significant premium to current share price, and was approved by 80% of InterOil shareholders. At both the trial and the appellate levels, the corporate governance process followed by the target, the adequacy of the financial fairness opinion, and the sufficiency of the information provided to shareholders were reviewed in detail. Ultimately, all were found wanting. Both levels of court identified the following as red flags:

- The failure to establish a robust independent process for meaningful review and oversight of the proposed arrangement (including a passive independent committee and the absence of independent advisors);
- The conflicted position of executive directors given the significant financial incentive (including change of control entitlements and the acceleration of significant performance based incentive compensation upon completion of the transaction);
- The lack of an independent non-success fee fairness opinion;
- The failure to assess the value of the contingent portion of the consideration as compared to the value of the undeveloped resource asset;
- The failure to provide a fairness opinion that was robust, rigorous, and independent, and contained facts and analysis to assist shareholders in evaluating the transaction; *and*
- The failure to provide sufficient meaningful information to shareholders (and the court) on the underlying analysis and considerations of the board, the financial impact of the deal terms and the value of the undeveloped resource asset ("the value

shareholders would be receiving and the value they would be giving up as part of the deal").

In all of these circumstances, the Court of Appeal found that it could not pay deference to the business judgment of the board, the verdict of the market, or the shareholder vote, and was not satisfied that the arrangement was objectively fair and reasonable. Importantly, the Court of Appeal made clear that a fairness opinion that was devoid of facts and analysis — the fairness opinion in *InterOil* was consistent with typical market standard short form fairness opinions — was of little utility to courts and shareholders and would not suffice on its own to establish financial fairness.

Shortly after the InterOil decision, Canadian securities regulators released important guidance on the role of target boards and special committees, disclosure requirements and fairness opinions in "material" conflict of interest transactions. They also advised that such transactions will now be reviewed on a real-time basis to assess compliance with regulatory requirements and identify any potential public interest concerns.[6] Such regulatory review will focus on the adequacy of disclosure and the corporate process followed by the target board in negotiating, reviewing and recommending the transaction to ensure adequate protection of shareholders. In terms of corporate process, Canadian securities regulators view special committees with a robust mandate as advisable for all material conflict transactions notwithstanding such committees are only statutorily mandated for insider bids. In terms of sufficiency of disclosure, Canadian securities regulators expect enhanced fairness opinion disclosure and include enhanced background disclosure of the review and approval process, the target board and/or special committee's reasoning and analysis and their views as to the fairness of the transaction, any reasonably available alternatives to the transaction (including the status quo), and the pros and cons of the transaction. Failure to meet these standards may result in issuers being required to provide additional or enhanced disclosure, thus delaying the completion of transactions or, in serious cases, enforcement action.

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## TACTICAL PRIVATE PLACEMENTS: A NEW FRONTIER

In *Re Dolly Varden Silver Corporation*,[7] the Ontario and British Columbia securities commissions jointly permitted a highly dilutive private placement transaction (43% dilution) to proceed in the face of a hostile takeover bid launched by Hecla Mining Company. This was the first time that Canadian securities regulators considered defensive tactics in the context of the new take-over bid regime[8] and demonstrates the difficult balancing required for assessing tactical private placements, as opposed to shareholder rights plans, while ensuring appropriate deference to the business judgment of the target board.

The Commissions applied a two-step test to assess potential tactical private placements in the context of a takeover bid with a view to limiting interference with business judgment while ensuring sufficient shareholder protection.[9] The Commissions permitted the highly dilutive private placement transaction to proceed, placing particular emphasis on the fact that the target board was contemplating an equity financing prior to the bid even though the size of the private placement was only determined and announced during the pendency of the bid. They did so notwithstanding that the amount greatly exceeded any immediate financial needs of the target; all current financial needs of the target were capable of being met through an existing credit facility; the pricing of the private placement was below the bid price; and the private placement had the effect of impeding an all cash premium bid (55% premium over current market price).

The Commissions were unwilling in the circumstances to second-guess the target board's decision to implement an equity financing and retire the existing debt facility absent clear evidence of abusive intent to defeat the bid. As most development stage resource companies will likely be able to demonstrate an ongoing need for capital and some prior consideration of equity financing, private placements with an additional tactical effect of impeding change of control transactions may become more common.

In *Eco Oro*,[10] the Ontario Securities Commission reviewed a private placement share issuance to certain supportive shareholders during the pendency of an ongoing proxy contest for board control.[11] The share issuance was effected by a partial early conversion (by the Company) of convertible notes issued to these shareholders as part of a comprehensive investment agreement and increased their share ownership from 41% to 46%. The Commission overturned the decision of the Toronto Stock Exchange conditionally approving the issue of shares pursuant to the

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conversion. Notwithstanding the stated business rationale of the target board — favourable market conditions and financial metrics for deleveraging debt with benefits of an improved balance sheet — and the separate review, and consideration and approval of the private placement by the independent directors, the Commission determined there was no compelling business purpose for the conversion to be effected prior to the record date. The Commission concluded the conversion was tactical and would materially affect control since the share issuance could "reasonably tip the balance"[12] in favour of management in the proxy contest.[13]

In doing so the Commission took a different approach than the TSX in determining whether a transaction would have a "material effect on control" within the meaning of the TSX rules. The Commission also took a very broad view of its remedial powers and granted novel orders effectively requiring that the completed conversion be unwound and prohibiting voting of the private placement shares until it was unwound. Such broad remedial powers have traditionally been viewed as being reserved to the courts and the Commission's exercise of its purported remedial jurisdiction in this respect has been the subject of considerable debate by market participants.[14] In fact, the dissident shareholders also brought a parallel court application seeking such remedies by way of an “oppression” action, which was dismissed by the court the day following the Commission decision.[15] The court demonstrated greater deference to the business judgment of the target board, finding the board acted with a view to the best interests of the company, that there was no evidence which challenged the bona fides of the board decision to proceed with the conversion, and that there was nothing improper in the timing of such decision in the context of an ongoing proxy contest. The court declined to unwind the transaction or restrain the voting rights of the shares issued on the conversion. In light of these potentially contradictory outcomes, the court, on its own motion, adjourned the pending shareholder meeting to allow the parties additional time to deal with any conflict between the decisions. This decision to adjourn the meeting was overturned on appeal.

It is important to note that the conversion of the debt into shares of Eco Oro was a right that was exercisable by the Company, not the creditors. This raises the question of whether the result would have been different if the right to convert was the right of the creditor. Presumably creditors/shareholders are entitled to act in their own perceived interest in the context of a proxy contest and if they want to convert debt into equity in order to ensure that the side they support in the contest wins, they should be able to do so. However, the reasoning followed by the OSC seems to indicate that the TSX must not approve the issuance of shares on such a conversion if the issued shares might have an effect on the proxy contest.

> The sufficiency of information disclosed to shareholders must be considered carefully as it may prove to be the cornerstone for approving or blocking a transaction

## BALANCE BETWEEN BUSINESS JUDGMENT AND SHAREHOLDER PROTECTION

These decisions highlight the increasing risk that courts and securities commissions may second-guess the business judgment of target boards, and the critical importance of robust corporate governance and adequate shareholder disclosure in the context of change of control transactions. In particular:

- The roles of Courts and Commissions cannot be taken for granted, and the approval process or oversight function is an important safeguard that will be taken seriously;
- A target board’s decision should be supported by a thorough, independent, robust process, including consideration of the establishment of an independent committee with review and oversight of the transaction, to better ensure appropriate deference to business judgment;
- The sufficiency of information disclosed to shareholders must be considered carefully as it may prove to be the cornerstone for approving or blocking a transaction;
- In arrangement transactions, the target must provide sufficient meaningful information to shareholders and the court regarding its reasoning and analysis of

the financial implications and considerations of the transaction, either in the information circular or the fairness opinion; *and*

- A shareholder vote is a not a proxy for fairness in the context of arrangement transactions whereas the lack of a shareholder approval process in the context of private placement transactions may invite increased scrutiny.

# 2 CIRCUMSTANTIAL SUCCESS: A RENEWED FOCUS ON INSIDER TRADING

Successful insider trading prosecutions in Canada have historically been few and far between, in large part due to the high evidentiary burden to be met by the prosecution. However, recent decisions by Canadian securities regulators and appellate courts have significantly changed the playing field by lowering the evidentiary burden. Trading activity in advance of significant corporate transactions, including mergers and acquisitions, is one of the most heavily scrutinized areas and we anticipate that this will encourage an increased focus on insider trading prosecutions by regulators, making it a critical time for market participants to review the adequacy of internal policies and compliance programs to ensure that they do not get caught in the cross-fire of invigorated regulators. An insider trading allegation against a single individual within an organization can be devastating to the organization, causing disruption to its business and reputational damage. Further, the trading activities of such an individual can trigger external scrutiny and criticism of an organization's policies, ethics and compliance systems by regulators, customers and business partners.

## 'WINK AND NOD' PROSECUTIONS: NEW ERA OF CIRCUMSTANTIAL EVIDENCE AND CONTINUED DEFERENCE TO CANADIAN SECURITIES REGULATORS

In two high profile and successful insider trading prosecutions, appellate courts upheld the securities regulators' significant reliance on circumstantial evidence to convict various market participants of insider trading and tipping.

In *Fiorillo*,[16] the Divisional Court demonstrated the procedural leeway and deference which the appellate court is willing to extend to the Canadian securities regulators. Based largely on circumstantial evidence, the Ontario Securities Commission found that a former administrative assistant at an investment banking firm used her position to gain access to material, non-public information about proposed M&A transactions, and provided that information to others, who then traded based on that information before it became public. The OSC determined that factual inferences were logically and reasonably drawn from the circumstantial evidence, which included unusual trading patterns, relationships between the parties and the timing and volume of trades, to support its conclusion of insider trading and tipping contrary to the *Securities Act* and its imposition of heavy sanctions. The three tippees appealed the OSC's decision.

> *Fiorillo* should serve as a caution to capital market participants and others that direct evidence will not always be required to support a finding of tipping or insider trading

The Divisional Court upheld the insider trading convictions and rejected the appellants' submission that a "rigid approach" to circumstantial evidence was required. Instead, it affirmed a flexible approach which recognizes that the type of circumstantial evidence sufficient to establish indicia of insider trading varies from case to case. The Court further found that as long as the OSC's inferences are reasonably supported by the evidence, the appellate court should refrain from engaging in a detailed review of the factual record. *Fiorillo* should serve as a caution to capital market participants and others that direct evidence will not always be required to support a finding of tipping or insider trading.

The Divisional Court also upheld the OSC's reliance on circumstantial evidence in another high profile successful insider trading prosecution in *Finkelstein*[17] and dismissed the appeals of 4 of the 5 convicted individuals. *Finkelstein* involved multiple actors along a chain who were alleged to have tipped and traded on material, non-public information contrary to the *Securities Act*, including a corporate lawyer at a major Canadian law firm and an investment advisor at a bank owned dealer. The OSC panel, again relying almost completely on circumstantial evidence, found that unlawful insider trading and/or tipping had taken place, and imposed substantial penalties. The appellate court confirmed the panel's reliance on the circumstantial evidence and also recognized the panel's ability to draw "reasonable and logical inferences" in considering varying evidence.

It is noteworthy that the Divisional Court upheld the insider trading conviction against one downstream tippee and dismissed the conviction against another.[18] This provision capturing successive downstream traders provides that if a recipient of material non-disclosed information knows or "ought reasonably to have known" that he/she received such information from a person in a special relationship with the issuer then the recipient is deemed to be in a special relationship and likewise prohibited from trading or further tipping. The "ought reasonably to have known" branch of the special relationship definition is arguably capable of much broader application and we may see more prosecutions relying on this branch.

In summary, these Divisional Court decisions are important in their confirmation that securities regulators are not always required to obtain direct evidence (which is often not available) to prove tipping or insider trading. Proof by circumstantial evidence may be sufficient, and the appellate court is prepared to defer to such findings provided the securities regulator reasonably considered the totality of the circumstantial evidence. *Finkelstein* further demonstrates that securities regulators are prepared to pursue tippees further down the chain, albeit with resulting evidentiary challenges. While it is still early days, we will be monitoring the current and future prosecutions of insider trading in light of these decisions, including in particular ongoing high profile tipping and insider trading prosecutions relating to Amaya Gaming Group Inc. (in Ontario and Québec) and the recently announced prosecution against a former legal assistant of a prominent law firm for disclosing privileged information about a series of high-profile takeover bids to downstream traders.

## DEVELOPMENTS IN THE US

In the US, a recent decision regarding the relationship between tipsters and their recipients may make prosecuting insider trading cases easier. In *United States of America v Mathew Martoma*,[19] the 2nd Circuit Court of Appeals in New York lessened the burden of establishing a sufficient relationship between tipsters and their recipients. The respondent hedge fund manager received confidential information from a consultant about a clinical trial for an Alzheimer's medication before it became public, and this information was used to make $80.3 million in gains and avert $194.6 million in losses, according to the ruling. The consultant was not paid directly for this information. Under past decisions of the US Supreme Court and the 2nd Circuit Court of Appeals, the test to establish a sufficient relationship between a tipster and a recipient required either an explicit "quid pro quo" or a meaningfully close personal relationship such that the tip could be considered a "gift." With the *Martoma* ruling, the 2nd Circuit Court of Appeals reversed its own prior jurisprudence and expanded the boundaries of liability by stating that an insider or tipper may be liable if the tipper discloses information with the expectation the recipient would use it for trading or other personal gain, regardless of whether there was a meaningfully close personal relationship.

This decision (which may be subject to additional appellate review and will certainly be developed in other circuit courts) has many commentators speculating that there will be an increase in insider trading investigations south of the border, as well.

## THE SCIENCE OF ENFORCEMENT — THE USE OF ANALYTICS IN MARKET REGULATION

While securities regulators continue to rely on circumstantial evidence to prosecute insider trading, there has been an uptick in reliance on data analytic tools to better investigate trading patterns and behaviours.

In particular, in the US, the SEC is increasingly relying on data analytics to identify suspicious trading as well as trading patterns to better predict and understand market participants' behaviours.[20] The SEC is using data analysis, rather than (often cumbersome) requests for information, as a basis to conduct targeted investigations and more efficiently answer questions surrounding potentially questionable market behaviour.[21]

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Like any significant change, however, relying on technological tools to create more efficient and accurate investigatory responses and outcomes requires a cultural shift within the regulator's structure. The bureaucratic nature of a regulator can be at odds with the fast-past changes and flexibility required by the use and application of technology to effectively regulate the capital markets. Discussions surrounding the proper use of data analysis tools will be a recurring trend as regulators decide how best to combine human review with technological intervention and innovation.

## CONCLUSION

We expect to see a continued focus on insider trading and tipping investigations and prosecutions on both sides of the borders. With this in mind, we recommend that corporations, compliance officers, and directors and officers continue to prioritize robust compliance regimes to detect and prevent illegal insider trading and tipping. We also recommend that corporations and compliance officers implement their own data analytics to track suspicious trading behaviour in order to ensure efficient prevention and detection.

# 3 NOT SO CONFIDENTIAL: EROSION OF PROTECTION OVER CORPORATE INFORMATION

Recent legal developments demonstrate growing risk to the control over, and protection of, sensitive confidential corporate information in the context of regulatory investigations and legal proceedings, including class actions. Corporations and their officers and directors face a troubling minefield in the wake of the erosion of privilege protection, increased cooperation and information sharing amongst domestic and foreign regulatory and law enforcement agencies, and increased efforts by third parties to obtain the "fruits" of government and internal investigations and privileged communications.

> …recent decisions encroach on "deal privilege" and create significant risk that privileged information shared among parties to a commercial transaction will no longer be protected from production to regulators or other third party litigants

## WHITHER GOES DEAL PRIVILEGE PROTECTION?

Canadian and US courts have recently rendered decisions which encroach on transactional common interest privilege or "deal privilege" and create significant risk that privileged information shared among parties to a commercial transaction will no longer be protected from production to regulators or other third party litigants. Deal privilege, although narrow, was previously recognized by multiple Canadian courts and many US federal and state courts as a practical, necessary protection in the transactional context to permit sharing of privileged opinions and communications among parties in furtherance of their common goal to complete the transaction.[22]

In *Ambac Assurance Corp v Countrywide Home Loans Inc.*,[23] a claim for misrepresentation regarding the quality of guaranteed loans, Ambac challenged the deal privilege protection asserted by the defendants over certain documents shared between them in the context of a merger. Although the trial court upheld the deal privilege, the New York Court of Appeal reversed and restricted such common interest privilege to *only* communications related to pending or anticipated litigation, rejecting any notion of protection over shared privileged communications between parties to a commercial transaction.[24] The Court concluded that extending common interest privilege beyond the scope of pending or anticipated litigation could result in the substantial loss of relevant evidence as well as the potential for abuse.

In Canada, the Federal Court in *Minister of Revenue v Iggillis Holdings Inc.*[25] also narrowed the application of common interest privilege to communications in the context of pending or anticipated litigation relying in part on the analysis in *Ambac* and academic commentary. *Iggillis Holdings* is currently under appeal to the Federal Court of Appeal.

In an action alleging an abusive tax avoidance scheme, the Canada Revenue Agency ("CRA") sought production of a legal memo prepared by purchaser's external counsel regarding the tax implications of a series of commercial transactions, and shared it with the vendor's counsel to advance negotiations. The Federal Court held that although the memo was protected by solicitor-client

privilege, the sharing of the memo with vendor's counsel was a waiver of privilege not otherwise protected by the common interest doctrine. Referring to *Ambac*, the Court concluded that deal privilege (also referred to as "advisory common interest privilege"[26]) was antithetical to the doctrine and rationale underlying solicitor client privilege and would place potentially relevant information off-limits to other litigants, regulators, governmental authorities and the courts.[27] The Court expressed concern for the potential for abuse through "over-claiming" deal privilege in large merger and acquisition transactions, the risk of enabling unlawful transactions and the impairment of the "truth-seeking legal process" of the courts.

Together, *Iggillis Holdings* and *Ambac* create a grey area for corporations seeking privilege protection over deal-related documents and sit at odds with prior decisions and market practice in respect of deal privilege. These decisions highlight the ideological tension between protection of privilege and truth-seeking and reflect a new low regard for certain policy considerations, including the economic and social benefits of fostering commercial transactions. Unless and until appellate courts rule differently, these decisions will have significant implications for how corporate parties interact in the context of potential transactions and may operate to stifle effective deal-making as parties may be less willing to share information which would otherwise advance the transaction. In addition, these decisions may embolden other litigants, including class counsel, to seek production of deal privilege communications.

For companies with dual listings or business in multiple countries, the risks and challenges of protecting sensitive confidential corporate information are substantial and "here to stay"

## OUT OF THE BAG: FORWARD SHARING OF CONFIDENTIAL INFORMATION

The increasing level of cooperation, coordination and intelligence sharing amongst domestic and foreign securities regulators and law enforcement agencies and the enhanced ability of Canadian securities regulators to forward-share information[28] have important implications for market participants regarding the use and dissemination of sensitive information. In 2016, challenges to the cross-border sharing of compelled documents and information by Canadian securities regulators were unsuccessful. For companies with dual listings or business in multiple countries, the risks and challenges of protecting sensitive confidential corporate information are substantial and "here to stay."[29]

Canadian securities regulators have broad power to compel market participants to disclose information[30] and discretionary power to share compelled information with foreign and domestic regulators when necessary in the public interest without any opportunity for the provider of such information to object or seek appropriate safeguards on the use of such information. There is little regulatory guidance on what circumstances would give rise to "no notice" disclosure of compelled information. Given the stark differences between the regimes in Canada and the US for the protection of compelled information, there is significant risk that sensitive confidential corporate information shared with US regulators may be obtained by, or "forward-shared" with, other parties, including US criminal authorities and civil litigants. Regulatory, criminal and quasi-criminal investigations often trigger parallel civil proceedings, including class actions, and such litigants have had increasing success with court sanctioned access to state-obtained evidence in furtherance of the policy goals of "ascertaining the truth."[31] This creates a difficult playing field for corporations, and their directors and officers, in navigating the risks and challenges of avoiding a multiplicity of costly proceedings.

These concerns surrounding cross-border sharing were raised before the Alberta Court of Appeal in *Beaudette v Alberta (Securities Commission)*,[32] a case that challenged the constitutionality of such information sharing without any guaranteed protection regarding the use of such information. The Alberta Court of Appeal confirmed the ability of the Alberta Securities Commission to share compelled information with foreign authorities, including the Securities and Exchange Commission and the US Department of Justice, and held that such information sharing powers were not inherently inconsistent with principles of fundamental justice, including the right against self incrimination. The Court held that there may be circumstances of improper use in which the regulator's conduct will violate such fundamental principles but did not provide any guidance or considerations which would delineate the parameters of improper use. The Court emphasized that the objectives of securities regulation to protect investors, facilitate efficient capital markets, and ensure public confidence in capital markets could not be achieved without the broad powers of compulsion and information sharing. The Supreme Court of Canada denied leave to appeal, and accordingly this decision stands as the last word on the validity of Canadian securities regulatory information sharing powers.[33]

The trend towards loosening privilege protection and increasing information-sharing carry significant implications for how corporations navigate the dissemination, and protection, of information. The proper parameters for navigating these tensions within the realm of privilege are far from settled and we anticipate that market participants, courts and regulators will continue to struggle with the balance between robust disclosure and appropriate information protection. In the interim, corporations and their directors and officers should consider the following practices: early establishment of communication protocols to maximize privilege protection in the context of transactions and internal and external investigations; and requesting conditions limiting forward-sharing of compelled information prior to production to Canadian securities regulators or requiring notice and an opportunity to seek appropriate restrictions in advance of any such forward-sharing.

# 4 COMPLEX CHESSBOARD: SECURITIES REGULATORY SETTLEMENTS CONTINUE TO EVOLVE

No-contest settlements are not new, having been introduced by the Ontario Securities Commission in 2014 and having long been available in US securities regulatory proceedings, as part of an effort to achieve more timely and efficient resolution of enforcement matters. Such settlements do not require market participants to admit facts alleged by securities regulators or contraventions of securities laws or that the alleged conduct is contrary to the public interest.

The approval of six[34] no-contest settlements in Canada in 2016 and 2017 confirms the regulatory commitment to cautious use of this enforcement tool in appropriate circumstances and dispels the floodgates concerns raised by detractors. Altogether, the voluntary fines and compensation in these settlements totalled just over $200 million. We expect a continued uptick in no-contest settlements going forward as market participants develop a better understanding of the landscape, including criteria for eligibility and expected consequences.

These settlements are only considered appropriate when certain factors are met, and, like all settlements, a Commission panel must approve the agreement in the public interest. Factors that favour the use of no-contest settlements include:

- Self-discovery and prompt self-reporting upon discovering the alleged inadequacies;
- The provision of prompt, detailed and candid cooperation with the regulator;
- No evidence of dishonest conduct;
- A commitment to take measures to establish and implement enhanced procedures and controls, supervisory and monitoring systems; *and*

We expect a continued uptick in no-contest settlements going forward as market participants develop a better understanding of the landscape, including criteria for eligibility and expected consequences

- Remedial steps such as voluntary payments to affected clients and/or to the regulator.

All of the approved no contest settlements in Canada involved major financial institutions who self-reported, provided prompt, detailed and candid cooperation to the regulator, provided appropriate compensation to affected clients and undertook remedial measures for enhanced compliance.

Traditional regulatory settlement agreements continue to evolve, as well, given the prevalence of parallel civil proceedings. The recent carefully coordinated settlements involving Home Capital Group Inc., a publicly listed issuer in the commercial and residential lending business, are noteworthy in that they simultaneously resolved a securities regulatory enforcement proceeding and a securities class action, with payments from one funding the other.[35]

Over a period of several months in 2015, Home Capital materially misled its shareholders about the reason for a decline in the number of its new mortgage originations by failing to disclose until July 10, 2015 that it had terminated various underwriters, brokerages and brokers because of its discovery of falsified loan applications in its broker channels. This disclosure had a significant market impact on the stock price (18.9%), and a class action and securities regulatory investigation followed.

In the end, Home Capital and three former senior executives admitted in a settlement with the OSC that Home Capital misled its investors about the causes of a decline in its mortgage originations from May to July 2015. Home Capital agreed to pay a penalty of $10 million and $500,000 in costs, and the three former senior executives agreed to collectively pay a penalty of $2 million and be banned from serving as an officer or director of any reporting issuer for various terms.

Interestingly, the OSC and class action proceedings were resolved simultaneously, with carefully coordinated settlement agreements that were each conditional on approval of the other, and with $11 million of the $13 million monetary penalty to be paid to the OSC ultimately used to fund part of the securities class action settlement amount.[36]

In approving the settlement, the OSC emphasized the importance of continuous disclosure obligations, which it referred to as “a cornerstone of our securities regulatory regime.” In particular, the OSC noted that “disclosure of material changes by a reporting issuer is not a discretionary decision for management, but a regulatory requirement” and that untimely disclosure “poses a fundamental risk that management will postpone the release of the information in the hope it can manage itself out of a hole.”

This development serves as a helpful reminder of the importance of timely continuous disclosure but also serves as a reminder that it is possible to kill two birds with one creative settlement structure.

# 5 SECURITIES CLASS ACTIONS: THE BEST DEFENCE IS A STRONG OFFENCE

We previously observed that a "chill" could be on its way for securities class actions given the court's confirmation of the meaningful leave test for commencing statutory secondary market securities class actions. In fact, securities class action filings in Canada declined in 2015 and 2016 as compared to earlier years, from an average of approximately 12 a year to just over 6 per year.[37] Although too soon to tell for sure, this decline may be due in part to recent developments in the case law which may make Canada a less attractive forum for secondary market class actions.

## CONSEQUENCES OF MEANINGFUL LEAVE TEST

Under the *Securities Act*, secondary market liability claims may only be pursued with leave of the court.[38] As reported last year, the Supreme Court of Canada and various provincial courts have affirmed that the test for leave is meaningful one, which has resulted in a more cautious approach by plaintiffs' counsel.

This is not to say that the leave requirement is insurmountable, by any measure. The Ontario Superior Court of Justice granted leave to proceed in *Wong v Pretium Resources*,[39] and recently, the Ontario Court of Appeal upheld the motion judge's decision to grant leave to proceed against the defendant corporation in *Rahimi v SouthGobi Resources*[40] (but also overturned the motion judge's denial of leave to proceed against the defendant officers and directors). Given the inconsistency and other deficiencies in the evidence at the leave stage, the Court of Appeal found the motion judge erred in finding there was certainty that the reasonable investigation defence of the defendants officers and directors would succeed.

One consequence of the rigorous leave mechanism, regardless of the outcome, is the required significant investment at the outset, which has resulted in an increased dependence on third party funding. Plaintiffs and defendants can also both face significant cost consequences on the determination of the leave application — in *Mask v Silvercorp*[41] the defendants were awarded $500,000 in costs, while in *Green v Canadian Imperial Bank of Commerce*, the plaintiffs were awarded $2.6 million in costs.[42]

## REJECTION OF CREATIVE EFFORTS TO CIRCUMVENT STATUTORY PROTECTIONS

Unlike secondary market securities class actions, primary market claims are not subject to a leave requirement or to a statutory cap on damages. Given this distinction, it may be tempting for plaintiffs to characterize claims as primary market claims where possible. However, the Ontario Court of Appeal decision in *Rooney v ArcelorMittal SA*,[43] has confirmed the restrictions placed on secondary market liability claims by the statutory regime in foreclosing an effort by security holders who had sold their shares in the secondary market to bring the action as a primary market class action. In this case, the plaintiffs had sold their shares in the secondary market rather than tender them to a takeover bid. The plaintiffs alleged that there had been misrepresentations in the takeover bid circular, and brought claims under the primary market liability section of the Act, which creates liability for the offeror and other specified defendants involved in the approval of the circular. The Court of Appeal reviewed the entire scheme of the provincial *Securities Act* and concluded that the statute had clearly and intentionally created a bright line between primary and secondary market liability claims. In doing so, they affirmed that in the context of a takeover bid, primary market claims are available only to security holders who tendered their securities to the takeover bid (with statutory deemed reliance on the misrepresentation). Those who elected to sell their shares in the secondary market are restricted to seeking secondary market damages, with the attendant leave requirement and damages caps.

## REJECTION OF EXPANDED CATEGORY OF DEFENDANTS

In *LBP Holdings v Allied Nevada Gold Corp.*,[44] the Ontario Superior Court found that the underwriters of a public offering are not proper defendants under the *Securities Act* secondary market liability regime.

The plaintiff investors in a secondary public offering initiated a class action against a resource company and two of its executives, alleging material representations in documents incorporated by reference into a short-form prospectus equity offering. Subsequently, the plaintiffs brought a motion to add the underwriters of the offering as defendants in the class action, alleging both common law and primary and secondary market statutory misrepresentation claims.

Although underwriters are not specifically included in the enumerated categories of potential secondary market liability defendants in the *Securities Act,* the plaintiffs attempted to categorize the underwriters as "experts" in order to bring them in as proper defendants. The Court rejected this attempt on two main grounds. First, the Act requires the alleged misrepresentation be repeated in a report, statement, or opinion made by the expert. Underwriters typically simply provide reassurance regarding the "full, true and plain disclosure of all material

Issuers and directors and officers will continue to face the risk of parallel securities class actions following the announcement of any significant corrective disclosure, regulatory investigations or US class actions

facts" in the underlying document, to the "best of their knowledge," but do not repeat any misrepresentations. Second, the design of the Act makes it clear that the term "expert" does not include underwriters. The two terms are separately defined in the Act, and the definition of an expert makes specific reference to professionals which are self-regulating and self-licensing: underwriters are neither.

Finally, the Court found that the Act could have, but did not, specifically include underwriters in the list of liable actors in the secondary market, and the *Securities Act* contains a "complete code" for secondary market liability. This decision provides reassurance to underwriters and other potential new categories of proposed defendants that courts will defer to the clear parameters placed on their liability in the Act in the face of attempts by plaintiffs to expand the explicit scope of statutory primary market liability.

## CONCLUSION

It will be interesting to see whether the slower pace of securities class action filings in Canada is here to stay, as plaintiffs exercise more discretion on what cases to bring in the face of a more stringent leave test and attendant costs, or whether it is a passing trend. Either way, it is safe to say that securities class actions are here to stay, and that issuers and directors and officers will continue to face the risk of parallel securities class actions following the announcement of any significant corrective disclosure, regulatory investigations or US class actions. We expect that defendants will continue to devote significant resources and effort at the leave stage, and that we will see further important developments in this area as the Canadian securities class action market continues to mature and develop.

# CASSELS IN BRIEF

- Canadian law firm focused on serving the transaction, advocacy and advisory needs of the country's most dynamic business sectors
- Emphasis on core practice areas of mergers and acquisitions, securities, finance, corporate and commercial law, litigation, taxation, intellectual property and information technology, international business and government relations
- One of the largest business law practices in Canada, serving multinational, national and mid-market entities and with a particular strength in the mining and natural resources sector
- Consistently ranked at or near the top of Bloomberg, Thomson Financial and Mergermarket deals league tables for mergers and acquisitions and equity offerings
- Cited as market leaders by *Chambers Global*, *ALM 500*, *Best Lawyers*, *Lexpert*, *Global Counsel* and others
- Regularly act on deals honoured at the Canadian Dealmakers' Gala and for counsel recognized at the Canadian General Counsel Awards
- Dedicated to staying on the leading edge of trends in law and business to offer timely proactive and preventative advice that adds demonstrable value
- Serving leadership roles in business, political, civic, charitable and cultural organizations in community, national and international organizations

# ENDNOTES

1 Cassels Brock & Blackwell LLP represented parties in each of these cases.

2 2016 YKCA 14.

3 2016 BSECCOM 359; 2016 ONSEC 31.

4 2017 ONSEC 23.

5 An arrangement is a statutory mechanism which permits, among other transactions, the acquisition of all of the outstanding securities of a target in a single step and also provides an exemption from US securities law registration and review requirements. The vast majority of board-supported acquisitions are structured as arrangements in Canada.

6 Multilateral CSA Staff Notice 61-302 — *Staff Review and Commentary on Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions*.

7 *Re Dolly Varden Silver Corporation and Hecla Mining Corporation,* 2016 BCSECCOM 359; *Re Dolly Varden Silver Corporation and Hecla Mining Corporation* 2016 ONSEC 31.

8 The new regime mandated, among other things, a longer minimum bid period of 105 days and a mandatory 50% minimum tender condition (National Instrument 62-104 *Take-Over Bids and Issuer Bids).*

9 Under the first step, Commissions will consider the threshold question of whether the evidence clearly establishes that the private placement is not a defensive tactic thereby engaging the principles contained in Canada's defensive tactics policy (NP 62-202), including whether the target has a serious or immediate bona fide need for the financing and whether the financing was planned or modified in response to or in anticipation of the bid. If the private placement is potentially a defensive tactic, the Commission under the second step will engage in a balancing exercise regarding deference to the business judgment of the target board and protection of shareholder choice through a consideration of a number of factors.

10 2017 ONSEC 23.

11 The shareholders signed letters supportive of the Company's current plans and strategic direction, which expressly stated that they did not constitute an agreement, understanding or commitment regarding their voting rights. These shareholders were also portfolio managers and expressly stated that they would continue to review and consider all information prior to the shareholder meeting and act accordingly in keeping with their fiduciary duties to clients.

12 This is the first case in which the Commission rejected the traditional TSX test of assessing whether the issuance creates a new 20% shareholder block and adopted a "tips the balance" test for materially affect on control.

13 The dissident shareholders held approximately 9% of the outstanding common shares at the time of the meeting requisition. Following the private placement, the dissidents and the Company issued competing press releases claiming majority shareholder support.

14 Eco Oro and the supportive shareholders appealed the Commission decision to the Ontario Divisional Court. Prior to the hearing of the appeal, Eco Oro, the dissident shareholders and the supportive holders entered into a settlement conditional on shareholder approval. The appeal has been adjourned and will be abandoned if the settlement is implemented by November 2017.

15 *Harrington Global Opportunities Fund Ltd. v Eco Oro Minerals Corp.,* 2017 BCSC 664.

16 2016 ONSC 6559.

17 2016 ONSC 7508.

18 The Divisional Court overturned the insider conviction of the one downstream tippee on the basis of the OSC's flawed consideration of the totality of the circumstantial evidence.

19 2017 WL 3611518 (2nd cir).

20 Ehret, Tom, "SEC's advanced data analytics helps detect even the smallest illicit market activity," Thomson Reuters, June 30, 2017. The SEC has listed several insider trading investigations using its Market Abuse Unit (created in 2010) which allows staff to study the flow of information regarding how traders use information and make trading decisions to detect suspicious patterns. See for example: *SEC Uncovers Wide-Reaching Insider Trading Scheme*, August 16, 2017, https://www.sec.gov/news/press-release/2017-143.

21 International regulators, like Singapore, are on the cutting-edge of applying data analysis to better understand and regulate investor behaviour. In February of 2017, the Monetary Authority of Singapore announced the formation of a new Data Analytics Group as part of a broader effort to "help position itself and the financial sector for the digital economy of the future." (see: http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/MAS-Sets-up-Data-Analytics-Group.aspx).

22 See for example: *Barclays Bank PLC v Metcalfe* 2010 ONSC 5519; *Pitney Bowes of Canada Ltd. v R* (2003), 57 DTC 5179 (Fed Ct); and *Fraser Milner Casgrain LLP v Minister of National Revenue*, 2002 BCSC 1344. In commercial transactions, although the solicitor may be retained by a single client, he or she may have to give advice to other members of the team who work for the client. In *Barrick Gold Corporation v Goldcorp Inc.*, 2011 ONSC 1325 for example, the court recognized that deal privilege applied to certain individuals who were not themselves lawyers but who were part of the "team" for the purpose of "requesting, obtaining and/or receiving legal advice."

23 27 N.Y. 3d 616 (2016) ("*Ambac*").

24 *Ambac*, p. 3.

25 2016 FC 1352 ("*Iggillis*").

26 *Iggillis,* paras. 10-11.

27 *Iggillis,* para. 156.

28 See for example *Securities Act*, R.S.O., 1990, c.S.5, s. 17 (2.1).

29 Recently, the Alberta Court of Appeal also confirmed that corporations cannot shield sensitive information simply because the information arose from an internal investigation. In *Alberta v Suncor Energy Inc.*, 2017 ABCA 221, the Court of Appeal found that while privilege can apply to documents and information created or collected during an investigation, each document would have to be scrutinized before determining whether any privilege protection applies.

30 *Securities Act*, R.S.O., 1990, c.S.5, s. 17, s. 17(2.1).

31 See for example *Imperial Oil v Jacques (et al)*, 2014 SCC 66.

32 2016 ABCA 9 ("*Beaudette*").

33 The added layer of "credit for cooperation" regimes in Canada and the US, which typically require extensive disclosure to qualify for leniency, including no prosecution or reduced penalties, creates additional risks regarding the dissemination and use of such information by other parties, including foreign regulators and civil litigants.

34 The OSC has approved nine no contest settlements in total since the implementation of the no-contest regime in 2014.

35 *Re Home Capital Group Inc*., 2017 ONSEC 32; *McDonald v Home Capital Group*, 2017 ONSC 5004.

36 The OSC approved the settlement agreement on August 9, 2017 and the Ontario Superior Court approved a $29.5 million settlement of the securities class action on August 21, 2017.

37 NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2016 Full-Year Review*

38 Canadian securities acts require a plaintiff to satisfy two requirements to obtain leave: that the claim was brought in good faith and that there is a reasonable possibility of succeeding at trial.

39 2017 ONSC 3361 (appeal pending).

40 2017 ONCA 719.

41 2015 ONSC 7780.

42 2016 ONSC 3829.

43 2016 ONCA 630.

44 2016 ONSC 1629 ("*Allied Nevada*"), appeal settled in January 2017.

# NOTES

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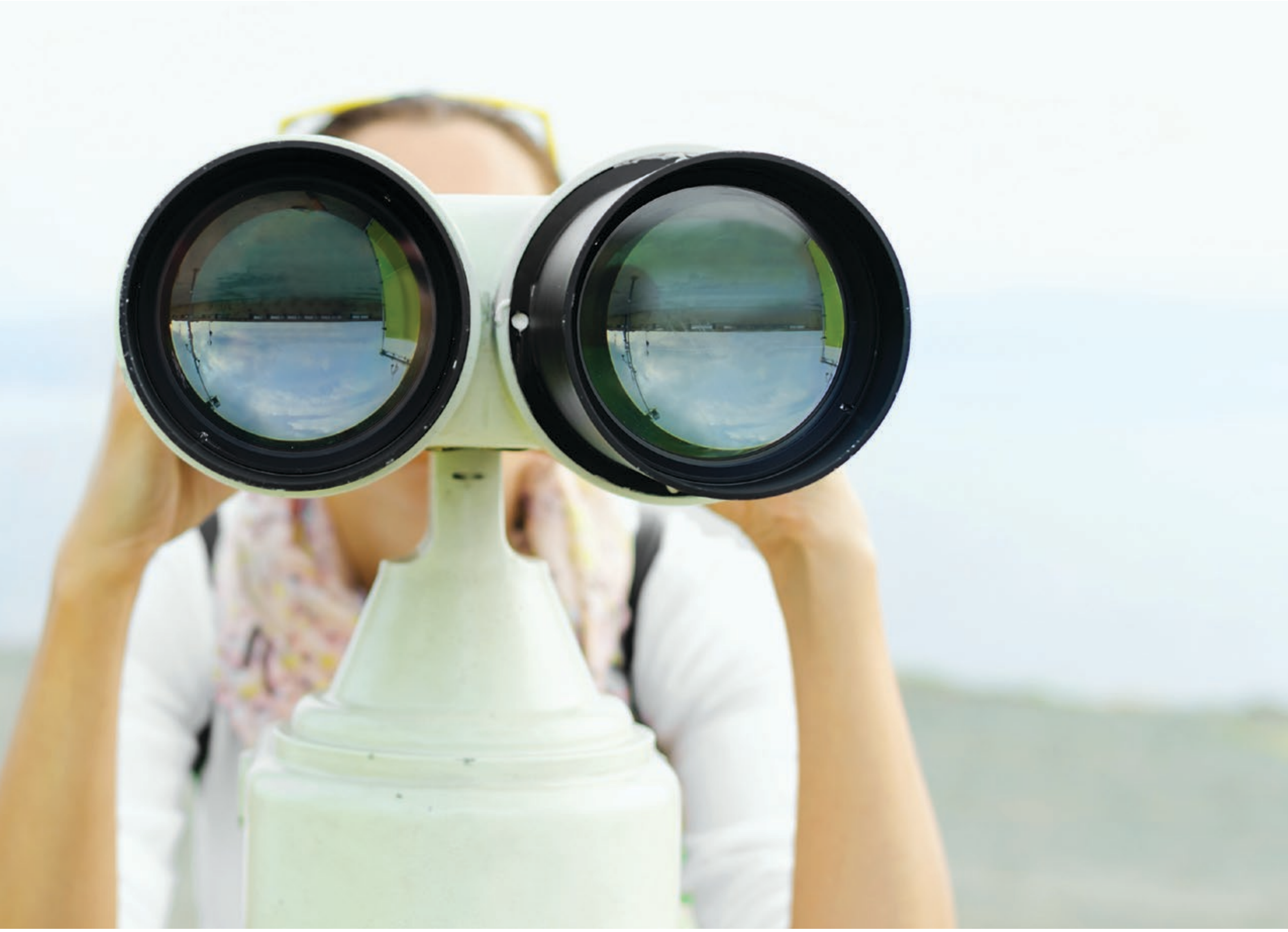

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