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Securities Litigation

RECENT DEVELOPMENTS OF IMPORTANCE

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I – Introduction

Despite hefty penalties for breach of provincial securities law and the existence of *Criminal Code* offences for fraud, market manipulation and insider trading, there appears to be a growing perception in Canada that the interests of investors are inadequately protected. In a study recently commissioned by the Task Force to Modernize Securities Legislation in Canada, for example, former Supreme Court Justice Peter Cory and law professor Marilyn Pilkington noted that there is a wide perception that too many high profile cases have not been prosecuted, insider trading is undeterred, some prosecutions are unfair, the processes for obtaining investor compensation are inadequate, and that Canada's continued failure to create a single national securities regulator is, to a large extent, to blame.¹

Recent developments over the past year have certainly contributed to this perception.

II – Enforcement Proceedings

(i) Failed Canadian Securities Prosecutions

Canadian securities regulators have failed in recent attempts to successfully prosecute serious breaches of securities law in the courts. The trend continued this year with two of the most high-profile prosecution failures to date, both in Ontario.

(a) Andrew Rankin

In early November 2006, the tipping conviction of Andrew Rankin, a former investment banker, was overturned and a new trial ordered. The Ontario Securities Commission (the "OSC") alleged that

Rankin had passed on insider information about coming takeover and merger deals to his long-time friend, Daniel Duic, who made more than \$4-million in profit on a series of stock trades in 2000 and 2001. In overturning the convictions, Justice Nordheimer stated that the trial judge had made legal errors, failed to properly assess the credibility of Duic (who had struck a deal with prosecutors and testified against Rankin), and that Rankin could very well be the victim of a "miscarriage of justice."²

The OSC's attempt to obtain leave to appeal Nordheimer J.'s ruling did not succeed. Despite arguments that the failure to reinstate Rankin's tipping conviction would hamper future insider trading prosecutions, the Court of Appeal, on February 27, 2007, dismissed the OSC's application for leave, noting that it had not raised questions of law on which guidance of the Court of Appeal was essential in the public interest or for the due administration of justice.³

The OSC has nevertheless announced that Andrew Rankin will stand trial for a second time on several counts of tipping. The trial is scheduled to commence in February 2008.

(b) John Felderhof

Another blow to the Ontario Securities Commission would come in the Bre-X Minerals Ltd. matter. On July 31, 2007, Justice Peter Hryn released his long-awaited decision which fully exonerated John Felderhof, who was alleged to have sold \$84 million worth of Bre-X shares while in possession of material non-public information.⁴ The decision came almost a full 10 years after the collapse of Bre-X.

Felderhof, the only key figure to stand trial in Canada, was chief geologist at Bre-X, a junior Canadian mining company once reported to be sitting on an enormous gold deposit at Busang, Indonesia. In 1997, the company

collapsed when it was discovered that the samples had apparently been salted with gold. The company's shares, which had peaked at C\$286.50 a share (with a total capitalization of over C\$6 billion), were rendered worthless.

Although a class action is still alive, no criminal charges were ever laid by the Royal Canadian Mounted Police (the "RCMP"). (The RCMP announced in 1999 that it did not have enough evidence to proceed). The OSC's recent decision not to appeal Justice Hryn's ruling has left many investors outraged that no one will be held accountable for the mining scandal.

(c) ATI Technologies and K.Y.H.

The OSC's difficulties in obtaining convictions for insider trading and tipping is not limited to prosecutions in court. Insider trading cases have also proven difficult to prosecute in tribunal hearings as well. In a recent highly publicized case involving ATI Technologies ("ATI"), for example, an OSC panel dismissed all allegations against ATI co-founder K.Y. Ho and his wife, Betty Ho, who allegedly avoided a total of \$7 million in stock losses on the basis of inside information prior to a warning that ATI would not meet certain sales and profit estimates.⁵

(d) Parallel American Prosecutions: Conrad Black and Nortel

In the face of these recent prosecution failures, some investors and government officials alike⁶ have suggested that Canadians have come to rely upon American securities regulatory authorities to bring their "home-grown" companies and individuals to justice.

Some, for example, point to Conrad Black's conviction by a Chicago jury, on July 13, 2007, on multiple fraud charges and obstruction of justice while parallel OSC proceedings were postponed. Lord Black, the Canadian media baron who once headed newspaper group Hollinger International, now potentially faces 35

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years in prison and a US\$1 million fine for misappropriating US\$60 million in bonuses disguised as non-compete payments from Hollinger International during the sale of newspaper assets.

Others may point to the Nortel Networks Corp. ("Nortel") matter involving allegations of falsified financial results. In Ontario, the OSC settled with Nortel for C\$1 million, whereas the SEC settled with the issuer for a civil penalty of US\$35 million.⁷ Both regulators gave Nortel credit for its substantial remedial efforts and cooperation. Query, however, whether the OSC's approach to penalty is not more consistent with investor protection than the SEC's. Presumably the fine of US\$35 million levied against the company will be paid at the expense of its shareholders, whom some would argue have already suffered enough.

(ii) Integrated Market Enforcement Teams (IMETs) Failure to Act

Created by the federal government in 2003, Integrated Market Enforcement Teams ("IMETs") were formed as a division of the RCMP with the intention of restoring investor confidence and tackling major abuses that some perceived to have given Canada a reputation as the Wild West of securities markets.

Despite five years since its creation, over \$120 million invested, and a number of high-profile investigations – including reviews of Nortel Networks Corp., Royal Group Technologies Ltd., Portus Alternative Asset Management Inc. and Norburg Asset Management Inc. – IMETs, as recently criticized by Doug Hyndman (Chair, British Columbia Securities Commission), have "achieved almost nothing."⁸

With little evidence of success or even progress, Superintendent John Sliter (Director, RCMP's Integrated Market Enforcement Branch) has recognized that IMETs have reached a "stage of process

constipation." He blames the lack of progress on the huge volume of data that must be analyzed in corporate cases, the slow pace of international investigations and disclosure, as well as the high levels of attrition which have significantly disrupted IMET investigations.

Sliter also noted that potential witnesses often simply refuse to speak to the RCMP. He suggests that Canada needs a way to force such individuals to give evidence, similar to the grand jury system in the United States or the provisions of most provincial securities acts which permit regulators to compel testimony.⁹

(iii) SRO Jurisdictional Attacks

Savvy brokers and dealers facing regulatory disciplinary proceedings by self-regulatory organizations ("SROs") have also recently sought and, in some cases, successfully managed, to avoid regulatory charges, not by contesting the charges on the merits but, by challenging the jurisdiction, or *vires*, of the SROs who are proceeding with regulatory offences against them.

The two SROs that have particularly come under recent attack are the Investment Dealers Association (the "IDA"), which regulates the activities of investment dealers and their registered employees in relation to both their capital adequacy and business conduct, as well as Market Regulation Services Inc. ("RS"), the independent regulation services provider which regulates the trading of securities on several Canadian equity marketplaces (including the Toronto Stock Exchange) and enforces, in particular, the Universal Market Integrity Rules ("UMIR").

In *Investment Dealers Assn. of Canada v. MacBain*¹⁰, for example, the Saskatchewan Court of Appeal upheld a decision of the Saskatchewan Financial Services Commission that barred the

IDA from proceeding with discipline proceedings against certain members on the grounds that they were no longer members of the IDA and that the IDA had, therefore, lost jurisdiction over them. Challenges to the jurisdiction of the IDA have also been recently made in *Charles Dass (Re)*¹¹ and *Stephen Taub (Re)*.¹² Both challenges failed at first instance yet are under appeal.

A challenge to the jurisdiction of RS has also been advanced in recent RS enforcement proceedings, such as *In the Matter of Northern Securities Inc. et al.*,¹³ in which the respondents have sought to challenge the validity of UMIR.

III – Civil Liability for Public Issuers

Civil processes for obtaining investor compensation have also been perceived by some to be inadequate. Despite a class action regime and provincial securities legislation designed to assist investors to recover losses arising from misrepresentations by issuers in primary market and, more recently, secondary market disclosure materials, securities class actions in Canada nevertheless continue to be relatively rare.

(i) Primary Market Liability: Danier Leather

The failure of the first class action in Ontario that proceeded to trial regarding alleged misrepresentations in an issuer's primary market disclosure will no doubt cause investors pause.

In *Kerr v. Danier Leather Inc.*, Danier Leather Inc. ("Danier") and its management were originally found liable for misrepresentations in its prospectus for having failed to disclose material facts of which they became aware between the filing of its prospectus and the closing of its initial public offering.¹⁴ The decision of the lower court was ultimately reversed by the Ontario Court of Appeal.¹⁵ Among other things, the court held that

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the *Ontario Securities Act*, R.S.O. 1990, c. S.5 (the "OSA") does not require an issuer to continuously disclose material facts (rather, only material changes) occurring after a final prospectus is receipted and before the end of a distribution period. The court also held that the business judgment rule is relevant to an analysis of whether an issuer and its management satisfied their disclosure obligations.

The decision, criticized by investor rights activists to have undermined the purpose and philosophy of the prospectus requirements in securities legislation, was recently affirmed by the Supreme Court of Canada.¹⁶ While the Supreme Court agreed with the class that the business judgment rule should not be used to qualify or undermine the duty of disclosure, the court nevertheless upheld the Court of Appeal's ruling that the prospectus disclosure regime presently mandated by the OSA only requires the continuous disclosure of material changes after a final prospectus has been receipted and that "the courts are obliged to give effect to [the legislature's policy]."¹⁷ Recognizing also that this case was "a piece of Bay Street litigation that was well run and well financed on both sides" and a very expensive piece of shareholder litigation, the court also rejected the appellants' "access to justice" argument and ordered costs against the representative plaintiff personally (with leave to extend the costs order against two other appellants).

(ii) Secondary Market Liability: IMAX, and CV Technologies and Southwestern

Despite warnings of an impending torrent of shareholder strike suits following the enactment of secondary market liability legislation throughout Canada,¹⁸ the statutes have thus far also failed to open the floodgate of class actions against Canadian issuers on the

basis of misrepresentations in an issuer's secondary market disclosure.

The legislation, intended to facilitate investor recovery for inaccurate secondary market disclosure by removing evidentiary obstacles for claims alleging misrepresentation (such as the common law requirement to prove reliance), originally generated tremendous concern among public issuers. To date, however, there have only been three actions filed pursuant to these legislative provisions.

The first, against global leader in large-format film projection, IMAX Corporation ("IMAX"), and a number of its directors and officers, was filed on September 20, 2006. The plaintiffs allege that IMAX and various individual co-defendants knowingly overstated the company's revenues in its financial reports with the intention of inflating IMAX's share price and the value of the individual defendants' holdings.

The second, filed on July 20, 2007 against CV Technologies Inc., the Edmonton-based maker of Cold-*FX* (a cold and flu remedy), some of its executives and directors, and its former auditor, alleges that the defendants negligently or recklessly overstated the company's revenues for fiscal 2006 and the first quarter of 2007 and thereby artificially inflated the trading price of its securities. The plaintiffs claimed \$110 million in damages on behalf of the class.

The third, filed the same day as the CV Technologies action, was commenced against Southwestern Resources Corporation and stems from a July 19, 2007 press release which, among other things, disclosed that there were deficiencies in its control procedures for its Boka Gold Project which resulted in errors in previously reported assay results. The plaintiffs claim that the defendants negligently or recklessly misrepresented the quantity of gold in the drill samples taken from the Project as well as \$320

million in damages on behalf of class members.

These actions have yet to overcome several procedural hurdles (incorporated into the legislation to curtail the risk of a proliferation of American-style strike suits), including the statutorily required leave motion which requires all such class actions to satisfy a court that the action is being brought in good faith and there is a reasonable possibility of success.

IV – Self-Incrimination and Cross-Border Investigations

Another emerging issue in the securities enforcement arena is the development of an effective framework for the protection of individuals against self-incrimination when compelled by a regulator to give evidence for use in another jurisdiction.

The issue arises particularly in respect of SEC cross-border investigations due to the different constitutional frameworks in Canada and the United States. In Canada, a person who receives a summons issued by the OSC to testify for the purposes of an investigation (for example, pursuant to s. 11(1)(b) of the OSA) may not avoid testifying by invoking the right against self-incrimination. Rather, pursuant to sections 7 and 13 of the *Charter of Rights and Freedoms*, section 5 of the *Canada Evidence Act*, R.S.C. 1985, c. C-5, as amended, and relevant provisions of the provincial evidence act, the compelled individual is required to answer incriminating questions under compulsion, but is protected from any evidence being used to incriminate her or expose her to civil liability in any other proceeding (with the exception of a prosecution for perjury or giving contradictory evidence). Section 17 of the OSA further prevents disclosure of the witness' compelled testimony to any police force or person responsible for the enforcement of criminal law in Canada or

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any other country or jurisdiction, without the consent of the person from whom the evidence was obtained.

In the United States, however, an individual can refuse to answer certain questions by invoking the right against self-incrimination contained in the *Fifth Amendment* to the *US Constitution*. If the *Fifth Amendment* is invoked, an adverse inference may be drawn against the person in a subsequent civil proceeding. If, however, the individual does answer, any evidence given may be used against that person in any subsequent proceeding, criminal or otherwise. Importantly, the SEC appears not to be subject to similar legislative restraints with respect to sharing information with US law enforcement agencies.

It is unclear whether American courts will respect the protections against self-incrimination available to Canadian residents under Canadian law in relation to testimony compelled of them by Canadian securities regulators at the behest of the SEC. Accordingly, there is a risk that disclosure to the SEC of compelled testimony, absent any limitations on how it can be used, could result in its use in a manner that would not be allowed in Canada, and contrary to protections afforded to such individuals under Canadian law.

While the courts have recently expressly recognized that the OSC must protect *Charter* rights of those being investigated under the OSA²⁰ and acknowledged the importance of crafting mechanisms to safeguard the rights of compelled individuals,²¹ an adequate solution, which advances cross-border cooperation yet preserves crucial protections afforded to individuals subject to Canadian compulsion orders, has yet to be found.

V – National Regulator

Efforts to create a single national

securities regulator and harmonized securities regulation throughout Canada which could deal with issues of national concern, eliminate unnecessary delays and costs, and be better placed to enforce investor rights across Canada by concentrating resources, acting more quickly and developing greater expertise, have, unfortunately, once again stalled.

Despite a debate that has been ongoing for over 40 years and recent coaxing by Federal Finance Minister Jim Flaherty, several provinces and territories continue to refuse to embrace the idea of a common regulator.

The provinces, instead, have attempted to harmonize the securities regulatory regime across the country through a so-called passport system, which would preserve the existing securities regulatory landscape (consisting of 13 provincial and territorial securities commission and 13 sets of laws) yet allow market participants to deal with only one regulator by permitting rulings and registrations in one jurisdiction to be recognized by the other commissions.

Disappointed with the lack of progress towards a national securities regulator and “better and more effective enforcement across Canada,” on March 28, 2007, the OSC, arguably Canada’s leading provincial regulator, issued OSC Notice 11-904, providing its reasons for not participating in the second phase of the passport system and for not adopting the Proposed National Instrument 11-102, “Passport System.”

VI – Future Direction

While claims that Canada lacks teeth when it comes to enforcement proceedings and that its legislation fails to provide meaningful rights of recovery to investors continue to be voiced, significant efforts to address these perceived deficiencies continue.

(i) Enforcement

With respect to IMETs, the federal government announced, in its March 2007 budget, that it would increase the funding available from \$30 million to \$40 million a year. The government also announced the appointment of Nick Le Pan, formerly Canada’s superintendent of financial institutions, as a “senior expert adviser” for the purposes of reviewing ways to improve the effectiveness of IMETs.

On September 26, 2007, IMET laid charges in its most high profile case yet. Boaz Manor and Michael Mendelson, both co-founders of Portus Alternative Asset Management, a now defunct Toronto hedge-fund firm which collected approximately \$750 million from 26,000 investors, were charged with multiple counts of fraud, money laundering and possession of property obtained by crime following a two-year investigation by the RCMP and the Ontario Provincial Police (OPP). *The Criminal Code* charges, laid by the RCMP, come with far heavier penalties than the administrative proceedings commenced against the pair by the OSC in October 2005.

While hopes of a national securities regulator remain elusive, the proposed merger of RS and the IDA to consolidate into a new national SRO that will oversee securities industry participants and regulate trading on the equity and fixed income markets is probably a positive step for regulatory enforcement. Among other things, the merger is intended to eliminate regulatory overlap and gaps with the overall purpose of increasing public confidence in the regulatory system.²²

(ii) Civil Liability for Misrepresentations

With respect to the class action regimes, however, it remains to be seen whether the Supreme Court of Canada’s

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decision in *Danier Leather* will have a chilling effect upon future primary market disclosure class actions. While Canada's highest court was clear that investors will be held to the lines drawn within the OSA, which set limits on what an issuer is required to disclose, and that representative plaintiffs may equally be subject to adverse cost consequences when they hope to attain significant personal gain from commencing protracted litigation, Canadian securities regulators and plaintiff lawyers nevertheless see a silver lining – that disclosure requirements under the OSA are not to be subordinated

to the exercise of business judgment by an issuer's management and that the business judgment rule can, therefore, not be used as a shield.

With respect to secondary market liability class actions, all eyes will be watching closely the upcoming certification and leave motions for *IMAX*, *CV Technologies* and *Southwestern*. These motions, which will signal the stringency of review that courts will apply when reviewing the merits as well as the bona fides of a proposed secondary market liability class action in order to determine whether such claims may

proceed to a hearing on their merits, will set the tone for future class actions which are expected to increase in number when the markets becomes less buoyant.

It is clear that concerted efforts are being made throughout Canada to improve securities enforcement and develop a more mature securities regime. How quickly the Canadian system can achieve what could be perceived by all as an appropriate balance between the rights of all parties involved, however, remains to be seen. ■

1. Hon. Peter de C. Cory, C.C. and Marilyn Pilkington, "Critical Issues in Enforcement," volume 6, *The Task Force to Modernize Securities Legislation in Canada*, October 2006, p. 171.
2. *R. v. Rankin*, [2006] O.J. No. 4579 (Ont. S.C.J.)
3. *R. v. Rankin*, [2007] O.J. No. 719 (Ont. C.A.)
4. *R. v. Felderhof*, [2007] O.J. No. 2974 (Ont. S.C.J.)
5. *ATI Technologies Inc. (Re)*, (2005), 28 O.S.C.B. 8558 (O.S.C.). It should be noted, however, that other respondents involved in the case settled with the OSC and admitted wrongdoing such as ATI itself as well as several key ATI directors and employees.
Julian Beltrame, "Flaherty wants stock safeguards; Canada's failure to catch white-collar criminal an international 'embarrassment,' finance minister says," *The Toronto Star*, Business Section, August 3, 2007, p. B01
6. U.S. Securities and Exchange Commission, "Nortel Networks Pays \$35 Million to Settle Financial Fraud Charges," Press Release, October 16, 2007, <http://www.sec.gov/news/press/2007/2007-217.htm> (last accessed: October 16, 2007)
Janet McFarland, "IMET's done 'almost nothing,' so let's start over, BCSC says," *The Globe and Mail*, Report on Business, 20 September 2007, p. B3
7. Janet McFarland, "RCMP securities unit wants enhanced power; Seeking legal tools to compel testimony," *The Globe and Mail*, Report on Business, 24 February 2007, p. B3
8. [2007] S.J. No. 292 (Sask. C.A.)
9. 2007 BCSECCOM 262 (B.C.S.C.)
(2007), 30 O.S.C.B. 4739 (O.S.C.)
10. In the Matter of Northern Securities Inc., Victor Alboini and Christopher Shaule (No. 2005-012) dated October 20, 2005
11. *Kerr v. Danier Leather Inc.*, [2004] O.J. No. 1916 (Ont. S.C.J.)
12. *Kerr v. Danier Leather Inc.*, [2005] O.J. No. 5388 (Ont. C.A.)
13. *Kerr v. Danier Leather Inc.*, [2007] S.C.J. No. 44 (S.C.C.)
14. *Ibid*, para. 43.
15. Ontario was the first jurisdiction to pass such legislation through Bill 198, An Act to implement Budget measures and other initiatives of the Government, 3rd Sess., 37th Parl., Ontario, 2002, cls. 190-202. Bill 198 received Royal Assent in December 2002, however, it was not until August 2005 that it was announced that the secondary market disclosure portions of the bill related to secondary market liability would be proclaimed in force on December 31, 2005. Similar legislation has now been enacted in Alberta and Manitoba, and is being considered by several other provinces.
16. Ontario Securities Act, R.S.O. 1990, c. S. 5, s. 138.8(1) ("Leave to proceed")
17. *A. v. Ontario Securities Commission*, [2006] O.J. No. 1768 (Ont. S.C.J.) at para. 57.
18. *Catalyst Fund General I Inc. v. Hollinger Inc.*, [2005] O.J. No. 2191 (Ont. S.C.J.) at paras. 80 and 99-100.
19. Speech of Susan Wolburgh Jenah (Incoming President and CEO, IDA), "Regulation in Canada: the Changing Landscape," in *Financial News: Institutional Trading Forum 2007* dated March 29, 2007, p. 7.
20. Jacquie McNish, "Paragraph 55: 'Good news... for investors,'" *The Globe and Mail*, Report on Business, October 17, 2007, p. B8.

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