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SISKINDS | THE LAW FIRM

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December 7, 2014

Dear Sirs/Mesdames:

Re: Cooperative Capital Markets Regulatory System – Draft *Capital Markets Act* and *Capital Markets Stability Act*

We are pleased to offer our comments on the draft uniform provincial *Capital Markets Act* (the "***CMA***") and the complementary draft federal *Capital Markets Stability Act*.

By way of introduction, Siskinds LLP is one of the leading plaintiff securities class action firms in Canada. We have substantial experience litigating class actions asserting the rights of action under Parts XXIII and XXIII.1 of the Ontario *Securities Act* (the "***OSA***") (which are equivalent to Parts 12 and 13 of the *CMA*). Since 2004, we have been plaintiffs' counsel in 47 such actions. Through this experience, we have developed a comprehensive understanding of the positive and negative aspects of the existing civil liability regime from the perspective of investors.

In light of our specific expertise, and given the breadth and complexity of the proposed capital markets legislation, we will focus our comments on the civil liability provisions of the *CMA* and other aspects of the draft legislation that could affect the operation of the civil liability provisions.

We may have additional comments after we have had an opportunity to review the draft regulations, which we understand will be released for public comment in early 2015.

We are also interested in reviewing the proposed transitional provisions to understand how the enactment of the *CMA* will impact existing actions asserting claims under Parts XXIII and XXIII.1 of the *OSA*, as well as actions commenced after the enactment of the *CMA* where the impugned conduct occurred prior to the enactment of the *CMA*. We expect that there will be no prejudice to the rights of investors in such actions as a result of the transition to the cooperative system. We welcome the opportunity to comment on the transitional provisions to ensure that there are no unintended consequences that may be harmful to investors' rights.

Based on our review of the draft legislation, it is our general impression that the civil liability provisions contained in Parts 12 and 13 of the *CMA* are reasonably closely modelled on Parts XXIII and XXIII.1 of the *OSA*. To the extent that there have been departures from the *OSA* civil liability regime, we view some of the changes as being positive for investors.

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We are especially encouraged by the amendments to the right of action for damages in respect of insider trading in section 129 of the *CMA* (and related changes to the prohibitions in section 66 of the *CMA*). Insider trading is a serious problem in the Canadian capital markets.[1] However, the burden of policing this misconduct has fallen almost exclusively on the shoulders of the regulators because of impediments to advancing civil claims caused by the significant limitations built into the right of action under section 134 of the *OSA*. In particular, section 134 of the *OSA* appears to require privity between the plaintiff and the defendant. In many cases, particularly in cases involving open-market purchases, proving the requisite privity between the plaintiff and the defendant constitutes an insurmountable obstacle because an individual trading over an anonymous stock exchange cannot ascertain, on the basis of publicly available information, the identity of the person on the other side of the trade. Section 129(1) of the *CMA* appears to address this important problem directly by eliminating the privity requirement. We view this as a very significant improvement in investor protection. Finally, we urge you to introduce joint and several liability in respect of defendants' liability under section 129, consistent with the approach to the rights of action under sections 117, 118, 120 and 122 of the *CMA*.

Although modelling the civil liability provisions of the *CMA* on the analogous provisions of the *OSA* will ensure a degree of continuity to the prosecution of civil actions in this area, it does have the effect of perpetuating a number of defects in the civil liability provisions of the *OSA*. We have identified these as material issues through our experience in litigating cases under Parts XXIII and XXIII.1 of the *OSA*. In our view, these deficiencies undermine the investor protection objective of the civil remedies and should be remedied. We encourage you to take this unique opportunity during the transition process to rectify the defects.

Based on our experience, there are four material defects in the *OSA* civil liability regime that have been replicated in the *CMA* that we believe deserve reconsideration, namely:

1. *Limitation periods*:

   Sections 146 and 171 of the *CMA* maintain the limitation periods set out in sections 138 and 138.14 of the *OSA*. These provisions essentially impose an ultimate limitation

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1 See, for example, "A Cure for Insider Trading?", *Mining Markets*, March 14, 2011, at http://www.miningmarkets.ca/news/a-cure-for-insider-trading/1000404812/?&er=NA.

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period of 3 years from the date of the misleading disclosure and there is no discoverability principle built into the limitation periods.[2]

The limitation periods are unduly harsh to investors. The absence of a discoverability principle in sections 146 and 171 of the *CMA* would cause injustice to investor plaintiffs. We know from experience that the analogous limitation periods in the *OSA* result in cases being circumscribed or not brought at all, thereby depriving investors of the right to seek recovery for losses that they sustain. If an issuer fails to discover and publicly correct a misrepresentation in a disclosure document – or worse, intentionally withholds corrective disclosure after discovering the existence of a misrepresentation – until three years after the misrepresentation was made, investors will, through no fault of their own, have no recourse against the culpable parties under the statute.

There is no persuasive justification for departing from the basic approach to limitation periods under the Ontario *Limitations Act, 2002* (and other provincial limitations statutes), which provides for a basic limitation period of two years post-discoverability and an ultimate limitation period of 15 years from the date of the relevant act or omission. The scheme set out in *Limitations Act, 2002* strikes a proper balance between the rights of plaintiffs and defendants.

We encourage you to amend the limitation periods in sections 146 and 171 of the *CMA* to lengthen the ultimate limitation period and to incorporate a discoverability principle, consistent with the *Limitations Act, 2002*. Taking away a plaintiff's right to seek damages before he or she is even aware of the entitlement to do so does not comport with basic notions of justice and fairness.

2. *Damages in secondary market actions*:

Consistent with section 138.5 of the *OSA*, section 163 of the *CMA* prescribes formulas for the presumptive assessment of damages in secondary market cases. Section 163(3) of the *CMA* confers on the defendant the ability to reduce damages by an amount that "is attributable to a change in the market price of securities that is unrelated to the misrepresentation or the failure to make timely disclosure." No corresponding right is given to the plaintiff to show that the plaintiffs' damages exceed the amount generated by applying the formulas in sections 163(1) and (2) of the *CMA*. To take an example that we have encountered repeatedly in our practice, an issuer might reveal,

2 We acknowledge that discoverability is built into section 146(b)(i) of the *CMA*, but that can only operate to *reduce* the limitation period below the three years under section 146(b)(ii).

contemporaneously with a corrective disclosure, materially positive information that is unrelated to the misrepresentation (e.g. an increase in a dividend or financial results that exceed market expectations). In such cases where there is "confounding news", the positive information could dampen the effect of the negative information on the issuer's stock price, and present a false picture of the degree to which the stock price was inflated by the misrepresentation. This would reduce or perhaps eliminate altogether recoverable damages under the formulas prescribed in sections 163(1) and (2) of the *CMA*. As currently drafted, the plaintiffs would have no opportunity to prove that the change in the market price of securities would have been greater had the unrelated, materially positive information not been released contemporaneously with the corrective disclosure. Defendants and plaintiffs should have corresponding rights to establish that the presumptive damages generated by the formulas may be too little or too great depending on the effect of confounding information.

There are other aspects of the damages provisions in section 163 of the *CMA* that are likely to lead to unintended results. Taking the example of a plaintiff who acquires an issuer's security after a misrepresentation is made, if the issuer's stock price subsequently appreciates prior to the corrective disclosure in such a way that the issuer's post-correction stock price[3] is higher than the plaintiff's purchase price, that plaintiff will have no damages under the formula in section 163(1) of the *CMA*. That arithmetic result fails to account for the fact that the plaintiff purchased securities at a time when the issuer's stock price was artificially inflated by the misrepresentation. Problems of that nature might also be addressed by affording equal rights to defendants and plaintiffs under section 163(3) to prove that the presumptive damages generated by the formulas may be too little or too great depending on the effect of confounding information, as discussed above.

Finally, we note in respect of the damages provisions that there is no definition of "published market" in the *CMA* even though that term is used in various places.

3. *Liability limits in secondary market actions*:

We recognize that the liability limits set out in section 165(1) of the *CMA* are viewed by some as an important tool for protecting the interests of issuers and their long-term securityholders. However, there are a number of aspects of the liability limits that we believe undermine the purpose of Part 13 of the *CMA* and require modification.

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3 In the ten trading days after the public correction of the misrepresentation.

First, the monetary liability limits in section 165(1) of the *CMA* have not changed since they were first proposed in the Interim Allen Report released in 1995, which was an important step in the process of introducing a secondary market liability regime in Canada.[4] The monetary liability limits should at least be adjusted periodically for inflation. The failure to do so amounts, over time, to an effective reduction in the liability limits.

Second, the liability limit for responsible issuers of the greater of $1 million and 5% of the issuer's market capitalization (which applies even in cases of fraud) has the effect of immunizing small-cap issuers from liability for misrepresentations in their continuous disclosure. The median and average market capitalization of issuers listed on the TSX Venture Exchange are $2.5 million and $15.5 million, respectively.[5] With a market capitalization at those levels, a cap on recovery fixed at 5% of the issuer's market capitalization means that, in most secondary market cases against issuers listed on the TSX Venture Exchange, it will be uneconomical to pursue a remedy on behalf of investors. That is highly troubling given the reality that the risk of fraud appears to be higher with venture issuers.[6] There needs to be some modification of the liability limits for issuers with a relatively low market capitalization to ensure that, with respect to such issuers, the secondary market liability regime achieves its "twin goals of a) facilitating and enhancing access to justice for investors, and b) deterring corporate misconduct and negligence."[7] That could be achieved by increasing the percentage from 5% where the issuer's market capitalization is below a specific threshold, and increasing substantially the liability limits for officers and directors of these issuers.

Third, the liability limit for experts of the greater of $1 million and the revenues earned by the expert from the issuer over a 12-month period is unreasonably low (even if adjusted for inflation). That is particularly true for auditors. The Canadian arms of the "big four" accounting firms audit almost 60% of all reporting issuers, representing more than 90% of Canada's market capitalization.[8] In 2013, those four Canadian firms

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4 Toronto Stock Exchange, Committee on Corporate Disclosure, *Interim Report: Toward Improved Disclosure – A Search for Balance in Corporate Disclosure* (Chair T.I.A. Allen, Toronto: 1995) ("Interim Allen Report") at pgs 78-79.

5 See http://www.tmx.com/en/pdf/Guide_to_Listing.pdf at pg 5.

6 See, for example, Douglas Cumming and Sofia Johan, "Listing Standards and Fraud" (2013) 34 Managerial and Decision Economics 451.

7 *Green v Canadian Imperial Bank of Commerce*, [2014] OJ no 419 at para 36 (CA).

8 See http://www.cpab-ccrc.ca/Documents/Topics/Public%20Reports/CPAB_2014_PublicReport_EN_FNL.pdf at pg 2.

collectively earned revenues of over $5 billion.[9] Given the financial capacity of the "big four" Canadian auditing firms and the difficulty faced by plaintiffs in proving that auditors acted fraudulently so as to lift the damages cap, the secondary market liability regime has little or no deterrent impact on auditing firms. Given the critical role of auditors and other experts as gatekeepers, the liability limit applicable to experts must be increased. Finally, we note that imposing liability on auditors and other third party experts for their culpable misrepresentations does not result in a cost to the long-term securityholders of the issuer, and the rationale for limiting the liability of the issuer has no application to the liability of auditors and other third-party experts.

4. *Ability to sue underwriters for offering memorandum misrepresentations*:

   We assume that the right of action for damages or rescission under section 122 of the *CMA* will be extended to offering memoranda. We agree with the decision to broaden this right of action beyond the comparable right of action in section 130.1 of the *OSA*, to include directors and signatories as potential defendants. In doing so, the right of action in respect of offering memorandum misrepresentations has been brought closer into line with the prospectus right of action in section 117 of the *CMA*. However, there remains a material gap between the two rights of action; namely that the right of action under section 122 is not available against underwriters involved in the private placement distribution whereas there is a right of action against underwriters in a prospectus offering. In both the prospectus and the private placement context, underwriters are properly treated as "gatekeepers" and should be subject to liability if they fail to satisfy their due diligence obligations. Under the proposed regime, underwriters will continue to extract substantial fees from their underwriting work in the private placement context, but will be immunized from statutory liability. In our view, there is no justification for the preferential treatment of underwriters in the private placement context.

There are also new aspects of the *CMA* that are different from the *OSA* model, which we believe are problematic, namely:

1. *Amendment of the statutory purposes*:

   Section 1 of the *CMA* expresses the purposes of the statute as follows:

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9 See http://www.thebottomlinenews.ca/documents/Canadas_Accounting_Top_30.pdf at pg 13.

> The purposes of this Act are, as part of Canadian capital markets regulatory framework, to provide protection to investors from unfair, improper and fraudulent practices, to foster fair, efficient **and competitive** capital markets in which the public has confidence **and to contribute to the stability and integrity of the Canadian financial system**.

[Emphasis added.]

This is to be contrasted with section 1.1 of the *OSA*, which provides:

> The purposes of this Act are,
>
> (a) to provide protection to investors from unfair, improper or fraudulent practices; and
>
> (b) to foster fair and efficient capital markets and confidence in capital markets.

We have concerns that the introduction of concepts of competitive capital markets and financial system stability as guiding principles in the interpretation of securities legislation may have unintended consequences.

Investor protection, capital markets fairness and efficiency, and confidence in our capital markets are, for the most part, complimentary concepts and have worked well as the various securities regulators and the courts have interpreted our securities legislation. As noted by the Supreme Court of Canada in *Pezim*, investor protection is the primary goal of Canadian securities legislation:[10]

> It is important to note from the outset that the Act is regulatory in nature. In fact, it is part of a much larger framework which regulates the securities industry throughout Canada. Its primary goal is the protection of the investor but other goals include capital market efficiency and ensuring public confidence in the system […]

The *CMA* introduces two new guiding principles of interpretation: "competitive capital markets" and "stability and integrity of the Canadian financial system".

While competition in the capital markets and the stability of the financial system may be laudable goals, one can easily imagine situations where they are at odds with the primary goal of investor protection.

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10 *Pezim v British Columbia (Superintendent of Brokers)*, [1994] 2 SCR 557 at para 59 (SCC).

The notion of "competitive capital markets" is subjective. To some, any government regulation is anathema to competition, and if the expense of regulation could be eliminated, then issuers would be better able to compete with those in other jurisdictions having minimal or only perfunctory securities regulation. Indeed, so these "no-regulation" proponents would argue, we would attract issuers into our capital markets from other jurisdictions having a more onerous regulatory burden.

The problem with this approach to securities regulation is that it encourages a "race to the bottom" at the expense of what have long been the cornerstones of securities regulation in this country; namely, investor protection, transparency and capital markets integrity.

In our view, a more robust regulatory environment predicated on a commitment to investor protection, transparency and integrity, will attract investment capital, not discourage it.

The introduction of financial system stability as a purpose of the *CMA* creates two problems, as we see it.

First, the concept of "stability […] of the Canadian financial system" is very broad, including (among other things) the banking sector. This goes well beyond securities law, and we query whether the Chief Regulator and the various provincial deputies will have the expertise to meaningfully consider financial system stability.

Second, it entrenches statutorily the concept that certain capital market participants are "too big to fail" or "too big to prosecute." This is particularly problematic in Canada's capital markets which are dominated by very large financial institutions. One can imagine a scenario whereby a major Canadian financial institution that has engaged in serious misconduct would argue that any meaningful enforcement action against it would have a destabilizing effect on the Canadian financial system. One need only look at the experience in the United States in the wake of the recent financial crisis to understand that such a scenario may occur. Concerns about the stability of the U.S. financial system have repeatedly been invoked to justify weak or no regulatory action against large U.S. financial institutions and their executives that have engaged in serious capital market misconduct.[11] If financial system stability is a guiding principle

11 See the work of Professor William Black, Associate Professor of Economics and Law at the University of Missouri-Kansas City School of Law, and Professor Simon Johnson, the Ronald A. Kurtz (1954) Professor of Entrepreneurship at the MIT Sloan School of Management. Both have comprehensively criticized the "too big to fail" and "too big to jail"

of interpretation of the *CMA*, one can expect that investor protection and capital markets integrity will necessary be subordinated when the regulation of major financial institutions or other senior capital markets participants are in play.

In our view, the existing purposes of securities legislation as set out in section 1.1 of the *OSA* are well understood by capital markets participants, securities regulators and the courts. The proposed change to include concepts of competition and financial system stability would undermine the primary goal of securities regulation, which is investor protection.

2. *Definition of "court"*:

In section 2 of the *CMA*, a general definition of "court" has been introduced. It is defined to mean "the superior court of **the** province" (emphasis added). It applies to the various references to "court" in Parts 12 and 13 of the *CMA*, including in the secondary market leave provision in section 166(1) and (2) of the *CMA*. While the definition is somewhat ambiguous, if the intention was to confer exclusive jurisdiction on the superior court of each participating province in respect of claims under that province's civil liability regime, we strongly recommend that this be abandoned.

It is typical in class actions asserting claims under Parts XXIII and XXIII.1 of the *OSA* to also assert claims under the analogous provisions of the securities legislation of the other Canadian provinces. That is necessary because some defendants have argued that only persons who reside or transact in a certain province may avail themselves of the civil rights of action in that province's securities legislation. Given the similarity of the liability regimes in the securities legislation of the provinces, there is no real concern about having a court in any of those provinces adjudicate claims under the comparable provisions of the different provincial statutes. Further, the approach taken in cases to date is eminently sensible from the perspective of efficiency and judicial economy in that it avoids the need for the same claims to be litigated separately in each province.

If the proposed definition of "court" in the *CMA* is intended to confer exclusive jurisdiction on the courts of the participating provinces in relation to their respective statutes, that will lead to undesirable consequences. If parallel actions must be commenced in multiple provinces, there is a real risk of inconsistent judicial decisions arising from the multiplicity of proceedings, as well as there being an unnecessary

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phenomena in the United States, and commented that, contrary to the arguments of Wall Street, those concepts are in fact inimical to financial system stability.

waste of the finite resources of the parties and the courts. Alternatively, it may be necessary to exclude certain investors from the litigation because it would not be economically feasible to pursue an action in the province where those investors are located. The approach also runs counter to the spirit and intent of the cooperative system. In our view, this problem could be remedied by simply changing the definition of "court" to: "the superior court of **a** province" (emphasis added).

We urge you to reconsider this aspect of the *CMA* as it relates to the civil liability provisions of the statute.

Thank you for your consideration of our comments.

Yours truly,

Siskinds LLP

Per:

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