New Concepts for Securities Regulation

February 18, 2002

A NEW WAY TO REGULATE

BCSC BRITISH COLUMBIA SECURITIES COMMISSION

Table of Contents

Page

Executive Summary **4**

Concept 1: The Continuous Market Access System **11**

Summary of the Concept 11
Details of the Concept 13
The CMA system 13
Unlisted issuers 19
Registration exemptions 19
Foreign-regulated issuers 20
Civil remedies 23
Escrow 23
Advertising 24
Advantages of the Concept 25
Questions 25

Concept 2: A Simpler Registration System **26**

Summary of the Concept 26
Details of the Concept 27
Code of conduct 27
Registration “passport” 29
Registration of individuals 30
Foreign registrants 32
Civil remedies for investors and enhanced public interest powers 33
Advantages of the Concept 34
Questions 34

Concept 3: A Better Mutual Funds Regime 35

The Current System 36
Summary of the Concept 37
Details of the Concept 37
Code of conduct 37
Prospectus requirements 38
Continuous disclosure 39
Foreign mutual funds 39
Civil remedies for investors 40
Advantages of the Concept 40
Questions 41

Table of Contents (cont'd)

Page

Concept 4: Trade Disclosure 42

Summary of the Concept 42
Details of the Concept 43
Insiders 43
Significant shareholders 44
Control persons 45
Issuers and registrants 46
Civil liability 46
Advantages of the Concept 46
Questions 47

Concept 5: New Enforcement and Public Interest Powers **48**

Summary of the Concept 48
Details of the Concept 48
Disgorgement and restitution 48
Professionals 49
Commission compliance or restraining orders 50
Prohibition on unfair practices 50
Advantages of the Concept 51
Questions 51

Concept 6: New Civil Remedies for Investors **52**

Summary of the Concept 52
Details of the Concept 53
Actions for misrepresentations 53
Actions against dealers and their directors and officers 55
Actions for insider trading 56
Actions for fraud and market manipulation 57
Actions for unfair practices 57
The class action regime 58
Protections for defendants 58
Advantages of the Concept 59
Questions 60

Executive Summary

The British Columbia Securities Commission Deregulation Project is reviewing securities legislation, rules and other instruments to ensure our system of regulation is as efficient and effective as possible. The Canadian Securities Administrators' (CSA) Uniform Securities Law Project is creating a uniform securities act and set of rules for adoption throughout Canada.

The Uniform Securities Law Project provides an opportunity to do two things that would substantially improve the efficiency and competitiveness of Canada's securities markets. We can both eliminate the vexing differences among securities legislation in different provinces, and simplify and update a system of regulation that has grown too complex and has failed to keep pace with a rapidly changing market.

This paper contains six concepts that the BC Securities Commission believes hold significant potential for improving the efficiency and effectiveness of securities regulation in Canada. We are publishing them in concept form for further research and study, including consultations with industry, our fellow regulators, self-regulatory organizations (SROs), and other stakeholders.

A New Approach to Regulation

The concepts reflect a new approach to securities regulation. That approach can be summarized in five points:

1. Keep the right balance between regulatory restrictions and market freedom.
2. Make the rules as simple and clear as possible.
3. Foster a culture of compliance in industry.
4. Act decisively against misconduct.
5. Equip investors with effective self-protection tools.

Keep the right balance

Securities regulation exists to protect investors and ensure the integrity of our capital markets. Regulators recognize, however, that regulation cannot be so rigorous that the markets can no longer function. To be effective, the regulator must strike the right balance between over-regulation, which can drive away business and stifle innovation, and lax regulation, which can leave cheating unchecked and damage confidence in the fairness and efficiency of the market.

We think the appropriate balance is reached if securities regulation imposes the minimum burden on industry necessary to maintain investor protection and market integrity. The regulatory burden takes many forms but boils down to cost and delay.

Criticism from industry about the cost of regulation is becoming more frequent and more insistent. Much of this criticism is focused on the lack of uniformity among provincial securities laws. This is certainly part of the problem, which is why CSA is working to create a set of uniform securities laws for the country.

The main problem, however, is the extent and complexity of the rules. In the past 10 years, the volume of regulation has increased by about 65%. In the past five years, compliance costs have doubled for junior issuers. In the same time frame, uniformity among securities laws has increased, not decreased, so it appears that the main culprit is not lack of uniformity, but the volume and complexity of the rules.

Of course, industry must accept some burden if investors are to be protected. However, rule-making is not always the best solution to a problem; it is a relatively ineffective tool, for example, for protecting investors who are reckless or gullible. Nor do rules help much in stopping deliberate fraud and misrepresentation. Other regulatory tools, such as investor education, compliance reviews, and enforcement action are more effective for these purposes.

An effective system of regulation must hold issuers and registrants accountable, but should also rely on investors to take reasonable care in making their investment decisions.

Maintaining market integrity is the core objective of securities regulation. If securities markets achieved this objective on their own, regulation would be unnecessary. Regulation is needed because securities markets are vulnerable to abusive and unfair practices, but the system should reflect most market participants' interest in preserving a market that is transparent, liquid, efficient and free of widespread abuse.

Make the rules simple and clear

The key here is to apply risk-management principles to regulation so that we deal with the most important threats to investor protection and market integrity. The first steps are to define the problem and understand how to measure a successful solution. The next steps are to identify solutions and implement them, using a variety of regulatory tools.

There are several regulatory tools available to us – rule making, policy guidance, enforcement, compliance reviews, industry education, and investor education. In the past, we have tended to look first to rules to solve problems, but sometimes other tools are more effective (for example, enforcing existing rules).

We should make new rules only if the benefits clearly outweigh the costs and burdens of compliance, and existing rules should be reviewed regularly to ensure this balance still holds.

When rules are necessary, they should be written so that industry can understand them. Many of our existing rules are so complex that industry needs professional assistance even for routine compliance matters. Part of this complexity comes from the detailed and prescriptive approach in many rules.

Prescriptive requirements are often counterproductive. They encourage market participants to focus on the details of compliance instead of exercising their judgment with their broader obligations to their clients and the market in mind. These kinds of requirements also calcify the regulatory system to reflect industry practice at a point in time. The more detailed the regulation, the less easily it can adapt to changing industry conditions.

This produces two problems: new developments that should be regulated are not (because the existing requirements are too narrowly defined), and new developments that should be left unregulated are hindered (because detailed prohibitions cover conduct that was never intended to be caught).

To avoid these problems, we should, where possible, impose general obligations instead of specific ones. This encourages market participants to consider the purpose of the rules, and their context within the objectives of securities regulation, in making compliance decisions. It also fosters a more flexible and sustainable regulatory system.

Obviously we must strike a balance. Industry complains about the volume and complexity of the rules and yet wants guidance on regulatory expectations so that it has reasonable certainty on compliance issues. Prescription to some degree for this purpose makes sense.

Foster a culture of compliance

Most market participants want to comply, and do comply, with the rules, but the number and complexity of the rules are both on the increase. Requirements change frequently. As a result, it is difficult for industry to comply and difficult for regulators to monitor and enforce compliance.

Regulation is most effective when the regulated community is motivated to comply. We need to pursue a variety of initiatives, both cooperative and punitive, to create a universal acceptance in industry that compliance with the rules is a basic corporate responsibility.

The concepts in this paper are designed to minimize the regulatory impact on those with a positive attitude to compliance, to encourage registrants and issuers to act responsibly, and to see they are held accountable if they do not. Simplifying the rules and increasing accountability both serve to improve compliance and the effectiveness of the system.

Act decisively against misconduct

If the rules are relatively few, easily understood, and well communicated, compliance will increase. Registrants and issuers have significant responsibilities that they must meet if investors are to be protected and market integrity maintained.

Those who choose to act in ways that cheat investors and threaten the integrity of our markets must understand they will be held accountable through enforcement action by regulators and civil action by investors.

Equip investors

Investors must be equipped with both preventative and remedial tools. The rules must ensure that investors get the disclosure they need and can rely on a system of registration to get suitability advice (unless they consciously choose not to get advice). Investors can then be expected to use the protection the system offers by reading disclosure and seeking advice (if they need it) from registrants. This, in combination with effective investor education programs, will help investors avoid ill-advised investment decisions.

Investors also need meaningful remedies when things go wrong. The concepts include ideas to improve investor remedies.

The Concepts

Concept 1 – The Continuous Market Access System

This concept would replace the prospectus system.

To enter the Continuous Market Access System (CMA), an issuer would file an entry document that would be similar to a prospectus, but with less mandated disclosure. Issuers would be required to disclose all material facts, but would have much more flexibility about what to disclose. Existing reporting issuers would automatically be CMA issuers.

Once in the system, an issuer would have to comply with an enhanced continuous disclosure regime that would require up to date, or "evergreen", disclosure of all material facts.

A CMA issuer could sell securities at any time based on its continuous disclosure record. The only regulatory requirement would be to file a press release announcing the offering. No form of offering document would be mandated; issuers and underwriters could produce an offering document with meaningful information for investors tailored to the needs of the market. Civil liability would attach to the continuous disclosure record and to any offering document prepared.

Since there would be no prospectus requirement, prospectus exemptions would disappear; hold periods and resale restrictions would remain only for restricted (non-CMA) issuers. The registration exemptions would be significantly simplified.

Issuers that are subject to a credible system of foreign regulation could enter CMA. Both approved foreign issuers and Canadian-based, foreign-regulated issuers, could comply with CMA's continuous disclosure requirements by using documents required by the foreign system, if certain conditions were met.

Concept 2 – A Simpler Registration System

This concept would replace many detailed, prescriptive registration rules with a code of conduct. The code would state general principles about registrant qualification, proficiency, character and behaviour. It would be accompanied by a policy or similar interpretive document to provide guidance to industry on the application of the code. Registrants would be liable to investors if the code were not followed.

A principled code of conduct approach would encourage securities firms to consider their broader obligations to their clients and the market. They would be held accountable if they did not.

We currently require those who sell securities to be registered in each province where they do business. The concept would allow a person registered in one Canadian jurisdiction to do business across Canada, easing some of the current regulatory burden on registrants. Securities commissions would administer this national regime through a mutual reliance approach.

We wonder whether we really need to register individuals. If we did not, we would continue to register firms and require that employees be qualified, proficient and ethical, but firms, through the code of conduct, would be responsible for ensuring these requirements are met. Firms would be accountable to regulators and absolutely liable to investors for any wrongdoing by their employees. We think this accountability and potential liability would motivate firms to scrutinize potential employees carefully.

The concept also considers whether foreign registrants that advise or open accounts for Canadians without soliciting their business should be exempt from our registration rules. This would allow Canadians complete freedom to seek the advice of foreign registrants on an unsolicited basis. (A foreign registrant soliciting business from Canadians would be subject to the usual registration requirements.)

Concept 3 – A Better Mutual Funds Regime

Under this concept, we would adopt a code of conduct approach similar to the one described under Concept 2. It would replace many of the current prescriptive requirements for conflicts of interest and sales practices. Mutual fund managers, portfolio managers, distributors and dealers would be subject to the code.

The concept considers whether mutual fund prospectuses are still necessary. Through past surveys, we learned that investors did not read mutual fund prospectuses and relied solely on their advisers when making investment decisions. Two years have passed since we implemented a new mutual fund prospectus regime in response to these comments. We believe it is time to re-survey investors to see if their use of mutual fund prospectuses has changed.

If we learn that the prospectus is still not meaningful to investors, we would consider eliminating the prospectus requirement. Full disclosure would be available on the internet for those who want it.

The concept would also enhance current continuous disclosure requirements for mutual funds, and require evergreen disclosure of significant changes, so that investors receive the information they need to adequately assess the performance of their investments.

Concept 4 – Trade Disclosure

We currently require some investors to disclose when they buy or sell securities. The disclosure obligations differ depending on the investor category. The concept would change the existing regimes so that the requirements match the market's need for information.

First, insiders would be defined in terms of their access to material non-public information, rather than title or salary.

Second, the concept would replace the existing early warning reporting system with a “significant shareholder” reporting regime. Control persons and shareholders with 10% or more of an issuer’s outstanding shares would be “significant shareholders” and would have to:

- report when their holdings reach 10% (as at present), and
- report both cumulative purchases and sales of 2% blocks (at present, only purchases are reported).

Disclosure would be made by press release. A significant shareholder that was also an insider (for example, a director) would report trades under both this and the insider reporting regimes.

The current reporting system for eligible institutional investors would be maintained.

The concept questions whether the current advance notice requirement for control persons gives the market meaningful information. If not, this requirement could be eliminated.

The concept would require issuers to make their insiders aware of their reporting obligations, to monitor compliance, and to file an evergreen list of insiders. When preparing for major transactions, issuers and registrants would have to keep a record of those with access to material non-public information about the transaction. The issuer would have to monitor trading in its securities until the transaction was announced and report anomalies to the appropriate exchange or other regulator.

Concept 5 – New Enforcement and Public Interest Powers

The concept considers giving securities commissions the ability to order that persons who breach securities law must disgorge their profits, or make restitution to those they have harmed.

The concept considers giving commissions the power to order that a professional could not appear before them or prepare documents filed with them on the basis of gross incompetence or egregious conduct.

Anyone could apply to a commission for a compliance or restraining order if the person could show a breach of securities law was imminent or in progress.

The concept would prohibit market participants from engaging in unfair practices, such as high-pressure sales tactics, whether or not they rise to the level of fraud.

Concept 6 – New Civil Remedies for Investors

This concept would significantly expand investors’ ability to sue market participants who break the rules.

Investors could sue:

- issuers who make misrepresentations or who do not keep their continuous disclosure record up to date and accurate,
- registrants and others who do not comply with the applicable code of conduct,
- people who trade illegally on inside information, and
- anyone who commits fraud or market manipulation or uses unfair practices.

A class-action regime tailor-made for these actions would be included in the legislation.

Defendants would have due diligence and other defences and appropriate procedural protections.

The Consultation Process

We developed these concepts by asking ourselves how effectively our current system of regulation deals with today's threats to investor protection and market integrity. It is now time to ask industry, investors, and our fellow regulators about their views on the concepts. We will be actively consulting with interested individuals and groups across the country over the next few months to find out their views. We will then use that feedback in working with our CSA colleagues to make our system of regulation both uniform and more effective, efficient and adaptable.

We are interested in your comments on all aspects of these concepts, but we draw your attention in particular to the questions that follow each concept.

Concept 1

The Continuous Market Access System

Under the existing system, an issuer cannot sell securities without a prospectus. The prospectus must contain full, true and plain disclosure of all material facts. An issuer must file a prospectus in a prescribed form, which requires information in addition to the material facts. The issuer cannot distribute securities until securities commissions review the prospectus and, once satisfied, give the issuer a receipt.

An issuer may sell securities without a prospectus under an exemption in situations where it is considered that investors, generally because of relationship, investment acumen, or financial status, do not need a prospectus. Securities acquired under exemptions are subject to hold periods and other restrictions before they can be freely traded in the public market. These restrictions are referred to as the closed system.

Summary of the Concept

1. The Continuous Market Access System (CMA) would replace the prospectus system for distributing securities. It would allow issuers to issue securities at any time, as long as they maintain an up to date, or "evergreen", continuous disclosure record. (For Canadian issuers who use the Multijurisdictional Disclosure System (MJDS) to offer securities into the United States, we would preserve a prospectus alternative with Canadian regulatory review.)

2. To enter CMA, the issuer would file an entry document disclosing all material facts concerning the issuer. (Issuers that are reporting issuers under our current system would be automatically included in CMA.) The entry document form would mandate some disclosure items and provide guidance on structure and content, but would not prescribe as much detailed disclosure as the current long form prospectus.

3. All CMA issuers would operate under a continuous disclosure system requiring the issuer to maintain an evergreen public disclosure record of all material facts.

4. A CMA issuer wishing to issue securities would issue and file a press release announcing the offering. There would be no other pre-distribution filing requirements and no prescribed offering documents. This would allow CMA issuers and their underwriters to tailor offering documents to the needs of the market.

5. Whether an issuer would be required to use a due diligence provider would depend on whether the issuer was listed or unlisted.

6. Under CMA there would be no prospectus requirement, so there would be no prospectus exemptions, nor would there be any resale restrictions on the securities of CMA issuers – for these issuers, the closed system would disappear.

7. CMA issuers would be subject to an appropriate continuous disclosure review program.

8. Restricted issuers could only issue securities to certain classes of purchasers. Resale of these securities would be restricted until the issuer entered the CMA system. The regime for restricted issuers would be based on the proposed BC and Alberta capital raising exemption rules.

9. A CMA issuer would not be required to be listed on a stock exchange.

10. The registration requirement would remain under CMA. Registration exemptions would still be necessary, but they would be simplified.

11. Issuers regulated in countries with mature market-based economies would have freer access to our markets.

12. New rights for investors, whether they buy securities in an offering, the secondary market or the exempt market, would allow them to sue the issuer and its directors and officers for misrepresentations in any public disclosure. Investors who buy securities in an offering where there is an underwriter could also sue the underwriter for misrepresentations in the offering document or the issuer's continuous disclosure record as it stood at the time of the offering.

13. We will consider whether imposing standard escrow conditions is the best way to accomplish the objectives of escrow.

14. Issuers would be free to advertise at any time, so long as the advertisement disclosed certain information about the issuer and, if a CMA issuer, the location of its continuous disclosure record.

CMA would take CSA's proposed Integrated Disclosure System (IDS) a step further. The IDS proposal permitted an issuer to "integrate" its public disclosure into its prospectus, providing the issuer with quicker access to market than the current prospectus system. Use of the system was intended to be voluntary – if an issuer chose to use the IDS system, it would become subject to the accompanying enhanced continuous disclosure requirements.

The main differences between CMA and IDS are as follows:

- *Eligibility / availability*. IDS was designed as a voluntary system, since existing prospectus regimes would continue to exist. CMA would replace all prospectus regimes.
- *Offering documents.* Under IDS, an issuer would have to file a prospectus for all offerings. Under CMA, all offerings other than an issuer's initial public offering (IPO) would be disclosed by press release; there would be no mandated offering document for subsequent offerings.
- *Underwriters / certificates.* IDS would require an underwriter for all offerings; the issuer and underwriter would have to certify the prospectus and the issuer's continuous disclosure documents. CMA would require an underwriter only if the issuer were unlisted; certificates would not be required (civil liability would be based on the continuous disclosure record, not the certificate).

- *Listing requirement*. Under IDS, an issuer's equity securities would have to be listed on a recognized exchange. There is no listing requirement under CMA.

Details of the Concept

The CMA system

The Problem

1. The prospectus regime is complex, costly and time-consuming. While the prompt offering system (POP) under National Instrument 44-101 *Short Form Prospectus Distributions* has addressed this to some degree for larger issuers, most issuers cannot access the market quickly and cost effectively.

2. The broad scope of the prospectus requirement requires a complicated exemptions regime.

3. The closed system resale restrictions are designed to address a wide range of circumstances. This has resulted in a complex set of rules.

4. The cost and complexity of the prospectus, exemption and resale regimes have generated an array of alternative regimes intended to address their shortcomings, for example POP, National Instrument 44-102 *Shelf Distributions*, National Instrument 44-103 *Post-Receipt Pricing*, and Multilateral Instrument 45-102 *Resale of Securities*. Each of these has further complicated the system.

5. The complexity and reach of the regimes have generated a steady stream of discretionary relief applications, resulting in individual orders, blanket orders, and additional rules.

6. The prospectus does not play a direct role in most investors' investment decisions. Most investors rely on the advice of their advisers and do not read the prospectus. Investors usually receive the prospectus only after they have already agreed to buy the securities.

7. The existing prospectus system focuses on the primary market where investors buy securities directly from the issuer (or its underwriter), but the vast majority of trading occurs in the secondary market through the facilities of a stock exchange or between investors privately. (In 2001, the amount raised under prospectuses in new issues was only about 2% of the total value of the trading on Canadian stock exchanges.)

8. Currently, there are different standards of disclosure – one for trades made under a prospectus, one for trades made under an offering memorandum, another for trades made under other prospectus exemptions, and yet another for trades in the secondary market.

The Concept

CMA system replaces prospectuses. CMA would replace the current prospectus system. Issuers in the system could issue securities at any time based solely on their continuous disclosure record.

Entry into CMA. All existing reporting issuers would automatically be included in CMA. New issuers would enter CMA by filing an entry document.

Under the entry document concept:

- All material facts must be disclosed.
- A form would mandate disclosure of information about the issuer and the securities, but the prescribed disclosure would be less comprehensive and less detailed than the current long form prospectus requirements.
- The issuer would have more latitude, and responsibility, to determine what is material. A companion policy or similar document would provide general guidance on structure and content.
- A share exchange take over bid or business combination information circular that contains similar information would qualify as an entry document, and would have to be prepared to the same standard.

A securities commission would vet the entry document to identify:

- Unsuitable directors and officers (for example, by checking criminal and bankruptcy records)
- Significant merit or public policy concerns
- Obvious non-compliance with entry document disclosure requirements

Enhanced continuous disclosure requirements. All CMA issuers would be required to comply with a comprehensive continuous disclosure regime. Like the entry document, the issuer's continuous disclosure obligations would be based on "disclosure of all material facts". This disclosure standard is intended to be different than the current "full, true and plain disclosure" standard that has come to mean the detailed disclosure in today's prospectuses. It would also replace the "material change" concept as a trigger to make timely disclosure. Also, unlike our current system, CMA contemplates one standard of disclosure for all trades.

The CMA continuous disclosure regime would differ from current requirements as follows:

1. The continuous disclosure requirements in all Canadian jurisdictions would be uniform.

2. All CMA issuers would be required to file:

    - Annual financial statements with management discussion and analysis (MD&A)
    - Quarterly financial statements with MD&A
    - Press releases disclosing new material facts (the material change report would be eliminated)

- A streamlined annual information form (AIF) – like the entry document, there would be less prescribed content than in the current form (the issuer would be allowed greater judgment in deciding what to disclose)

3. Filing deadlines for annual financial statements would be reduced from the current 140 days in most jurisdictions to 90 days for "TSE-exempt" companies and 120 days for all other issuers.

4. Filing deadlines for interim financial statements would be reduced to 45 days for "TSE-exempt" companies and remain at 60 days for all other issuers.

5. Issuers would be obligated to deliver financial statements and MD&A only to those shareholders that request them.

6. The annual report (Form 28 in most jurisdictions) would be eliminated.

The issuer's continuous disclosure record would provide current information for registrant firms to use when preparing information documents for individual registrants to use in advising their clients. (This function is currently served by the prospectus, which, as a static document, is less useful outside the primary distribution context.) It would also serve as the primary record against which any claim for misrepresentation would be tested.

Offering process. CMA issuers would have continuous and immediate access to the public market to sell their securities, based on their continuous disclosure record. Except for IPOs, there would be no mandated offering document, although we anticipate that issuers and their underwriters would produce an offering document containing meaningful information for the investor and otherwise tailored to the needs of the market. (We will consider whether some minimum disclosure requirements should be imposed if an issuer decides to prepare and deliver an offering document for offerings after the IPO.) Issuers and underwriters would be liable for the information in the offering document (see Concept 6).

The issuer would be required to issue and file a press release announcing its intention to make an offering, and disclosing the terms of the offering and the use of proceeds. Once the offering was completed the issuer would issue and file another press release.

This approach leaves the content of the offering document up to the issuer and the underwriter (or other due diligence provider), if there is one. In their sales effort, they would be motivated to present the information investors want and need to know. The spectre of enforcement action and civil liability would discourage them from making misrepresentations and from using unfair practices in selling the securities.

The offering document would be filed but commissions would not vet it as a pre-condition of the offering.

For Canadian issuers who use MJDS to offer securities into the US, a prospectus alternative with Canadian regulatory review would be preserved. We will consult with the United States Securities and Exchange Commission to ensure that Canadian issuers maintain simplified access to the US market.

Due diligence providers. Whether an issuer would be required to use a due diligence provider would depend on whether the issuer was “listed” or “unlisted”:

- A listed issuer is one whose securities trade or, on completion of its IPO would be traded, on a market that has trading regulation and issuer regulation. Trading regulation looks for symptoms of market manipulation, such as price and volume anomalies. Issuer regulation includes director and officer review, material transaction review, and a consideration of the issuer’s continuous disclosure record when conducting trading regulation.

- An unlisted issuer is one whose securities are traded or quoted on a trading facility that has no issuer regulation, no trading regulation, or neither. The continuous disclosure record of an unlisted CMA issuer would be required to include a warning to investors that the trading facility where its securities are traded or quoted has no issuer regulation and, if applicable, no trading regulation, including, in both cases, a short discussion of what this means.

To maintain market integrity, it is important that issuers are scrutinized when they first enter the public market. For a listed issuer, CMA would rely on the requirements of the issuer’s market to provide this scrutiny. Listed issuers would not be required to use an underwriter or other due diligence provider for their IPOs or subsequent offerings (although we expect that usually they would). Exchanges might require a sponsor.

For an unlisted issuer, CMA would require the involvement of a due diligence provider for all offerings.

Due diligence providers could be either underwriters or other competent third parties. Issuers in the junior market tell us that the cost of underwriters is often prohibitive relative to the benefits they provide. Therefore, we will consider a model in which non-registrants, such as venture capital companies, accounting firms, or financial institutions, could perform the due diligence function, as they do in London’s Alternative Investment Market. This could increase competition for these services and could lead to lower costs to issuers.

If a CMA issuer retained a due diligence provider in connection with an offering, an investor buying in the offering would be able to sue the due diligence provider if there was a misrepresentation in the offering document (if any) or the issuer’s continuous disclosure record as it stood at the time of the offering, subject to a due diligence defence. If the due diligence process identified a matter in the issuer’s continuous disclosure record that required correcting, there is some risk that investors who traded on the basis of that record would make claims. This risk is not new – it exists under today’s POP system – and it may motivate issuers to enhance the quality of their continuous disclosure.

For listed issuers that complete offerings without due diligence providers, we would rely on oversight by their market and on the continuous disclosure compliance review program.

As is generally the case today, all issuers would have to use registrants to sell securities to investors, and CMA issuers would continue to be able to rely on registration exemptions for private placements. A CMA issuer would have the same access to the private placement market that reporting issuers have today.

No exemptions or hold periods. Under CMA, the prospectus requirement would be replaced by an evergreen continuous disclosure system, so there would be no prospectus exemptions and no resale restrictions for CMA issuers, regardless of "seasoning" (the period an issuer has been reporting) or size. There would no longer be a closed system for CMA issuers.

When CSA staff considered these factors in the context of the IDS system, they concluded they were no longer necessary because:

- marketplace information is immediately and widely disseminated through SEDAR and other advances in information technology, and
- even if large issuers have better continuous disclosure practices than small issuers (an assertion CSA staff questioned), any disparity could be addressed through continuous disclosure review programs and enforcement action.

Continuous disclosure compliance review. The integrity of CMA depends on good continuous disclosure. CMA would require an organized, disciplined and high profile program of continuous disclosure compliance review. It is contemplated that CSA would adopt national continuous disclosure review standards and administer the program through a mutual reliance or similar regime.

The continuous disclosure compliance review program would look at the issuer's disclosure as a whole to see whether it accurately reflects the issuer's business and financial position. We would generally not require issuers to re-file documents that contain non-material deficiencies, but would provide instructive comment to be taken into account by the issuer on future filings.

An issuer whose continuous disclosure record is found to be seriously misleading could be the subject of enforcement action.

Restricted issuers. "Restricted issuers" would not be in the CMA system. Restricted issuers are so-called because they would be restricted to selling securities only to certain classes of investors, and secondary trading in their securities would be restricted to those same persons.

These are the classes of investors to whom restricted issuers could sell securities (they follow the conditions currently set out in the proposed BC and Alberta capital raising exemptions rule and in some of the existing prospectus exemptions):

1. Investors in private issuers

This refers to "private issuers" as currently defined – issuers that have a limited number of shareholders and whose securities are subject to restrictions on transfer – that may sell securities to persons who are not "the public".

2. Family, friends, and business associates

A restricted issuer would be permitted to sell securities to relatives, close personal friends, and close business associates of principals of the issuer. We would provide guidance as to who is a “close personal friend” or a “close business associate”.

3. Investors who buy under an offering memorandum

A restricted issuer would be permitted to sell any amount of securities to any person if:

- the issuer gives the investor an offering memorandum in a prescribed form, and
- the investor signs an acknowledgement that contains a clear, blunt warning of the risks of investing in restricted securities.

4. Accredited investors

A restricted issuer would be permitted to sell any amount of securities to “accredited investors”, including financial institutions, pension and investment funds, substantial corporations, and wealthy individuals. An individual would be an accredited investor if the individual and his or her spouse:

- have financial assets exceeding $1 million, or
- have net income exceeding $300,000 ($200,000 without a spouse) in each of the last two years, and a reasonable expectation of exceeding that amount in the current year.

No disclosure would be required.

5. Other investors based on current exemptions

These investors include:

- employees and consultants
- vendors of properties and other assets
- persons outside Canada in compliance with applicable foreign laws

Investors in a restricted issuer could trade only among themselves. A restricted issuer could not have its securities listed or quoted on any domestic or foreign trading facility (exchange, market, or alternative trading system (ATS)). A restricted issuer that wants to provide greater liquidity to its investors would have to enter CMA.

A restricted issuer could stay outside CMA and its enhanced continuous disclosure requirements by ensuring that it limits sales and trading of its securities so that it stays within the definition of restricted issuer.

Unlisted issuers

The Problem

BC has historically placed a great deal of importance on the issuer regulation of junior issuers that stock exchanges provide. For example, BC will generally not receipt a prospectus for a junior issuer unless the securities will be listed on an exchange, and National Instrument 21-101 *Marketplace Operation* (the ATS rule) limits trading in equities to listed equities.

The Concept

A CMA issuer would not be required to be listed on an exchange. Our policy has not prevented a local market from developing in securities of unlisted issuers. By bringing these issuers into CMA, we would acknowledge the existence of this market and make these issuers visible to the system. It follows that the ATS rule would also be amended to remove the restriction on trading unlisted equities.

CMA's approach to unlisted issuers is also consistent with the view that we are entering an era of international competition among marketplaces, many of which will not offer issuer regulation or trading regulation. In this environment, it seems doubtful that we will be able to sustain our current policies. (Currently, an ATS operating in Canada is required to register and to contract with Market Regulation Services Inc. for trading regulation.)

This approach would be supported by requiring that unlisted issuers use underwriters or other due diligence providers and disclose their lack of issuer or trading regulation.

Registration exemptions

The Problem

Currently, the registration exemptions are worded identically to the prospectus exemptions, which contain conditions intended to address disclosure and resale issues. These conditions are not relevant to exemptions from the registration requirement.

The Concept

Under CMA, there would be no prospectus requirement, but the registration requirement would remain. Registration exemptions would still be necessary, but they can be simplified.

Under the CMA system, registration would not be required for trades:

1. To "exempt purchasers", which would include:

    - directors, senior officers, and control persons of the issuer, their families, close friends and close business associates, and employees and consultants (as described above under "Restricted issuers")
    - accredited investors (as described above under "Restricted issuers")

- vendors of properties and other assets
- existing shareholders

2. To registrants

3. To issuers of their own securities

4. In connection with a reorganization, merger, take over bid, or other business combination

5. In securities to satisfy *bona fide* debts, finders' fees, etc.

6. In debt securities issued or guaranteed by:

   - financial institutions (including certain foreign financial institutions)
   - federal, provincial or municipal governments, government agencies, or Crown corporations
   - countries or political divisions of countries

7. To persons outside Canada in compliance with applicable foreign laws

8. That are isolated trades

Additional exemptions may be needed, for example for co-operatives, charities, mortgage brokers, and for trades in commercial paper. We will also consider whether each registration exemption should apply to both advising and trading.

Foreign-regulated issuers

The Problem

Currently, foreign issuers selling securities in Canada must either file a prospectus or rely on an available exemption. This means that some issuers who would otherwise offer their securities in Canada choose not to do so, which reduces investment opportunities for Canadians.

We remain concerned about unlisted issuers that are subject to no continuous disclosure requirements. For example, an issuer whose securities are quoted on the pink sheet market may not be required to report under the US *Securities Exchange Act of 1934*.

The Concept

Approved foreign issuers. Issuers that are regulated in countries with mature market-based economies would have freer access to our markets.

Specifically, we would allow into CMA issuers that are subject to a credible foreign system of securities regulation – that is, one that has:

- rules for investor protection and market integrity, including continuous disclosure requirements,

- an effective infrastructure for administering and enforcing the rules, and
- a track record of effective securities regulation.

A foreign regulatory system that meets these criteria would be recognized as credible, even if its requirements did not exactly correspond with ours. Issuers regulated under these systems would be “approved foreign issuers”.

Approved foreign issuers could use the documents required by the foreign system to comply with Canadian continuous disclosure requirements under CMA if:

- their continuous disclosure was publicly accessible, whether on SEDAR (the electronic system used in Canada for filing securities documentation), EDGAR (the US equivalent of SEDAR) or another system accessible through the internet,
- they directed investors to their continuous disclosure, for example by a notation on SEDAR directing investors to EDGAR, and
- they cautioned investors that they are subject to a foreign regime of securities regulation that differs from that in Canada.

This would reduce the burden on approved foreign issuers, because they would need comply with only one set of requirements.

In some circumstances, Canadian-based issuers could be considered “foreign” under this concept. We will have to consider what factors are appropriate for determining whether a Canadian issuer is “foreign”. A significant factor would be the location of the principal market where its securities trade. Other factors may also be relevant.

Canadian-based, foreign-regulated issuers could choose to prepare their documents under the foreign system. For example, Canadian-based NASDAQ issuers could file documents prepared under US rules.

“Pure” approved foreign issuers (those with no meaningful connection to Canada) would have the same access to the Canadian private placement market that they have today, without becoming subject to CMA’s disclosure requirements. Under CMA, they would be able to sell securities only to the persons identified in the restricted issuer definition (although these investors would be free to resell the securities in the foreign marketplace). An approved foreign issuer wishing to make a public offering in Canada would be required to enter CMA and be subject to the system’s disclosure obligations.

Issuers quoted on the US NASD (National Association of Securities Dealers) OTCBB, which are required to report under the US 1934 Act, would be approved foreign issuers.

The OTCBB provides no issuer regulation and limited trading regulation. As a consequence, there is more abuse in this market. There may be concern that bringing OTCBB issuers into CMA could lead to more abuses.

We do not think the answer is to keep these issuers out of CMA or to patrol these markets from Canada. To protect investors who trade in securities of these and other unlisted approved foreign issuers, we would:

- require these issuers to warn investors that they will not have the benefit of issuer regulation or, if applicable, trading regulation,
- increase investors' awareness of the risks associated with these markets through investor education,
- rely on registrants to inform clients about these risks when discussing whether a particular investment is suitable for them, and
- require unlisted CMA issuers to use a due diligence provider whenever they sell securities, as discussed above.

The abuses related to this and similar markets have little to do with the disclosure system. These abuses exist today and will continue whether or not unlisted foreign issuers are permitted to use CMA.

Non-approved foreign issuers. We draw a distinction between the unlisted issuers just described and unlisted issuers that are publicly traded but have no continuous disclosure obligations. Issuers not subject to continuous disclosure obligations (such as those on the US pink sheet market that do not report under the US 1934 Act) would be "non-approved foreign issuers" and could not use CMA to distribute securities without filing a CMA entry document and complying with CMA continuous disclosure requirements or acceptable foreign equivalents. This is because a continuous disclosure regime is central to the CMA concept.

Because this approach would not restrict trading in the shares of these issuers in the secondary market, it has an internal inconsistency: there would be restrictions on primary, but not secondary, trading in the shares of these issuers.

There are three possible ways to resolve this inconsistency:

1. Justify it, that is, identify that there is a sound policy reason to treat primary and secondary trading in these securities differently.

2. Prohibit secondary market trading in these securities unless the issuer joins an acceptable continuous disclosure regime. This approach is consistent with a view that CMA is based on a system of publicly available evergreen continuous disclosure and issuers that do not fit there or in the restricted issuer category have no place in the system.

3. Allow these issuers into CMA and rely on disclosure and the role of registrants to protect investors. This solves the inconsistency but is at odds with the CMA system's reliance on a continuous disclosure record.

More consideration is required to determine the appropriate position to take on this issue.

Assessing whether foreign regimes ought to be recognized as credible would in some cases involve extensive study. Initially, recognition could be granted to countries that appear to have credible regulation regimes (such as the US). We would defer the study of other regimes until it is justified by significant demand from Canadian investors.

Foreign-regulated issuers that are currently reporting issuers in Canada would be automatically included in the CMA system. New approved foreign issuers could enter CMA by using documents prepared under the laws of the foreign regime that contained similar disclosure to the CMA entry document. Approved foreign issuers in CMA would be subject to Canadian enforcement and the civil liability provisions discussed below (based on contraventions of the foreign laws).

Civil remedies

The Problem

Today, investors who buy securities directly from the issuer under a prospectus have more rights than investors who buy the same securities from the issuer under an exemption or in the secondary market.

The Concept

Civil liability for prospectuses would be replaced by a comprehensive civil liability regime that applies to the issuer's continuous disclosure record. Investors in the primary and secondary market would have the same rights of action for damages if an issuer made a misrepresentation in any public disclosure or failed to make timely disclosure of material facts.

The enhanced civil liability regime would include a class action system tailored for securities regulation (see Concept 6).

Escrow

The Problem

In most junior issuers, management holds a significant share position and looks to appreciation in share value rather than salary as the primary source of its compensation. If management of an issuer sells its shares immediately following the issuer's IPO, management may lose interest in the issuer's success and the issuer's business plan may be abandoned. This could cause a drop in the value and liquidity of the shares bought by public investors and damage confidence in the junior equity market generally.

Escrow requirements were designed to tie management to the issuer for a sufficient period of time following the IPO to ensure management carries out the issuer's business plan. Escrow imposes hold periods on shares acquired by management before the IPO.

The Concept

Mandated escrow conditions may not necessarily be the best way to accomplish the objective of escrow. Other solutions, such as employment contracts, non-competition agreements, vesting periods for options, and bonus systems, may be more likely to motivate management. Alternatively, underwriters may require escrow as a condition of the underwriting.

There is a risk that in hot markets, underwriters would be under pressure not to impose escrow or other restrictions. However, underwriters would be motivated to protect their investment clientele, their own investment, and their reputation for underwriting issuers with stable after-markets.

A liberalized national escrow regime was recently implemented. We are not certain whether the market favours retaining this escrow regime, or whether the existence of mandated escrow is still viewed as an obstacle to raising capital. We will consider the best approach after consultation.

Advertising

The Problem

Existing national policies place numerous unnecessary restrictions on advertising. The current approach to advertising was developed in the context of a prospectus-based system, and reflects concerns that advertisements could communicate messages that are not consistent with the approved disclosure contained in an issuer's official disclosure materials.

The Concept

Issuers would be free to advertise at any time, so long as the advertisement:

- is identified as an advertisement,
- states, if the issuer is an unlisted CMA issuer, that trading in its securities is not subject to issuer regulation or, if applicable, trading regulation, and what that means,
- states, if the issuer is a restricted issuer, that fact and what it means,
- directs the public to the issuer's continuous disclosure record, if applicable, and
- states that investors have a statutory right of action against issuers that make a misrepresentation.

In a system that recognizes that the prospectus is not the foundation for an investor's investment decisions and that permits an issuer to offer securities on the basis of its continuous disclosure record, the existing restrictions on advertisements no longer appear to make sense.

Under Concept 5, enforcement action would be available against issuers that make misrepresentations or engage in unfair practices. Under Concept 6, issuers would be subject to civil liability for misrepresentations in any public disclosure, including misleading advertising that is intended to induce investors to buy securities.

Investor education programs will help investors identify what they need to know before investing.

Advantages of the Concept

1. It would be simple to understand and use. It would significantly lower offering costs and allow issuers immediate access to the market to sell their securities.

2. It would eliminate the complex prospectus regime and the associated exemptions, alternative offering regimes, hold periods and resale restrictions. The closed system would disappear for CMA issuers.

3. It would significantly reduce the need for issuers to apply to commissions for relief from the requirements of securities legislation and the resulting commission orders and rules.

4. It reflects the significance of the secondary market.

5. CMA issuers would have one disclosure standard for all purchasers of their securities. All investors in CMA issuers would have equal rights.

6. CMA issuers may have higher costs of continuous disclosure, but these costs would be outweighed, or at least significantly mitigated, by the benefit to issuers of immediate access to the market, lower offering costs, and savings resulting from the simplification of the system.

Questions

1. What are the factors we should consider in weighing the costs and benefits of this concept?

2. Most investors do not use prospectuses when making their investment decisions. Are there other reasons to keep the prospectus requirement? Can those reasons be addressed in other ways?

3. If a CMA issuer chooses to prepare a disclosure document in connection with an offering, should we prescribe some minimum disclosure requirements? Should the commission vet the offering document?

4. The concept would require unlisted issuers to use an underwriter or other due diligence provider for all offerings. Are there other circumstances in which an underwriter should be required?

5. Are there any problems created by replacing the “material change” concept as a trigger to make timely disclosure with a “material fact” concept?

6. The paper describes three ways to deal with secondary trading in securities of issuers that have no continuous disclosure obligations. Which one should we adopt? Is there another alternative?

7. Should we maintain the current escrow requirements?

Concept 2

A Simpler Registration System

The current registration system requires firms and their employees that trade in or advise on securities to register. Applicants for registration must provide us with detailed information to prove they are fit to trade or advise. Employees must satisfy us they meet our educational requirements and are of good character. Firms must satisfy us they have employed competent and ethical individuals to manage and operate their business, that they have adequate capital and sound financial and records management systems, and, in some cases, that they are members of an investor protection fund.

The registration requirement is intended to ensure that those who trade in or advise on securities are competent and do not engage in inappropriate selling practices. It is also designed to address conflicts of interest, curb market manipulation, and minimize the risk that registered firms will fail and their clients will suffer financial loss. Registered individuals and firms must meet our initial qualification requirements and they must continue to comply with our rules for competency, ethical conduct, and financial responsibility in order to retain their registration status.

Responsibility for registering firms and their employees has in some cases been transferred from the securities commissions to self-regulatory organizations (SROs). For example, in BC the Investment Dealers Association (IDA) registers investment dealers and their salespersons. The BC Securities Commission retains ultimate authority to regulate investment dealers and their salespersons, but the IDA has day-to-day regulatory responsibility.

In this paper, we use the term “employees” to include a firm’s employees (including personal service corporations), agents, representatives, partners, directors and officers.

Summary of the Concept

1. Move existing prescriptive rules about qualification, ongoing proficiency, and ethical conduct to a mandated code of conduct. The code would replace existing detailed requirements with general principles. Registered firms would be required to enforce the code and would be free to supplement it as they thought necessary to suit their own business circumstances.

2. Implement a registration “passport” system so that a firm or employee registered in one Canadian jurisdiction can carry on business anywhere in Canada.

3. Consider eliminating the registration requirement for individual employees.

4. Consider allowing foreign registrants to do unsolicited business with Canadian residents without registering here.

5. Give investors new civil remedies and give regulators new powers to ensure that registered firms are motivated to comply with the code of conduct.

Details of the Concept

Code of conduct

The Problem

The registration system works best when registrants are focused on their broader obligations to their clients and the market and are accountable for meeting them. The present system contains a mixture of broad obligations and complex, detailed requirements.

Some registrants like detailed rules because they provide certainty. If they follow them, they know they are in compliance.

Unfortunately, it is possible in some cases for registrants to follow the detailed rules and not consider their broader obligations. For example, current rules for those who sell mutual funds focus on the details of what kinds of perks mutual fund companies may offer to salespersons (golf balls) and what kinds of perks they may not (trips to the Caribbean). This can have the unfortunate effect of focusing registrants on the details of what they can and cannot do, rather than the more important question of whether they are meeting their duty to act in the interests of their clients and to recommend only suitable investments.

Other registrants complain that the present system is costly and forces them to think of compliance as an exercise in filling out forms and auditing their practices to ensure they avoid stepping offside of technical requirements. This work, they say, takes the place of higher level monitoring of salespersons to ensure they are acting in clients' interests and not putting the reputation of the firm, and the integrity of the market, at risk.

Prescriptive rules also make it difficult for us to keep regulatory requirements aligned with commercial practice. The market changes far faster than commissions can revise rules. The current system does not offer the flexibility that is needed for the fast pace of change in the industry.

The Concept

A code of conduct would replace existing provisions regulating registrants' qualifications, ongoing proficiency, and ethical conduct. Commissions would mandate specific proficiency qualifications only for registrants who do not belong to an SRO. SROs would, under commission supervision, mandate proficiency for their members. The SROs are more familiar with the proficiency needed to meet the requirements of the market and are already expected to set appropriate proficiency levels so that their members can carry out their responsibilities competently.

The code would set out general statements of principle and allow firms to decide how to achieve them. A companion policy or similar document would provide guidance to firms and their employees to help them interpret the code.

By casting registration requirements in general, principled terms, we would create a framework that protects both investors and Canadian markets while encouraging innovation. Firms would be responsible for enforcing the code and would be accountable to regulators and absolutely liable to investors, for breaches of the code by their employees. We think this will motivate firms to take an active and continuing interest in compliance.

Some firms may incur transition costs to adapt their compliance systems to a code of conduct approach, but this approach would ultimately offer firms more control over costs by allowing them to design the details of their compliance systems rather than having the details imposed on them.

Firms would also have more flexibility and their compliance programs would yield better quality results. Time currently spent filling out forms and going through checklists would instead be spent on employee education, policy-making, supervision, and solving problems with the broad principles as guidance.

The code of conduct would be in the securities rules. It would be developed with reference to existing codes of professional organizations (such as the Association of Investment Management and Research – AIMR) and regulatory codes under development in Canada (for example, by the Joint Forum of Financial Market Regulators) and elsewhere – such as Britain (Financial Services Authority Code of Market Conduct) and Australia.

The code of conduct would state:

1. Registrants must meet the proficiency requirements mandated by their SRO or, if not an SRO member, by the commission. Registrants who underwrite securities must ensure their employees have sufficient knowledge and expertise to conduct due diligence.

2. Registrants must have integrity and good character, be competent, and act ethically.

3. Registrants must deal fairly, honestly and in good faith with their clients. They must know their clients and ensure investment recommendations are suitable for clients. Registrants must ensure that investors get adequate and appropriate information about securities before accepting orders from clients for trades. (These principles would replace sections 14, 48 and 49 of the BC securities rules (and similar rules elsewhere), which require registrants to deal fairly, know their clients, recommend suitable investments, and explain relevant terms and conditions in the exchange contract context.)

4. Registrants must provide clients with information that is material to the client-adviser relationship, including information about registration status, discipline history, and changes of information provided to the regulator (for example, changes in address, charges or indictments, findings of fraud). Registrants must also provide clients with all relevant information about transactions they conduct on the client’s behalf.

(These principles would replace sections 36 to 38 and 50 of the BC securities rules (and similar rules elsewhere) and section 42 of the BC *Securities Act*, which deal with confirmations and statements of account and registrant information.)

5. Registrants must disclose to clients any limitation on the registrant's ability to provide objective services, including conflicts of interest, compensation incentives, contingency fees, and allocation of investment opportunities among clients. Registrants must resolve conflicts in favour of the client or, when there are conflicts between clients, they must use objective, fair and transparent criteria to resolve those conflicts. (These principles would replace sections 16, 53, 54 and 75 to 85 of the BC securities rules (and similar rules elsewhere), which deal with prohibition on cross-ownership of firms, disclosure of referral fees and commission splitting, prohibitions on contingent fees without the client's consent, and registrants' conflicts of interest. They would also replace National Instrument 33-105 *Underwriting Conflicts*.)

6. Registrants must not disclose client information, unless the client consents or disclosure is required under securities or other laws. They must inform their clients of these exceptions.

7. Firms must create and use adequate procedures for handling client complaints effectively. Clients must be told they can refer complaints to the SRO or the commission. Firms must report all disciplinary actions against employees to their SRO (if any) and the commission.

8. Firms must ensure their conduct and their employees' conduct complies with all applicable laws.

9. Firms must always be in a position to meet their financial obligations when due and must immediately inform the commission and their SRO (if any) if they are unable to do so at any time.

10. Firms must demonstrate to commissions that they have adequate business and compliance systems. (These principles would replace sections 44, 45 and 47 of the BC securities rules (and similar rules elsewhere), which address registrants' business procedures, underwriters' due diligence procedures, and responsibility for opening and supervising new client accounts.)

In addition to the other specific provisions described above, BC Policy 31-601 *Registration Requirements* (and similar policies elsewhere) would be replaced by a policy providing guidance on how the code would apply.

Registration "passport"

The Problem

If registrants want to do business in two or more provinces or territories, they must register in each jurisdiction. National firms spend significant time and resources filing applications for registration in multiple jurisdictions, dealing with commission staff in those jurisdictions, and keeping track of the differences between the rules of the various jurisdictions. This process is costly and time consuming for both applicants and commissions.

The proposed National Registration Database (NRD) will ease the existing burden significantly by allowing registrants to register their employees in multiple Canadian jurisdictions with the click of a mouse. NRD will eventually contain all information provided by registered employees (not firms) to securities regulatory authorities in all the jurisdictions (except Québec) where they are registered. The system is also designed to process employee (not firm) applications for registration or renewal, and termination notices.

However, NRD will not address the differences in requirements from jurisdiction to jurisdiction. Nor does NRD, of itself, eliminate the need to apply to multiple jurisdictions for registration, although it will provide a single entry point for registering employees.

The Concept

Registrants already registered in their principal Canadian jurisdiction could automatically carry on the same category of business in every other jurisdiction where they wished to carry on business.

This system would be administered through a mutual reliance regime. Once the principal jurisdiction registered the firm or the employee, it would notify the other jurisdictions of the registration and the registrant would be entitled to automatic registration in any other jurisdiction by giving notice and paying the fee through the principal jurisdiction. The principal jurisdiction would also notify the other jurisdictions of any changes in registration status or disciplinary action. The other jurisdictions could rely on the principal jurisdiction to conduct periodic compliance reviews and to enforce the code of conduct through enforcement action, if necessary.

Although many of the registration cost and convenience issues that are faced by national firms today will be addressed through NRD, this concept goes further by creating a single registration system across Canada so that registrants would need to deal with only one commission.

Registration of individuals

The Problem

We currently require all individuals who trade or advise on securities to register and to comply with our ongoing requirements for individual registrants. Individuals cannot trade or advise unless they are employed by firms that are also registered.

This creates a large paper burden on registered firms. They must submit detailed applications in each jurisdiction where they wish individuals to be registered. Firms must also keep track of differences in ongoing requirements across the country for individuals and deal with commission and SRO staff in multiple jurisdictions.

In most jurisdictions, individuals who transfer between firms cannot work while their transfers are being processed.

Individuals who wish to use a personal services corporation, for tax or other reasons, as the vehicle for trading in or advising on securities are difficult to accommodate in the current system. Commissions have traditionally required a strict employer-employee relationship between firms and their salespersons or advising employees so that the firms would clearly be vicariously liable for the actions of their employees.

Some firms attempt to shift responsibility for employee compliance to commissions or SROs. Others, rather than taking an active interest in preventing their clients from losing money, or compensating them for any losses suffered, take the position that the responsibility rests solely with the employee. In enforcement proceedings by commissions or SROs, some firms attempt to avoid responsibility for their employees' actions entirely.

NRD is expected to decrease costs for registrants because applications will be submitted once, rather than separately for each jurisdiction. NRD is also intended to help eliminate the delay in transfers of registration when individuals change firms.

NRD will decrease the time firms spend preparing paperwork, but without a mutual reliance system for registration, firms will continue to spend too much time interacting with multiple commissions about registration issues.

Nothing in NRD addresses the use of personal services corporations or encourages firms to take an increased interest in screening employees.

The Concept

Only firms would be required to register. Firms would be primarily responsible for screening employees for proficiency and good character. For example, firms would have to get applicants' consents to conduct criminal records checks, obtain relevant information from regulators, and check references.

Under the code of conduct (whether or not individual registration is eliminated), firms would have to ensure the ongoing proficiency and ethical conduct of their employees. They would need to design internal compliance systems that provide employees with adequate training, supervision, and systems to achieve the general principles in the code of conduct. On compliance reviews by commissions or SROs, firms would have to demonstrate to regulators they have effective systems in place to achieve the code's objectives.

Firms would be required to file with the commissions a list of those employees carrying on trading and advising activities and keep it current.

Is individual registration critical to maintaining investor protection and market integrity?

The regulatory benefits of individual registration are:

- Individuals are required to be qualified, proficient and ethical.
- Commissions or SROs can suspend or terminate registration or attach conditions to registration.
- Commissions or SROs can bar unsuitable individuals from the industry at the outset and review their suitability each time they change jobs.

- Investors can obtain relevant information about their advisers from commissions or SROs (by contacting them directly or by visiting their web sites).

The concept addresses these benefits as follows:

- Commissions and SROs would continue to mandate qualification, proficiency and ethical standards.
- Commissions and SROs would have the power to order that an individual is not suitable for employment in the industry, or that their employment is subject to conditions.
- Investors could still check commission and SRO records for any disciplinary history. Instead of checking with the commission or SRO to see if their advisers are registered (and perhaps taking false comfort in that information), investors would rely on firms to ensure their advisers are qualified, proficient and ethical.

The concept also has these advantages:

- Firms would be relieved of a major paper-processing burden and could focus on training and effective compliance activities.
- Firms would be motivated to make sure that individual salespersons are liable for their actions, whether they are employed directly or use personal service corporations.
- Firms could not shift responsibility for the actions of their employees to others.

If individuals were no longer required to register, commissions or SROs would lose the opportunity to prevent unsuitable individuals from entering the system or transferring between firms. Commissions and SROs currently use information from other regulators to decide whether an application warrants closer scrutiny, but firms would not be able to access such non-public information.

These apparent disadvantages would be at least partially offset by making firms accountable to regulators and absolutely liable to their clients for the actions of their employees. We think this would motivate firms to scrutinize potential employees very carefully.

Foreign registrants

The Problem

The current registration requirements apply to all firms, domestic or foreign.

A foreign registrant cannot advise or open accounts for Canadians unless it registers in each Canadian jurisdiction where it wishes to operate. This means it must incorporate a Canadian subsidiary, keep records in the jurisdictions where it is registered, become a member of the IDA or the Mutual Fund Dealers Association, participate in a Canadian compensation or contingency trust fund such as the Canadian Investor Protection Fund, and comply with all other rules relating to registrants in each Canadian jurisdiction.

As a result, few foreign registrants register in Canada. This limits Canadians' access to the expertise of foreign registrants when they wish to invest in foreign securities.

The Concept

Consider allowing foreign registrants that do not solicit business from Canadians to advise or open accounts for Canadian residents to trade in foreign securities without registering here.

Foreign firms could then deal with Canadian clients who open accounts on an unsolicited basis without complying with duplicative Canadian requirements. Canadian investors that wish to invest in foreign securities could benefit from the expertise in those securities provided by foreign registrants.

Canadian residents who seek out foreign registrants would not have the protections of Canadian law, but that would be their choice. Our responsibility to protect investors in our markets does not extend to protecting them when they voluntarily and without solicitation choose to do business in foreign markets.

If foreign registrants wanted to solicit business from Canadian investors, the registration requirements would continue to apply.

Civil remedies for investors and enhanced public interest powers

The Problem

A code of conduct approach would give firms and their employees more freedom to decide how to meet the broad investor protection goals of registration. It is important to balance that freedom with significant consequences for firms that fail to meet their responsibilities. Without these consequences, there is a danger that some firms would not take their compliance responsibilities seriously.

The Concept

To balance the increased freedom firms would have to design their compliance programs in ways that work for their businesses, we would give investors new remedies against firms and their employees.

- Investors could sue registered firms and their employees if they fail to comply with the code of conduct.
- Investors could sue anyone, including registered firms and their employees, if they engage in unfair practices.
- Investors could sue anyone, including registrant firms and their employees, who participate in a fraud or market manipulation.
- There would be a class action regime tailored for these remedies.

These new remedies are described in detail in Concept 6.

The code of conduct approach would also be supported by enhanced public interest powers for commissions. These would include powers to order that firms disgorge profits resulting from breaches of the code or make restitution to investors who suffer loss if the code is breached. These powers are described in detail in Concept 5.

Advantages of the Concept

1. The concept avoids the problems associated with prescriptive rules, yet provides industry with reasonable certainty about its compliance responsibilities.

2. Registrants would be fully accountable to their clients.

3. Obtaining registration in one jurisdiction would enable the registrant to carry on business anywhere in Canada.

4. The costs and burdens associated with individual registration would be eliminated without compromising investor protection or market integrity.

5. Canadians would gain free access to advisers in foreign markets to trade in foreign securities.

6. A significant number of provisions in the securities rules relating to registration (see above under “Code of conduct”) would be replaced, along with a number of national and local instruments, including National Instrument 33-105 *Underwriting Conflicts* and its companion policy, BC Policy 31-601 *Registration Requirements*, and similar policies elsewhere.

Questions

1. What are the factors we should consider in weighing the costs and benefits of the code of conduct approach?

2. What are the factors we should consider in weighing the costs and benefits of the individual registration approach?

3. Are there reasons not to allow foreign registrants that do not solicit business from Canadians to advise or open accounts for Canadian residents to trade in foreign securities without registering here?

Concept 3

A Better Mutual Funds Regime

Mutual funds have unique features that require special regulatory attention. A mutual fund is both a security issuer that has no secondary market (that is, investors can not buy and sell mutual fund units among themselves) and a vehicle through which professional management services are provided to investors. It is a means to pool the investments of a number of investors in a single portfolio under common management. The skills of the portfolio manager are largely what an investor is choosing when purchasing mutual fund securities.

Mutual funds are widely distributed to retail investors. About $400 billion is currently invested in over 2,500 mutual funds in Canada. In BC alone, there are approximately 77 mutual fund dealers and 14,000 registered mutual fund representatives. Mutual funds are also sold in BC through 111 investment dealers and their approximately 7,200 representatives.

These are the various players in mutual fund structures and distribution:

The mutual fund itself. Usually structured as an open-end trust, although sometimes as a corporation. Most mutual funds are sold to public investors through a variety of distribution channels.

The mutual fund sponsor. Usually the mutual fund manager or a related party.

The mutual fund manager. The person, usually a corporation in the financial services or mutual fund industry, who is responsible for all aspects of managing the mutual fund, including hiring the service providers to the fund.

The portfolio manager. The person who chooses the investments the mutual fund will make. Can be the fund manager or a third-party portfolio manager.

The principal distributor. The person with primary responsibility for marketing the fund units. Frequently, the mutual fund manager, but can be a dealer.

Participating dealers. The dealers contracted by the principal distributor to distribute the fund units.

Trustee. The person theoretically responsible to the “beneficiaries” – the investors – for the management of the fund. However, the trustee is almost always a bare trustee, that is, it contracts out of its fiduciary obligations. The trustee can be the mutual fund manager, a registered trust company (which may or may not be related to the manager), or an individual or group of individuals.

Custodian. The person appointed to receive and disburse money to and from investors and to hold the mutual fund’s investment portfolio.

The Current System

The current regime addresses disclosure, liquidity, conflicts of interest, and unit holder protection.

1. **Disclosure.** To ensure that there is disclosure to investors and the market about mutual funds being publicly distributed, the current regime:

   - provides investors with a simplified plain-language prospectus that contains all the necessary information they need to make an informed investment decision (including information about mutual funds in general),
   - requires mutual funds to file (and provide to investors on request) an annual information form (AIF) containing additional relevant information,
   - requires mutual funds to file (and provide to investors on request) annual and semi-annual financial statements and to file significant change reports, and
   - limits advertising and regulates disclosure of rates of return.

2. **Liquidity.** There is no secondary market for the sale of mutual fund units. Investors can only sell their units back to the mutual fund. To minimize the risk of mutual funds being unable to buy back units from investors, or “redeem”, the current regime:

   - regulates the types of investments that mutual funds can make (for example, there are prohibitions against certain investments and limits on concentration and control in investments),
   - requires segregation of mutual fund assets and places limits on the fund’s ability to lend its assets,
   - requires all portfolio assets of the fund to be held by a large regulated custodian, and
   - prescribes the processes for unit purchases, switches and redemptions (including the method of calculating net asset value), portfolio transactions, capital transactions, and valuations of restricted securities.

3. **Conflicts of interest.** The structure and organization of mutual funds and the mutual fund industry create potential for conflicts between the interests of the mutual fund sponsor and those of the investors. To minimize the risks to investors, the current regime:

   - requires regular compliance reports,
   - imposes a statutory standard of care on mutual fund managers, portfolio managers, principal distributors, and custodians,
   - prohibits most transactions and investment holdings involving related parties, and
   - prescribes prohibited and acceptable sales practices and investment practices.

4. **Unit holder protection.** As mutual funds are usually trusts, the protections for shareholders provided under corporate legislation are not available to unit holders. To minimize the risks to investors, the current regime:

   - creates investor rights, and

- requires unit holder approval for some fundamental changes, for example, changes in the investing style.

Summary of the Concept

1. A mandated code of conduct (like that described in Concept 2) for mutual fund managers, portfolio managers, distributors and dealers would replace many of the current prescriptive requirements dealing with conflicts of interest and sales practices.

2. Mutual fund investors would be surveyed to see whether they rely on the information a prospectus provides when making investment decisions. A survey conducted before the current mutual fund prospectus regime was introduced two years ago found that investors did not read mutual fund prospectuses and looked only to their advisers for information on investing. If this is still true, the simplified prospectus is not performing its primary function, and we should consider whether to retain the prospectus requirement for mutual funds.

3. A new continuous disclosure regime tailored to mutual funds would require up to date, or “evergreen”, disclosure of all significant changes and provide relevant information to investors.

4. We would consider allowing foreign mutual funds that are subject to a credible regime of regulation to offer their securities in Canada, using documents prepared under the foreign regime. They would have to provide extra disclosure regarding any tax or legal factors specific to Canadian investors.

5. The code of conduct and the disclosure system would be supported by enhanced civil remedies for investors.

Details of the Concept

Code of conduct

The Problem

As noted in Concept 2, prescriptive requirements are sometimes counterproductive. For example, detailed rules about the types of incentives mutual fund companies may offer to mutual fund salespeople stifle competition and tend to divert attention from the mutual fund salesperson’s fundamental responsibility to recommend only suitable investments to clients. Similarly, the anti-conflict provisions sometimes prohibit investments that would benefit investors, increase compliance costs (that are ultimately passed on to investors), and generate numerous applications to commissions for relief from the rules. For example, the current rules prevent a mutual fund sponsored by a Canadian chartered bank from purchasing securities in a public offering by a blue-chip company underwritten by that bank’s investment dealer subsidiary.

The Concept

Mutual fund managers, portfolio managers, distributors and dealers would adhere to and enforce a mandated code of conduct covering competency and ethics, including those principles discussed in Concept 2. The code would be contained in the securities rules. We would provide general guidance on compliance issues in a companion policy or similar document.

Mutual fund managers would be subject to the code of conduct in recognition of the important role they play in the operation of the fund. This would make fund managers more accountable to investors for their actions.

In addition to the general principles described in Concept 2, this code of conduct would include the following:

1. Fund managers must ensure that each mutual fund that they manage is solvent and can meet redemption requests.

2. Fund managers must segregate the assets of each mutual fund that they manage.

3. Fund managers must retain an appropriate custodian for each mutual fund that they manage.

As discussed in Concept 2, the minimum proficiency level for registrants who belong to an SRO, such as the Mutual Fund Dealers Association, would be left to the SRO to determine.

Prospectus requirements

The Problem

Past surveys of investors found that they did not read mutual fund prospectuses and relied solely on their adviser when making investment decisions. Since those surveys were completed, a new disclosure regime was implemented under National Instrument 81-101 *Mutual Fund Prospectus Disclosure*. It was designed to encourage investors to read the documents. The format of the simplified prospectus is now much easier for investors to read and understand.

The Concept

After two years with this improved system, we should re-survey investors to find out if they rely on the prospectus more than they did formerly. If investors are still relying primarily on their advisers when making investment decisions, we should consider whether to retain the prospectus requirement for mutual funds.

If the prospectus requirement were eliminated, the features of the new disclosure system would be:

- The existing AIF and simplified prospectus form would be combined into one comprehensive disclosure document that would be updated annually.

- Mutual funds would have to keep the material facts in their annual filing document up to date through a continuous disclosure regime.
- As in the current system, a mutual fund issuer could issue securities at any time but it would no longer be required to deliver a prospectus. Investors and advisers could access the current disclosure record through the internet.

The existing registration exemptions for non-reporting mutual funds and the private mutual fund exemption would continue to exist in some form.

Continuous disclosure

The Problem

Existing continuous disclosure materials contain little information to help investors assess the performance of their investments. The annual and semi-annual financial statements currently required provide information that is of some use, but they are not directly relevant to the typical investor.

Investors need information to help them assess the performance of their fund, such as management discussion by the fund manager about the performance of the portfolio. There is currently no requirement for fund managers to provide this information.

The Concept

Reporting, or “public”, mutual funds would comply with a continuous disclosure regime tailored to mutual funds that would require up to date, or “evergreen”, disclosure of all significant changes and provide meaningful information to investors. For example, the fund manager would have to provide a discussion of fund performance in light of the fund’s objectives, investment style and performance benchmarks, and the outlook for the fund going forward.

Foreign mutual funds

The Problem

Currently, foreign mutual funds that access the Canadian market must comply with the same rules as domestic mutual funds. This imposes additional costs on foreign funds, which are already incurring the costs of complying with their home regime. This creates a barrier to entering the Canadian market, with the result that Canadians’ investment options are artificially limited.

The Concept

We would consider allowing foreign mutual funds that are subject to a credible regime of regulation to offer securities in Canada using documents prepared under the foreign regime.

If foreign funds were allowed access to our markets, Canadian investors would have more choice, including the potential for lower cost investment options. Competition from foreign mutual funds would likely benefit Canadian investors. Although other factors, like tax laws, may inhibit these mutual funds from offering securities in Canada, there seems to be no securities regulation reason to deny Canadians access to foreign mutual funds that are subject to a credible foreign system of regulation.

A credible foreign system of regulation would include:

- rules for market integrity and investor protection,
- an effective infrastructure for administering and enforcing the rules, and
- a track record of effective securities regulation.

The foreign mutual fund could use the documents required by the foreign system of regulation to comply with Canadian continuous disclosure requirements if:

- its continuous disclosure was publicly accessible, whether on SEDAR (the electronic system used in Canada for filing securities documentation), EDGAR (the US equivalent of SEDAR) or another system accessible through the internet,
- it directed investors to its continuous disclosure, for example by a notation on SEDAR directing investors to EDGAR,
- it cautioned investors that it is subject to a foreign regime of securities regulation that differs from that in Canada, and
- it provided extra disclosure regarding any material tax or legal factors specific to Canadian investors.

Civil remedies for investors

These concepts would be supported by a more comprehensive civil liability regime.

- Investors could sue the mutual fund and the fund manager for misrepresentations.
- Investors could sue firms and their employees if they fail to comply with the code of conduct.
- Investors could sue anyone, including firms and their employees, if they engage in unfair practices.
- There would be a class action regime tailored for securities litigation.

We would maintain a mutual fund investor’s right to rescind, or cancel, an agreement to buy mutual fund securities in the event of a misrepresentation. However, these investors would no longer be able to withdraw an offer to purchase within two days.

These remedies are described in detail in Concept 6.

Advantages of the Concept

1. The concept avoids the problems with prescriptive rules. Industry would have more flexibility to determine how to comply. Fund managers could structure their distribution channels in response to market conditions.

2. The need for mutual funds to obtain exemption relief would be significantly reduced.

3. If investors do not use the prospectus to make an investment decision, industry, and ultimately the investor, would be spared the costs of preparing and distributing them. A comprehensive plain-language disclosure document about the mutual fund would still be available for the adviser, the market, and any investors who want it.

4. A continuous disclosure regime tailored to mutual funds would provide more meaningful information for investors.

5. Canadians would have more investment choice.

6. A significant number of mutual fund rules could be eliminated, including the parts of National Instrument 81-102 *Mutual Funds* and its companion policy dealing with product regulation, and most, if not all, of National Instrument 81-105 *Mutual Fund Sales Practices* and its companion policy.

Questions

1. What are the factors we should consider in weighing the costs and benefits of this concept?

2. If we discover that investors do not use prospectuses in making their investment decisions, are there any reasons to keep the prospectus requirement for mutual funds? Can those reasons be addressed in other ways?

3. What continuous disclosure do mutual fund investors need? How often do they need it? How important to investors is the information found in the fund's financial statements?

4. Is there any reason not to allow foreign mutual funds that are regulated under a credible regime of regulation in their home jurisdiction to sell their funds in Canada using the documents from their home jurisdiction (with the additional disclosure described in the concept)?

Concept 4

Trade Disclosure

Today, we require some investors to publicly report their trades in securities. These special disclosure requirements apply to:

- insiders
- significant shareholders (those holding more than 10% of an issuer's shares)
- control persons (those whose holdings are large enough to affect control of the issuer)

Information about these investors' trades is valuable to the market. Why it is valuable depends on the investor's relationship to the issuer:

- Information about trades by insiders is important primarily because insiders have the best access to information about the issuer.
- Information about trades by significant shareholders is important because many investors consider an issuer's ownership profile when making an investment decision.
- Information about trades by control persons is important because these trades can affect control of the issuer, or move the market price of the issuer's securities even if there is no change in control.

Summary of the Concept

1. Only those with routine access to material non-public information (inside information) would have to file insider reports.

2. Control persons and shareholders holding 10% or more of an issuer's outstanding shares would disclose by press release:

   - when their holdings reach 10% (as at present), and
   - when they had cumulatively bought or sold 2% blocks (at present, only purchases need to be reported).

   Unlike the current situation, the reporting obligation would not cease when the shareholder's holdings reached 20%. It would continue for as long as the investor's holdings were 10% or more, or the investor was a control person.

   We would no longer require the separate early warning reports and insider reports these shareholders currently file.

3. Eligible institutional investors who are exempt from the current "early warning" regime would continue to be exempt under the significant shareholder reporting concept and would report as they do now.

4. Through consultation with market participants and the public, we will find out if advance notice of sales by control persons is important information to the market, and if so, what information the market needs, and when it needs it.

5. Issuers and registrants would have increased responsibilities for ensuring investors satisfy their trade disclosure obligations.

6. Investors could sue people who trade on inside information, tippers, tippees and issuers if the investors traded during the relevant period. (Inside information is material non-public information. A tipper is a person who discloses inside information to someone else. A tippee is a person who receives inside information from a tipper.)

Details of the Concept

Insiders

The Problem

The legislation says insiders must report their trades. The law uses title or position to determine who is an "insider".

This broad definition of insider catches people who do not necessarily have regular access to inside information. For example, anyone with the title "vice president" is an insider, but many vice-presidents hold that title only for corporate profile purposes. Their jobs do not routinely expose them to inside information.

This is recognized in National Instrument 55-101 *Exemption from Certain Insider Reporting Requirements*, which exempts some people who do not have routine access to inside information from filing insider reports. However, this rule does not exempt everyone in that category, so industry and regulators are put to the expense and inconvenience of processing applications for relief. Most of these applications are routinely granted.

The Concept

Simplify the definition of insider. The new definition would be based primarily on function and routine access to inside information, rather than title or salary.

We would define "insiders" as:

- directors,
- the chief executive officer, chief operating officer and chief financial officer, and
- those employed by the issuer (or its affiliates) in an executive capacity whose usual responsibilities expose them to material non-public information.

Shareholders holding 10% or more of an issuer's securities would no longer be insiders just because of their shareholdings. If a 10% shareholder were otherwise caught by the new insider definition (e.g. as a director), the shareholder would report trades under both the insider reporting and significant shareholder reporting regimes. Otherwise, only a press release under the new significant shareholder system would be required.

The concept does not change the timing of the insider reporting requirement, although more timely reporting could be considered. Currently, insider reports must be filed 10 days after the trade.

Significant shareholders

The Problem

The present “early warning” system requires anyone who acquires 10% or more of an issuer’s shares to disclose that fact in both a press release and a separate early warning report. The same disclosure is required each time the investor cumulatively buys 2% or more of the issuer’s outstanding securities, up to 20%.

Because the current definition of insider includes shareholders holding 10% or more of an issuer, these “10% shareholders” must file a press release, a report that essentially duplicates the information in the press release, and an insider report that contains much of the same information.

The early warning system requires reports only for purchases, although information about a significant shareholder’s sales can be just as meaningful to the market.

Because the system was originally designed to catch those planning to make a take over bid, the reporting obligation ceases once a person’s holdings reach 20%.

The Concept

Introduce a significant shareholder reporting system to replace the early warning system.

Similar to the current early warning system, anyone who acquires 10% or more of an issuer’s outstanding securities would be required to issue and file a press release immediately on attaining a 10% position. The same requirement would apply whenever the shareholder cumulatively purchased or sold, since the last report, 2% or more of the issuer’s outstanding securities. These requirements would apply to control persons. (Someone can own less than 10% and still be a control person. If a control person’s holdings were less than 10%, they would still report cumulative trades of 2% blocks.)

Unlike the current situation, the reporting obligation would not cease when the shareholder’s holdings reached 20%. It would continue for as long as the investor is a control person or holds 10% or more.

The concept would eliminate many duplicate filings. Early warning reports would be eliminated (in favour of the press release), and 10% shareholders would not have to file insider reports unless they were also insiders under the new, better focused definition.

The concept would also ensure that investors receive information about all significant trades by persons holding 10% or more and by control persons.

The concept would maintain the existing alternative reporting system for an eligible institutional investor that does not have regular access to inside information and does not intend to make a take over bid. The system allows these investors to report significant net changes in their holdings on a monthly basis, so that the market still receives the information it requires about these investors' trades. It also relieves large financial institutions with several business units from having to aggregate their holdings.

The concept would maintain this system for the same reason it was adopted a few years ago – any benefit to the market in requiring eligible institutional investors to report on a more timely basis would be outweighed by the significant burden that requirement would impose on these investors.

Eligible institutional investors are also currently exempt from insider reporting requirements if they comply with their alternative monthly reporting obligations and if they do not have regular access to material non-public information. If we implement the changes to the other reporting systems we discuss above, this exemption would not be necessary because eligible institutional investors would not be caught by the new definition of insider.

Control persons

The Problem

Currently, a control person must give at least 7 days' advance notice before selling securities into the market. The initial notice can only be effective for 60 days, but 28-day renewal notices can be filed indefinitely. Because of this, many control persons keep an evergreen (i.e. constantly updated) notice, which makes the notice meaningless.

In many Canadian jurisdictions, a control person can sell securities in a private arrangement without giving the market advance notice of the trade. This is because notice is only required when the control person relies on the specific "control person" prospectus exemption to sell securities. If the control person is able to fit the sale under another exemption from the prospectus requirement, no disclosure of the trade is required (except in BC).

The Concept

We are not certain whether advance notice by control persons of an intention to sell is information that is meaningful to the market.

If investors tell us that advance notice provides valuable information, we will examine how to make the notice more meaningful. We think that a one-day notice period would be sufficient and that advance notice should apply equally whether the trade is to be made in a public market or in a private transaction.

In any case, we would not impose any special post-trade reporting obligations on control persons. A control person would have to disclose trades under the new significant shareholder reporting system and, if an insider, under the insider reporting regime, whether or not we retain an advance notice requirement.

Issuers and registrants

The Problem

Currently, we do not require issuers and registrants to take any responsibility for controlling illegal insider trading by persons who work for them and have access to inside information. (CSA is considering these issues in proposed National Policy 51-201 *Disclosure Standards.*)

The Concept

Issuers would have to make their insiders aware of their reporting obligations and to put reasonable procedures in place to monitor compliance. An issuer would also have to file a list of its insiders with the commission and keep it up to date.

In addition, issuers would have to keep current records of persons with access to undisclosed material facts during periods of confidential activity in connection with a major transaction or other pending material change. A registrant assisting the issuer with the transaction would have similar obligations. An issuer would have to monitor trading in its securities and report any unusual trading to the commission, or, if its securities trade on a stock exchange or other trading facility with a market oversight function, to that trading facility.

We would impose these obligations on issuers and registrants because they have the information and influence necessary to directly discourage insider trading.

Civil liability

Investors could sue people who trade on inside information, tippers, tippees and issuers if the investors traded during the relevant period.

These rights are described in detail in Concept 6.

Advantages of the Concept

1. The insider reporting obligation would be focused on those who actually have routine access to inside information.

2. Investors would be immediately informed about significant changes in the holdings of significant shareholders and control persons.

3. Advance information about control person trades, if important to the market, would be available in a form that meets market needs.

4. Issuers and registrants would play a meaningful role in helping to reduce illegal insider trading.

5. Investors who are victims of illegal insider trading would have better civil remedies.

Questions

1. What are the factors we should consider in weighing the costs and benefits of this concept?

2. Under the current system, a 10% shareholder that holds no office with the issuer is an insider. All trades by that shareholder are reported. Under the concept, these shareholders would not be insiders. They would report their trades under the significant shareholder regime, which means they would only report when they bought or sold cumulative blocks of 2% or more of the issuer's outstanding securities. The same is true of control persons. The market would therefore have slightly less information about the trading of these shareholders, although it would get information on a more current basis.

   Are there any problems with this approach?

3. The concept would not change the time for reporting insider trades. Should we consider this? What change would you make?

4. Should the market have meaningful advance notice of a control person's intended trades? What post-trade information should be provided by control persons, whether or not advance notice is given?

Concept 5

New Enforcement and Public Interest Powers

Securities legislation contains various provisions that prohibit fraud and authorize regulators to make orders in the public interest. For example, securities commissions can bar those involved in securities markets in various ways, prohibit them from holding office in any issuer, assess administrative penalties against them, and order them to pay hearing costs. Commissions can also order that certain securities not be traded and can apply to court for an order compelling market participants to comply with the legislation.

Effective enforcement is essential to a credible regime of securities regulation. We should ensure that commissions have effective tools to deal with those who fail to meet the required standards of conduct in the market.

The existing enforcement powers in the BC legislation are reasonably comprehensive, but we have identified a few enhancements that are worth considering.

Summary of the Concept

1. A commission could order that people who breach securities legislation disgorge their profits or make restitution to those they have harmed.

2. A commission could prohibit professionals from engaging in practice involving that commission if the professionals' conduct related to trading in securities was so egregious or grossly incompetent as to be contrary to the public interest.

3. An interested party could seek a compliance or restraining order from a commission where the party was able to show a breach of securities legislation.

4. We would prohibit people from engaging in unfair practices when selling securities.

Details of the Concept

Disgorgement and restitution

The Problem

Disgorgement and restitution are remedies designed to return money or other items of value to a person who has lost them as a result of another's illegal activities. Disgorgement is the involuntary surrender of stolen goods or money. Restitution restores the victims to the position they were in before the harm occurred.

Securities legislation in many Canadian jurisdictions does not provide for disgorgement or restitution. (They are available in BC and some other provinces through the courts).

The Concept

Consider giving commissions the power to order disgorgement and restitution as types of enforcement orders.

These powers could be constructed so that commissions had the power both to order disgorgement and restitution and to order the distribution of assets among investors. Alternatively, the commission's power could be limited to ordering restitution and disgorgement, leaving the distribution of assets to the courts. (In that case, disgorged funds could be held in trust and distributed under a streamlined court process.)

Our system of securities regulation would be more effective if we could expedite the return to investors of investment losses stemming from illegal actions. Giving commissions the power to order disgorgement and restitution may be an effective way to do that.

Professionals

The Problem

Professionals such as lawyers, accountants and geologists sometimes engage in behaviour that negatively affects the integrity and efficiency of the capital markets.

We currently have no enforcement options for dealing directly with professionals who do this. For instance, we cannot prevent these professionals from continuing to appear before a commission or from preparing documents that are filed with it.

The Concept

A commission would be able to order that a professional cannot appear before it or prepare documents that are filed with it. This power would be similar to existing powers of the US Securities and Exchange Commission.

A commission would only issue these orders when it found a professional's conduct in structuring transactions to violate the public interest objectives of the legislation (or advising clients how to do so) to be egregious or found the professional to be grossly incompetent in commission filings. Effective regulation requires sanctions to address this behaviour and the power to limit a professional's ability to practice would achieve that purpose.

As is the case in all commission proceedings, the hearing panel would have to be satisfied that the order was in the public interest in connection with trading in securities.

Commission compliance or restraining orders

The Problem

Market participants are often in the best position to spot potential problems arising from a breach, or intended breach, of the legislation. However, except in the case of take over bids, the legislation does not provide an efficient way for market participants to bring these problems to the commission's attention.

The Concept

Permit anyone to apply for a compliance or restraining order from a commission when they could show a breach of securities legislation was imminent or in progress. By giving commissions these powers, we would expand existing powers in the take over and issuer bid area and help commissions protect the public interest by preventing wrongdoing.

Anyone (likely to be an investor, insider or business rival) could apply for an order if that person had evidence showing that another person (likely to be an issuer or a registrant) was contravening or about to contravene the legislation.

The applicant would need permission from a single commissioner to proceed with the application. This would help prevent abuses because leave would only be granted if the matter involved an issue of public interest and was not primarily a dispute between parties. The commissioner's decision on the leave application would be final (no appeal).

If leave were granted, the commission would hear the application and have the power to order that a person comply with or stop breaching the legislation. If the commission did not grant the order requested, the unsuccessful applicant would be liable to pay costs to the other party. The commission could order the applicant to put money in trust to ensure costs, if awarded, were paid.

Prohibition on unfair practices

The Problem

There is an existing prohibition in the legislation against fraud, but some market participants, when selling securities, engage in unfair practices that, although egregious, do not meet the stringent test for fraud. These include

- high-pressure sales tactics,
- taking advantage of an investor's physical or mental infirmity, ignorance, illiteracy, age, or lack of sophistication, or
- imposing unduly harsh terms or conditions on a sale.

Commissions can deal with this type of conduct under their public interest powers but in the absence of a prohibition in the legislation, there is no basis for criminal prosecution or civil remedies.

The Concept

This conduct would be prohibited. (The BC and Alberta securities commissions have proposed this prohibition as a legislative amendment in connection with their proposed capital raising exemptions rule.)

Advantages of the Concept

1. It would be more difficult for market participants who breach the legislation to keep illegally obtained monies. Investors would save time and money in recovering the funds they lost through market misconduct that was the subject of enforcement action.

2. Professionals whose conduct threatens the integrity of the markets would be unable to deal with the commission in their professional capacity.

3. There would be a process for market participants to seek preventative orders from commissions when people engage in abusive activity that breaches any aspect of the legislation and threatens the market. This remedy is currently only available in the take over and issuer bid area.

4. Investors would be better protected from unfair practices.

Questions

1. What are the factors we should consider in weighing the costs and benefits of this concept?

2. Should securities commissions have the power to order disgorgement and restitution? If so, should they have the right to order the distribution of assets among investors, or should that aspect be left to the courts?

3. Is it appropriate for commissions to have the power to prevent professionals who act egregiously or are grossly incompetent from appearing before them or preparing documents filed with them?

Concept 6

New Civil Remedies for Investors

Under existing securities legislation, investors have these statutory rights:

- They can sue for misrepresentations in a prospectus.
- They have the right to change their minds and get a refund within two days of buying securities under a prospectus.
- They can sue if an issuer fails to deliver a prospectus, take over bid circular, or issuer bid circular.
- They can sue those who trade on inside information (if they can prove they were the person with whom the trade occurred).

Investors also have common law rights, but these have practical limitations. Sometimes investors have no right to sue, or the evidentiary or procedural requirements they face are too onerous.

Statutory rights are created to address the common law's limitations, but even where there is a statutory right of action, the investor must still deal with the costs and delays inherent in the litigation process.

The statutory rights described below would be in addition to any common law remedies.

Summary of the Concept

1. Investors (whether buying in an offering, the secondary market or the exempt market) could sue for damages if an issuer made a misrepresentation or if a CMA issuer (see Concept 1) failed to maintain up to date, or "evergreen", disclosure of all material facts. (The existing rights to rescission and withdrawal would be eliminated for CMA issuers.)

2. Clients could sue a dealer and its directors and officers if the dealer or its salespeople failed to comply with the dealer's code of conduct (see Concept 2). Liability at the dealer level would be absolute.

3. Investors could sue people who trade on inside information, tippers, tippees and issuers if the investors traded during the relevant period. (Inside information is material non-public information. A tipper is a person who discloses inside information to someone else. A tippee is a person who receives inside information from a tipper.)

4. Investors could sue those who commit fraud and market manipulation if the investors traded during the relevant period.

5. Investors could sue market participants who engage in unfair practices.

6. There would be a class action regime specifically designed for these lawsuits.

7. There would be protections for defendants against frivolous and abusive litigation.

Details of the Concept

Actions for misrepresentations

The Problem

Currently, only investors who buy securities from the issuer under a prospectus have a statutory right of action, yet the vast majority of trading in securities occurs in the secondary market. (In 2001, the amount raised under prospectuses for new issues was only about 2% of the total value of the trading on Canadian stock exchanges.)

In recognition of this, CSA developed a civil remedies regime for continuous disclosure misrepresentations, which some CSA members recommended to their governments in November 2000. The regime has have not yet been adopted in any jurisdiction.

The Concept

Liability for all misrepresentations. All investors – whether buying in an offering, the secondary market or the exempt market (liability has already been proposed for exempt offerings under an offering memorandum in BC and Alberta) – could sue for damages if an issuer made a misrepresentation in an offering document or the issuer's continuous disclosure record.

An issuer would be liable for written and oral misrepresentations in any public disclosure. A CMA issuer (see Concept 1) would also be liable if it failed to disclose all material facts as required under the CMA continuous disclosure regime.

An investor would be able to sue:

- the issuer
- the issuer's directors and officers
- the issuer's "influential persons" (essentially significant shareholders and mutual fund managers)
- auditors and other experts (for misrepresentations in opinions used with their consent)

Investors could also sue underwriters or other due diligence providers for misrepresentations in a CMA issuer's offering document or the issuer's disclosure record as it stood at the time of the offering.

Investors would not need to prove that they relied on the misrepresentation or failure to make timely disclosure in making their investment decision.

Many elements of this concept come from the CSA civil remedies proposal, although this concept is more robust in some respects. For example, we suggest that those who are reckless or willfully blind should be treated in the same manner as those who act with actual knowledge. (A “reckless” defendant does not care whether or not the disclosure was accurate or was made at all. A “willfully blind” defendant deliberately avoids acquiring knowledge of the wrongdoing.)

As under the CSA civil remedies proposal, the standards of proof and potential defences would vary depending on the defendant and the type of document containing the misrepresentation.

Defences would vary by defendant:

1. The issuer would not be liable if it had a reasonable regime to prevent misrepresentations and make timely disclosure and a reasonable process for monitoring compliance with that regime. For example, a disclosure policy like that described in proposed National Policy 51-201 *Disclosure Standards* might serve as a defence if the issuer could also show it followed the policy.

2. Directors, officers or influential persons who are responsible for the disclosure would not be liable if they exercised due diligence to determine there was no misrepresentation.

3. Experts would not be liable if the misrepresentation based on their reports was as a result of misinformation provided by the issuer or if the issuer did not fairly represent the expert’s opinion or report.

4. Others relying on experts’ reports, including directors, officers, influential persons, and the issuer itself, would not be liable unless they acted knowingly or were reckless or willfully blind.

5. Underwriters or other due diligence providers would not be liable if they exercised due diligence to ensure that the issuer’s continuous disclosure record was complete and accurate at the time of the offering and that the offering document did not contain a misrepresentation.

Defendants would be proportionately liable (that is, liable only for their portion of the damages) unless they acted knowingly or were reckless or willfully blind. In that case, liability would be joint and several (that is, each defendant would be liable for the full amount of the damages).

Common remedies for all investors in CMA issuers. The only remedy for misrepresentations would be damages, which in some circumstances would be capped. Today, the remedies for misrepresentations in a prospectus include both damages (which are not capped) and rescission (the right to get your money back).

The concept gives all investors in CMA issuers the same rights of action for misrepresentation, whether they buy in an offering or trade in the secondary market. This is because under the CMA system all investors are trading on the basis of the same disclosure record. On that premise, it does not seem fair that some investors would have a right of rescission when others do not. Similarly, it is not fair that the damages would be capped for some investors but not for others. This is especially so given that the vast majority of trading is in the secondary market and that all shareholders ultimately bear the cost of the damages paid by an issuer.

Rescission for mutual fund and restricted issuer investors. Investors in mutual funds and restricted issuers (see Concept 1) would still be entitled to rescission for misrepresentations, because the secondary market for securities of these issuers is either non-existent (mutual funds) or very limited (restricted issuers). In these cases, there is no need to balance rights between investors who buy from different sources.

Two-day withdrawal right. Investors would no longer have a two-day withdrawal right, except for those who buy securities of restricted issuers. This is because we expect investors to exercise reasonable care and judgment in making their investment decisions and because they usually trade in the securities of CMA issuers and mutual funds through registrants, who have a duty to ensure the investment is suitable (unless the investor has chosen not to have the dealer perform suitability checks). Investors in CMA issuers or mutual funds who change their minds can also resell.

The two-day withdrawal right would be retained for investments in restricted issuers. There is a very limited market for these securities, and our experience shows that high-pressure sales tactics are more prevalent in this market. (The two-day withdrawal right is proposed as part of the BC and Alberta capital raising exemptions proposal.)

Actions against dealers and their directors and officers

The Problem

At common law, dealers are vicariously liable for the actions of their employees if the employee is acting within the scope of his or her employment, and employees themselves are liable for their own actions. However, vicarious liability can be difficult to prove, especially against directors and officers.

The Concept

Clients of dealers and advisers could sue dealers, advisers, mutual fund managers, portfolio managers, and mutual fund dealers for failure to comply with the applicable code of conduct (see Concepts 2 and 3).

This statutory right would tie liability to a breach of the mandated code and would increase the accountability of firms and their directors and officers for the actions of their representatives.

Potential defendants would be:

- the dealer, adviser, or mutual fund firm
- the firm’s directors and officers
- the individual salesperson or adviser

Defences would vary by defendant:

1. Dealer and adviser firms and the individual who breached the code of conduct would be absolutely liable.

2. Directors and officers would not be liable if (a) the dealer or adviser had a reasonable regime to ensure compliance with the code and a reasonable process for monitoring compliance with that regime, and (b) they did not act knowingly and were not reckless or willfully blind.

Investors would be entitled to recover their entire damages from either the firm or the individual who breached the code. We think holding firms absolutely liable would motivate them to take an active and continuing interest in compliance.

Actions for insider trading

The Problem

Trading on inside information is a serious type of market abuse. The current legislation focuses on “persons in a special relationship (SRP) with a reporting issuer”. An SRP includes an insider, someone engaging in a business activity with the issuer or its insiders, and tippees.

Currently, to sue an SRP, investors have to prove they traded with the SRP – a difficult, and usually impossible, burden to overcome.

The Concept

An investor could sue an SRP for trading on inside information if the investor traded during the relevant period. Because issuers would have some obligations designed to discourage insider trading (see Concept 4), investors could also sue the issuer and its directors and officers if the issuer failed to meet those obligations.

Potential defendants would be:

- the reporting issuer
- its directors and officers
- SRPs (for insider trading by them or by people they tipped)

Defences would vary by defendant:

1. The issuer and its directors and officers would not be liable if the issuer had a reasonable regime to prevent SRPs from tipping and trading on inside information and a reasonable process for monitoring compliance with that regime.

2. SRPs would not be liable if they reasonably believed that the information had been generally disclosed or that the information was given in the necessary course of business.

3. Persons who inform others about a proposed take over bid, reorganization, or property acquisition would not be liable if providing the information was necessary to effect the transaction.

The investor would be entitled to claim the loss incurred or the profit lost as a result of the improper trades. For example, if the SRP knew some good news about the issuer and bought securities before that news was disclosed, investors who sold during the relevant period could claim the difference between the (lower) selling price and the (higher) price after the news was disclosed. The relevant period begins when the SRP trades, and ends after the non-public information is disclosed.

The issuer would be proportionately liable based on its degree of fault. Other defendants would be liable up to the amount (or a multiple of the amount) they gained or the loss they avoided because of their insider trading.

Actions for fraud and market manipulation

The Problem

There is currently no statutory right of action for fraud or market manipulation. In a common law action, the only investors who can sue are those who traded with the person carrying out the fraud or manipulation. In addition, those investors have to show that the defendant had a fraudulent intent.

The Concept

An investor could sue anyone who knew or ought to have known they were participating in a fraud or market manipulation, if the investor traded during the relevant period. The relevant period would be the period during which the fraud or manipulation took place.

This means anyone could sue if they were in the market during the relevant period, whether or not they dealt directly with the person committing the fraud or market manipulation.

Liability would be linked to a provision, which BC and some other provinces have already, that prohibits a person from participating in a transaction if the person knew or ought to have known that the transaction perpetrated a fraud. This means an investor suing under this provision need not show fraudulent intent – only that the defendant knew facts from which he or she ought reasonably to have known that the transaction perpetrated a fraud.

Actions for unfair practices

The Problem

People who sell securities sometimes engage in unfair practices. These include:

- high-pressure sales tactics,
- taking advantage of a disadvantaged investor’s physical or mental infirmity, ignorance, illiteracy, age, or lack of sophistication, or

- imposing unduly harsh terms or conditions on a sale.

There is no statutory right of action against people who do these things.

The Concept

Investors could sue anyone who engaged in these activities. An investor could claim either damages or rescission.

The potential for liability, combined with the commission's ability to take action when unfair practices have been used, would deter those who might otherwise be tempted to take advantage of investors in these ways.

The class action regime

The Problem

The time and expense required to pursue a civil remedy often makes it impractical or uneconomic for an individual investor. Pursuing remedies through class actions would improve investors' prospects of success, but class action legislation is not available in all jurisdictions and, where it does exist, it has administrative hurdles that make securities cases difficult to pursue. For example, having to show that all investors have a cause of action can be very challenging, particularly if investors must show they relied on the misrepresentation if they are to sue successfully.

The Concept

Securities legislation would contain a separate class action regime specifically for investors to exercise the rights of action described above. This regime would replace provincial class action legislation for securities cases and would make class actions easier in appropriate cases. For example, the regime would establish presumptions about which investors would be included in the class.

Protections for defendants

The Problem

Without safeguards, the additional rights in this concept could increase costs and could discourage qualified people from serving as directors, officers and advisers for fear of potential liability.

These concerns surfaced in connection with the CSA civil remedies regime. Commenters were concerned over the spectre of "strike suits" (cases where plaintiffs without a legitimate claim bring an action to try and coerce the defendant into settling). In response, CSA added protections for defendants to the CSA regime, which seem to have calmed the concerns of the issuer community. We can also take some comfort from the fact that in the US, where strike suits have been common, companies still seem to be able to attract directors and officers.

The Concept

To balance the additional rights given to investors, these protections would be introduced for defendants:

1. Investors would need the court's permission to commence an action. The court would have to be satisfied that the action was being brought in good faith and had a reasonable possibility of success before it would permit the case to proceed.

2. Losing parties would have to pay a portion of the legal and other costs of the winning parties. In appropriate cases, the court could require investors to post security for costs, that is, put money in trust to ensure costs, if awarded, were paid.

3. The court would have to approve any proposed settlements. The court would have to be satisfied that there was evidence establishing a reasonable likelihood of wrongdoing.

4. There would be caps on liability. For example, the issuer's maximum liability under the CSA regime is the greater of $1 million or 5% of market capitalization. Directors' and officers' maximum liability is the greater of $25,000 or 50% of the total annual compensation, including stock or deferred compensation, they receive from the issuer. Experts' liability is the greater of $1 million or the amount the expert received from the issuer during the prior 12 months.

   Liability for individual defendants would be limited unless the defendant acted knowingly or was reckless or willfully blind. Under the CSA regime, the liability of an issuer is always capped. There are good reasons for this but we are considering whether there are any circumstances in which issuer liability should not be capped. We are also considering whether liability for directors and officers of registrants should be capped, and if so, at what level.

5. As is currently the case for prospectus liability, liability of underwriters or other due diligence providers would be capped at the total amount of the offering.

Advantages of the Concept

1. Many more investors would be entitled to statutory remedies:

   - All investors would have equal rights if there was a misrepresentation in an issuer's disclosure.

   - Clients could sue registrants for inappropriate actions.

   - Investors would no longer need to prove they were on the other side of trades by an SRP trading on inside information. They would only need to prove they were in the market at the time of the trade.

   - Investors would have statutory rights against those who commit fraud or engage in unfair trade practices.

2. Some elements of common law that make it difficult for investors to sue would be mitigated.

3. Statutory rights of action would ease evidentiary requirements, and a class action regime that is specific to securities law would make it easier for investors to establish classes and pursue their claims as a group.

4. Private rights of action can be an effective tool to motivate market participants to meet their obligations. Additional civil remedies would result in more detection of wrongdoing. They would also help to deter market abuse and encourage a compliance culture throughout the securities industry.

Questions

1. What are the factors we should consider in assessing the costs and benefits of this concept?

2. Is there any reason not to treat those who act recklessly or are willfully blind any differently than those who act with actual knowledge?

3. Are there any circumstances in which an issuer’s liability for misrepresentations or failure to make timely disclosure should not be limited?

4. Is there any reason to retain the right of rescission or the two-day withdrawal right for investors who buy securities in an offering by a CMA issuer?

5. Is there any reason to retain the two-day withdrawal right for mutual fund investors?

6. Is there any reason that the liability of registrant firms should not be absolute for breaches of the code of conduct?

7. Should we place caps on the potential liability of directors and officers of registrants for breaches of the code of conduct? If so, what would be an appropriate cap?

8. Should we adopt the liability caps used in the CSA civil remedies regime, or should they be revisited?