

## **APPENDIX A**

### **Proposal to Redefine the Materiality Standard**

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## Proposal to Redefine the Materiality Standard

“Material fact” and “material change” are both defined in BC and under most other provinces’ securities legislation in terms of the significance of their impact on the market price of the issuer’s securities.

However, the definition of material fact is broader than material change; it encompasses any fact that can “reasonably be expected to significantly affect” the market price or value of an issuer’s securities and is not limited to changes in the “business, operations, assets or ownership” of an issuer that would reasonably be expected to have such an effect. *Pezim v. British Columbia (Superintendent of Brokers)*, [1994] 2 S.C.R. 577.

Material fact and material change are used for different purposes:

- an issuer must make full, true and plain disclosure of all material facts when it sells securities under a prospectus
- a person (including an issuer) cannot trade a security if the person has knowledge of a material fact or a material change that has not been generally disclosed
- an issuer must disclose material changes as soon as practicable by press release and file a material change report within 10 days, and
- there is a general duty on senior management to enquire about material changes before an issuer trades securities, but there may not be a duty for them to enquire about material facts.

In addition, “misrepresentation” is defined in terms of material fact – a misrepresentation is an untrue statement of a material fact, or an omission to state a material fact that is required to be stated, or necessary to prevent a statement made, from being misleading.

### Summary of Proposal

#### ***We will redefine the disclosure standard:***

- to be similar to the “material information” standard that is described in the timely disclosure policies of the Canadian exchanges,
- to omit the retroactive test currently contained in the definition of material fact, and
- to omit the reference currently in the definition of material change to a decision by senior management that they think the directors will approve.

#### ***We will apply the standard consistently***

- as the minimum required disclosure in an issuer’s CMA entry document
- to prohibit insider trading
- to determine an issuer’s continuous disclosure obligations, and
- to determine liability for misrepresentation.

***We will clarify what disclosure is required and when disclosure must be made.***

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## The Problem

1. **The current distinction has been problematic to apply.** The courts and Commissions have struggled to characterize information as either changes or facts in order to apply the law.

Perhaps the best example is found in *Pezim v. British Columbia (Superintendent of Brokers)* [1994] 2 SCR 577 where the BCSC found three matters to be material changes requiring disclosure, one of which was drilling results. At the Court of Appeal, Lambert J.A. determined that this was an error, stating that drilling reports were capable of being material facts, but not material changes. Lambert J.A. said the information might be a basis for a perception that there was a change in the value of an asset, but distinguished that from a change in the asset itself.

The Supreme Court disagreed. In his opinion Iacobucci J. said

- the determination of what constitutes a material change for disclosure purposes falls squarely in the regulatory mandate and expertise of the BCSC, and the majority of the BC Court of Appeal in rejecting the BCSC's finding was in error
- the BC Court of Appeal's majority view was clearly wrong and inconsistent with the economic and regulatory realities the *Securities Act* sets out to address.

Iacobucci J. buttressed his position by approving the argument that new exploration results can change the character of a mineral property from waste to ore. George C. Stevens and Stephen D. Wortley, *Murray Pezim in the Court of Appeal: Draining the Lifeblood from Securities Regulation*, (1992), 26 UBC L. Rev. 331. Of interest too, is Locke J.A.'s dissenting opinion in the Court of Appeal that information is capable of being an asset. Therefore a change in information could be a change in an asset, and thus a material change, within the meaning of the Act.

In another example, the OSC found a statement made by an issuer's officers to a significant shareholder, that a take-over would not succeed because 60% of the issuer's shares were in friendly hands, to be a material fact and the basis for finding illegal tipping. *Royal Trustco Ltd. et al., White and Scoles* (1981) 2 OSCB 322C.

On appeal, the Ontario Divisional Court stated that the term "fact" should not be read "super-critically" and that the "information" in the statement was sufficiently factual or a significant alteration of circumstances to be a material change to fall within the tipping provision. *Re Royal Trustco Ltd. et al. and Ontario Securities Commission* (1983) 43 O.R. (2d) 147 (Div. Ct.).

One commentator has suggested that the distinction between a fact and a change can generally be seen in terms of an internal vs. an external event. This is based on a seemingly sensible notion, that generally speaking, an issuer should only be responsible for making continuous disclosure of "internal type" events. Alboini, *Securities Law* section 18.1.2, at p. 18-110-11. As appealing as this analysis may be, it is not entirely consistent with the definitions or with the analyses made by the courts. Also, it does not address the external event that has a particular impact on an issuer that is both material and different from its impact on other issuers in the same industry (for example, political instability in a localized area where the issuer's property is located), which it seems an issuer should be required to disclose.

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Other commentators have suggested that the duty to disclose material changes should be seen as the duty to disclose changes in the basket of facts disclosed originally in the issuer's prospectus and from time to time afterwards. Stevens and Wortley, *supra.* at 338-339. This more closely approximates the appropriate duty, but does not clearly directly address the "new" fact, except to the extent it can be seen as an omission from disclosed facts.

The niceties of whether information is a change or a fact should not matter. If information could reasonably be expected to have a significant impact on the issuer's market price or value, the issuer should be required to disclose the information and persons who have the information should be prevented from trading while it remains undisclosed.

2. **It is more difficult to determine when disclosure must be made.** The issue of when an issuer must make disclosure is exacerbated by the difficulty in determining whether the information is a material fact or a material change, and by policies stating that even if it isn't either, it should be disclosed anyway.
3. **The current distinctions are inconsistent with the principles of CMA.** The CMA system recognizes that the investor who purchases securities in the market is making an investment decision, the same as an investor who purchases securities directly from the issuer under a prospectus. Under CMA they are both entitled to the same, appropriate, level of disclosure. The distinction that is currently made between material fact and material change, which allows the issuer's securities to be traded, by persons who are not insiders or in a special relationship with the issuer, in the market while material facts are undisclosed, but does not allow the issuer to make a trade in its own securities, is not consistent with the underlying principles of the CMA system.
4. **The retroactive element in the current definition of material fact is inappropriate, particularly in view of potential liability for the disclosure.** The definition of "material fact" includes both a fact that "significantly affects" the market price of a security and a fact that "would reasonably be expected to have a significant effect" on the market price. The first part of the definition allows materiality to be determined retroactively on the basis of actual market activity even if there was no reasonable ground for the issuer's management to expect, when they made their judgment as to whether or not the fact was material, that the fact would have a significant effect on the market price. Our view is the same as the view of the Allen Committee and the CSA Civil Remedies Committee on this matter.
5. **The inclusion of a decision by senior management that they think the directors will approve in the current definition of material change is inappropriate.** It confuses what a material change is – the purpose of the definition – with when disclosure should be made. Pending board approval should be treated like other uncertain events—management must balance the likelihood that the event will occur and the anticipated impact of the event if it were to occur to determine if and when disclosure should be made. This should lead management to either make the disclosure if board approval is anticipated, or keep the event confidential until the board considers the matter.

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6. **The timely disclosure policies of the exchanges “go beyond” the issuer’s statutory obligations, causing confusion as to the extent of the issuer’s obligations and liabilities.** Adding to the confusion is the statement in the policies that a cornerstone principle of securities regulation is that all persons investing in securities should have equal access to information that may affect their investment decisions. This could be interpreted to require disclosure of non-material information.
  7. **Applying the statutory definition of material fact in some, but not all instances, where material fact is referred to in the *Securities Act* leads to uncertainty and confusion.** Another difficulty arising from the current definition of material fact is that the definition is stated to apply when the term is used in relation to securities issued or proposed to be issued. This has led to courts to conclude that there are two different definitions of material fact, and that they must determine whether the statutory definition based on market impact applies, or whether the “ordinary” meaning of material fact—important and significant information—applies, to a particular situation. See *R. v. Crimeni* (March 13, 1998) Vancouver Registry No. 21053-01 (unreported) and *R. v. Coglon* [1998] B.C.J. No. 2573 (B.C.S.C.)
  8. **Quebec and the US use a “reasonable investor test” that is more subjective than the market impact test.** The US Supreme Court set out this approach in *TSC Industries Inc. v. Northway, Inc.* 426 US 438 (1976). Under the Northway test, information is material if there is a substantial likelihood that a reasonable shareholder would think it important in making an investment decision, or put another way, there must be a substantial likelihood that a fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available. This test is more difficult than the market impact test to apply with certainty, and may result in a different determination of materiality. In the US, there is a line of insider trading cases that have used the market impact test to decide whether facts are material under Northway’s reasonable investor test – seemingly concluding that a reasonable investor cares about facts that are likely to affect the value of a security, and it is these facts that are material. See Davis, 24 *Materiality and SEC Disclosure Filings* 24 *Securities Regulation Law Journal* 180, 187-189 discussing, *Cady, Roberts & Co* 40 SEC 907 (1961), *List v. Fashion Park, Inc.* 340 F2d 457, 462 (2d Cir. 1965), quoting *Kohler v. Kohler Co.* 319 F2d 634, 642 (7<sup>th</sup> Cir. 1963), *SEC v. Texas Gulf Sulphur*, 401 F2d 833 (2d Cir. 1968), and *Elkind v. Liggett & Myers* 635 F2d 156, 166 (2d Cir 1980). In his article, Davis argues that this is the proper standard for materiality and there should be no other.

## **Details of the Proposal**

We will redefine the disclosure standard in terms of material information. Issuers will be required to make disclosure of all material information in their entry documents, and to ensure that the disclosure remains current.

### **1. Underlying policy**

The basis for securities legislation is that all persons investing in securities have equal access to material information.

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## 2. Definition of “material information”

“Material information” means information relating to the business or affairs of an issuer that would reasonably be expected to result in a significant change in the market price or value of any of the issuer's securities.

(A different definition will need to be proposed for mutual funds.)

The language – “reasonably expected to **result in a significant change** in the market price or value” – is from the TSX's policy. We think it expresses more plainly the language that is currently in the legislation – “reasonably be expected to **have a significant effect on the market price or value**”.

The concept of the change having to be expected to **result in a significant change** is very important to ensure that frivolous suits are not brought because of nominal changes in the price of an issuer's securities. Significant means meaningful, important, of consequence-- the information that was misstated or omitted is of such importance that it results in a significant change in the market price or value of the issuer's securities. Similarly, the change contemplated must be distinguished from a change in the market generally, or the issuer's industry segment at large. The change referred to in the definition is that portion of the change in the market price or value of an issuer's securities that is not related to or explained by other movements in the marketplace. This concept of related significant change, coupled with the anticipated costs of litigation, will serve as a gatekeeper, keeping out frivolous litigation.

## 3. Assume a rational, efficient market

We will make it clear in guidance that the definition of “material information” assumes a rational, efficient market where investors' behaviour is based on economic interest alone. Management cannot presume that because historically there has been little response in the issuer's stock price to news released about the issuer, that no news about the issuer's business and affairs is material. Similarly, we know that markets often appear to be interested in information that does not have an economic impact – we can leave it to the market to call for this information, and for issuers to respond to market demand. If an investor learns of information that does not have an economic impact and wishes to sell the shares as a consequence of the information, the investor can do so with nominal financial impact to the price. Also information that is “noneconomic” can become economic – for example, when an issuer's policies are so unpopular that they result in a boycott of an issuer's products. At that point the information, provided it meets the significance test, is material.

Under the market impact definition, management must assume that the price of the issuer's securities immediately prior to the time disclosure is to be made is determined in an efficient, free market that has processed all disclosed information, and ask themselves whether, assuming the same efficient, free market, the information would reasonably be expected to result in a significant change to that price. This is extremely important because it permits the decisions of management to be made examined and reviewed based on principles that are fair and transparent. This is especially important because the issuer and management are liable for misrepresentations, ie, misstatements and omissions of material facts.

In addition, under these principles, materiality is capable of measurement using standard market models developed by financial economists that can test whether false information caused a security to trade at an artificially high or low price by measuring whether investors earned any

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abnormal returns at the time the correct information was released to the public. The model incorporates the observed relationship between the return on a particular stock and the market or market segment as a whole, to isolate the change in the return that is attributable solely to the allegedly withheld or false information. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 *The Business Lawyer* 1 (Nov. 1982), referring to Schwert, *Using Financial Data to Measure Effects of Regulation*, 24 *J. Law & Econ.* 121 (1981). This brings greater certainty and assists management in making appropriate decisions in this regard.

#### **4. Redefining the standard**

The requirement to disclose material information is not the same as the requirement to make “full, true and plain disclosure of all material facts” or “prospectus-level disclosure” which industry has come to understand to mean answering each and every question in the long form prospectus, whether or not the information called for is material to the issuer. Imposing a requirement to keep this detailed level of disclosure current would be overly burdensome to issuers and would delay the release of important information to the market. Disclosure should focus on significant items; if the volume of disclosure increases, focus on the main issues can be lost.

Properly defining the standard for disclosure is fundamental to CMA and the related investor remedies regime. As the US Supreme Court stated in *Northway*:

“..if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions and misstatements, but also management’s fear of exposing itself to substantial liability may cause it to simply bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making.” *TSC Industries v Northway*, USSC June 14, 1976, reported at p. 90,069 of CCH Federal Securities Law Reports at ¶ 23, cited with approval in by Montgomery J. *Royal Trustco Ltd. v. Campeau Corp* (Ontario High Court of Justice) (1980) 31 OR 2d 75.

Issuers must disclose all material information in their entry documents. Press releases would be used to disclose material information that should be disclosed between regular filings in a timely way. Should an issuer wish to do so, additional information may be provided in its annual information forms, quarterly reports, in supplemental filings or on their websites. This system ensures that press releases are used for their true purpose: to give the market notice of truly important -- that is, material -- information, but recognizes that there may be additional information of a more detailed or a background nature the issuer may wish to put on the public record.

#### **5. Disclosure of “external” events**

Issuers would not generally be required to interpret the impact of external political, economic and social developments on their business and affairs. However, if an external development has had or will have a direct effect on the business and affairs of an issuer that is both material and uncharacteristic of the effect generally experienced by other issuers engaged in the same business or industry, the issuer must make disclosure of the development and its impact or potential impact on the issuer.

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## 6. Timely disclosure

An issuer will be required to disclose material information as soon as practicable on the information becoming known to management, or in the case of information that is previously known to management as soon as practicable on it becoming apparent that the information is material.

Generally, an issuer should make disclosure when the material information is “established”, ie, when management has reviewed the information, has reasonable confidence in it and put it into context. If every suspicion that could affect the market price were to be published the result would be a chaotic market.

Timely does not mean immediate - it means as soon as practicable. And that means that management must be able to review the information, have reasonable confidence in it and put it into context.

*Amirault v. Westminer Canada Ltd* (N.S. Supreme Court Trial Division)[1993] NSJ No. 129 provides a good illustration. This case considered whether certain information indicating that the company’s mineral property was not as promising as the public record indicated was a “material fact” that should have been disclosed. Nunn J. wrote:

In a mining exploration company there are many facts, ie events, occurrences, results and the like occurring regularly and often important to the company’s operations but to hold that all these, or all important things are material and must be disclosed would create not an open and fair market place but rather a chaotic one. For example, as here, if you have an expected grade which upon some initial sampling turns out to be lower that certainly is a fact and undoubtedly an important one. However, to say it is material and required to be disclosed is another matter for within a day or week the sample grade may change upward dramatically. If both were disclosed as material information, the market could go up and down like a yo-yo and would be open to unresolvable and myriad claims of manipulation—reveal a few pessimistic facts, bring down the price of the stock, then release some favourable facts for the reverse effect.

To my mind, this is not what is intended. In order to give proper effect to the policy, a determination of materiality must be based upon a reasonable expectation that the price of the stock would undergo a significant change. In this situation...the facts of grade and ore reserves become material facts when the company is satisfied after performing the necessary work, in this case, as recommended by the consultants, as to the accuracy of the fact and that that is significantly different from earlier facts as to cause a significant change in the market price of the stock.

### However:

1. While the issuer is establishing the material information, the issuer must have a system in place to keep the information confidential and to prohibit persons with knowledge of the information from trading in the issuer’s securities, and the issuer must not trade in its securities.

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2. If market activity indicates that the information has leaked or the existence of rumour, or if management has made selective disclosure that it realizes should have been made generally public, the issuer must issue a clarifying press release.
  3. In no event, may the issuer make misleading disclosure. Where an issuer is required to make a statement, management is responsible to make appropriate inquiries to assure themselves that the statement they make is truthful and not misleading.

## **7. Clarifying the duties of management**

Issuers are responsible for having systems in place:

- to bring important information about the issuer's business and affairs to management's attention
- for management to review the information, to determine whether it is material and to disclose material information as soon as practicable
- to prohibit trading in the issuer's securities by the issuer, its directors, senior officers and anyone with knowledge of undisclosed material information.

Where the application of the materiality test is not straightforward because of the uncertainty an event will occur, management must balance both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the issuer's circumstances to determine if, and when, the information becomes material information and must be disclosed. Similar to the situation where the issuer is establishing material information, the issuer and its management will not be liable for not making disclosure during a pending event, provided the information is held in confidence and there is no trading in the issuer's securities by the issuer or others with knowledge of the information. Again, if there is evidence that the information has leaked or there is a rumour that is in some way associated with the issuer, management must issue a clarifying statement immediately.

When an issuer must make a clarifying statement about a matter (eg, because of rumour or leak or inadvertent selective disclosure), management must make inquiries and otherwise take due care to ensure that the issuer discloses all material information and that it does so within 24 hours of learning of the rumour or leak, or of unintentionally making selective disclosure. If management complies with this, neither the issuer nor management will be liable.

This defence recognizes that during a private placement and in certain other business contexts, management may unintentionally make selective disclosure and permits management to correct the situation without liability. It is not available to anyone who has engaged in tipping, insider trading, fraud or market manipulation.

Management's decisions in determining whether information is material and in timing public disclosure will be viewed in the context of whether management acted reasonably in the circumstances, and not with the benefit of 20/20 hindsight.

An issuer has no general duty to correct or update third party statements or rumours unless:

- The issuer or its management is responsible for the rumour
- The issuer or its management are closely associated with the statements (such as analyst reports where the issuer has provided the information to the analyst or has encouraged the report)
- There is undisclosed material information that appears to have leaked.

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## 8. Confidential filing where undue detriment

We will preserve the procedure for an issuer to make a confidential filing with the Commission where management is of the view that disclosure of material information would cause undue detriment to the issuer. This function is currently served by the material change report. As is the case now, the executive director may disagree and require the issuer to make disclosure.

One the basis for confidentiality is no longer present, if the information is still material information, the issuer must make disclosure. In no event can disclosure of material information be deferred permanently.

## 9. Materiality depends on the issuer's circumstances

The materiality of information varies from one issuer to another according to the size of its profits, assets and capitalization, the nature of its operations and many other factors. Information that is "material" in the context of a smaller issuer's business or affairs is often not material to a larger issuer. We will provide a list of developments that are likely to be material to an issuer and will refer to the lists included in the disclosure policy of the exchanges. The issuer, itself, is in the best position to determine the materiality of particular information in the context of its own affairs.

## 10. Materiality in financial statements

Materiality may be defined by others differently in other contexts, for example, by the CICA Handbook for the purpose of financial statement disclosure. Accordingly, information may be material for the purpose of disclosure in an issuer's financial statements that may not be material for purposes of an issuer's continuous disclosure obligations or insider trading prohibitions.

## Advantages of the Proposal

The Proposal clarifies what disclosure is required and when disclosure must be made.

1. **The difficulties that arise in determining whether something is a fact or a change will disappear.** Issuers and their management will focus on what is really important—if information (of whatever type) would reasonably be expected to result in a significant change in the market price or value of the issuer's securities then it is material, must be disclosed, and until it is disclosed persons who know that information must keep it confidential and cannot trade.
2. **All investors will have an equal right to the disclosure that really matters - information that would reasonably be expected to result in a significant change in the market price or value of the issuer's securities.** This is consistent with the principles of CMA that recognize that investors in the primary market and investors in the secondary market are both entitled to an appropriate level of disclosure and the same rights if the disclosure is not made or contains a misrepresentation.
3. **Issuers and their management will not be liable if there is a significant change in the market price if it was not reasonable to expect this would have occurred.** Issuers and their management will not be judged with the benefit of 20/20 hindsight.

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4. **Issuers and their management will be liable for ensuring material information is disclosed in a timely manner.** Not all information is material. In fact, not all important information is material either. In order for information to be material, it must be reasonable to expect that the information would result in a significant change in the market price or value of the issuer's securities.
  5. **When an issuer must release information is clarified.** We will provide that an issuer may keep material information confidential until the information is established —ie, management has reviewed the information, has determined that it is material, is reasonably comfortable with its accuracy, has put it into context and has determined that it is material. Issuers will be responsible for having systems in place:
    - a. to bring important information to management's attention
    - b. for management to review the information, to determine whether it is material and to disclose material information, and
    - c. to prohibit trading during the period that material information is being established, during pending events and when the issuer has disclosed material information in confidence to the Commission by anyone with knowledge of the information.

Management will also be responsible to make appropriate inquiries and to release the information or otherwise clarify the situation by issuing a press release within 24 hours in the event there is evidence that the information has leaked.

6. **There will be only one test for materiality.** The same test will apply for all purposes under the *Securities Act*. Legal requirements and policies will be consistent.