Investor Remedies In Securities Legislation

A Regulatory Impact Analysis

New Legislation Project
British Columbia Securities Commission

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BCSC

A NEW WAY TO REGULATE

BRITISH COLUMBIA SECURITIES COMMISSION

About This Study

This study is among series of studies prepared by the British Columbia Securities Commission to analyze the impact of significant elements of proposed new securities legislation for British Columbia.

The other studies in the series are also posted on the BCSC website at www.bcsc.bc.ca/policy:

- *Better Disclosure, Lower Costs – A Cost-Benefit Analysis of the Continuous Market Access System* (October 2002)
- *Strong and Efficient Investor Protection: Dealers and Advisers under the BC Model – A Regulatory Impact Analysis* (November 2003)
- *Cost Savings Under a Firm-Only Registration System* (May 2004)
- *Enforcement of Outcomes-Based Securities Legislation* (May 2004)

About The New Legislation Project

The New Legislation Project was established by the British Columbia Securities Commission in October 2001 to modernize, streamline and simplify securities regulation in British Columbia. Its mandate was to prepare new securities legislation for introduction in the British Columbia Legislative Assembly during the Spring 2004 legislative session. The new *Securities Act* (Bill 38) was introduced on May 5, 2004.

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Executive Summary

This report summarizes a study conducted by the British Columbia Securities Commission on a set of investor remedies considered for inclusion in securities legislation. The study was part of a process begun in October 2001 to replace the current *Securities Act* with more modern and effective legislation. The new legislation (Bill 38 *Securities Act*) was introduced in the British Columbia Legislative Assembly on May 5, 2004.

Role of statutory remedies

- Statutory remedies are a critical component of one of the four key elements of the BCSC's approach to securities regulation: creating a culture of compliance.
- Remedies should provide a meaningful deterrent against non-compliance without penalizing compliance-minded market participants by unduly increasing their liability risk or imposing unnecessary costs.

Remedies included in Bill 38

- Bill 38 continues most of the investor remedies from the current legislation.
- Bill 38 includes several new remedies – the right to sue for misrepresentations in continuous disclosure and for not making timely disclosure. Investors will also be able to sue more easily for insider trading, front running, and related misconduct.

Remedies considered but not included in Bill 38

- Various proposed remedies were compared to the common law to determine the increase in potential liability that potential defendants would face. An intended quantitative analysis was not completed, as explained later in this report.
- The rights of action considered related to:
  1. misrepresentation generally,
  2. contravention of the code of conduct for dealers and advisers,
  3. market manipulation and fraud,
  4. unfair practice, and
  5. trading or advising without registration.
- Numbers 1 and 2 would have added significantly to existing common law remedies; this risk was not quantified so neither of these causes of action is included in Bill 38 (existing common law remedies are being used by litigants and appear to be reasonably effective).
- Numbers 3, 4 and 5 would not have provided a meaningfully better remedy for plaintiffs than existing common law remedies (particularly after taking into account the provisions in the regime to protect defendants), so these are also not included in Bill 38.

I. Background

On April 15, 2003, the British Columbia Securities Commission published the "BC Model" – draft legislation and rules that embodied the Commission's commitment to a new way of regulating securities markets. This was a major step in a process begun in October 2001 to replace the current *Securities Act* with more modern and effective legislation. The new *Securities Act* (Bill 38) was introduced in the British Columbia Legislative Assembly on May 5, 2004.

The inclusion of an appropriate investor remedies regime in the legislation is a critical component of one of the four key elements of the BCSC's approach to securities regulation: creating a culture of compliance among market participants.[1] The primary purpose of these remedies is to deter contravention of the legislation. It is not primarily to compensate investors, although that is obviously an ancillary effect. This means that when adding new remedies, the goal is to supplement the common law enough to provide a meaningful deterrent, but not so much that market participants who do comply with the legislation face an undue increase in liability risk, or incur unnecessary costs.[2]

The BC Model proposed a new approach to investor remedies – a single right of action for any material contravention of the Act or rules. As a result of additional study, and the results of our consultations on the BC Model, we did not pursue further development of that approach.

Instead, we developed the regime that was the subject of this study. That regime reverted to the structure in the current legislation – a separate right of action for a contravention of specified provisions of the Act and rules. The study regime, which was not published for comment, proposed several new rights of action, including a set of new rights of action for misrepresentation in continuous disclosure based on a proposal published by the Canadian Securities Administrators in November 2000 (and since enacted in Ontario).[3] The CSA proposal followed the recommendations in a report of an industry committee established by the Toronto Stock Exchange. Both the TSE report and the CSA proposal were the subject of extensive study and consultation prior to their publication.

The BCSC used the results of this study in the course of advising government about the content of Bill 38. The investor remedies in Part 10 of Bill 38 continue most of the remedies in the current *Securities Act*, and include new remedies based on the CSA November 2000 proposal. Bill 38 does not include any of the other elements of the regime we studied, for the reasons explained in this report.

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[1] The other elements are keeping the rules few, simple and clear, acting decisively against misconduct, and educating investors and market participants.

[2] These costs would include legal fees for designing legal preventative measures, as well as the impact those measures could have on a market participant's ability to take advantage of the increased flexibility inherent in the new legislation.

[3] Canadian Securities Administrators, CSA Notice 53-302 *Proposal for a Statutory Remedy for Investors in the Secondary Market*, November 3, 2000. The government of Ontario has passed amendments, not yet in force, to the *Securities Act* (*Ontario*) based on that proposal.

II. Methodology

The study analyzed the investor remedies regime described under *Background*. We designed the study to have two components:

- a legal analysis comparing the regime to the existing common law to determine the degree of increased liability risk, if any, to potential defendants under the regime, and
- a quantitative analysis intended to quantify that risk and determine the impact, if any, on the cost and availability of directors' and officers' liability insurance and errors and omissions insurance.

Legal Analysis

We retained an independent legal research firm to review the common law relevant to each head of liability under the regime. The objective was to determine whether the regime would have significantly expanded the avenues of redress available to a plaintiff compared to those under common law.

We then retained two experienced litigation counsel to review both the research and our own tentative conclusions from the research. Each of these counsel reviewed different rights of action contained in the regime and gave us their opinions about the degree to which each right of action would have added a new avenue of redress.

We were interested in this question because it goes to the heart of the balance that must be struck when enhancing common law redress through statutory rights of action, as described under *Background*.

The legal analysis covered the provisions in the regime that would have provided a statutory right of action against a person who:

- made a misrepresentation
- contravened specified provisions of the proposed Code of Conduct for dealers and advisers
- committed market manipulation or fraud
- committed an unfair practice, or
- traded in or advised on securities without being registered

The analysis also considered these aspects of the regime:

- classes of defendants
- defences
- remedies
- protections for defendants

The analysis did not cover the investor remedies that Bill 38 continues from the current legislation[4] or the new remedies it includes based on the CSA November 2000 proposal.[5]

Quantitative Analysis

With a view to quantifying the impact of the legal analysis, we contacted several Canadian insurers and asked them to review the conclusions drawn from the legal analysis. We chose insurers to perform this function because they are experts at quantifying risk, and because we wanted to know the estimated impact, if any, of the regime on the cost and availability of directors' and officers' liability insurance and errors and omissions insurance.

We received excellent cooperation from the insurers we contacted (and from the major insurance broker in Vancouver who helped us make contact with those insurers). They were very interested in the project and were prepared to devote considerable resources to provide us with the analysis we required. However, we underestimated the time required for the insurers to complete their analysis and it soon became apparent that they could not produce a credible analysis that met our needs in time to advise government on the content of the new legislation.

We therefore drew our conclusions about the regime on the basis of the legal analysis alone.

[4] This includes liability for misrepresentations in, or failure to deliver, a prospectus or other offering document, a circular or other documents related to a takeover bid or issuer bid, for trading on inside information, and for "front running".

[5] These were considered part of the "base case". Bill 38 includes these provisions so that the remedies available to British Columbia investors will be no less than those available to investors elsewhere in Canada.

III. Findings

1. *Misrepresentation*

Under the current legislation, an investor can sue an issuer, its officers and directors, and others, for a misrepresentation in a prospectus or an offering memorandum, or in documents related to takeover bids or issuer bids. Bill 38 continues this remedy and provides a new remedy for a misrepresentation in continuous disclosure.

These rights of action for misrepresentation go beyond the common law. Under these rights of action, the plaintiff does not have to prove several elements that are required in common law actions: that the defendant was negligent, that the plaintiff relied on the misrepresentation to his or her detriment, or that that the plaintiff's reliance on the misrepresentation was reasonable. Furthermore, a misrepresentation is actionable under common law only if it is a misstatement of fact. Under these statutory rights of action, omissions, not just misstatements, are actionable.

Liability under the regime we studied would have been even broader. Under the regime, an investor could have sued anyone for a misrepresentation. In addition to misrepresentations made by issuers, actionable misrepresentations would have included ones that a reasonable investor would consider important in considering a trade or a relationship with a dealer or adviser.

Because we were unable to complete the quantification part of the analysis, we could not quantify the increased liability risk to market participants (including dealers and advisers, and their directors and officers, who would have been particularly affected by the new right of action). For this reason, we recommended that government not include the broader right of action for misrepresentation, and it is not in Bill 38.

However, investors are not without a remedy under common law. Today, clients of dealers and advisers who seek compensation for misrepresentation sue in tort for misrepresentation or for breach of contract.[6] These claims are relatively common, and the common law requirements do not appear to be particularly problematic for plaintiffs in these circumstances.

2. *Contravention of Code of Conduct*

The draft rules under the BC Model contained a Code of Conduct that set out several principles that dealer and adviser firms and their employees would have to follow. (Although the rules under the new legislation have not been finalized, we expect they will include a Code with similar requirements.)

Under the regime, a client could have sued a firm, and its directors and officers, if it, or any of its trading or advising employees, contravened any of these Code provisions:

[6] Misrepresentation could also be alleged in a breach of contract action as a breach of an implied term of the contract that the broker will tell the truth (or at least will not be negligent in giving advice).

Integrity and fairness

- acting fairly, honestly and in good faith and in the best interests of clients
- exercising the care, diligence and skill of a reasonably prudent person

Dealing with clients

- keeping the client informed of all facts that a reasonable person would consider important to the business relationship
- providing the client with the information necessary to make informed investment decisions

Confidentiality

- holding in strict confidence all confidential information acquired in the course of the relationship with clients, unless the client consents, disclosure is legally required, or the client's activities are a threat to the market

Suitability

- determining the general investment needs and objectives of the client, and recommending only those investments that are suitable
- advising the client about unsuitable investments requested by the client

Conflicts of interest

- resolving conflicts of interest in favour of the client
- disclosing to the client information that a reasonable client would consider important in determining the objectivity of the service or advice
- when acting as an underwriter, disclosing to investors any relationships with the issuer that would lead a reasonable investor to question the independence of the underwriter

Conduct that has amounted to a violation of some of these duties has provided aggrieved clients with a common law cause of action for breach of contract, negligence or misrepresentation. Some conduct in the conflict of interest area has been litigated on the basis of fraud and deceit.

The most fertile basis of action for litigants, however, is an action based on breach of fiduciary duty, although under common law, the broker-client relationship is not necessarily a fiduciary relationship. The courts consider the circumstances of each case to consider whether the broker owed a fiduciary duty to the plaintiff.

In cases where a fiduciary duty is owed, that duty encompasses much of what would have been actionable under this part of the regime. However, the broad obligation in the Code to act "in the best interests of the client" could have gone beyond even the duties owed in a fiduciary relationship.

The regime had the potential to go even further beyond the common law in cases where a fiduciary duty is not owed. The effect of imposing liability for a contravention of the provisions of the Code described above could, in many cases, have imposed a duty that in essence would have been the same as a fiduciary duty.

The regime also added directors and officers of firms as potential defendants. Under usual circumstances, these individuals would not be potential defendants under the common law, so this represented another expansion.

This right of action in the regime would therefore have significantly increased the risk of liability for this misconduct compared to the common law. Because we were unable to complete the quantification part of the analysis, we could not quantify this risk to dealers, advisers, and their directors, officers and representatives, or to estimate the impact on the cost and availability of insurance coverage. For this reason, we recommended that government not include the right of action and it is not in Bill 38.

However, as noted above, investors are not without a common law remedy. Litigation in this area is fairly common, which suggests that the courts are providing redress to clients in appropriate circumstances.

3. Market manipulation and fraud

Like the current legislation and Bill 38, the BC Model included prohibitions against market manipulation and fraud. A contravention can lead to administrative sanctions and quasi-criminal penalties. Under the regime, investors could also have sued a person who contravened that prohibition.

There are common law causes of action for this kind of conduct based on the torts of deceit (fraudulent misrepresentation) and conspiracy. The regime would not have significantly expanded the liability under those torts.

If the plaintiff can establish that there was a fiduciary relationship between the plaintiff and the defendant, a common law action is also available on the basis of a breach of that fiduciary duty. However, establishing that the defendant owed a fiduciary duty to the plaintiff in the first place is a significant hurdle for a plaintiff in these actions, especially in the issue context. The general principle is that, absent exceptional circumstances, a director or officer does not owe a fiduciary duty to individual shareholders.

The regime could have increased the risk of liability for directors and officers of issuers in actions brought on that basis. Under the regime, all a plaintiff would have had to show was that the individual defendant was an officer or director of the issuer at the time of the alleged wrongdoing (and, in the case of an officer, that the officer authorized, permitted, or acquiesced in the misconduct).

The cause of action is not in Bill 38. It appears that the common law provides adequate redress. Although it is difficult to sue directors and officers for breach of fiduciary duty, the law does not preclude them as defendants under the torts of deceit or conspiracy.

4. Unfair practice

Like the current legislation, and Bill 38, the BC Model would have included a prohibition against engaging in an unfair practice, which is defined to include:

- putting unreasonable pressure on a person
- taking advantage of a person's inability or incapacity to protect his or her own interests because of physical or mental infirmity, ignorance, illiteracy or age
- taking advantage of a person's inability to understand the character, nature, or language of any matter relating to a decision to trade a security
- imposing terms or conditions that make a transaction inequitable

A contravention can lead to administrative sanctions and criminal penalties. Under the regime, investors could have sued a person who contravened that prohibition.

Common law cases for this type of conduct are rare. When they occur, they are most often founded on breach of fiduciary duty, although the facts in some cases may establish the torts of deceit (fraudulent misrepresentation) or conspiracy. The analysis under *Market manipulation and fraud* applies equally here, although in many situations where this conduct occurs, the elements of the plaintiff's dependence and vulnerability may be more likely to lead to a finding that the defendant owed a fiduciary duty.

This cause of action is not in Bill 38. Although cases are rare, the common law provides adequate redress, at least in the context of a fiduciary relationship, which is the context in which this conduct is most egregious.

5. Trading or advising without registration

Under the regime, investors and clients could have sued a person who was not registered to trade in or advise on securities if the person was required to be so registered.

Few cases involving this type of misconduct have come before the courts, so the common law side of the comparison was thin. The cases found were based on breach of contract. Possible, but untested, causes of action could also be breach of fiduciary duty, or either of the torts of misrepresentation or negligence.

Including a statutory right of action for this misconduct would eliminate the need to find a common law cause of action, but this would not significantly increase the risk of liability compared to the common law because the plaintiff would still have to prove that the unregistered trading or advising caused the plaintiff damage. It is unlikely that a breach of the registration requirement alone would cause damage to a plaintiff. Damages would more likely result from other wrongs that occurred as part of a pattern of misconduct, of which the failure to register would be only one element.

This cause of action is not in Bill 38. A statutory right of action for failure to register would not have significantly increased the risk of liability beyond that under common law, but neither would it likely have provided any meaningful remedy beyond the common law.

6. Other factors

Defendants

All of the proposed actions in the regime we studied would have expanded the risk of liability by enlarging the class of defendants against whom these actions could be brought. Under common law, the plaintiff must prove a relationship between the plaintiff and the defendant (one arising from contract, from the defendant's owing a fiduciary duty to the plaintiff, or a duty under negligence principles, or by reason of the plaintiff's being within the class of plaintiff who can sue under the intentional torts). Under the regime, potential defendants would have included persons that had no direct relationship with the plaintiff.

Defences

The defences proposed in the regime (and contained in Bill 38) are substantially similar to those available under common law. In the few areas where they differ, the statutory defences are slightly broader. Therefore, the regime would not have significantly increased the risk of liability as a result of the nature of the defences that would have been available (in fact, some defences would have decreased that risk, compared to the common law).

Remedies

Damages would have been the sole remedy available under the regime for the actions described above. Furthermore, for some of the actions, the damages would have been capped, and exemplary and punitive damages would not have been available (except in cases of intentional misconduct). In these situations, the plaintiff's potential remedies under common law could be greater than they would have been under the regime. In cases of intentional misconduct, where damages would not have been capped, the outcome under the regime would have been no worse for a defendant than under the common law.

There are common law remedies available in some circumstances that would not have been available under the regime. These include exemplary and punitive damages and some remedies unique to fiduciary situations.

Therefore, the regime would not have increased the risk of liability as a result of the remedies available (and in many instances would have decreased it). This generally holds true for the investor remedies regime in Bill 38 as well.

Protections for defendants

The regime (and Bill 38) includes several protections for defendants. These are:

- a requirement to obtain court approval before starting or settling an action
- proportionate liability
- the caps on damages mentioned in the previous section

All of these protections are not available under the common law,[7] so actions under the regime would decrease the risk of liability as a result of these measures.

The class proceedings legislation in BC does not allow the court to make cost orders against plaintiffs. In that respect Bill 38 differs from the CSA November 2000 proposal (and the Ontario legislation). However, the protections listed above are significant. The remedies are new, so until there is experience with them in the courts, no one can say whether the right balance has been struck in every area. However, every attempt has been made to do so. Future changes can be considered on the basis of actual experience with the legislation.

[7] Actions under the *Class Proceedings Act (British Columbia)* cannot be commenced until the court certifies the class; settlements must also be approved by the court.

IV. Investor Remedies in Bill 38

As reported above, our study found that creating a statutory right of action for fraud, market manipulation, unfair practice, or trading or advising without registration would not have provided a meaningfully better remedy for plaintiffs than existing common law remedies, particularly after taking into account the provisions in the regime for the protection of defendants. They are therefore not in Bill 38.

Our study also found that creating a statutory right of action for misrepresentation generally, or for a contravention of the Code of Conduct, would have significantly added to available common law remedies. The corollary is that they would also have significantly increased the liability risk for potential defendants. As noted above, we were unable to complete the quantitative analysis of this risk. For that reason, neither of these rights of action is in Bill 38.

The rights of action contained in Bill 38 constitute a significant regime of investor remedies. The Bill contains a right of action for:[8]

1. damages, for a misrepresentation in a prospectus or the continuous disclosure of a public issuer, against the issuer, its directors, officers and major shareholders, experts and underwriters;[9]

2. damages, for a misrepresentation in a prospectus or the continuous disclosure of a mutual fund, against the mutual fund manager, its directors, officers, and experts (and rescission against the mutual fund);[10]

3. damages, for a misrepresentation in a private placement offering memorandum, against the issuer and its directors and officers (and rescission against the issuer, as well as the right to cancel the contract within two days, without cause);[11]

4. damages, for not making timely disclosure about a public issuer, against the public issuer and its directors, officers and major shareholders;[12]

5. damages, for not making timely disclosure about a mutual fund, against the mutual fund manager and its directors and officers;[13]

6. damages or rescission, for making an offering without a prospectus or a prospectus exemption, against the person making the offering;[14]

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[8] This is a brief summary, for details of the actual rights of action, see part 10 of Bill 38.

[9] Bill 38, ss. 90, 91. This right of action is broader than the current legislation. Under the current legislation there is no right of action for a misrepresentation in continuous disclosure, and a major shareholder is not a potential defendant (unless it is a selling securityholder). The current legislation also contains a right of rescission for a misrepresentation in a prospectus, which has not been continued in Bill 38.

[10] Bil 38, ss. 93, 94. This right of action is broader than the current legislation. Under the current legislation there is no right of action for a misrepresentation in continuous disclosure.

[11] Bill 38, ss. 96-98. This right of action is continued from the current legislation.

[12] Bill 38, s. 92. This is a new right of action.

[13] Bill 38, s. 95. This is a new right of action.

[14] Bill 38, s. 99. The corresponding right of action in the current legislation is based on the failure to deliver a prospectus.

7. damages, for a misrepresentation in a take over bid or issuer bid document, against the offeror, its directors and officers, and experts;[15]

8. damages, for a misrepresentation in a circular prepared by directors or officers of an offeree issuer in a takeover bid, against those individuals;[16]

9. damages, rescission, and other remedies, for contravening the take over bid and issuer bid provisions in the legislation, against the person contravening the provision;[17]

10. damages, or an accounting, for trading, or recommending to others that they trade, on the basis of inside information, or passing on inside information to others, against the person who does so;[18] and

11. an accounting, for front running, against a dealer, adviser, or a mutual fund manager, and its directors and officers.[19]

To balance these rights of action, Bill 38 contains a broad range of defences and includes the protections for defendants described above under *Other Factor–Protections for defendants.*[20]

[15] Bill 38, s. 100. This right of action is continued from the current legislation.
[16] Bill 38, s. 101. This right of action is continued from the current legislation.
[17] Bill 38, ss. 102, 103. This right of action is continued from the current legislation.
[18] Bill 38, ss. 104, 105(1). This right of action is continued from the current legislation but the class of potential plaintiffs is much broader. Under the current legislation, the plaintiff must show that the defendant was the other party to the plaintiff's trade, which under today's trading systems is rarely possible to show. Under Bill 38, any plaintiff can sue who traded while the inside information was not disclosed. The Bill also adds liability for using inside information to make trading recommendations to others.
[19] Bill 38, s. 105(2). This right of action is broader than under the current legislation, which limits the action to the mutual fund and portfolio management context. Bill 38 allows a person to sue for any potentially market-moving undisclosed order information, adds liability for informing others about undisclosed order information and for using that information to make trading recommendations to others, and no longer limits liability to cases where the defendant derived personal gain.
[20] Bill 38, ss. 108-125.

V. Conclusion

At the outset we stated the importance of including an appropriate investor remedies regime in the legislation as a way of helping to create a culture of compliance among market participants. We also stated the importance of striking an appropriate balance between deterrence and compliance cost.

The investor remedies regime in Bill 38 has been designed to achieve these goals. As the study showed, there were other rights of action that could have added significantly to common law remedies. These would also have significantly increased the liability risk to market participants. That risk was unquantified at the time the decision had to be made about the content of the Bill 38, so they are not included.

Nor does Bill 38 include the rights of action that the study found would not have provided a meaningfully better remedy for plaintiffs than existing common law remedies.

Bill 38 does, however, include several new remedies for investors. Investors will be able to sue for misrepresentations in continuous disclosure and for not making timely disclosure. Investors will be able to sue more easily for insider trading, front running, and related misconduct. The class of potential defendants has been broadened.

The regime in Bill 38 continues most of the investor remedies from the current legislation and adds new ones. The new ones have been the subject of extensive consultation, study and analysis. It is time to put the regime in place and let experience demonstrate its effectiveness, and where improvements, if necessary, can be made.