

## Corporate Securities Law

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### Ontario Court of Appeal Clarifies Scope of Insider Trading and Tipping Restrictions

In its recent decision in *Finkelstein v. Ontario Securities Commission*, the Ontario Court of Appeal clarified important questions about when the restrictions on illegal insider trading and tipping under Ontario's securities laws apply to people who are not insiders of a company. The decision is a cautionary tale for anyone considering trading (or encouraging others to trade) based on a "tip" or "rumour", or passing that information on to others.

#### Background

Ontario's *Securities Act* (the "Act") restricts persons or companies who are in a "special relationship" with an issuer, and who have knowledge of material non-public information related to the issuer (often referred to as "inside information"), from trading (or encouraging others to trade) in securities of the issuer or disclosing that information to others (except for disclosure made "in the necessary course of business"). These restrictions exist to protect investors, promote efficiency of Ontario's capital markets and ensure public confidence in those markets.

The Act deems insiders and others with a close connection to an issuer (i.e., professional advisers, business partners, etc.) to be in a "special relationship" with the issuer. The Act goes on to provide that any other person or company can come to be in a special relationship with the issuer if (i) that person or company learns insider information from any other special relationship person, and (ii) the person or company knows or *ought reasonably to have known* that the source of the information was a special relationship person. This provision establishes a potentially endless chain of "tippees" who can be deemed to be in a special relationship with the issuer and therefore subject to the

insider trading and tipping restrictions. The *Finkelstein* case – which was the first time the Ontario Court of Appeal considered the special relationship definition – focused on the second part of this test (specifically, the circumstances in which a tippee "ought reasonably to have known" that the tipper was a special relationship person).

#### The *Finkelstein* Case

A Canadian lawyer working on a potential take-over of a Canadian public company target (and who was, therefore, in a special relationship with the target) disclosed specific details about the potential take-over (including price and anticipated timing) to an investment advisor friend, who in turn passed that information on to an accountant. The accountant disclosed that information to another investment advisor (Miller) who then passed it on to his colleague (Cheng). With knowledge of the inside information, each of these tippees bought the target's shares for their own benefit, and/or for the benefit of their family members and/or their clients, and also disclosed the information to others. The Ontario Securities Commission (OSC) commenced administrative proceedings against five individuals, including Miller and Cheng, alleging breaches of the insider trading and tipping restrictions in the Act.

The OSC held that each of the tippees in the "information chain" – including Miller and Cheng – was in a special relationship with the target and, therefore, contravened the insider trading and tipping restrictions by trading with knowledge of the inside information and passing the information on to others. While the OSC accepted neither Miller nor Cheng had actual knowledge their respective sources of inside information was in a special relationship with the target, in each case it concluded, based on a number of factors that the OSC considered relevant in the circumstances, a person standing in their shoes would reasonably assume the inside information passed on to him originated from a special relationship person.

Each of the tippees appealed the OSC's decision to the Ontario Divisional Court, which upheld the OSC's decision with respect to each individual other than Cheng (due to the Divisional Court's conclusion that the OSC's decision with respect to Cheng was based on certain factual errors). Miller appealed his conviction to the Ontario Court of Appeal, and the OSC appealed the Divisional Court's ruling with respect to Cheng.

## The Court of Appeal Decision

The Court of Appeal upheld the OSC's decision with respect to both Miller and Cheng. In doing so, the Court endorsed the OSC's framework for determining when a tippee "ought to have reasonably known" the tipper was in a special relationship with an issuer, including the following non-exhaustive list of the factors to be considered:

- the relationship between the tipper and the tippee;
- the professional qualifications of the tipper and the tippee;
- the detail and specificity of the information;
- the time between when the information is received and when a trade is made;
- intermediate steps (if any) taken by the tippee before trading to verify the information received;
- whether the tippee previously owned the security; and
- whether the trade was a significant one given the size of the applicable portfolio.

Of particular importance is the Court of Appeal's endorsement of the OSC's statement that market registrants (as compared to retail investors) should be held to a higher standard, and that when the tippee is a registrant (as was the case for both Miller and Cheng), there will be a stronger inference that the tippee ought reasonably to have known the tipper was a special relationship person.

## Key Takeaways

The *Finkelstein* case clarifies that even tippees far removed from the initial source of inside information can be found guilty of illegal insider trading and tipping if the facts support an inference that a reasonable person in the tippee's circumstances would have assumed the information originated from an insider or another person in a special relationship with the issuer. It is also clear that market participants and industry professionals will be held to a high standard and must take positive steps to confirm that any material non-public information did not originate from an insider or other special relationship person. If there is any doubt as to the materiality or source of the information, the information should be kept confidential and no trading should take place until the information has been generally disclosed or is clearly no longer material. In addition to the potentially significant statutory penalties that can apply in the event of a breach of insider trading and tipping laws, even the mere allegation of improper insider trading or tipping can have devastating reputational consequences for those involved.

Please contact any member of our Corporate Securities Group to discuss these developments.