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Corporate Securities Law

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Civil Liability For Secondary Market Disclosure To Be Effective In Ontario At Year-End

Introduction

Culminating a process that began in October, 2002 with the introduction of Bill 198, the Province of Ontario has announced that significant amendments to the *Securities Act* (Ontario) will take effect on December 31, 2005 introducing civil liability for secondary market disclosure. The amendments will impact virtually all participants in Ontario's capital markets, including issuers, investors, directors, officers and auditors.

Civil liability for secondary market disclosure means that investors will more easily be able to hold issuers responsible for the accuracy and completeness of information provided in documents such as financial statements and press releases that companies release on an ongoing basis. The *Securities Act* previously provided such rights to investors with respect to misrepresentations in prospectuses for public offerings of securities in the primary market but not for continuous disclosure documents in the secondary market. The secondary market in Canada dwarfs the size of the primary market as approximately 90% of all equity trading in Canada occurs in the secondary market.

I. Civil Liability

General Right of Action

The civil remedy regime provides investors in the secondary market with a limited right of action to seek compensation for damages resulting from a misrepresentation in public disclosure or a failure to make disclosure of a material change. This right of action exists regardless of whether a particular investor relied upon the misrepresentation or the failure to make disclosure, making class actions more likely than was previously the case under common law.

Potential Defendants

The right of action exists against:

- an issuer of securities (includes a reporting issuer and any other issuer with a real and substantial connection to Ontario, any securities of which are publicly traded);
- each director of the issuer;
- responsible senior officers of the issuer;
- "influential persons" (i.e., control persons, promoters, and insiders who are not directors or senior officers) and each director or officer thereof who knowingly influenced the misrepresentation;
- auditors; and
- other responsible experts but excluding rating organizations.

Potential Liability

As illustrated below, liability differs for the various categories of defendants.

Defendant	Liability Limit will be the Greater of:	
Issuer	5% of market capitalization	$1,000,000
Director or officer of issuer	$25,000	50% of individual's compensation from the issuer and its affiliates
Influential person (that is not an individual)	5% of market capitalization	$1,000,000
Influential person (who is an individual)	$25,000	50% of individual's compensation from the issuer and its affiliates
Director or officer of influential person	$25,000	50% of such individual's compensation from the influential person and its affiliates
Expert	$1,000,000	12 month revenues earned from issuer and its affiliates
Any other person not listed above who makes a public oral statement	$25,000	50% of such person's compensation from the issuer and its affiliates

These liability limits will not apply to persons who "knowingly" make misrepresentations or fail to make timely disclosure.

The liability of each defendant will be assessed proportionately to that defendant's relative responsibility for making, and not correcting, public disclosure that contained a misrepresentation or the failure to make required disclosure. Defendants who "knowingly" make misrepresentations or fail to make timely disclosure will be jointly and severally liable for the whole amount of the damages assessed in the action.

Proof of Claims

Plaintiffs alleging misrepresentation will be required to prove that the defendant:

- knew of the misrepresentation;
- deliberately avoided acquiring knowledge of the misrepresentation; or
- was, through action or failure to act, guilty of gross misconduct in connection with the making of the misrepresentation

where the document in question is not a "core document" (in most cases, prospectuses, take-over bid circulars, issuer bid circulars, directors' circulars, rights offering circulars, MD&A, annual information forms, information circulars, material change reports and annual and interim financial statements). A plaintiff will not be required to prove any of the matters set out above in respect of claims relating to core documents or to prove such matters in an action against an expert.

Plaintiffs alleging failure to make timely disclosure will be required to prove that the defendant:

- knew that a material change had occurred;
- deliberately avoided acquiring knowledge of the material change; or
- was, through action or failure to act, guilty of gross misconduct in connection with the failure to make timely disclosure.

A plaintiff will not be required to prove any of the matters set out above in an action against an issuer or an investment fund manager or an officer of an issuer or an investment fund manager.

Defences

The proposed regime includes specific defences to such claims. The main defence that is available is for the defendant to prove that before release of the misrepresentation or the failure to disclose, there was a "reasonable investigation" and the defendant had no reasonable grounds to believe that there was a misrepresentation or failure to make timely disclosure. The legislation sets out specific circumstances that a court is to consider as to whether this "due diligence" defence is available to a defendant. Among other things, the court is to consider:

- the existence, if any, and the nature of any system designed to ensure that the issuer meets its continuous disclosure obligations; and
- the reasonableness of reliance by the defendant on the issuer's disclosure compliance system and on the issuer's officers, employees and others whose duties would, in the ordinary course, have given them knowledge of the relevant facts.

A person or company will not be held liable for a misrepresentation with respect to forward-looking information[1] (other than a misrepresentation in forward-looking information in a financial statement or in a document released in connection with an initial public offering) if such person or company proves all of the following:

- the document or public oral statement containing the forward-looking information contained, proximate to that information, reasonable cautionary language identifying the forward-looking information and identifying factors that could cause actual results to differ materially, and a statement of the material factors or assumptions used in drawing a conclusion or making a forecast or projection set out in the forward-looking information; and
- the person or company had a reasonable basis for drawing the conclusions or making the forecasts and projections set out in the forward-looking information.

A person making an oral statement with forward-looking information may refer listeners to the issuer's public filings in meeting the above requirements.

Leave of Court Required

Leave of the court, after notice to each defendant, is required to commence an action. The court will grant leave only where it is satisfied that:

- the action is being brought in good faith; and
- there was a reasonable possibility that the action would be resolved at trial in favour of the plaintiff.

[1] "Forward-looking information" is defined to mean "disclosure regarding possible events, conditions or results of operations that is based on assumptions about future economic conditions and courses of action and includes future oriented financial information with respect to prospective results of operations, financial position or cash flows that is presented either as a forecast or a projection."

No action can be discontinued, abandoned or settled without the approval of the court.

Actions for Consideration

The introduction of civil liability for continuous disclosure and the resultant threat of class actions makes it important for issuers to consider whether their existing procedures are sufficient to establish a due diligence defence. Such a review is especially important for issuers that have not yet put in place a formal disclosure control system and related procedures. While many issuers have put systems in place with respect to interim and annual financial statements as a result of the introduction of the requirement that Chief Executive Officers and Chief Financial Officers certify the financial statements, consideration of the process for the preparation of press releases has now taken on additional significance. Proper procedure for the release of company information is vital, including control of oral statements made during quarterly conference calls with analysts and investors. It can be expected that more Canadian issuers will now establish formal Disclosure Committees to help deal with these issues on an ongoing basis. A Disclosure Committee might include the issuer's principal accounting officer, general counsel, principal risk management officer, internal auditor, investor relations officer, head of human resources and the head of each material department or business unit. The formation of a Disclosure Committee can help to ensure that the materiality of information and disclosure obligations are properly considered on a timely basis.

Please contact any member of the Goodmans securities team to discuss the implications of the legislation.

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