Canada introduces securities disclosure liability

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Canada has finally introduced the controversial, long-debated regime of statutory civil liability for secondary (that is, trading) market disclosure. The new provisions – effected by amendment to Ontario's Securities Act – came into effect on December 31 2005. They will impact all companies (and other entities) listed on The Toronto Stock Exchange (Canada's national securities trading exchange) and most of the stakeholders in Canada's capital markets, including issuers, investors, directors, officers, auditors and professional advisers.

Civil liability for secondary market disclosure means that investors will more easily be able to hold issuers and their individual representatives responsible for the accuracy and completeness of information provided in documents, such as financial statements and press releases, that companies publish on an ongoing basis. The Securities Act previously provided these 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: about 90% of all equity trading in Canada occurs in the secondary market. This anomaly has severely restricted – if not eliminated – liability redress for most investors in Canadian public companies.

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. Some high-profile class action failures – based in part on the refusal of Canadian courts to import the *fraud on the market* theory that underpins liability in the US in comparable circumstances – required Canadian plaintiffs (and putative class members) to clear the high evidentiary hurdle of actual reliance. The new regime *deems* reliance.

The new right of action exists against:

- an issuer of publicly traded securities with a "connection" to Ontario;
- each director and responsible senior officer of the issuer;
- influential persons (that is, control persons, promoters and insiders who are not directors or senior officers) and each director or officer of such persons who knowingly influenced the misrepresentation;
- auditors; and
- other responsible experts (excluding rating organizations).

As illustrated by Table 1, liability differs for the various categories of defendant.

These liability limits will not apply to persons who knowingly make misrepresentations or fail to make timely disclosure. So, for example, issuers and their individual decision makers who consciously decide not to make disclosure of a material change will face uncapped liability.

The liability of each defendant will be assessed proportionately to that defendant's responsibility for either: (i) making and not correcting a public disclosure that contained

DEFENDANT	LIABILITY LIMIT WILL BE THE GREATER OF:	
Issuer	5% of market capitalization	C$1 million
Director or officer of issuer	C$25,000	50% of individual's compensation from the issuer and its affiliates
Influential person (that is not an individual)	5% of market capitalization	C$1 million
Influential person (who is an individual)	C$25,000	50% of individual's compensation from the issuer and its affiliates
Director or officer of influential person	C$25,000	50% of such individual's compensation from the influential person and its affiliates
Expert	C$1 million	12-month revenues earned from the issuer and its affiliates
Any other person not listed above who makes a public oral statement	C$25,000	50% of the person's compensation from the issuer and its affiliates

a misrepresentation; or (ii) 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.

Plaintiffs will be required to satisfy specific pleading and evidentiary requirements, and these vary depending upon whether or not the alleged misrepresentation is in a *core* document (generally a prospectus, information circular or financial statement).

The proposed regime includes specific defences to such claims. The main defence 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 must consider to decide whether the due diligence defence is available to a defendant, including: (i) the existence, if any, and the nature of any system designed to ensure that the issuer meets its continuous disclosure obligations; and (ii) 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 (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 that person or company proves both that: (i) the document or public oral statement containing the forward-looking information contained reasonable cautionary language identifying the forward-looking information and identifying factors that could cause results to differ materially, and a statement of the material factors or assumptions used in drawing the conclusion or making the forecasts and projections set out in the forward-looking information; and (ii) 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. *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". A person making an oral statement with forward-looking information may refer listeners to the issuer's public filings in meeting the above requirements.

Presumably in an effort to mitigate some of the strike-suit abuses that have plagued the class action securities litigation system in the US, the new Canadian regime provides that an action may not be commenced until the court grants leave to do so. The court will grant leave only if it is satisfied that the action is being brought in good faith, and there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff. Court approval will also be required for all discontinuances, abandonments or settlements.

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The introduction of civil liability for continuous disclosure and the resultant threat of class actions means that issuers must consider whether their existing procedures are enough to establish a due diligence defence. This is especially important for issuers that have not set up a formal disclosure control system and related procedures. Although many issuers have put systems in place with respect to interim and annual financial statements, as a result of the new requirement that chief executive officers and chief financial officers certify financial statements, consideration of the process for the preparation of press releases is now more significant. Proper procedure for the release of company information is vital, including control of oral statements made during quarterly conference calls with analysts and investors. More Canadian issuers are now expected to establish formal disclosure committees to deal with these issues. 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.