

Corporate Securities

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Donnini: The OSC Sends a Message on Insider Trading

The Ontario Securities Commission has closed the book, with a resounding slam, on the last chapter of its enforcement proceeding involving Yorkton Securities Inc. and certain of its principals. By imposing a fifteen-year suspension on Piergiorgio Donnini, the former head liability and institutional trader at Yorkton, the Commission has given a clear indication of the severity of the sanctions which it is prepared to impose, which is reflective of the increased vigour of the Commission's recent enforcement activity. Additionally, in the reasons released in support of its findings in the Donnini matter, the Commission has outlined its perspective on subjects of widespread interest and impact, including the insider trading rules, the identification of "material" information and the use and importance of "Chinese walls" and restricted lists.

The Facts

In February 2000, Yorkton underwrote a special warrant financing for Kasten Chase Applied Research Limited, a TSX-listed company. After the closing of the special warrant transaction Donnini, on behalf of Yorkton, began executing short sales of Kasten Chase shares to lock in profits in relation to compensation securities and special warrants held by Yorkton.

Within a week of the closing of the first offering Yorkton (principally through Scott Paterson, its then Chief Executive Officer) and Kasten Chase, which was in need of additional capital, commenced negotiations concerning a proposed second special warrant financing. After those discussions had been initiated, Paterson (and another colleague, Mark McQueen) met with Donnini on February 29, 2000, outlined the terms of the proposed second offering and asked for his perspective, as Yorkton's head institutional trader, on whether the proposed offering would sell. After confirming that the offer could be sold, Donnini then continued to heavily short sell Kasten Chase shares on behalf of Yorkton. The Commission found that these sales were effected by Donnini while he was possessed of undisclosed material facts, specifically information concerning the second Kasten Chase special warrant deal.

What Constitutes "Knowledge of a Material Fact"?

Counsel for Donnini argued that he did not have knowledge of any material facts with respect to Kasten Chase because he had simply had a informal three minute "hallway-type" conversation about the proposed financing at a time when no agreement for a financing had been reached, the terms had not been settled and the approvals of Kasten Chase's board and Yorkton's "bought deal" committee had not been obtained. Rejecting those arguments, the Commission concluded that:

- Contingent events can be "facts". Knowledge of serious negotiations concerning a proposed transaction, even where terms are not finalized or the transaction is subject to conditions, can constitute knowledge of a "material fact" for the purposes of the insider trading rules. In fact, part of the determination of the materiality of undisclosed information should be an assessment of probability — materiality is a function of probability and magnitude. In the circumstances, the Commission found that the potential magnitude of the second financing would be significant for Kasten Chase *and* that there was a good probability of

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occurrence (notwithstanding that the necessary approvals had not been obtained and no agreement had been signed).

- Each of the proposed financing (in view of its size relative to Kasten Chase's balance sheet), the negotiations concerning it and the proposed terms was a material fact, defined under the *Securities Act* as a fact "that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value" of securities. The Commission focused on the "reasonably be expected" part of the definition and did not refer by way of confirmation to the actual effect on the market once disclosure was made; in fact the share price rose by 30% on the date of public announcement of the second financing.
- Whether the alleged inside trader has "knowledge" of the relevant undisclosed material information is a fact-oriented, subjective analysis. The Commission concluded that, notwithstanding the brief and informal nature of the discussion between Donnini and Paterson, Donnini had knowledge of undisclosed material facts given what he was told by Paterson (specifically, the fact of the proposed transaction, that serious negotiations were ongoing at the highest level between Yorkton and the issuer and the general terms of the proposed transaction) and what he knew or should have known (that Kasten Chase needed money and was likely to proceed with a financing, that market conditions were excellent for completion of another offering, and that Paterson was an accomplished deal-closer).
- In order to violate the insider trading rules a person need not be found to have *used* the undisclosed material information within his or her knowledge, only that he or she traded with that knowledge. Nevertheless, the Commission still found that Donnini *had* used the information, and was influenced in particular by its conclusion that Donnini's short sales covered not only Yorkton's position from the first offering but also its eventual position from the second (then proposed) transaction.

Restricted Lists and Chinese Walls

The Commission noted that Ontario's securities policies (specifically OSC Policy 33-601) recommend, and

investment dealers typically have, the following procedures to address insider trading rule compliance issues:

- "Grey lists", which are highly confidential lists of issuers about which the dealer has insider information. Grey lists, which would typically include issuers in respect of which the dealer had been invited to participate in a transaction not then publicly disclosed, are typically available only to a small group of a dealer's employees who use the list to monitor and, if necessary, restrict trading. These lists can help support a defence to insider trading charges based on the fact that institutional knowledge of material undisclosed information was not in fact known to the representative(s) of that institution who participated in the trade in question.
- "Restricted lists", which list issuers in respect of which the dealer has been actually engaged to provide services for a publicly disclosed transaction. Trading is restricted for securities of issuers listed on the restricted list on the theory that, notwithstanding the public disclosure of the transaction (and possibly the issuance of a prospectus for a financing), the dealer may still be in possession of or gain access to inside information during the course of the transaction. In addition, restricted lists are used to prevent a dealer involved in a public offering from offending "market stabilization" trading restrictions.
- "Chinese walls", which are artificial boundaries that segregate a dealer's employees who have knowledge of inside information from those who do not. Use of such walls would permit a dealer's corporate finance department to seek the advice of traders, by bringing them "over the wall", without freezing other traders not brought over the wall from normal trading activity.

These safeguards do not protect persons who trade with knowledge of material undisclosed information. For example, the Commission clearly regarded Donnini as having been brought "over the wall", and the use of a grey list would not have protected him as he was personally possessed with the relevant knowledge. Donnini was also not entitled to rely on the fact that nobody at Yorkton had put Kasten Chase on a grey list. The Commission clearly concluded that in the Donnini decision and in earlier Yorkton-related decisions that a dangerous culture of non-compliance can result in an

environment where strict adherence to the rules is not paramount. The Commission stated that “In our experience, reputable firms meticulously follow the procedures in Ontario Policy 33-601 and are not faced with the set of facts that Mr. Donnini was faced with because of the way that Yorkton appeared to be operating, based on the evidence we saw in this case.”

The Sanctions

The fifteen-year suspension imposed on Donnini effectively ended his career in the securities industry (he is thirty-seven years old). The severity of the sanction is notable, when compared, for example, to the Commission’s settlement with Paterson (relating to Kasten Chase and other matters) under which Paterson received a two-year suspension and made a voluntary payment of \$1 million. However, the Commission concluded that the terms of the Paterson settlement were different, in that Paterson’s failure was a failure to properly manage and supervise and that he had not been found to have engaged in insider trading. The Commission was clearly persuaded that a strict sentence was indicated in view of the seriousness of insider trading, the volume of the impugned trading activity, the fact of Donnini’s seniority and experience and the Commission’s apparent concern about Donnini engaging in further inappropriate activity. Interestingly, the precedent cited by the Commission, the *Woods* decision, was a case where a non-registrant was sanctioned by the Commission with trading restrictions for fifteen years *after* having been convicted in court for insider trading and imprisoned for ninety days; Donnini was not charged with a criminal offence and there was no criminal trial where the procedural protections and “beyond a reasonable doubt” threshold would have applied. The Commission concluded that fifteen years for Donnini was appropriate to keep him from repeating his conduct while also noting the sanctions would incidentally serve as a general deterrent for insider trading.

Conclusion

The decision in the Donnini matter provides detailed and instructive guidance to the insider trading rules, but it is the severity of the penalty imposed that has drawn the most attention. The Commission has sent a

clear message to the marketplace that it means business in enforcing the insider trading rules. Please contact any member of the Goodmans securities team to discuss the decision and its implications.

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