

## **Developments in the Canadian Capital Markets and Financial Services Industries: 2004**

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# Developments in the Canadian Capital Markets and Financial Services Industries: 2004

## Introduction

Since Canada is the U.S.'s continental neighbour and the U.S.'s largest foreign trading partner, it is not surprising that Canada's financial system and its capital markets are intimately linked to, and influenced by activities in, the U.S. Canadian issuers constitute the single largest cohort of foreign firms listed on the New York Stock Exchange (NYSE), the NASDAQ and American Stock Exchange (AMEX), with 180 inter-listed firms at the beginning of 2004. About 15 percent of companies listed on the Toronto Stock Exchange (TSX) are also listed on one of the three principal U.S. exchanges and trading in the U.S. accounts for an average of 40-50 percent of the trading in these inter-listed securities. In terms of size, together the TSX and the TSX Venture Exchange (the two principal Canadian stock exchanges) have a market capitalization of approximately ten percent of the market capitalization of the three principal U.S. exchanges – the NYSE, NASDAQ and the AMEX.<sup>1</sup> Although this ratio is roughly equal to the ratio of Canada's population as compared to the population of the United States, the Canadian financial system and its capital markets are not simply a junior version of what is found in the U.S.

While although intimately linked to and influenced by the U.S. capital markets and financial system, Canada has a different legal infrastructure and also has some issuer and market participant characteristics that make its system distinct from the U.S. For example, the Canadian capital markets and financial system are characterized by: less fragmentation of financial institutions; more legal and jurisdictional fragmentation; a higher percentage of small-capitalization issuers in its public markets; and a higher percentage of dual class share structures and corporate ownership by wealthy families. The Canadian financial system has evolved from its traditional four-pillar<sup>2</sup> structure where participants in each of these pillars were generally confined to offering products and services within their respective core businesses, into a resilient, complex financial web which, although certain merger restrictions exists, has allowed for a greater level of consolidation than in the U.S. system. Another differentiating feature from the U.S. however, is that the Canadian capital market's regulatory and enforcement environment is widely considered by international market observers to be fairly weak and cumbersome for a very modernized and savvy western nation. Commentators often suggest that this is due, in large part, to the fact that the regulation of Canada's capital markets is fragmented into 13 separate jurisdictions each with its own securities regulatory regime with only a relatively informal mechanism in place to coordinate their activities.<sup>3</sup> The Territory of Nunavut (created in 1999)

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<sup>1</sup> Scott Hendry and Michael King "The Efficiency of Canadian Capital Markets: Some Bank of Canada Research" *Bank of Canada Review*, Summer 2004.

<sup>2</sup> The four traditional pillars were: banking, insurance, securities, and trust services.

<sup>3</sup> Each of Canada's ten Provinces and its three Territories has enacted securities legislation.

with a population of only 22,000 people even has its own securities regulator!

Apart from the burdensome multi-jurisdictional issues within Canada, the reputation of Canada's capital markets has also been compromised among international observers for a different reason. As much as Canadians are internationally famous for their niceness, Canadians have also earned a reputation due to some stock market abuses. The list of these scandals – Livent, Bre-X Minerals, YBM Magnex, Nortel – are as well know to Canadians and those who follow the Canadian markets as are the names Enron, WorldCom, Tyco and ImClone are to investors in the U.S. and elsewhere.

This patchwork of regulatory jurisdictions and the resulting inefficiencies due to the various sets of regulatory regimes, along with Canada's own series of stock market scandals and a "nice Canadian" enforcement environment, appear to have had an impact on the vibrancy of Canada's capital markets. A recent study found that Canadian listed companies trade at a discount to U.S. listed companies and the authors of the study postulate that this discount can be reduced when Canadian companies become inter-listed on a U.S. exchange and thereby come under the oversight of the U.S. securities regulators.<sup>4</sup> The study concluded that cross-listed Canadian firms that are subject to SEC supervision and tougher enforcement in the U.S. are valued more highly than Canadian firms listed exclusively in Canada.

The year 2004 was marked by the implementation of several Canadian initiatives and decisions, some of which are intended to harmonize Canada's system with regulatory policies and initiatives elsewhere (most notably the initiatives of the SEC, the reforms found in the *Sarbanes-Oxley Act of 2002*, and the enforcement assertiveness of New York State Attorney General Eliot Spitzer), while others are an attempt at a distinct "made in Canada" solution to both domestic and international issues. The following is an update of some of these major developments in Canada during the past year.

## **A. Reforming Canadian Corporate Governance Practices, Improving Investor Confidence and Improving Civil Remedies**

### **1. *New Corporate Governance Guidelines and Related Disclosure***

On January 16, 2004, the securities regulatory authorities in all of the provinces and territories of Canada (except for the provinces of British Columbia and Quebec) published for comment a proposed new rule known as Multilateral Instrument 58-101 *Disclosure of Corporate Governance Practices* and a companion policy known as Multilateral Policy 58-201 *Effective Corporate Governance*. Proposed MP 58-201 was an attempt to expressly recognize a Canadian approach to corporate governance and to confirm, as best practice, certain governance standards

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<sup>4</sup> King, M. and D. Segal "Corporate Governance, International Cross Listing and Home Bias" Canadian Investment Review, Winter 2003, available at: [http://www.investmentreview.com/archives/2003/winter/cross\\_listing.pdf](http://www.investmentreview.com/archives/2003/winter/cross_listing.pdf).

and guidelines derived from various regulatory, legislative, and market initiatives, including the TSX<sup>5</sup> and those introduced by the NYSE<sup>6</sup> and NASDAQ under the United States' *Sarbanes-Oxley Act of 2002* (Sarbanes-Oxley Act).<sup>7</sup> The corporate governance practices identified in MP 58-201 were not expressly intended to be prescriptive, but, under the proposed rules found in MI 58-101, if an issuer has not adopted any of the specified practices, this rule would require disclosure of that fact and the reason why the issuer has not done so. MI 58-101 also proposed to require each reporting issuer (i.e. a "public company"), if it has a code of business conduct and ethics, to publicly file the code on the SEDAR<sup>8</sup> website. Proposed MP 58-201 also recommended that issuers adopt a code of business conduct and ethics.

The securities regulatory authorities in British Columbia (the British Columbia Securities Commission (BCSC)) and Quebec (the *Autorité des marchés financiers* (the "Financial Markets Authority")) chose to not participate in the new rules and guidelines that were proposed in January 2004. At that time, the BCSC viewed a uniform set of standards as counterproductive to the needs of small issuers and had concerns regarding the proposed definition of independence, while the Financial Markets Authority did not support the proposed methodology of a "comply with standardized best practices or explain" approach.

On April 23, 2004, the BCSC, the Financial Markets Authority and the securities regulatory authorities in Alberta (the Alberta Securities Commission (ASC)) published for comment proposed Multilateral Instrument 51-104 *Disclosure of Corporate Governance Practices*. This proposed rule differed from MI 58-101 and addressed the BCSC's reasons for not participating in the initial proposals made in January 2004. MI 51-104 also did not include a

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<sup>5</sup> Since 1995 and as at the end of 2004, the TSX required all TSX-listed companies to disclose their corporate governance practices each year in their annual report or their management information and proxy circular. To comply with this TSX requirement, a listed company must fully and completely describe its system of corporate governance and compare its practices against each of the 14 guidelines set out in Section 474 of the *TSX Company Manual*. When comparing the company's practices to the guidelines, a company needs to explain how its practice complies with the guideline, or how its practice differs from the guideline and why, or why the guideline doesn't apply to the company. These TSX requirements only require a company to explain its practices, not to adopt the practices in the guidelines. For more information, see the *TSX Company Manual*; available at: <http://www.tsx.com/en/pdf/CompanyManual.pdf>. On September 28, 2004, the TSX approved amending the *TSX Company Manual* such that, in order to avoid confusion in the marketplace and duplication of effort for TSX issuers and investors, each listed issuer subject to NI 58-101 will be required to disclose its corporate governance practices in accordance with that instrument, once NI 58-101 becomes effective. See: TSX Request for Comment, Corporate Governance Policy - Proposed New Disclosure Requirement (October 29, 2004); available at: [http://www.tsx.com/en/pdf/TSXRuleReview\\_Oct29-04.pdf](http://www.tsx.com/en/pdf/TSXRuleReview_Oct29-04.pdf).

<sup>6</sup> Final NYSE Corporate Governance Rules, at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>.

<sup>7</sup> The SEC approved the NYSE and NASDAQ corporate governance proposals on November 4, 2003; see SEC Release No. 34-48745, NASD and NYSE Rulemaking: Relating to Corporate Governance, available at <http://www.sec.gov/Rules/SFO/34-48745.htm>.

<sup>8</sup> "SEDAR" stands for the System for Electronic Document Analysis and Retrieval and is the computer system operated by the Canadian securities commissions for the purpose of the transmission, receipt, acceptance, review, and dissemination of documents filed in electronic format. Similar to its United States counterpart, EDGAR, SEDAR contains all of the documents filed by reporting issuers in Canada. See <http://www.sedar.com>.

policy containing prescribed corporate governance guidelines and therefore gained the support of the Financial Markets Authority.

The various securities regulators received comments on this patchwork of proposed rules and the proposed policy. Later in 2004, all of the various securities regulatory authorities in Canada decided to create one national rule and one national policy that would reflect elements of, and the comments received on, the proposals made in January 2004 and the proposal made in April 2004. On October 29, 2004, the Canadian Securities Administrators (CSA)<sup>9</sup> released for comment proposed National Policy 58-201 *Corporate Governance Guidelines*<sup>10</sup> and proposed National Instrument 58-101 *Disclosure of Corporate Governance Practices*.<sup>11</sup> Consistent with the earlier proposals, the purpose of the NP 58-201 is to provide guidance on corporate governance practices. The purpose of NI 58-101 is to provide greater transparency for the marketplace regarding issuers' corporate governance practices.

Proposed NP 58-201 will apply to all reporting issuers; however, the guidelines in NP 85-201 are expressly not intended to be prescriptive. The CSA simply encourages issuers to consider the following guidelines in developing their own corporate governance practices:

- maintaining a majority of independent directors on the board of directors (note: the definition of independent will be consistent with, although not the same as, that used for the rule regarding audit committees; however, British Columbia will have a different definition of independence);
- appointing a chair of the board or a lead director who is an independent director;
- holding regularly scheduled meetings of independent directors at which members of management are not in attendance;
- adopting a written board mandate;
- developing position descriptions for the chair of the board, the chair of each board committee, and the chief executive officer;
- providing each new director with a comprehensive orientation, and providing all directors with continuing education opportunities;
- adopting a written code of business conduct and ethics;

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<sup>9</sup> The CSA is a council of the 13 securities regulators of Canada's provinces and territories. It attempts to coordinate and harmonize securities regulation for the Canadian capital markets. More information is available at the CSA website, [www.csa-acvm.ca](http://www.csa-acvm.ca).

<sup>10</sup> Proposed National Policy 58-201 *Corporate Governance Guidelines* is available online at: [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule\\_20041029\\_58-201\\_corp-gov-guidelines.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20041029_58-201_corp-gov-guidelines.pdf).

<sup>11</sup> Proposed National Instrument 58-101 *Disclosure of Corporate Governance Practices* is available online at: [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule\\_20041029\\_58-101\\_disc-corp-gov-prac.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20041029_58-101_disc-corp-gov-prac.pdf).

- appointing a nominating committee composed entirely of independent directors;
- adopting a process for determining what competencies and skills the board as a whole should have, and applying this result to the recruitment process for new directors;
- appointing a compensation committee composed entirely of independent directors; and
- conducting regular assessments of board effectiveness, as well as the effectiveness and contribution of each board committee and each individual director.

The proposed NI 58-101 will apply to all reporting issuers, other than investment funds, issuers of asset-backed securities, designated foreign issuers, SEC foreign issuers, certain exchangeable security issuers, certain credit support issuers and certain subsidiary issuers. NI 58-101 will establish certain disclosure requirements, will require the filing of any written code that the issuer has adopted and will require an issuer to disclose those corporate governance practices it has adopted. However, certain exceptions will be made for smaller "venture issuers".

## 2. *New Investor Confidence Rules*

On March 30, 2004, a series of new rules that promote investor confidence and significantly change a number of the disclosure and governance practices of most Canadian public companies came into force in most Canadian jurisdictions. The rules apply to almost all reporting issuers other than investment funds. The intended result of these rules is that investors receive more consistent disclosure on a more timely basis and that investors be more confident in the quality of the information they receive. In addition, it is hoped that international investors would have confidence that Canada's disclosure and governance standards are as stringent as those anywhere in the world.

One of the new rules harmonizes continuous disclosure requirements across Canada for the first time and introduces a number of changes, including shorter filing deadlines for financial statements. Another rule requires CEOs and CFOs to certify their financial disclosure. There is also an instrument establishing the responsibilities and composition of audit committees and yet another requiring that an issuer's auditors participate in the oversight program of the Canadian Public Accountability Board.

The following is a summary of the Investor Confidence Rules:

- (a) National Instrument 52-108 *Auditor Oversight*,<sup>12</sup> a rule adopted by securities regulatory authorities in all Canadian provinces and territories, requires reporting issuers to engage auditors which participate in an independent oversight program established by the Canadian Public Accountability Board (CPAB) for public

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<sup>12</sup> National Instrument 52-108 *Auditor Oversight*, available at [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule\\_20040326\\_52-108-aud-oversight.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20040326_52-108-aud-oversight.pdf)

accounting firms that audit the financial statements of public companies (CPAB Oversight Program) and which are participants in good standing with the CPAB. Canadian federal and provincial financial and securities regulators, as well as Canada's chartered accountants, assisted in sponsoring the formation of the CPAB in July 2002. The CPAB represents a new independent public oversight system for accountants and accounting firms that audit public companies. The mandate of the CPAB is to promote high quality external audits of reporting issuers and it will be responsible for developing and implementing an oversight program that includes regular and rigorous inspections of the auditors of Canada's public companies. Once a public accounting firm's application is approved by the CPAB, it will enter into a participation agreement agreeing to abide by all of the provisions of the by-laws and rules and regulations of the CPAB pertaining to the CPAB Oversight Program.

- (b) MI 52-109 *Certification of Disclosure in Companies' Annual and Interim Filings*<sup>13</sup> is a rule intended to improve the quality and reliability of reporting issuers' annual and interim disclosures. The rule came into force on March 30, 2004 in each of the provinces and territories of Canada (except for the provinces of British Columbia and Quebec). This rule closely parallels the SEC's certification requirements<sup>14</sup> implementing section 302 of the Sarbanes-Oxley Act and requires CEOs and CFOs of all reporting issuers in Canada, other than investment funds, to certify the accuracy of their company's annual and interim filings. The rule requires reporting issuers to file annual and interim certificates in which their CEOs and CFOs personally certify that, based on their knowledge, their issuer's annual and interim filings do not contain a misrepresentation and their issuer's annual and interim financial statements fairly present the financial condition of their issuer.<sup>15</sup> In addition, similar to section 404 of the Sarbanes-Oxley Act, an issuer's CEO and CFO will also have to make certifications regarding the design and effectiveness of disclosure controls and internal controls over financial reporting. Issuers will also be required to disclose in the management discussion and analysis document (MD&A) that accompanies its financial statements any material change in their internal control over financial reporting and, in the case of the annual MD&A, the conclusions of their CEO and CFO as to their evaluation of the effectiveness of the issuer's disclosure controls and procedures.

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<sup>13</sup> Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*, available at [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule\\_20040326\\_52-109-cert.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20040326_52-109-cert.pdf).

<sup>14</sup> See Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, Sarbanes Oxley Release No. 33-8124 (Aug. 29, 2002); Proposed Rule: Disclosure required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act 2002, Sarbanes Oxley Release No. 33-8138 (Oct. 22, 2002), at <http://www.sec.gov/rules.htm>.

<sup>15</sup> The filings required to be certified by CEOs and CFOs include issuers' annual information forms, annual financial statements, annual MD&A, interim financial statements, and interim MD&A.

A transition period exists within MI 52-109 whereby, for financial years ending on or before March 30, 2005, an issuer may elect to file a “bare certificate” that certifies the accuracy of the financial disclosure but is silent on the topic of disclosure controls and internal controls. On November 26, 2004, the securities regulatory authorities in the participating jurisdictions proposed amendments to MI 52-109 whereby, as far as the certifications related to internal controls are concerned, the transition period would be extended to include financial years ending on or before June 29, 2006.<sup>16</sup>

- (c) MI 52-110 *Audit Committees*<sup>17</sup> is a rule based on the audit committee requirements that have been and continue to be implemented in the United States. In particular, MI 52-110 is derived from the audit committee requirements in the Sarbanes-Oxley Act, certain requirements of the SEC, and corporate governance requirements of the NYSE and NASDAQ. The rule came into force on March 30, 2004 (except in British Columbia and Quebec) and requires every issuer to have an audit committee to which the external auditors must directly report. The rule provides that each audit committee must be responsible for, among other things:
- overseeing the work of the external auditors engaged for the purpose of preparing or issuing an audit report or related work;
  - pre-approving all non-audit services to be provided to the issuer or its subsidiary entities by its external auditors or the external auditors of the issuer’s subsidiary entities;
  - reviewing the issuer's financial statements, MD&A, and earnings press releases before they are publicly disclosed by the issuer;
  - being satisfied that adequate procedures are in place for the review of the issuer’s disclosure of financial information derived from its financial statements; and
  - establishing procedures for the receipt and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters and also the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

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<sup>16</sup> The proposed amendments to Multilateral Instrument 52-109 *Certification of Disclosure in Companies’ Annual and Interim Filings* are available at:

[http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule\\_20041126\\_52-109\\_rfc-pro-amend.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20041126_52-109_rfc-pro-amend.pdf)

<sup>17</sup> Multilateral Instrument 52-110 *Audit Committees*, available at

[http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule\\_20040116\\_52-110\\_mi.pdf](http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_20040116_52-110_mi.pdf).

MI 52-110 also requires that an audit committee recommend to the board of directors the external auditors to be nominated for the purpose of preparing or issuing an audit report, or any related work, as well as the compensation to be paid to such auditors. This practice differs from the U.S. audit committee requirements because, under Canadian corporate law, an audit committee cannot appoint, compensate, or retain the external auditors.<sup>18</sup> An issuer also is required to disclose in its publicly disclosed Annual Information Form if the board of directors has not adopted a nomination or compensation recommendation of the audit committee.

MI 52-110 requires every<sup>19</sup> audit committee to have a minimum of three members, and each member must be independent and financially literate.<sup>20</sup> Unlike the new rules in the United States, however, the proposed rule does not require an issuer to appoint an “audit committee financial expert” to its audit committee.

On October 29, 2004, the various securities regulatory authorities in Canada (with the exception of British Columbia) proposed amendments to MI 52-110. The principal reasons for proposing the amendments was the desire to clarify the definition of “independence” and update the definition as well to be consistent with the proposed amendments to the corporate governance rules set out in Section 303A of the NYSE Listed Company Manual. These proposed clarifications will permit a convenient cross-reference in the proposed policy NP 58-201 *Corporate Governance Guidelines* and proposed rule NI 58-101 *Disclosure of Corporate Governance Practices* to the definitions found in the amended MI 52-110.

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<sup>18</sup> In Canada, the external auditors must generally be elected by, and report to, the shareholders. See, e.g., Canada Business Corporations Act § 162, available at <http://laws.justice.gc.ca/en/C-44/text.html>.

<sup>19</sup> The rule contains an exemption for venture issuers. A venture issuer is an issuer that does not have any of its securities listed or quoted on any of the Toronto Stock Exchange, the New York Stock Exchange, the American Stock Exchange, the Nasdaq National Market, the Nasdaq SmallCap Market, the Pacific Exchange, or a marketplace outside of Canada or the United States. In addition, the proposed rule provides that an issuer whose securities are listed on a national securities exchange or are listed in an automated inter-dealer quotation system of a national securities association registered pursuant to the U.S. Securities and Exchange Act of 1934 is exempt from the requirements of the proposed rule. The exemption is conditional upon compliance with U.S. audit committee requirements.

<sup>20</sup> MI 52-110 defines “financially literate” as an individual who has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer's financial statements. *Supra* note 18.

### 3. *Ontario's New Statutory Regime for Civil Liability in the Secondary Market*

In 2004, the Ontario government re-introduced legislation amending the *Securities Act* (Ontario) to bring in statutory civil liability to the secondary market for misrepresentations in continuous disclosure documents. In Ontario, statutory civil liability for misrepresentations found in a prospectus, offering memorandum, or take-over bid circular has existed for many years<sup>21</sup> but there has been no similar statutory civil liability regime for misrepresentations made in any other form of corporate communication. The legislation creating this new regime was originally found in the Ontario Legislature's Bill 198.<sup>22</sup> Although Bill 198 received Royal Assent on December 9, 2002, and although several of the amendments to the *Securities Act* (Ontario) found in Bill 198 were proclaimed into force on April 7, 2003, the new statutory civil liability regime has not yet been implemented. Technical amendments to the statutory civil liability regime were introduced in 2003 as a series of amendments found in Bill 41.<sup>23</sup> These amendments were stated to relate to certain technical fixes that were needed to implement the new liability regime contained in Bill 198. However, Bill 41 was never enacted into law as a result of a change in provincial government in the fall of 2003. In 2004, the Ontario Legislature introduced Bill 149. Bill 149 contained minor changes to the technical fixes that were found in Bill 41 and the Ontario Government has indicated that they will seek proclamation of the remaining sections of Bill 198 (including the section on civil liability for secondary market disclosure) and Bill 149 together. One of the changes found in Bill 149 as compared to Bill 41 is that specific rule-making power is given to the Ontario Securities Commission (OSC) in regard to civil liability for secondary market disclosure. Accordingly, the entire new regime will not be put into force until after these new rules have been drafted, distributed for comments and then finalized.

In the United States, SEC Rule 10b-5 is a U.S. federal anti-fraud rule that applies to the sale of securities and this rule "makes it unlawful to make material misstatements or to omit material facts in connection with the purchase or sale of any security."<sup>24</sup> Rule 10b-5 has long been held by American courts to give rise to a private cause of action for misrepresentations in both the primary and secondary markets.<sup>25</sup> Until 1988, Rule 10b-5 required the investor plaintiff, the buyer, to demonstrate that the seller of the securities: (i) made a misstatement or omission of material fact; (ii) with intent (i.e. *scienter*); (iii) upon which the buyer reasonably relied; and (iv) which caused the buyer's injury. However, in 1988, in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (hereinafter "*Basic*"), the U.S. Supreme Court adopted the "fraud-on-the-

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<sup>21</sup> See Securities Act (Ontario) §§ 130, 130.1, and 131.

<sup>22</sup> The full text of Bill 198 is available at [http://www.ontla.on.ca/documents/Bills/37\\_Parliament/Session3/b198ra.pdf](http://www.ontla.on.ca/documents/Bills/37_Parliament/Session3/b198ra.pdf).

<sup>23</sup> The first reading of Bill 41 occurred on May 22, 2003. No subsequent readings of Bill 41 occurred in the Ontario Legislature and the bill died on the order table when the Legislature was dissolved in 2003 for a provincial election.

<sup>24</sup> See: *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 188 (2d Cir. 1998).

<sup>25</sup> See: *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976).

market” presumption of reliance in private damages actions under Rule 10b-5. The fraud-on-the-market presumption that material public information is reflected in the market price of a security and that investors rely on the integrity of this market price in making investment decisions. Therefore, since *Basic*, in an action involving securities that trade in a public market, an investor's reliance on any public material misrepresentations may be presumed for purposes of lawsuits based upon Rule 10b-5.

The common law in Ontario does not provide investors with the benefit of a presumption of reliance. Traditionally, under Ontario common law, in order for an investor to obtain an award for damages from a court for negligent misrepresentation, an investor has to demonstrate to the court that: (1) the defendant owed the investor a duty of care; (2) there was a breach of that duty; (3) a causal connection exists between the defendant’s misrepresentation and the investor’s loss; and (4) the investor in fact relied on the defendant’s misrepresentation when the investor made his or her investment decision. On November 4, 1998, an Ontario Court rendered a judgment in *Carom et. al v. Bre-X Minerals Ltd. et. al* (1998), 41 O.R. (3d) 780 (hereinafter “*Bre-X*”), where the “fraud on the market” argument was attempted in order to demonstrate the reliance requirement. The Ontario Court rejected this argument and stated that the presumption of reliance created by the fraud on the market theory can have no application as a substitute for the requirement in Ontario of actual reliance in either the tort of fraudulent or negligent misrepresentation. The Ontario Court stated that “fraud on the market” as a cause of action had no place in Canadian law. In 2002, arguably in reaction to the decision in *Bre-X* as well as reaction to the accounting scandals in the U.S. involving Enron and others, the Ontario Legislature attempted to change the *Securities Act* (Ontario) and create a statutory regime for civil liability for secondary market disclosure.

The new regime found in Bill 198 (as amended by Bill 149), once put into force, attaches a “deemed reliance” feature to any misrepresentations made in publicly released corporate disclosures, including both written and public oral statements, made by any “responsible issuer.”<sup>26</sup> Therefore, once the new regime is finalized and comes into effect, an investor will no longer have to demonstrate reliance upon a misrepresentation when seeking compensation for any related investment losses. The new liability regime will provide investors with the right to sue the issuer and other responsible parties for damages if they acquire or dispose of an issuer’s securities during a period of time when there is an uncorrected misrepresentation in a document released by the issuer or in a public statement made relating to the affairs of the issuer or if the issuer fails to make timely disclosure of a “material change.”

#### **4. *New Rules Regarding Continuous Disclosure Obligations***

On December 19, 2003, the CSA, representing the securities regulatory authorities of all

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<sup>26</sup> A “responsible issuer” is defined in section 138.1 of the Securities Act (Ontario) as a reporting issuer in Ontario as well as any other public issuer with a “substantial connection” to Ontario.

13 Canadian jurisdictions, released NI 51-102 *Continuous Disclosure Obligation*,<sup>27</sup> and Canada thereby took a significant step towards a more uniform regulatory and regime for Canadian public companies. NI 51-102 also introduced important changes to the existing continuous disclosure regime in Canada. The instrument is comprehensive in scope, setting out obligations for public companies with respect to financial statements, annual information forms, MD&A, material change reporting, information circulars, proxies and proxy solicitation, and other continuous disclosure obligations.<sup>28</sup> NI 51-102 came into force on March 30, 2004 in all 13 securities regulatory jurisdictions across Canada.

On March 30, 2004, National Instrument 71-102 *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers*<sup>29</sup> also came into force, providing certain exemptions to two classes of foreign reporting issuers: “SEC foreign issuers” and “designated foreign issuers.”<sup>30</sup> These issuers are exempted from most of NI 51-102 as long as they comply with requirements of the SEC or an applicable foreign jurisdiction, file copies of their foreign disclosure documents, and send copies of these documents to Canadian security holders at the same time, and in the same manner, as they are sent to foreign security holders. These exemptions are intended to ease compliance for foreign issuers and increase their access to Canadian capital markets.

## **B. Investment Funds**

### **1. CSA Propose Mutual Fund Governance Regime**

On January 9, 2004, the CSA published a proposed rule known as National Instrument 81-107 *Independent Review Committee for Mutual Funds*.<sup>31</sup> Proposed NI 81-107 is designed to promote investor protection in mutual funds while fostering market efficiency. It requires all publicly offered mutual funds to have an independent committee charged with reviewing any conflicts of interest that may arise out of the management of the funds and making recommendations to the manager as to how these conflicts may be fairly resolved. Under

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<sup>27</sup> National Instrument 51-102 *Continuous Disclosure Obligations*, available at [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule\\_20040402\\_51-102-cont-disc-ob.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20040402_51-102-cont-disc-ob.pdf).

<sup>28</sup> For a useful summary, see the CSA’s brochure *Canada's Continuous Disclosure Rules Are Changing* (Feb. 24, 2004), at [http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule\\_20040220\\_51-102\\_csa-brochure.pdf](http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_20040220_51-102_csa-brochure.pdf).

<sup>29</sup> National Instrument 71-102 *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers*, available at [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule\\_20031219\\_51-102\\_con-dis.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20031219_51-102_con-dis.pdf).

<sup>30</sup> A “foreign reporting issuer” is a reporting issuer, other than an investment fund, that is incorporated outside of Canada, unless the issuer has more than 50 percent of its voting shares held in Canada and one or more of the following is true: the majority of its directors and officers are Canadian residents, more than 50 percent of its assets are in Canada, or the business is principally administered in Canada.

<sup>31</sup> Proposed National Instrument 81-107 *Independent Review Committee for Mutual Funds*, available at [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule\\_20040109\\_81-107\\_review-mutual.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20040109_81-107_review-mutual.pdf).

Proposed NI 81-107, conflicts of interest would be regulated through a structural solution involving a governance regime rather than restrictive rules and wide-ranging prohibitions.

Proposed NI 81-107 intends to regulate all publicly offered mutual funds in Canada, but not hedge funds, closed-end funds, quasi-closed-end funds, scholarship plans, labour-sponsored venture capital funds, or mutual funds that are listed and posted for trading on a stock exchange or quoted on an over-the-counter market.

Proposed NI 81-107 is the CSA's response to comments that the CSA received on its Concept Proposal 81-402 *Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers* which was published for comment on March 1, 2002 and which in turn was largely based on the recommendations in the Erlichman Report (discussed below). As a result of numerous negative comments from both the Canadian mutual fund industry and investor advocates about proposed NI 81-107, as well as the market timing problems that surfaced in Canada in 2004 which resulted in settlements of almost CAD\$200 million as described in section B-5 below, the CSA are again rethinking the components of a mutual fund regime for Canada.

## **2. *Income Trusts and the Proposals to Limit the Liability of Trust Beneficiaries***

The last several years have seen a huge growth in the number and size of income trusts in Canada.<sup>32</sup> At the end of 2004, there were 175 income trusts listed on the TSX with a collective market capitalization of more than CAD\$118 billion and income trusts represented eight percent of the total market capitalization of the TSX at that time.

An income trust is a uniquely Canadian investment vehicle that pays out substantially all of the cash flows generated from a typically mature business or revenue-producing asset in a tax-efficient manner.<sup>33</sup> This structure allows the owners of a corporation to sell off assets at a higher valuation than when the assets are held in the corporate structure. This higher valuation is driven by investors' demand for high yield in the current low interest rate environment as well as the tax savings generated by this structure, which reduces or eliminates corporate tax for the operating company. Investors in an income trust typically receive a higher level of cash distributions than would be possible if the same assets were instead held by a corporation.

Although still considered the fastest-growing segment of the Canadian equity markets, during 2004 there was slowdown in income trust activity as income trusts accounted for "only" about 30 per cent of activity on the initial public offering (IPO) market during the year, down

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<sup>32</sup> For more information, see: Michael R. King, "Income Trusts - Understanding the Issues" Working Paper 2003-25, Bank of Canada; available at: <http://www.bankofcanada.ca/publications/working.papers/2003/wp03-25.pdf>.

<sup>33</sup> To date, income trusts have typically been structured to capture the income from such business as: oil and gas producers or related rights to oil and gas royalties; pipeline, energy related facilities and services including power generation; residential and commercial real estate properties as well as hotel and temporary lodging facilities; food related operations; storage operations; as well as other forms of business.

from almost 40 per cent the previous year and more than 50 per cent in 2002. The value of all income trust IPOs in 2004 declined to CAD\$3.3 billion from CAD\$4 billion a year earlier. One possible reason for the reduction in the number of new income trust IPOs in Canada is the possible lack of any more Canadian businesses that are an appropriate fit for the income trust structure. Commentators suggest that most of the obvious candidates already been converted to income trusts during the past few years. Another possible reason involves the issue of possible unlimited liability for unitholders of trusts in Canada. Some institutional investors both in Canada and abroad have refused to purchase income trusts until this issue of potential unlimited liability of unitholders of trusts is settled.

The June 2000 report to the CSA entitled “Making it Mutual: Aligning the Interests of Investors and Managers – Recommendations for a Mutual Fund Governance Regime for Canada” written by Fasken Martineau Senior Partner Stephen Erlichman (Erlichman Report)<sup>34</sup> suggested that no matter how remote the liability to unitholders may be, there should not even be an issue as to whether unitholders could possibly be liable for claims against a trust if there are insufficient assets in the trust from which the trustee could satisfy the liability. The Erlichman Report noted that Delaware law, for example, limits the personal liability of beneficiaries of a Delaware business trust to the same extent as liability is limited for shareholders of private for-profit corporations organized under the laws of Delaware. The Erlichman Report then recommended that legislation be enacted to ensure that unitholders of Canadian mutual fund trusts have limited liability similar to shareholders of Canadian mutual fund corporations.

In May 2003, the Ontario government introduced a bill purporting to provide limited liability to unitholders of a public mutual fund or income fund formed as a trust governed by Ontario law. The bill was never enacted into law as a result of a change in provincial government in the fall of 2003. On December 18, 2003, Bill 35, the *Trust Beneficiaries’ Liability Act, 2003* (Ontario) was introduced to the Ontario Legislature as a private member’s bill<sup>35</sup> but it was never passed. In 2004, Bill 106, the *Budget Measures Act, 2004 (No. 2)*, which proposed the enactment of the *Trust Beneficiaries’ Liability Act, 2004*, received Royal Assent on December 16, 2004.<sup>36</sup> This legislation, which is now in force, provides that beneficiaries of a trust governed by the laws of Ontario are not, as beneficiaries, liable for any act, default, obligation, or liability of the trust or any of its trustees that occurs or arises after December 16, 2004 if, when the act of default occurs or the obligation or liability arises, the trust is a “reporting issuer” under Ontario securities law. On May 6, 2004 the Alberta government introduced Bill

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<sup>34</sup> Available at: [http://www.osc.gov.on.ca/About/Publications/op\\_20000727\\_makingitmutual.pdf](http://www.osc.gov.on.ca/About/Publications/op_20000727_makingitmutual.pdf).

<sup>35</sup> Ontario’s Bill 35, *Trust Beneficiaries’ Liability Act*, Dec 2003 (Ontario), available at: [http://www.ontla.on.ca/documents/Bills/38\\_Parliament/Session1/b035.pdf](http://www.ontla.on.ca/documents/Bills/38_Parliament/Session1/b035.pdf).

<sup>36</sup> Ontario’s Bill 106, the *Budget Measures Act, 2004 (No. 2)*, which proposed and contains the *Trust Beneficiaries’ Liability Act, 2004* (Ontario), available at: [http://www.ontla.on.ca/documents/Bills/38\\_Parliament/Session1/b106ra.pdf](http://www.ontla.on.ca/documents/Bills/38_Parliament/Session1/b106ra.pdf).

34,<sup>37</sup> a proposal to enact a statutory limitation on the liability of unitholders of Alberta income trusts. The bill was passed and received Royal Assent on May 19, 2004 thereby enacting the *Income Trusts Liability Act* (Alberta). Partially as a result of the enactment of this legislation, Standard & Poor's announced that income trusts will qualify for inclusion in the S&P/TSX Composite Index. This index is regarded as the broad equity benchmark index for the TSX. In the near future, it is expected that pension funds and other institutional investors will increase their holdings of income trusts investments which, to date, have primarily been purchased by retail investors.<sup>38</sup>

### 3. *CSA Adopts a National Policy on Income Trusts*

On December 3, 2004, the CSA adopted National Policy 41-201 *Income Trusts and Other Indirect Offerings*.<sup>39</sup> NP 41-201 provides guidance and clarification to market participants regarding income trusts and other similar issuers, such as real estate investment trusts and royalty trusts, which issue securities that entitle the holder to substantially all of the net cash flows generated by an underlying business or income-producing property. NP 41-201 takes the form of a series of questions and related discussions by the CSA on the topics of prospectus disclosure, continuous disclosure, liability of vendors, and sales and marketing materials.

The principal concern of the securities regulators is that an income trust offering is an indirect offering by an underlying operating entity (Opco). The income trust becomes a reporting issuer and Opco remains a non-reporting issuer. The income trust uses the proceeds from a prospectus offering to acquire debt and/or equity interests in Opco. Net cash flows generated by Opco are distributed to the income trust and the income trust distributes such cash to unitholders. Securities regulators are concerned that investors may not have access to relevant information in order to make an informed investment decision where there is an indirect offering as opposed to a direct offering. NP 41-201 is intended to address the concerns of securities regulators and, if implemented, provide enhanced disclosure to investors. The CSA have advised that they plan to revisit the policy in approximately two years.<sup>40</sup>

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<sup>37</sup> Alberta's Bill 34, *Income Trusts Liability Act* (Alberta), available at: <http://www.assembly.ab.ca/pro/bills/ba-bill.asp?SelectBill=034>.

<sup>38</sup> For more information see: "Tax Revenue Impacts of Pension Fund Investment in Business Trusts - Final Report" Pension Investment Association of Canada (April 14, 2004); available at: [http://www.piacweb.org/assets/piac\\_lev1\\_HLBFinalReport.pdf](http://www.piacweb.org/assets/piac_lev1_HLBFinalReport.pdf).

<sup>39</sup> National Policy 41-201 *Income Trusts and Other Indirect Offerings*, available at [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part4/pol\\_20041203\\_41-201\\_income-trusts-oi.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part4/pol_20041203_41-201_income-trusts-oi.pdf).

<sup>40</sup> For a detailed description of NP 41-201, see: "Canadian Securities Administrators implement National Policy 41-201 - Income Trusts and Other Indirect Offerings" Fasken Martineau Securities and M&A Bulletin (January 2005); available at: <http://www.fasken.com/SecuritiesMergersAcquisitionsBulletin/Jan05B>.

#### ***4. CSA Republished Proposed New National Instrument on Continuous Disclosure for Investment Funds***

On May 28, 2004, the CSA, representing the securities regulatory authorities of all 13 Canadian jurisdictions, published a proposed rule known as National Instrument 81-106 - *Investment Fund Continuous Disclosure* which, if adopted, will replace existing local continuous disclosure rules and regulations and result in a nationwide harmonization of the continuous disclosure obligations of investment funds. The first version of this proposed rule was published by the CSA in September 2002. If it is implemented in its current form, NI 81-106 will apply to all mutual funds and non-redeemable investment funds (together, “investment funds”) that are reporting issuers and, except in the provinces of Alberta, British Columbia, Manitoba and Newfoundland and Labrador, certain provisions of NI 81-106 will also apply to mutual funds organized under the laws of the applicable province or territory of Canada even if such mutual funds are not reporting issuers. NI 81-106 will not apply to reporting issuers that are not investment funds since they are regulated by NI 51-102 - *Continuous Disclosure*, which came into force on March 30, 2004 (as indicated above).

To a large extent, NI 81-106 reproduces existing continuous disclosure requirements applicable to investment funds. However, it contains a number of significant changes to investment funds’ continuous disclosure obligations. NI 81-106 will have effect of: shortening filing deadlines for financial statements and annual information form; eliminating mandatory delivery of financial statements to security holders; introducing the requirement to prepare and file management reports of fund performance; introducing the requirement to provide quarterly portfolio disclosure; and introducing the requirement to provide proxy voting disclosure.

#### ***5. OSC Approves Mutual Fund Settlements - CAD\$156.5 Million Set Aside For Harmed Investors - IDA Follows Suit With Settlements Totalling CAD\$41.4 Million With Dealers***

As a result of New York Attorney General Eliot Spitzer’s headline grabbing investigations of late trading and market timing in the U.S. mutual fund industry, in November, 2003, the OSC launched Phase One of its mutual fund probe into trading practices such as market timing by sending a letter to the 105 managers of publicly offered retail mutual funds that trade in Ontario.<sup>41</sup> In February, 2004, the OSC initiated Phase Two of the probe by requesting

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<sup>41</sup> Market timing involves short-term trading of mutual fund securities to take advantage of short-term discrepancies between the “stale” values of securities within a mutual fund’s portfolio and the current market value of those securities. Stale values can occur in mutual fund portfolios comprised, in whole or in part, of non-North American foreign equities. Stale values of those securities may result in stale values of the units of a mutual fund as a result of the way in which the net asset value of most mutual funds is calculated for the purpose of determining the price at which an investor may buy or sell a unit of the fund. A market timer will attempt to take advantage of the difference between the “stale” value and an expected price movement of a fund the following day by trading in anticipation of those price movements. Commentators have noted that harm may be incurred by a fund in which frequent trading market timing occurs and such harm would be borne by long-term investors in the fund rather than by the market timers.

detailed trading information from 36 of the 105 fund managers originally surveyed. These 36 fund managers were selected based on the information they provided in Phase One and also included a random sampling of fund managers. The data they submitted was analysed for the purpose of identifying indicators that would require further analysis. Phase Three of the probe was launched in May, 2004. In this phase, the OSC conducted detailed analysis of trading data as part of the site visits of 20 mutual fund managers. The fund managers reviewed in Phase Three of the probe account for approximately 90% of the CAD\$473 billion in mutual fund assets under management in Canada. The OSC's probe teams closely examined trades worth a total of CAD\$100 billion. This investigation was the largest ever undertaken by the OSC and, as indicated below, resulted in record settlements.

On December 16, 2004, the OSC approved settlement agreements with four major mutual fund managers that will result in CAD\$156.5 million being distributed to mutual fund unit holders who suffered harm from market timing activities in mutual funds managed by those four managers. The settlement agreements said that the conduct of the four fund managers - in failing to protect fully the best interests of investors in the relevant funds - was contrary to the public interest. The OSC stated that these settlements marked the completion of the OSC's probe into the late trading and market timing activities in mutual funds, except for a fifth fund manager which the OSC was still investigating for possible market timing. In the probe, OSC staff did not uncover any evidence of late trading.

On December 16, 2004, the Investment Dealers Association of Canada (IDA) imposed discipline penalties against three of Canada's largest investment dealers. In settlement agreements reached with these dealers, the dealers acknowledged that they failed to implement appropriate supervisory systems to address red flags regarding market timing activities and thereby detect and prevent potentially harmful market timing activities. The penalties assessed against these dealers, which collectively totalled CAD\$41.4 million, were in the form of a fine, disgorgement, costs and a requirement to establish an internal committee to consider how to identify and address emerging issues in the securities industry.

## **C. Federal Issues and Federally Regulated Financial Institutions**

### **1. *Bank Merger Rules***

In July 2003, the federal Department of Finance released the government's response to parliamentary committee reports on public interest considerations in the government's review of bank merger proposals. Subsequently, the Department held public consultations and was expected to announce its policy, including revised merger review guidelines, by June 30, 2004. The government had indicated that, following the release of the revised guidelines, a three-month transition period would be imposed before bank merger applications would be accepted.

A federal election was held on June 28, 2004 and the proposed policy and merger rules were not released. A Liberal government was re-elected, but with a minority of the seats in Parliament. To date, the merger policy and revised merger review guidelines have not been released. The government has indicated that the bank merger rules are still under review. Many commentators believe that bank mergers are unlikely to proceed in the current political environment.

## **2. *Federal Financial Institutions Statutes Review***

Federal financial institutions statutes dealing with banks, foreign bank branches, federal trust and loan companies, federal insurance companies and cooperative credit associations contain sunset clauses, which mandate the government to re-enact the legislation in 2006, subject to an extension in limited circumstances. The Department of Finance will be consulting the financial services industry in respect of proposals for amendments to this legislation during the course of 2005.

## **3. *Consultative Paper on the New Basel II Framework***

In August 2004, the federal financial institutions regulator, the Office of the Superintendent of Financial Institutions (Canada) (“OSFI”), released a *Consultative Paper on the New Basel II Framework* addressing its proposals for the implementation for Canadian deposit-taking institutions of the new Basel capital adequacy framework, commonly known as Basel II, prepared by the Basel Committee on Banking Supervision (“BCBS”) with the endorsement of the central bank governors of the G-10 countries. The consultative paper describes OSFI’s proposed approach to a number of national discretion policy issues relating to Basel II. The paper also describes the timing of implementation and reporting periods for Basel II.

Basel II encompasses three pillars: pillar 1 - minimum regulatory capital requirements for exposure to credit risk, operational risk and, for institutions with significant trading activity, market risk, pillar 2 - supervisory review, and pillar 3 - market discipline.

Under the first pillar, Basel II provides several methodologies for determining capital requirements for both credit and operational risk. Basel II provides alternatives for determining the risk weighting of assets, the standardized approach and the internal ratings-based (“IRB”) approach, which is sub-divided into foundation IRB (“FIRB”) and advanced IRB (“AIRB”) approaches. OSFI expects Canadian deposit-taking institutions that have total net regulatory capital in excess of CAD\$5 billion or that have greater than ten per cent of total assets or liabilities that are outside of Canada to implement an AIRB approach for all material portfolios and credit businesses in Canada and in the United States from the fourth quarter of 2007. The FIRB and standardized approaches will be available to all other deposit-taking institutions. OSFI has determined that it will develop only one standardized approach for measuring credit risk under Basel II.

OSFI proposes to permit a deposit-taking institution incorporated in Canada to implement any one of three approaches for measuring operational risk: a basis indicator approach, a standardized approach or an advanced measurement approach (“AMA”). OSFI does not propose to allow a Canadian deposit-taking institution to use the alternative standardized approach developed by the BCBS for institutions operating in non-G-10 countries. Basel II states that internationally active deposit-taking institutions and those with significant operational risk exposures are expected to use an approach that is more sophisticated than the basic indicator approach and is appropriate for the institution’s risk profile. OSFI therefore encourages deposit-taking institutions in Canada to implement either the standardized approach or the AMA. OSFI also encourages those institutions that implement an IRB approach for credit risk to implement over time an AMA for operational risk. OSFI proposes to allow a Canada deposit-taking subsidiary of a foreign bank to use an allocated amount of its parent’s AMA capital to determine its operational risk capital requirements. The same flexibility would be available to subsidiaries of Canadian deposit-taking institutions.

OSFI expected deposit-taking institutions that were working towards an IRB approach status to submit a rollout plan by November 30, 2004. In addition, OSFI has proposed a number of timelines for implementation of Basel II. Deposit-taking institutions planning to use the AIRB approach to credit risk are permitted to use Basel I rules up to and including the fourth quarter of 2007. Deposit-taking institutions using the AIRB approach are expected to provide parallel-run capital information for a two-year period commencing the first quarter of 2006. OSFI plans to communicate timing for the implementation of the standardized approach and the FIRB approach after discussions with other jurisdictions about their implementation plans. The timing for deposit-taking institutions’ implementation of the third pillar of Basel II - market discipline - will be consistent with the timing for implementation of Basel II. Consequently, the pillar three public disclosure requirements will commence in 2008.

The second pillar of Basel II proposes to make internationally active deposit-taking institutions’ determination of the adequacy of their capital subject to a more focussed supervisory review. OSFI expects these institutions to conduct their own internal capital adequacy assessment process and establish their own internal target capital levels taking into account their risk profile and capital strategy. OSFI does not expect to employ an explicit model approval process under pillar two of Basel II. OSFI expects that institutions will conduct their assessments in a comprehensive, well thought out manner. A Canadian subsidiary of a foreign bank will be able to employ the methodology used by its parent bank, but the subsidiary would be responsible to explain how the data and methodology have been modified to reflect the subsidiary’s business strategy and the risks to which it is exposed in Canada.

OSFI has established a joint working group on Basel implementation with the Canadian Bankers Association. OSFI is in the process of preparing a first draft of a revised capital adequacy guideline for deposit-taking institutions, which is expected to be issued early in 2005.

#### **4. *Interest Rate Risk Management***

In December 2004, OSFI issued a draft guideline in respect of interest rate risk management. OSFI has expressed support for the principles set out in the BCBS paper, *Principles for the Management and Supervision of Interest Rate Risk*, which support the Basel II pillar two approach to interest rate risk in the institution's banking book.

In the draft guideline, OSFI states that it expects the boards of directors of deposit-taking institutions to determine the aggregate risk appetite for the institution and to take steps to ensure that the control functions responsible for measuring and monitoring risk remain independent of position-taking operations. OSFI's draft guideline also indicated its concurrence with the BCBS's view that senior management should have an integrated view of interest rate risk. Consequently, senior management should understand interest rate risk management methodologies and should encourage discussion between risk management functions and position-taking operations within the institution. OSFI expects complex deposit-taking institutions to establish a committee to oversee assets liability management, which committee would be responsible for managing and vetting the strategic direction of interest rate risk within the institution. Risk management personnel on such a committee would be expected to be impartial observers and not participate in committee decisions in respect of interest rate risk position-taking.

OSFI expects that where deposit-taking institutions use models to measure and mitigate their interest rate risk exposure, these models would be vetted by an independent function. Periodic full reviews of interest rate risk management models are expected, the frequency of which would depend on the complexity of the institution, the size of interest rate risk exposures, the nature of market changes, and the complexity of innovation with respect to measuring risk.

In the guideline, OSFI also endorses the BCBS's principles on the disclosure of interest rate risk, and supports the view that limits should be commensurate with risk undertaken by institutions. OSFI expects complex deposit-taking institutions to utilize an appropriate funds transfer pricing mechanism to transfer risk to appropriate centres of expertise, and that pricing mechanism would be managed independently of position-taking operations. Finally, OSFI emphasizes the importance of internal audit as a key check in ensuring that control functions are operating effectively.

#### **5. *Capital Regime for Regulated Insurance Holding Companies and Non-Operating Life Companies***

In 2001, the Canadian federal *Insurance Companies Act* was amended to permit the incorporation of federally regulated insurance holding companies. In January 2005, OSFI issued a draft guideline setting out a capital framework for regulated insurance holding companies and non-operating life insurance companies, collectively holding companies. OSFI's framework for assessing the adequacy of capital in a holding company compares capital available with a capital

risk matrix. The holding company would include consolidated operations of all subsidiaries other than non-life solvency regulated financial corporations and, with OSFI approval, significant foreign life subsidiaries. Investments in these entities are deducted from capital. Moreover, holding companies may increase their capital available by taking credit for capital in significant foreign life subsidiaries that is reasonably above the level at which the foreign regulator would take action against that subsidiary. The guideline imposes no minimum or target requirements; however, OSFI expects holding companies to manage capital in a manner commensurate with the group risk profile and control environment.

## ***6. Outsourcing Guidance for Financial Services Business Activities, Functions and Processes***

In December 2003, OSFI issued a revised guideline dealing with the outsourcing of business functions by federally regulated financial institutions. The guideline addresses OSFI's expectations concerning the risk management of this increasingly popular strategy in the financial services industry. Federally regulated financial institutions were expected to comply with the new guideline by December 15, 2004.

Federally regulated financial institutions are expected to assess the materiality of all outsourcing arrangements and to follow a risk management program in respect of all such arrangements other than those that are clearly immaterial. The application of this risk management program will vary depending on the degree of the materiality of the outsourcing arrangement. Where a material outsourcing arrangement is entered into between a federally regulated entity and an entity that is a member of the same corporate group, reduced expectations may apply. All outsourcing arrangements involving out-of-Canada processing of specified information or data, regardless of its materiality, are subject to regulatory approval.

The guideline indicates that an institution's board of directors is periodically expected to approve and reaffirm outsourcing risk management policies and to review a list of the entity's material outsourcing arrangements and other relevant reports. Management is expected to develop and implement outsourcing policies and procedures that include an outsourcing risk philosophy, a materiality assessment for outsourcing arrangements and a risk management program that complies with the guideline and places limits on the authority of officers to approve arrangements. Earlier guidance from OSFI set out quantitative criteria for determining whether an outsourcing arrangement was material. The revised guidance recognizes that the assessment of materiality is fundamentally a matter of judgment and instead sets out factors that entities must consider in developing their own materiality assessment.

The guidance requires institutions to design a risk management program applicable to all outsourcing arrangements except those that are clearly immaterial. The program would include appropriate due diligence processes, appropriate contracts for services that address a range of subjects set out in the guidance, and requires a business continuity plan to address situations where the service provider fails to provide service. The guidance also sets out additional

expectations in respect of the monitoring and oversight of material outsourcing arrangements. Institutions must maintain a centralized current list of all material outsourcing arrangements and provide for monitoring of those arrangements and the service provider.

#### **7. *Insurance Commission Disclosure***

Following the New York Attorney General's filing of a complaint against a U.S. insurance broker concerning solicitation and acceptance of contingent commissions and rigging bids by insurers for business placed through the broker, contingent commission issues became a matter of public interest in Canada. In November 2004, the Insurance Bureau of Canada, the property and casualty insurance industry trade association, disclosed details of a plan to provide enhanced consumer disclosure about insurance sales. Companies committed to provide full disclosure on their websites by January 1, 2005 of information concerning the way in which their sales intermediaries - agents, brokers and other company sales staff - are compensated. In addition, point of sale disclosure information will be provided by insurers who sell through dedicated agents or other intermediaries.

#### **8. *Personal Information Protection Legislation***

Effective January 1, 2004, Canada's federal private-sector privacy legislation, the *Personal Information Protection and Electronic Documents Act* ("PIPEDA") applies to all organizations in Canada, including businesses that collect, use and disclose personal information solely within a province. Since, under Canada's constitution, provinces have jurisdiction over property and civil rights, PIPEDA provides that, where a province had enacted legislation that is deemed to be substantially similar to PIPEDA, an organization is exempt from the application of PIPEDA in respect of the collection, use or disclosure of personal information within that province. As of January 1, 2004, three provinces - Quebec, Alberta and British Columbia - have enacted private sector privacy legislation that has been deemed substantially similar to PIPEDA. Some provinces have also enacted private sector privacy legislation that deals with the collection, use and disclosure of health information. Accordingly, while the Canadian approach of generally enacting omnibus private-sector rather than industry or sectoral privacy legislation is distinct from the sectoral approach in the United States, there are still jurisdictional differences in privacy legislation among the provinces and between the provinces and the federal government.

The application of federal and provincial privacy legislation to financial institutions varies. Canadian banks and foreign bank branches are subject to the application of the federal PIPEDA in respect of their banking activities. Insurance companies and trust and loan companies are subject to PIPEDA in respect of their collection, use or disclosure of personal information across provincial boundaries and in respect of those jurisdictions in which substantially similar provincial private sector privacy legislation have not been enacted. Provincial privacy legislation will apply in respect of the collection, use or disclosure of personal information in jurisdictions that have substantially similar privacy legislation in force and, in Ontario, the health privacy statute will apply in limited circumstances.

Despite the patchwork quilt of privacy legislation, all privacy legislation seeks to address ten basic principles for the protection of personal information, albeit not necessarily in a harmonized manner. These principles are: (1) accountability, (2) identifying purposes, (3) knowledge and consent for collection, use or disclosure, except in certain circumstances, (4) limited collection, (5) limited use, disclosure and retention, (6) accuracy, (7) safeguards for the protection of information appropriate to its sensitivity, (8) openness in respect of organizational policies and procedures for the management of personal information, (9) individual access, except in certain circumstances, and (10) the ability to challenge compliance with the principles.

Privacy commissioners have been appointed federally and in the provinces that have private-sector privacy legislation in effect. A privacy jurisprudence is emerging as the commissioners interpret their legislation. Enforcement is increasingly emphasized, and some (but not all) commissioners identify the businesses about whom complaint reports are issued (this policy is colloquially referred to as "naming and shaming.") A key emerging business issue for financial institutions is outsourcing. The issue is of such political sensitivity that the federal and many provincial governments have reviewed all their outsourcing arrangements to determine the extent to which data is accessible from outside Canada, and at least one Canadian financial institution suffered a serious consumer backlash when it changed its privacy policy to account for a data processing arrangement that was to be carried out in the United States.

#### **D. Other Developments Affecting Canada's Capital Markets and Financial System**

##### ***1. The Status of Major Reform Initiatives: the Uniform Securities Law Project, the Passport System, and the Dream of a Single Securities Regulator***

The CSA began the Uniform Securities Law Project (USL Project) in March 2002 with the objective of developing uniform securities legislation among Canada's 13 legislative jurisdictions within two years. In January 2003, the CSA published the *Blueprint for Uniform Securities Laws for Canada*<sup>42</sup> and received extensive comments on this concept proposal. In December 2003, the CSA released for consultation two pieces of proposed legislation that, if adopted, would substantially alter the legislative framework for securities regulation in Canada. The consultation drafts consist of a proposed *Uniform Securities Act*<sup>43</sup> and a model *Securities Administration Act*.<sup>44</sup> The CSA proposes that each jurisdiction in Canada replace its existing securities act with the Uniform Securities Act and the Securities Administration Act. The Uniform Securities Act would be uniform for each jurisdiction and would cover substantive areas of securities laws such as prospectus and registration requirements. The Securities

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<sup>42</sup> Available at: [http://www.msc.gov.mb.ca/legislation/notices/usl\\_concept\\_proposal.pdf](http://www.msc.gov.mb.ca/legislation/notices/usl_concept_proposal.pdf)

<sup>43</sup> Uniform Securities Act: A Legislative Proposal For Harmonization of Securities Laws—Consultation Draft (Dec. 16, 2003), available at [http://www.osc.gov.on.ca/Regulation/USL/usl\\_20031216\\_harmonization.pdf](http://www.osc.gov.on.ca/Regulation/USL/usl_20031216_harmonization.pdf).

<sup>44</sup> Securities Administration Act: A Proposed Legislative Model for Alberta – Consultation Draft (Dec. 16, 2003), available at [http://www.osc.gov.on.ca/Regulation/USL/usl\\_20031216\\_pro-leg-model.pdf](http://www.osc.gov.on.ca/Regulation/USL/usl_20031216_pro-leg-model.pdf).

Administration Act would govern procedural matters that would necessarily vary from jurisdiction to jurisdiction, such as the composition of a securities commission or other regulatory body, and would also cover other procedural topics such as investigations, reviews, and appeals of decisions.

On September 24, 2004, the CSA released its views on the comments it received from stakeholders.<sup>45</sup> According to the CSA's release, the USL Project remains the CSA's proposal for significant and meaningful reform of Canada's current system of securities regulation. The CSA believes the USL Project is superior to other proposals for reform since, in addition to harmonizing securities laws, the USL Project proposes mutual recognition and delegation of authority between securities regulators.

Although the draft legislation proposed by the CSA has not been approved by any provincial or territorial government, a steering committee composed of six provincial government ministers was set up in February 2003 to study ways of streamlining Canada's regulatory system. On September 30, 2004, all of Canada's provincial governments, except Ontario, signed or committed to sign a Memorandum of Understanding<sup>46</sup> on a "passport system" of securities regulation whereby a company could comply with the regulations of its home jurisdiction to be deemed in compliance in other Canadian jurisdictions without additional obligations. The Memorandum of Understanding proposes implementing a passport system by August 2005. It also proposes to implement a harmonized set of securities laws by the end of 2006 that take into consideration the CSA's USL Project. In addition, the Memorandum of Understanding also calls for a review of regulatory fees and promises to explore further options for reform, which could one day include a single securities commission.<sup>47</sup> Ontario's refusal to participate deals a big blow to the inter-provincial passport initiative as Ontario hosts the country's largest capital market. Critics say the passport system would fail to improve enforcement, policy making, governance and accountability, would lead to "jurisdiction shopping" and would create the risk of instability and further fragmentation because of opt-out provisions it could contain.<sup>48</sup>

Ontario's provincial government, as well as the OSC, continues to support a single Canadian securities regulator. On August 18, 2004 in a speech to the Ontario Government's

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<sup>45</sup> See CSA Notice 11-307 Responses to Comments Received on Consultation Drafts for a Uniform Securities Act and a Model Securities Administration Act (September 24, 2004); available at: [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part1/csa\\_20040924\\_11-307\\_resp-com-rec.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part1/csa_20040924_11-307_resp-com-rec.pdf).

<sup>46</sup> Memorandum of Understanding (September 30, 2004); available at: [http://www.securitiescanada.org/2004\\_0930\\_mou\\_english.pdf](http://www.securitiescanada.org/2004_0930_mou_english.pdf).

<sup>47</sup> For more information, see: Reform of the Current Canadian Securities System; a Website available at: [www.securitiescanada.org](http://www.securitiescanada.org). Also see: Securities Regulation in Canada: An Inter-Provincial Securities Framework Discussion Paper (June 2003); available at: [http://www.securitiescanada.org/securities\\_discussion\\_paper\\_english.pdf](http://www.securitiescanada.org/securities_discussion_paper_english.pdf).

<sup>48</sup> See: "Critics slam securities passport system: 'Our reputation suffers while we have a patchwork system'" by Wojtek Dabrowski, National Post newspaper, October 1, 2004.

Standing Committee on Finance and Economic Affairs, David Brown, the Chair of the OSC, stated:

“... the Premier [of Ontario] and Minister Phillips [the Chair of the Management Board of Cabinet] have both done an excellent job of articulating the reasons Canada needs a single securities regulator. I will emphasize just one point - the competitive disadvantage of being out of step with the rest of the world.

Ours is the only advanced national economy in the world that does not have a national securities regulator ... Can we really afford this competitive disadvantage?

Canada’s current system of 13 regulators with 13 different sets of rules and regulations is costly, cumbersome and carries the risk of marginalizing Canadian interests in an increasingly global marketplace, a place where capital flows across national borders with few restrictions. ... In an effort to address this fragmentation problem, the OSC has worked closely with our fellow provincial and territorial securities regulators on the Uniform Securities Legislation (USL) project. ... But it important to keep in mind, while USL is a positive step forward, it is no permanent substitute for a single securities regulator. Canada cannot simply afford the duplication and overlap of 13 separate regulators when every country Canadians compete with has one.”<sup>49</sup>

As far as Canada’s federal government is concerned, the Government of Canada, following the Wise Persons’ Committee report,<sup>50</sup> committed in its 2004 budget to work with the provinces and territories towards the development of a single securities regulator to promote greater efficiency in Canada’s capital markets. The International Monetary Fund (“IMF”) has also thrown its weight behind calls for a single national securities regulator for Canada.<sup>51</sup> There is no end in sight, however, for those in Canada who are trying to create a single securities regulator.

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<sup>49</sup> See: Remarks by David A. Brown, Q.C., Chair, Ontario Securities Commission, At the Standing Committee on Finance and Economic Affairs, Legislative Assembly of Ontario, Toronto, Ontario, Canada (August 18, 2004); available at: [http://www.osc.gov.on.ca/About/Speeches/sp\\_20040818\\_db-legislative-assembly.pdf](http://www.osc.gov.on.ca/About/Speeches/sp_20040818_db-legislative-assembly.pdf).

<sup>50</sup> *It’s Time*, (December 2003), available at: <http://www.wise-averties.ca/reports/WPC%20Final.pdf>. In 2003, Canada’s Federal Minister of Finance established committee called the “Wise Persons’ Committee” to independently assess Canada’s securities regulation system and to make recommendations for the development of a new regulatory structure. Just before Christmas 2003, the Wise Persons’ Committee released a report with the not unexpected major recommendation that Canada establish at the federal level a single national securities regulator called the “Canadian Securities Commission” (CSC), a body that would administer a new, single, national, securities statute.

<sup>51</sup> See the IMF’s “2005 Article IV Consultation with Canada - Preliminary Conclusions of the IMF Mission” (December 1, 2004); available at: <http://www.imf.org/external/np/ms/2004/120104.htm>.

## **2. BC Securities Commission's New Model for Securities Regulation and BC's New Securities Act**

On April 15, 2003, the BCSC published for comment a draft of the "BC Model" for securities regulation.<sup>52</sup> The draft legislation represents a significant departure from the existing regulatory landscape by presenting a comprehensive principles-based model for securities regulation in Canada.

In announcing the proposal, the BCSC noted that governments and securities regulators are reviewing the structure of Canadian securities regulation through several concurrent processes including the federal Wise Persons Committee and the CSA's USL Project described above. These various initiatives have sparked public debate centering on two critical issues:

- (1) Whether securities regulation should be based primarily on core principles or detailed rules; and
- (2) Whether Canada should retain provincial securities regulation or move to some form of a national securities regulatory body.

According to the BCSC, the BC Model is a "unique contribution to that debate." Instead of focussing on eliminating the differing rules between the provinces, which is the aim of the USL Project, the BC Model focuses on reducing the overall regulatory burden on market participants. It proposes to entirely replace the existing *Securities Act* (British Columbia) and its rules and policies with a more general, flexible regime. This concept of streamlining and simplification has received considerable support from market participants that have participated in the BCSC's consultation and review process.

The backbone of the BC Model is a principles-based regulatory model, a shorter set of broad regulatory principles backed by enhanced enforcement powers rather than the extensive, detailed system of rules currently in place. The BC Model is intended to permit market participants to reduce costs and to permit the flexibility to tailor compliance systems to their own business model. It is contemplated that market participants will focus on the bigger picture – what is right for investors, clients and markets – rather than technical compliance with prescriptive rules and hunting for loopholes.

On May 11, 2004, the British Columbia Legislature passed Bill 38, an act repealing the existing *Securities Act* (British Columbia)<sup>53</sup> and replacing it with a new *Securities Act* (British

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<sup>52</sup> Securities Regulation That Works: The BC Model - Commentary on Draft Legislation (Apr. 15, 2003), at [http://www.bsc.bc.ca/Publications/BC\\_Model/Commentary.pdf](http://www.bsc.bc.ca/Publications/BC_Model/Commentary.pdf).

<sup>53</sup> Securities Act, R.S.B.C. 1996, c. 418.

Columbia)<sup>54</sup> based upon the BC Model. Bill 38, and therefore the new *Securities Act* (British Columbia), received Royal Assent on May 13, 2004. This new legislation was to be proclaimed into force on November 29, 2004; however, on November 18, 2004, the British Columbia government announced that it is delaying proclamation of the new *Securities Act* (British Columbia) without specifying the new proposed proclamation date.

### ***3. Proposed National Instrument 45-106: A Proposal For a New National Rule for Prospectus and Registration Exemptions***

On December 17, 2004, the CSA proposed National Instrument 45-106 Prospectus and Registration Exemptions, which contains exemptions from the prospectus and registration requirements. Proposed NI 45-106 attempts to consolidate and harmonize the prospectus and registration exemptions contained in various provincial statutes and national, multilateral and local instruments into a single national instrument. NI 45-106 accordingly proposed to repeal the current commonly utilized rules regarding prospectus and registration exemptions - MI 45-103 – *Capital Raising Exemptions* and OSC Rule 45-501 – *Prospectus Exempt Distributions*.

As at the end of 2004, most Canadian provincial and territorial jurisdictions have a similar set of exemptions; however they are not identical, and it is current practice for market participants that wish to distribute securities in more than one jurisdiction by way of private placement (i.e. a prospectus exempt distribution) to familiarize themselves with the various exempt distribution regimes of the relevant jurisdictions. This can be cumbersome and requires familiarity with the various acts, regulations and instruments of the different jurisdictions. Upon implementation of the proposed NI 45-106, however, market participants will generally have to look no further than NI 45-106 to view the landscape of exemptions available in Canada. This is intended to result in reduced transaction costs because market participants will no longer need to expend time and money dealing with a collection of exempt distribution regimes and their associated disclosure and filing requirements. For example, an issuer that wishes to rely on the accredited investor or business combination exemption to distribute securities across Canada will need to review only one exemption.

Although proposed NI 45-106 makes some progress toward harmonization since it intends to capture all of the Canadian prospectus and registration exemptions in one instrument, it does not in fact achieve harmonization because it permits exceptions to exist from the various exemptions depending upon the investor's jurisdiction. For example, NI 45-106 contains exemptions already familiar to most market participants such as (i) the private issuer exemption, (ii) the offering memorandum exemption, and (iii) the "accredited investor" exemption similar to those found in MI 45-103 – *Capital Raising Exemptions* and OSC Rule 45-501 – *Prospectus Exempt Distributions*, yet NI 45-106 contains two versions of the offering memorandum exemption, one intended for use in British Columbia, New Brunswick, Nova Scotia and Newfoundland and Labrador and the other one for use in Alberta, Manitoba, Northwest

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<sup>54</sup> Securities Act, S.B.C. 2004, c. 43. Available at: [http://www.legis.gov.bc.ca/37th5th/3rd\\_read/gov38-3.htm](http://www.legis.gov.bc.ca/37th5th/3rd_read/gov38-3.htm)

Territories, Nunavut, Prince Edward Island, Quebec and Saskatchewan. The primary difference between the two versions is that the second one requires that purchasers either be “eligible investors” as defined in NI 45-106 or purchase securities at an aggregate acquisition cost that is less than CAD\$10,000, which are not requirements in the first version. Ontario is not adopting the offering memorandum exemption. There are also other such examples of exemptions that still are treated differently by different provinces and territories.

Therefore, although NI 45-106 does harmonize some exemptions and thus is a move forward in terms of streamlining the private placement process in Canada, it still does not present a fully harmonized set of rules related to prospectus and registration exemptions.

#### 4. *Quebec’s New Single Financial Services Industry Regulator*

On December 11, 2002, Quebec’s National Assembly adopted Bill 107, *An Act respecting the Agence nationale d’encadrement du secteur financier*, which resulted in the creation of a single “super regulator” (Agency) for the Quebec financial industry.<sup>55</sup> On February 7, 2003, the *Bureau de transition de l’encadrement du secteur financier* (the “transition Office for the framing of the financial sector”) was established for the purpose of setting up the Agency effective February 1, 2004. The Agency has adopted the business name, “*Autorité des marchés financiers*” (the “Financial Markets Authority”).

Since February 1, 2004, the Agency is the regulatory body that administers the regulatory framework governing Québec's financial sector. The Agency replaces the four most important financial industry regulators in Quebec: (1) the *Commission des valeurs mobilières du Québec* (CVMQ), which has jurisdiction over public companies, securities offerings, and investment dealers and advisors; (2) the *Bureau des services financiers*, which has jurisdiction over market intermediaries such as insurance agents and brokers, mutual fund dealers, and financial planners; (3) the Inspector General of Financial Institutions, which has jurisdiction over Quebec insurance, trust, and savings companies; and (4) the *Régie de l’assurance-dépôt*, which has jurisdiction over Quebec deposit-taking institutions. The IGFI’s jurisdiction over company incorporation, registration and reporting will be assumed by the enterprise registrar, a new department of the Ministry of Industry and Trade.

The creation of the Agency is the central recommendation of a report prepared by the Task Force on Financial Sector Regulation, chaired by Fasken Martineau senior partner, Yvon Martineau, and published by the Quebec Government in December 2001.<sup>56</sup> The Task Force had the mandate to analyze and submit recommendations to improve Quebec’s regulatory framework

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<sup>55</sup> Bill 107, *An Act respecting the Agence nationale d’encadrement du secteur financier* (May 2002), available at <http://www.ddsm.ca/pdf/aj2002-05-1-en.pdf>.

<sup>56</sup> See Report of the Task Force on Financial Sector Regulation, “A Streamlined Regulatory Structure for Quebec’s Financial Sector” (Dec. 2001), at <http://www.gesef.gouv.qc.ca/pdf/gesefang.pdf>.

for the financial industry. The creation of the Agency may present an additional hurdle to those advocating the formation of a single, Canadian securities regulator.

## **5. *Changes to Private Placement Resale Rules***

Effective March 30, 2004, the securities regulatory authorities in all Canadian provinces and territories (other than Quebec) rescinded existing Multilateral Instrument 45-102 *Resale of Securities* and replaced it with a new rule under the same name.<sup>57</sup> MI 45-102 imposes resale resections on securities acquired under exemptions from the prospectus requirements found in the securities legislation (Quebec has its own rules).

Under the former resale rule, securities acquired in a private placement were subject to a four month hold period if the issuer was a “qualifying issuer” (that is, its securities were listed on a specified exchange and it had filed a current Annual Information Form). If the issuer was not a qualifying issuer, resale was restricted for twelve months. The four-month/twelve-month regime also applied to “seasoning periods” after an IPO and to control block distributions.

The new MI 45-102 eliminates the qualifying issuer concept and replaces it with a four-month hold/seasoning regime for all reporting issuers. Pre-IPO shareholders will be permitted to sell their securities as soon as the company receives a receipt for its final prospectus if the shareholder is not a controlling shareholder, the shareholder has held the securities for at least four months, and other conditions are met. However, contractual conditions with the underwriters may still require certain pre-IPO investors to hold their securities for a longer period of time. “Control persons” still have additional statutory restrictions on their ability to resell securities.

## **6. *The Ontario Securities Commission’s Reform Proposal: “The Fair Dealing Model”***

On January 29, 2004, the OSC released a concept paper describing its proposal to reform the way the retail investment industry is regulated. The “Fair Dealing Model”<sup>58</sup> proposes to regulate the industry on the basis of the relationships people and firms form rather than the products they buy and sell.<sup>59</sup> The OSC suggests that there are three basic types of relationships which should be regulated differently: (i) a “self-managed” relationship where an investor seeks no investment advice from a firm and the investment dealer simply facilitates its client’s instructions; (ii) an “advisory” relationship where the investment representative provides investment advice to its investor client; and (iii) a “managed-for-you” relationship where a portfolio manager administers an investor client’s assets while observing the investor’s general investment parameters. The

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<sup>57</sup> Multilateral Instrument 45-102 *Resale of Securities*; available at: [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part4/rule\\_20040402\\_45-102-resale-sec.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part4/rule_20040402_45-102-resale-sec.pdf).

<sup>58</sup> The OSC’s Fair Dealing Model Concept Paper is available at: [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part3/cp\\_33-901\\_20040129\\_fdm.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part3/cp_33-901_20040129_fdm.pdf).

<sup>59</sup> Also see: [www.fairdealingmodel.ca](http://www.fairdealingmodel.ca)

Fair Dealing Model envisions that investors would receive more robust information - at the account opening stage, at the time of transactions, and in their account statements. Investment advisers would have clearer conduct standards to guide their activities, which hopefully will result in fewer disputes between investment advisors and their retail clients.

The Fair Dealing Model has thus far been a project in Ontario only, but given the OSC's preference for regulatory harmonization, it is unlikely to remain a local initiative. The OSC's Chairman has even indicated that the OSC does not intend to implement the Fair Dealing Model without the participation of other provincial regulators.

The Fair Dealing Model lists 35 specific proposals that would be introduced under the model and enunciates three principles: (i) allocation of responsibilities - there must be a clear, documented allocation of roles and responsibilities among the investor, the investment representative or advisor and the investment firm(s); (ii) transparency - all dealings with the investor must be transparent; meaning that there must be disclosure which is understandable and meaningful to the investor and which is communicated at the time and in the manner most likely to be useful to the investor; and (iii) managing conflicts - any conflicts of interest that the investment representative has must be appropriately managed to avoid self-serving outcomes. Appendices to the Fair Dealing Model document include samples or templates for client documentation that would be created or altered as a result of the Fair Dealing Model, such as: account opening documents; investor information sheets; transaction summaries; and account statements.

## **7. *Securities Regulators Propose Uniform Securities Transfer Act***

On May 28, 2004, the CSA's Uniform Securities Transfer Act Task Force released for public comment a revised consultative draft of a proposed provincial Uniform Securities Transfer Act (USTA). The USTA project is unrelated to the CSA's Uniform Securities Legislation project. The proposed USTA is not securities regulatory law, but is commercial property transfer law, governing the transfer and holding of securities and interests in securities. The USTA requires conforming amendments to the common-law provincial Personal Property Security Acts that govern the use of securities as loan collateral. It also replaces securities settlement rules currently contained in provincial Business Corporations Acts.

Current Canadian law in this area needs to be modernized to deal with securities market practices, particularly the holding and trading of securities through multiple tiers of financial intermediaries. Implementation of the USTA will provide a sound legal foundation for existing practices and support the continuing evolution of market practices in the future. It is important that Canadian legislation in this area be uniform within Canada and harmonized with existing similar legislation in the United States including the *Uniform Commercial Code*.<sup>60</sup> While the vast majority of stakeholders applaud the proposed USTA and its related initiatives, like other

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<sup>60</sup> Available online at: <http://www.law.cornell.edu/ucc/ucc.table.html>.

Canadian initiatives this proposal is challenged by the need to implement and then maintain provincially harmonized legislation.

#### **8. *Report of the Fairness Committee on the OSC's Roles as Policy Setter, Rulemaker, Investigator, Prosecutor and Adjudicator***

In 2003, the OSC created a committee known as the "Fairness Committee" headed by Ontario's Integrity Commissioner, Coulter Osborne. The mandate of the Fairness Committee was to review and provide advice on the Commission's current structure and, in particular, its adjudicative function in light of the increased sanctioning powers (fines of up to CAD\$1 million and disgorgement orders) given to the Commission in 2002 through amendments to the *Securities Act* (Ontario).

The OSC is currently structured to engage in policy setting, rulemaking, investigation, prosecution and adjudication under one corporate, statutorily established umbrella. Some commentators have stated that there may be a perception of bias regarding the OSC's adjudicative function, even though by both practice and legislation a Commissioner involved in the investigation of a matter cannot participate in the adjudication of the same matter. Critics of the existing structure contend that the perception of bias works to erode the credibility of the OSC. This is not a new issue and it was also the subject of similar debates in England and in the United States in the 1930s.

On August 18, 2004, the Fairness Committee submitted its report<sup>61</sup> which examined the structure of the Commission and the potential for the perception of bias and the possibility that such a perception would erode the credibility of the Commission. While the report advises the Commission to undertake structural changes to eliminate the perception of bias (these changes will require authorizing legislation), the report found no impediment to the Commission continuing to fulfill its adjudicative responsibilities and functions on a business-as-usual basis. The report further pointed out that the Supreme Court of Canada has found no complaint about the apprehension of bias where organizations adopt an integrated regulatory model. Canada's highest court has recognized, in the words of Chief Justice McLachlin, that "... the overlapping of investigative, prosecutorial and adjudicative functions in a single agency is frequently necessary for [an administrative agency] to effectively perform its intended role." Nevertheless, the Ontario government's Standing Committee on Finance and Economic Affairs feels that a perception of bias exists in the current system and believes that fairness would be better served with an arm's-length structure. The Ontario government believes the benefits of dividing the OSC's functions clearly outweigh the risks and the Fairness Committee's report, along with the standing committee's comments, led to the government's announcement in November 2004 that

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<sup>61</sup> See: Report of the Fairness Committee (March 5, 2004); available at: [http://www.osc.gov.on.ca/Regulation/FiveYearReview/fyr\\_20040818\\_fairness-committee.pdf](http://www.osc.gov.on.ca/Regulation/FiveYearReview/fyr_20040818_fairness-committee.pdf).

it will move to take the adjudicative function out of the OSC and establish it in a separate entity unless significant progress is made towards a single national regulator within a year.

## 9. *Enforcement and Class Action Progress*

Recognizing the need for swifter and stronger enforcement measures in the Canadian capital markets, Canadian securities regulators and enforcement officials made an effort in 2004 to raise their profile and better target high visibility cases. In a Spitzer-style move, Canada's stock market regulator, Market Regulation Services Inc. (Market RS), has put the investment community on notice that it will target senior officers (and not just compliance officers) in enforcement proceedings, for the first time holding them accountable for trading violations.<sup>62</sup> The regulator appears quite willing to make good on its word. In 2004, Market RS levied fines totalling CAD\$5.5 million against 11 firms. By Canadian standards, that was a large amount. The Investment Dealers Association of Canada, by comparison, fined firms a total of only CAD\$265,189 in 2003 (that figure, however, is dwarfed by the IDA's precedent-setting fine of almost CAD\$42 million against three brokerages in December 2004 over market timing, described in section B-5 above). The philosophy is spreading as evidenced by the CSA proudly publishing a report on December 10, 2004 about enforcement activities undertaken by members of the CSA during the 6 months ended September 30, 2004.<sup>63</sup> In this report, to ensure the message is clear to investors, the CSA states on the first page of the report that "Investigation and enforcement are core CSA activities. By identifying contraventions of securities laws or conduct in the capital markets that is contrary to the public interest, and by imposing appropriate sanctions, the CSA deter wrongdoing, protect investors, and foster fair and efficient capital markets in which investors have confidence."

On May 7, 2004, the Ontario Superior Court of Justice issued what has been called a precedent setting judgment against Danier Leather Inc. (Danier) and its CEO and CFO for an amount that could total approximately CAD\$15 million. The judgment in this case is expected to be precedent setting because it is the first time a plaintiff has been successful in bringing an action under the *Securities Act* (Ontario) resulting in statutory liability for a misrepresentation in a prospectus.

The plaintiffs in *Kerr. v. Danier Leather*<sup>64</sup> purchased shares in Danier pursuant to its CAD\$65 million IPO in 1998. Two weeks before the closing of its IPO, Danier issued a prospectus that contained a financial forecast for the remainder of Danier's fiscal fourth quarter. Two weeks after the transaction closed, Danier warned that "unseasonably warm weather" had

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<sup>62</sup> See: "Stock cop sets sights on big fish" by Karen Howlett, Globe and Mail newspaper, January 28, 2005 - Page B1.

<sup>63</sup> Report on Enforcement Activities From April 1 to September 30, 2004 (December 10, 2004); available at: [http://www.csa-acvm.ca/pdfs/Enforcement2004\\_Eng.pdf](http://www.csa-acvm.ca/pdfs/Enforcement2004_Eng.pdf).

<sup>64</sup> *Kerr v. Danier Leather Inc.* [2004] O.J. No. 1916 (Sup. Ct); available at: <http://www.canlii.org/on/cas/onsc/2004/2004onsc11174.html>.

reduced the expected sales of its leather goods. It revised its forecast for the fiscal fourth quarter ending on June 27, 1998, and the market price of Danier's shares fell almost 30% in the next four days, leaving investors sitting on millions of dollars of paper losses. However, by the end of the fourth quarter, the results in the original forecast were in fact substantially achieved. Nevertheless, s. 130(1) of the *Securities Act* (Ontario) gave investors in the IPO the right to sue for damages where the prospectus contained an untrue statement of material fact or omitted to state a material fact at the time of purchase.

The investors alleged that when the IPO closed, the original forecast no longer reflected management's best judgement of the most probable economic conditions and that, in fact, management already knew at that time that there had been a business downturn. Sales information was available to management of Danier on a daily basis. The investor plaintiffs argued that disclosure was required to correct the false and misleading forecast. They alleged that the purchase price of the shares was artificially high due to the misrepresentation and that, if the misrepresentation had been corrected, the purchase price would have been lower. The Ontario Superior Court of Justice accepted the plaintiffs' argument and held Danier as well as its CEO and CFO liable for the damages calculated by the Court. The Court ruled that investors who bought shares in the IPO and sold them in the immediate aftermath of Danier's profit warning were entitled get their losses back. Those who held on to their stock were awarded CAD\$2.35 per share in damages. Danier has said that it plans to appeal.

## E. Conclusion

As one can see from the foregoing, in 2004 there were numerous actual and proposed legislative and regulatory developments relating to the Canadian financial system and capital markets. This pace of regulatory change is expected to continue in 2005, a year that will continue to see Canadians strive for harmonization between jurisdictions, improved investor confidence, and a more robust enforcement regime.

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