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Research Study

A Survey of Corporate Gatekeeper Liability in Canada

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Strengthening Credibility and Integrity

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1. Executive Summary[1]

Overview

This paper outlines the liabilities imposed on eleven corporate gatekeepers to Canadian capital markets. For the purpose of this paper, corporate gatekeepers are defined as third parties who can disrupt misconduct by withholding support. Following some debate among the Task Force as to which gatekeepers should be included in this list, the eleven were agreed upon. For some, these gatekeepers may not represent an exhaustive list, and for others, the list may be too broad. However, taken together the focus on these gatekeepers provides a useful canvas of the liabilities that corporate gatekeepers are currently exposed to in Canada.

For the purpose of this paper, gatekeeper liability includes civil, administrative and criminal sanctions that can be imposed on gatekeepers who fail to withhold support. This includes rules that can be enforced by public regulators and also rules that can be enforced by private parties (e.g. investors). The sources of law that were reviewed are: statute (corporate and securities); common law; self-regulatory organizations' (SROs) rules; and rules of professional conduct set by industry bodies. The focus of this paper is on gatekeepers of public companies.

This paper is intended to provide the descriptive context that will form the basis of the assessment in the following paper of the effectiveness of the Canadian corporate gatekeeper liability regime in the context of modernizing securities legislation in Canada to facilitate and enhance the competitiveness of Canadian capital markets. The following is a summary of the general trends that were observed with respect to civil, administrative, criminal and quasi-criminal corporate gatekeeper liability. A detailed analysis of the gatekeeper liability imposed on the eleven corporate gatekeepers examined follows.

Civil Liability

Under the current regime, investors' ability to impose civil liability on corporate gatekeepers is quite limited. Both substantive and procedural obstacles limit common law remedies. The application of the business judgment rule and a range of statutory defences, in addition to procedural obstacles, limit statutory remedies, including the new secondary market civil liability regime. The rules of professional

[1] The research assistance provided by Yan Chan and Linus Yung is gratefully acknowledged.

conduct provided by gatekeepers' SROs or industry bodies either do not provide for or are unlikely to result in liability to third parties.

Administrative Liability

The provincial securities commissions have a broad ability to impose sanctions on corporate gatekeepers. In addition, SROs and industry bodies also have detailed codes of conduct specific to the gatekeepers they regulate, giving rise to administrative sanctions that can have far-reaching consequences for gatekeepers, such as the inability to continue in their profession. Given that there are so many codes of conduct and some provincial variation, a key contribution of this paper is to document the various regulatory responses for each gatekeeper under analysis. To the extent that the liability of corporate gatekeepers has been discussed in the Canadian context, no study has provided a detailed examination of the rules of professional conduct imposed on each gatekeeper by SROs and industry bodies. This likely follows from the fact that collecting and understanding these rules and codes is a large task and raises the issue of whether the average investor understands these standards and the liability that attaches.

Criminal and Quasi-Criminal Liability

There have been two recent attempts to expand criminal liability in Canada, for gatekeepers both as individuals and as organizations. Bill C-13 increased the penalties for market-related offences, created a list of aggravating factors that would impose stiffer penalties and also created a whistle-blowing provision with criminal sanctions for employers. Bill C-45 has expanded corporate criminal liability to include a wide range of "organizations" and broadened the circumstances when such liability would attach. It does appear, however, that mere failure to withhold support, without other aggravating circumstances, will not result in criminal liability, even in its expanded form for corporate gatekeepers.

The possibility for quasi-criminal gatekeeper liability provided by corporate and securities legislation is similarly limited by the due diligence defences available under this legislation.

2. Directors

Directors can act as gatekeepers to capital markets because they are in a position to scrutinize and question corporate activities and management proposals. Ultimately, directors are responsible for managing or supervising the management of the business and affairs of the corporation. As well, the federal and provincial corporate law statutes vest in directors an integral role in making fundamental changes to the corporation. Essentially, subject to the constraints imposed by law, directors have complete discretion to exercise their powers as they deem appropriate.[2] Directors also have the ability to act as gatekeepers due to their role in appointing and evaluating the executives of the corporation.

In many of these functions, some consider independent directors more able to perform a gatekeeping role because of their more arms-length relationship with management. A major role of independent directors is to serve on audit committees, which must usually be composed of independent directors, or at least have a majority of outside directors. It is possible that a director who is a member of an audit committee will be held to a higher duty of care and greater liability for misrepresentations than other directors, because she or he will have more opportunity to obtain knowledge about, and to examine, the affairs of the corporation than do the other directors.

i. Civil Liability

a) Common Law

The provincial securities acts provide that investors' statutory rights to damages do not derogate from any other right the purchaser of securities may have at law.[3] While investors have traditional common law remedies against directors for breach of fiduciary duty and duty of care, as well as remedies in contract and tort (e.g. negligent or fraudulent misrepresentation or the intentional tort of deceit), these have generally been supplanted by securities and corporate legislation, as the common law remedies have more onerous substantive and procedural requirements to be met.

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[2] Osler, Hoskin & Harcourt, "Corporate Governance in Canada: A Guide to the Responsibilities of Corporate Directors in Canada", online: < http://www.osler.com/resources.aspx?id=8115>.

[3] *Securities Act*, R.S.A. 2000, c. S-4, s. 203(14) [*ASA*]; *Securities Act*, R.S.B.C. 1996, c. 418, s. 131(14) [*BCSA*]; *Securities Act*, R.S.O. 1990, c. S.5, s. 130(10) [OSA]; *Securities Act*, 1988, S.S. 1988-89, c. S-42.2, s. 137(12) [*SSA*]; *Securities Act*, C.C.S.M. c. S50, s. 5(7) [*MSA*]; *Securities Act*, S.N.B. 2004, c. S-5.5, s.149(1) [*NBSA*]; *Securities Act*, R.S.N.S. 1989, c. 418, s. 137(10) [*NSSA*]; *Securities Act*, R.S.P.E.I. 1988, c. S-3, s. 16(10) [*PEISA*]; *Securities Act*, R.S.N.L. 1990, c. S-13, s. 130(10) [*NLSA*]; *Securities Act*, R.S.Y. 2002, c. 201, s. 25(4) [*YSA*]; *Securities Act*, R.S.N.W.T. 1988, c. S-5, s. 30(4) [*NWTSA*]. Note the cited legislation applies to prospectus misrepresentation liability. An equivalent section could not be located in the Quebec *Securities Act*.

At common law, as a fiduciary, a director owes to the corporation (but not to the individual shareholders) loyalty, good faith, and avoidance of a conflict of duty and self-interest.[4] Further, directors are required to exhibit in the performance of their duties the degree of skill that may reasonably be expected from a person of their knowledge and experience ("duty of care").[5] However, a director may not be made responsible in damages for a breach of his or her duty of care unless he or she is guilty of gross or culpable negligence in a business sense, as measured by the care which an ordinary person might be expected to take in the circumstances on his or her own behalf.[6] Further, it has been established in *Foss v. Harbottle* that a shareholder cannot personally claim for an injury to the corporation.[7] This rule has been alleviated through corporate statutes, which allow for derivative actions. Derivative actions are addressed in the following section of this paper.

Purchasers of securities may also have an action at common law for fraudulent misrepresentation or negligent misrepresentation against directors.[8] However, there are significant barriers to this type of action, as is illustrated in *Carom et. al v. Bre-X Minerals Ltd. et. al.*[9] In *Bre-X,* the initial central causes of action of negligent and fraudulent misrepresentation were advanced against Bre-X Minerals Ltd., its officers and directors, brokers and analysts. These claims were unsuccessful because the investors were unable to prove reliance. It was alleged that various communications prepared by individual defendants contained material misrepresentations, and that the common misrepresentation was that gold was present in mineable qualities in a certain area. During the class action certification hearing, in order to address the problems in proving reliance, the plaintiffs sought to amend their Statement of Claim in order to plead the doctrine of fraud on the market. The Ontario Court refused to grant leave, 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 of actual reliance in either the tort of fraudulent or negligent misrepresentation. As will be discussed in greater detail in the section on secondary market liability, the new secondary market civil liability regime under Ontario's securities legislation is poised to respond to this quandary.

The policy concerns articulated in *Hercules Management Ltd. v. Ernst & Young*,[10] discussed in greater details in the following section of this paper on auditors, have also narrowed the possibility for a

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[4] *Canadian Aero Service Ltd. v. O'Malley*, [1974] S.C.R. 592 at 620.
[5] *Re City Equitable Fire Insurance Co.* (1924), [1925] 1 Ch. 407 (Eng. C.A.).
[6] CED, Directors and Officers – Duties and Liabilities – Duty of Care and Duty to Manage, s. 388.
[7] (1843), 2 Hare 461, 67 E.R. 189 [*Foss*].
[8] David B. Tennant, "Securities Offerings" in M. Patricia Richardson, ed., *Directors' and Officers' Duties and Liabilities in Canada* (Toronto: Butterworths, 1997) 175 at 193.
[9] (1998), 41 O.R. (3d) 780 (Gen. Div.).
[10] [1997] 2 S.C.R. 165 [*Hercules*].

successful action for negligent misrepresentation against directors. The reasoning in *Hercules* was applied to directors in *NPV Management Ltd. v. Anthony*,[11] where representations had been made to public shareholders of Conpak that valuable fishing assets would be transferred to the corporation. The defendant director held knowledge that the transfer was not completed, yet continued to make representations that it had been effected. NPV claimed detrimental reliance upon those representations. However, the Newfoundland Court of Appeal held that an action for negligent misrepresentation could not be made out because there was nothing unique about the relationship between the claimants and the directors, which would distinguish them from the broad class of other investors in the public company. The policy concern at issue was indeterminate liability to an indeterminate class.

Investors making a claim under the common law lose the many advantages they hold under a securities act claim (discussed below). Under a common law claim:

- the plaintiff must show reliance on the misrepresentation;
- the burden of showing damages, based on the difference between the purchase price and the true value of the shares had the misrepresentation not been made, rests with the plaintiff; and
- it may also be difficult to claim against the directors who did not sign the prospectus individually, and/or for the plaintiff to establish the requisite unique relationship with the directors.[12]

b) Statutory Liability

Corporate Statutes: Statutory Fiduciary Duty and Duty of Care

A director has a statutory fiduciary duty to the corporation under s. 122(1)(a) of the *Canada Business Corporations Act* [CBCA] (and the equivalent sections of the provincial acts) to "act honestly and in good faith with a view to the best interests of the corporation".[13] In addition to the statutory fiduciary duty, Canadian directors have a statutory duty of care to "exercise the care, diligence and skill that a reasonably

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[11] 2003 NLCA 41 [*NPV*].
[12] John J. Chapman, "Class Proceedings for Prospectus Misrepresentations" (1994) 73 Can. Bar Rev. 492 at 501. Chapman suggests that it may be possible to make the argument that the directors signing the prospectus do so as agents for their fellow directors, or that the other directors are breaching their duty of care.
[13] R.S.C 1985, c. C-44 [*CBCA*]; see also *Business Corporations Act*, R.S.O. 1990, c. B.16, s. 134 [*OBCA*]; *Business Corporations Act,* RSBC 2002, c. 57, s. 142 [*BCBCA*]; *Business Corporations Act,* R.S.A. 2000, c. B-9, s. 122 [*ABCA*]; *Corporations Act,* C.C.S.M. c. C225, s. 117 [*MCA*]; *Business Corporations Act*, R.S.S. 1978, c. B-10, s. 117 [*SBCA*]; *Business Corporations Act*, S.N.B. 1981, c. B-9.1, s. 79 [*NBBCA*]; *Corporations Act*, R.S.N.L. 1990, c. C-36, s. 203 [*NFCA*]; *Business Corporations Act,* R.S.Y. 2002, c. 20, s. 124 [*YBCA*]; *Business Corporations Act*, S.N.W.T. 1996, c. 19, s. 123 [*NWTBCA*].

prudent person would exercise in comparable circumstances" as set out in s. 122(1)(b) of the CBCA (and the equivalent sections of the provincial acts).[14] Nova Scotia, Prince Edward Island and Quebec have not codified the fiduciary duty or duty of care of directors, so duties of directors governed by the corporate statutes in these provinces will be determined under the common law duties discussed above.[15] Similar standards to the CBCA are incorporated into the Quebec Civil Code at s. 322, which requires that "[a] director shall act with prudence and diligence" and "…with honesty and loyalty in the interest of the legal person".[16]

Investors and other stakeholders in the corporation are prevented from directly bringing actions against the directors for breach of the fiduciary duty via the holding in *Foss v. Harbottle*.[17] Corporate statutes such as s. 239 of the CBCA allow derivative actions by complainants on behalf of the corporation.[18] Section 238 of the CBCA defines complainants and includes "any other person who, in the discretion of a court, is a proper person to make an application under this Part".[19] The derivative action statutes thus allow stakeholders to seek redress on behalf of the corporation, from directors who breach their fiduciary duty to the detriment of the corporation itself. Nova Scotia's *Companies Act* is not based on the CBCA, but incorporates the concepts of a derivative action in the Third Schedule. Prince Edward Island and Quebec do not have equivalent statutory rights of derivative actions, and these jurisdictions would thus continue to follow the rule in *Foss v. Harbottle* or in the case of Quebec, shareholders would make use of the Civil Code to initiate such actions.

The impact of this potential liability for directors through a derivative action is lessened by the indemnification provisions of the CBCA and provincial statutes, which allow for the indemnification of directors from actions that arise from their duty as a director, with court approval, and subject to some

[14] *Ibid.*
[15] See, e.g. *2475813 Nova Scotia Ltd. v. Ali* (2001), 189 N.S.R. (2d) 363, 590 A.P.R. 36 (C.A.); *Wedge v. McNeill* (1981) 33 Nfld. & P.E.I.R. 272, 93 A.P.R. 272 (P.E.I.S.C.). The Supreme Court dealt with this issue in *Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] 3 S.C.R. 461 at paras. 54-64 [*Peoples*].
[16] Art. 322 C.C.Q.
[17] *Supra* note 6.
[18] *CBCA, supra* note 12; see also *OBCA, supra* note 12, s. 246; *BCBCA, supra* note 12, s. 232; *ABCA, supra* note 12, s. 240; *MCA, supra* note 12, s. 232; *SBCA, supra* note 12, s. 232; *NBBCA, supra* note 12, s. 164; *NFCA, supra* note 12, s. 369; *YBCA, supra* note 12, s. 241; *NWTBCA, supra* note 12, s. 241; and *Companies Act*, R.S.N.S. 1989, c. 81 Third Schedule, s. 4 [*NSCA*].
[19] *CBCA, ibid.*; see also *OBCA, ibid.*, s. 245; *BCBCA, ibid.*, s. 232; *ABCA, ibid.*, s. 239; *MCA,* ibid., s. 231; *SBCA, ibid.*, s. 231; *NBBCA, ibid.*, s. 163; *NFCA, ibid.*, s. 368; *YBCA, ibid.*, s. 240; *NWTBCA, ibid.*, s. 240; *.NSCA, ibid.*, Third Schedule, s. 1.

exceptions including a failure to act honestly and in good faith.[20] Nova Scotia's *Companies Act* provides additional protections for directors. Section 20(2) of the Nova Scotia Companies Act provides that the articles of association may incorporate any of the regulations in Table A of the First Schedule, including s. 204 which allows indemnification of directors for liabilities incurred "by reason of any contract entered into, or act or thing done by him as such officer or servant or in any way in the discharge of his duties".[21] Section 204 of Table A also allows for a prohibition of liability for directors for acts of conformity, errors of judgment or "damage or misfortune whatsoever which happens in the execution of the duties of his or her office or in relation thereto" subject to the existence of dishonesty. By contrast, s. 205 of the Newfoundland *Corporations Act* specifically excludes indemnification of a director for actions "by or on behalf of a corporation or body corporate to obtain a judgment in its favour".[22]

Notwithstanding *Foss v. Harbottle*, there have also been attempts to extend the fiduciary duty to the underlying investors of the corporation. In *United Services Funds v. Lazzell,*[23] it was held that the directors of a corporation had a duty to a principal shareholder (in that case a mutual fund) to apprise it of illegal trading that the directors knew was occurring. In that case, the directors in question were daughters of the fraudulent stock promoter, who took little notice of or interest in the corporation. However, most recently, in the case of *Peoples Department Stores Inc. v. Wise*, the Supreme Court held that the fiduciary duty of directors does not extend beyond the corporation directly to its creditors.[24] The Court stated that "in determining whether [directors] are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, inter alia, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment".[25] Similarly, the Court of Appeal for Ontario in *Brant Investments v. Keeprite* held that importing the fiduciary duty beyond the corporation to its shareholders "could be inimical to the statutory fiduciary duty imposed upon directors in s. 122(1) of the CBCA".[26] The fiduciary duty is owed to the corporation itself, allowing directors to balance the interests of multiple stakeholders and utilize their business judgment to determine what is best for the corporation.

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[20] *CBCA, ibid.* at s. 124; *OBCA, ibid.*, s. 136; *BCBCA, ibid.*, s. 160; *ABCA, ibid.*, s. 124; *MCA, ibid.*, s. 119; *SBCA, ibid.*, s. 119; *NBBCA, ibid.*, s. 81; *NFCA, ibid.*, ss. 205-206; *YBCA, ibid.*, s. 126; *NWTBCA, ibid.*, s. 125; see also *Companies Act*, R.S.P.E.I. 1988, c. C-14, s. 64 [*PEICA*]; *Companies Act*, R.S.Q. c. C-38, s. 90 [*QCA*].
[21] *NSCA, supra* note 17, First Schedule, Table A s. 204.
[22] *Supra* note 12, s. 205.
[23] (1988) 28 B.C.L.R. (2d) 26 (S.C.).
[24] *Supra* note 14 at para. 43.
[25] *Ibid.* at para. 42
[26] 80 D.L.R. (4^{th}) 161 (O.C.A.) [*Brant*].

The ability for a successful action against a director for breach of the fiduciary duty is also significantly constrained by the use of the "business judgment rule". This rule is utilized by the judiciary to "(protect) Boards and directors from those that might second-guess their decisions of the business decisions".[27] To apply the rule, the courts must find that the directors were "scrupulous in their deliberations and demonstrate diligence in arriving at decisions".[28] Directors are not obliged to give continuous attention to the company's affairs. However, their duties are awakened when information and events that require further investigation become known to them. For example, in the case of *YBM Magnex*, several directors were held liable for misrepresentations in a prospectus made in reliance on recommendations from a special committee that had been struck by the board. By failing to ensure that the special committee was independent, the directors' unquestioning acceptance of its proposals was rendered unreasonable.[29]

The CBCA also allows directors to raise a due diligence or good faith reliance defence to avoid liability for breach of their statutory duties.[30] Similarly, section 135(4) of the Ontario Business Corporations Act (OBCA) allows for a good faith reliance defence; and the Acts of British Columbia, Saskatchewan, Manitoba and New Brunswick contain similar provisions.[31] Using this defence, directors can be relieved of any liability, if they relied in good faith on financial statements produced by an officer or auditor of the corporation, or a report of a professional. A number of provinces offer directors both a good faith reliance and due diligence defence similar to s. 123(4) of the CBCA.[32]

On its face, the statutory duty of care appears to be broader than the statutory fiduciary duty. Unlike the statutory fiduciary duty, which stipulates the identity of the beneficiary of that duty as the corporation, the duty of care leaves the beneficiary of the duty open. Accordingly, in *Peoples Department Store Inc. v. Wise*, the Supreme Court of Canada held that such a duty could be owed to creditors. However, in practice, the application of the statutory duty of care has been extremely limited by the business judgment rule and the statutory defences available to directors.

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[27] *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.* [2002] O.J. No. 2412 at para. 152 [*UPM*].
[28] *Ibid*. at para. 153.
[29] *Re YBM Magnex International Inc*., (2003), 26 O.S.C.B. 5285 at para. 182 [*YBM*].
[30] Specifically, under s. 123(4), the defence is available if the director has exercised the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances, including reliance in good faith on financial statements represented to him or her by an officer of the corporation or in a written report of the corporation's auditor to reflect fairly the financial position of the corporation, or a report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him or her. On the strength of this reliance, he/she can avoid liability for breach of fiduciary duty and the duty of care (s. 122). Section 123(5) maintains the traditional defence of good faith reliance to meet the duty of care set out in s. 122.
[31] *CBCA, supra* note 12, s. 123(4); *OBCA, supra* note 12, s. 135(4); *BCBCA, supra* note 12, s. 157; *SBCA, supra* note 12, s. 118(4); *MCA, supra* note 12, s. 118(4); and *NBBCA, supra* note 12, s. 80(3).
[32] *ABCA, supra* note 12, s. 123(3); see also *YBCA, supra* note 12, s. 125(3); and *NWTBCA, supra* note 12, s. 124(3).

Corporate Statutes: Oppression Remedy

Directors do not owe a fiduciary duty to investors beyond their statutory and common law obligations to the corporation, and the possibility of liability based on breach of the statutory duty of care is extremely limited given the judiciary's use of the business judgment rule and the availability of statutory defences. However, the oppression remedy holds the potential for individual investors to bring an action against directors who have failed in their gatekeeping role.[33]

Under the CBCA and the corporate statutes of all provinces except Prince Edward Island and Quebec, a "complainant" may apply to the Court for relief if the business of the corporation or the powers of the directors have been exercised in a manner that is "oppressive or unfairly prejudicial to or that unfairly disregards the interests" of any security holder, creditor, director or officer.[34] British Columbia's statute is differently worded, but the legal effect is quite similar.[35]

The oppression remedy is not only intended to protect strict legal rights, but also to protect the expectations of the complainant.[36] The approach that has most commonly been taken by Canadian courts in interpreting the oppression remedy has been a general fairness standard based on the reasonable expectations of the applicant, rather than the three different standards outlined by the statute.[37] On a finding of oppression, the court has the discretion to choose from fourteen prescribed forms of relief or to make "the order it thinks fit".[38]

In *Peoples Department Stores Inc. v. Wise,* the Court held that "the availability of such a broad oppression remedy undermines any perceived need to extend the fiduciary duty imposed on directors by paragraph

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[33] *Brant, supra* note 25.

[34] *CBCA, supra* note 12, s. 241(1) and (2); *OBCA, supra* note 12, s. 248; *ABCA, supra* note 12, s. 242; *SBCA, supra* note 12, s. 234; *MCA, supra* note 12, s. 207; *NBBCA, supra* note 12, s. 166; *NSCA, supra* note 17, Third Schedule, s. 5; *NFCA, supra* note 12, s. 371; *YBCA, supra* note 12, s.243; and *NWTBCA, supra* note 12, s. 243. Under the CBCA, (*ibid*., s. 238), a complainant is defined as a registered holder or beneficial holder of a security (or a former registered holder or beneficial holder) of a corporation or any of its affiliates, a director or an officer of a corporation or any of its affiliates (or a former director/officer), the Director (appointed under s. 260 of the act), or any other person deemed a "proper person" by the court.

[35] *BCBCA, supra* note 12; see also Gordon Phillips, *Personal Remedies for Corporate Injuries* (Toronto: Thompson Canada, 1992) at 450.

[36] See e.g. *Westfair Foods Ltd. v. Watt* (1991), 115 A.R. 34, 79 D.L.R. (4th) 48 (C.A.), leave to appeal to SCC refused, (1991) 85 D.L.R. (4th) viii. The case was recently referred to in *Clarke v. Rossburger* (2001), 18 B.L.R. (3d) 197, 108 A.C.W.S. 74 (C.A.).

[37] For a discussion of the standard see Jeffrey MacIntosh, "Bad Faith and the Oppression Remedy: Uneasy Marriage or Amicable Divorce?" (1990) 69 Can. Bar Rev. 276.

[38] *CBCA*, *supra* note 12, s. 241(3).

122(1)(a) of the CBCA to include creditors".[39] This reasoning suggests that in future cases the oppression remedy analysis will not require a determination of whether directors have breached their fiduciary duties and that it may be possible to use the oppression remedy to hold directors accountable to individual stakeholders. Neither positions are new; however, the above statement can be taken as obiter as the case itself did not concern an oppression action.[40]

The direction in *Peoples Department Store Inc. v. Wise* that the judicial application of the oppression remedy is to be divorced from a fiduciary duty analysis has been articulated by lower courts in the past without significant impact on how the judiciary has engaged in their analysis of oppression actions.[41] As a practical matter, judges draw on their overall knowledge of corporate law in dealing with the relatively few oppression actions that they are faced with each year.[42] As a result, the judicial treatment of the oppression remedy has frequently drawn from the case law on breach of statutory duties, importing concepts such as the "best interests of the corporation" and the "business judgment rule" from this case law.

For example, in *820099 Ontario Inc. v. Harold E. Ballard Ltd.*,[43] Justice Farley granted the oppression remedy to a minority shareholder of a closely-held corporation. Justice Farley referenced the Supreme Court's definition of a corporation in *Ringuet v. Bergeron*,[44] and held that "while it would be appropriate for a director to consider the individual desires of one or more various shareholders … it would be inappropriate for that director to only consider the interests of certain shareholders and to either ignore the others or worse still act in a way detrimental to their interests. The safe way to avoid this problem is to have directors act in the best interests of the corporation".[45] The *Ballard* decision has been frequently

[39] *Peoples*, *supra* note 14 at 48 and 51.
[40] Rather, the case was based on the issue of whether directors owe a duty to creditors. The trustee, representing the interests of the creditors, sued the directors for an alleged breach of the duties imposed by s. 122(1) of the CBCA. In its analysis, the Court recognized that, according to article 300 of the Q.C.C. and s. 8.1 of the *Interpretation Act*, R.S.C. 1985, c. I-21, the civil law serves as a supplementary source of law to federal legislation. The CBCA does not entitle creditors to sue directors directly for breach of their duties, and so the Court deemed it appropriate to have recourse to the Q.C.C. to establish how rights grounded in a federal statute should be considered in Quebec. The Court also looked to the Q.C.C. to determine how s. 122(1) of the CBCA can be harmonized with the principles of civil liability. See *ibid* at paras. 29-30.
[41] See for example *Brant supra* note 25 affing. (1987), 60 O.R. (2d) 737 (H.C.).
[42] See for example, Stephanie Ben-Ishai & Poonam Puri, "The Canadian Oppression Remedy Judicially Considered: 1995-2001" (2004) 30 Queen's L.J. 79 at para. 21, where the authors noted there were 71 cases that dealt with the oppression remedy on its merits between January 1995 and November 2001.
[43] (1991), 3 B.L.R. (2d) 123 (Ont. Gen. Div.) at 171, aff'd (1991), 3 B.L.R. (2d) 113 (Ont. Div. Ct.) [*Ballard*].
[44] [1960] S.C.R. 672, 24 D.L.R. (2d) 449.
[45] *Ballard*, *supra* note 42 at para. 105.

cited and followed by Canadian courts applying the oppression remedy,[46] and was referred to in the *Peoples* discussion of the fiduciary duty,[47] reflecting how difficult it is for the judiciary to divorce their understanding of the Canadian fiduciary duty from their analysis and application of the oppression remedy.

In addition, while Canadian courts have recognized that the oppression remedy is a broad and flexible tool designed to protect the interests of corporate stakeholders in a variety of ways, they have also been influenced by the business judgment rule and its application to the statutory fiduciary duty and duty of care. For example, in *Re Ferguson and Imax Systems Corp.*,[48] the Court of Appeal for Ontario held that it was imperative that the oppression remedy be applied in a manner that balances the protection of stakeholders and the ability of management to conduct business in an efficient manner. More recently, in *Catalyst Fund General Partner Inc. v. Hollinger Inc.*,[49] when Justice Campbell invoked the oppression remedy to remove the directors of Hollinger, he held that this was an extreme form of judicial intervention that should be a measure of last resort where directors were "motivated by putting their interests first, not those of the company".[50]

Securities Statutes: Primary Market Liability

Directors may be liable to persons who acquire securities in a corporation during the period of distribution while there are uncorrected misrepresentations in a prospectus.[51] The purchaser need not show reliance

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[46] See for example, *Riverstar Inc. v. Hookenson*, [2004] A.J. No. 1500 (Q.B.) (QL); *McAteer v. Devoncroft Developments Ltd.*, [2001] A.J. No. 1481 (Q.B.) (QL); *Deluce Holdings Inc v. Air Canada*, [1992] O.J. No. 2382 (Gen. Div.) (QL).
[47] *Peoples, supra* note 14 at para. 41.
[48] (1983), 43 O.R. (2d) 128 (C.A.) at 137. This was an appeal after the application for relief was dismissed under s. 234 of the *Canada Business Corporations Act*. S.C. 1974-5, c. 33. The appellant claimed that the corporation and the directors had, by organizing a special meeting to vote on a resolution to amend its articles to reorganize its capital, acted in a manner that was oppressive, unfairly prejudicial, or unfairly disregarded her interests as a security holder. On appeal, Brooke J.A. found for the appellant and granted her relief for oppression.
[49] 2004 Carswell Ont 4772 (S.C.J.) (eC). This was an application by Catalyst against Hollinger Inc., where it sought the removal of a majority of the company's board of directors pursuant to the power granted under the oppression remedy. The allegations against those directors concerned the fact that $1.1 million loan made by Hollinger Inc. to its parent Ravelston had not been authorized by the board of Hollinger Inc. at the time it was made in June 2004. Further, the existence of the loan had not been disclosed during Catalyst's first application heard earlier by the court.
[50] *Ibid.* at para. 83.
[51] *OSA*, *supra* note 2, s. 58; *BCSA*, *supra* note 2, s. 68; *ASA*, *supra* note 2, s. 116; *MSA*, *supra* note 2,, s. 52(1) (requires certification by the directors that a prospectus contains "full true and plain disclosure"); *YSA*, *supra* note 2, s. 22 (requires only the signing of the prospectus by the directors with no specific certification); see also *QSA*, *supra* note 20, s. 33.1 [*QSA*]; *SSA*, *supra* note 2, s. 66; *NBSA*, *supra* note 2, s.74(3); *NSSA*, *supra* note 2, s. 63; *PEISA*, *supra* note 2, s. 8.5; *NLSA*, *supra* note 2 s. 59; but see also *NWTSA*, *supra* note 2, which does not mention certification by directors.

on the misrepresentation for liability to attach.[52] The onus shifts to the defendant to show that any depreciation in the value of the securities was not the result of the misrepresentation.[53] The plaintiff has no claim if he/she knew of the representation.[54] Directors, along with the issuer, underwriter, an expert who has filed consent, and anyone else who has signed the prospectus, are jointly and severally liable. These liabilities also attach in each case, except PEI, to misrepresentations in a take-over circular.

Liability for a prospectus misrepresentation is generally only alleviated if the prospectus was filed without the director's consent, the director withdrew consent within a reasonable period of time upon discovery of a misrepresentation, or the director exercised due diligence but failed to ascertain the existence of the misrepresentation (other defences are not relevant to the gatekeeping function).[55] Most recently, in *Kerr v. Danier Leather Inc.*,[56] the first class action to be litigated to the final stages by shareholders for a prospectus misrepresentation under section 130 of the *Ontario Securities Act* [OSA], the Court of Appeal for Ontario used the business judgment rule to protect directors from personal liability. The trial judge found that the unreasonableness of the belief rendered false the implied representation that the prospectus forecast was objectively reasonable and held the CEO and CFO personally liable for the company's prospectus misrepresentation. The Court of Appeal rejected this analysis, finding that the trial judge had given "very short shrift" to management's years of knowledge, expertise and experience gained in running a successful company, and had ignored key expert testimony validating management's approach. The decision suggests that the business judgment rule will serve as an important shield for directors in future litigation using the statutory liability provisions for misrepresentation found in the provincial securities acts, including the new secondary market civil liability regime in Ontario discussed below.

As demonstrated in *ScotiaMcLeod Inc. v. Peoples Jewellers Ltd.,*[57] the courts have also been unwilling to extend statutory liability for prospectus misrepresentations to create liability for negligent

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[52] *OSA, ibid.*, s. 130(1); *BCSA, ibid.*, s. 131(1)(a); *ASA, ibid.*, s. 203(1); *SSA*, *ibid.*, s. 137(1); *NBSA*, *ibid.* s. 149(1); *NSSA*, *ibid*,. s. 137(1); *PEISA*, *ibid.*, s. 16(1); *NLSA*, *ibid.*, s. 130(1); but see *QSA, ibid.*, ss. 217-219 (where there is no specific reference to deemed reliance, although non-reliance is not a listed defence under s. 217 or s. 220); *MSA*, *ibid.* (This act makes no specific reference to deemed reliance, although non-reliance is not a listed defence under s. 65. The right to rescission under s. 65 applies only to the issuer). See also *NWTSA and YSA, ibid.* (Under these acts, like the *MSA*, the right to rescission applies only against the issuer and there is no specific mention of deemed reliance).
[53] *ASA, ibid.*, s. 203(9); *BCSA, ibid.*, s. 131(10); *OSA, ibid.*, s. 130(7); *SSA, ibid.*, s. 137(8); *NBSA*, *ibid.*, s. 149(8); *NSSA, supra* note 2, s. 137(7); *PEISA, ibid.*, s. 16(7); *NLSA, ibid.*, s. 130(7).
[54] *ASA, ibid.*, s. 203(4); *BCSA, ibid.*, s. 131(4); *OSA, ibid.*, s. 130(2); *SSA, ibid.*, s. 137(3); *NBSA, ibid.*, s. 149(3); *NSSA, ibid.*, s. 137(2); *PEISA, ibid.*, s. 16(2); *NLSA, ibid.*, s. 130(2).
[55] *Ibid;* see also *MSA supra* note 2, s. 97.
[56] [2005] O.J. No. 5388 (C.A.) (QL) [*Kerr*].
[57] [1995] O.J. No. 3556 (C.A.) (QL) [*ScotiaMcLeod*].

misrepresentation outside of the intended scope of legislation. In *ScotiaMcLeod*, the court refused to extend liability for the misrepresentation in a prospectus, which was used to market debentures in a subsequent distribution for which the prospectus was not originally created.

The liability for initial disclosure documents in general does not appear to be consistent across Canada. In Ontario, offering memorandums provided in the context of private placement exemptions only create liability for the issuer and selling security holder under s. 130.1 of the OSA.[58] By contrast s. 132.1 of the British Columbia *Securities Act* creates liability for the issuer, directors and anyone who has signed a prescribed disclosure document.[59] The Alberta, Saskatchewan, Quebec, New Brunswick (for all sales literature), Nova Scotia and Prince Edward Island, securities acts also provide the right to damages against directors in an offering memorandum.[60] In Newfoundland, an offering memorandum must include a contractual right of action against the issuer, but the statute is silent on a requirement for director liability within the contractual right.[61] In these provinces, the defences available under the prospectus section are also applicable.

The scope of damages for a misrepresentation in the primary markets is limited to the price at which the securities were offered to the public,[62] with the exception of Quebec, where there does not appear to be a specific clause to limit damages.

Securities Statutes: Secondary Market Liability

Pearson v. Boliden Ltd.[63] confirms that to take advantage of the above statutory provisions creating civil liability for primary market misrepresentations, the purchaser must have purchased the securities directly from the issuer rather than in the secondary market. However, in Ontario, the recent proclamation of the "Keeping the Promise for a Strong Economy Act (Budget Measures), 2002", which came into effect on December 31, 2005, has introduced a statutory regime of civil liability for secondary market disclosures through the introduction of part XXIII.1 to the OSA. The amendments extend the civil liability regime

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[58] *Supra* note 2, s. 130.1.
[59] *Supra* note 2, s. 132.1.
[60] *ASA, supra* note 2, s. 204; *SSA, supra* note 2, s. 138; *QSA, supra* note 20,,s. 221; *NBSA, supra* note 2, s. 151; *NSSA, supra* note 2, s. 138; *PEISA, supra* note 2, s. 16.1.1.
[61] *NLSA supra* note 2, s. 2, s. 54 and s. 73.
[62] *OSA, supra* note 2, *s.* 130(9); *BCSA, supra* note 2, s. 131(13); *ASA, supra* note 2, s. 203(13); *SSA, supra* note 2, s. 138(11); *NBSA, supra* note 2, s. 149(11); *NSSA, supra* note 2, s. 137(9); *PEISA, supra* note 2, s. 16(9); *NFSA, supra* note 2, s. 130(9) . NWT, Yukon and Manitoba appear to only provide a right of rescission, which would preclude a need to limit damages to the price at offering.
[63] 2002 BCCA 624, 7 B.C.L.R. (4th) 245 (C.A.).

beyond primary market disclosures. The amendments apply to all Ontario reporting issuers and to any company with publicly traded securities that has a real and substantial connection to Ontario. The amendments open the door for class action lawsuits that allege misrepresentations, by creating a statutory right of action without regard to whether the purchaser or seller of securities relied on the alleged misrepresentation or delay in disclosure. It is important to note that in order to proceed with an action for damages under the new secondary market liability scheme; an investor must obtain leave of the court. Each defendant must receive notice of the motion for leave to proceed. The court will grant leave only if it is satisfied that the investor is bringing the action in good faith, and there is a reasonable possibility that the action will be resolved at trial in favour of the investor.[64]

In Ontario, directors may now be liable to purchasers in secondary markets for improper continuous disclosure in both documents and in oral statements.[65] The plaintiff has a higher burden to meet if the misrepresentation was not in a "core document".[66]

Improper continuous disclosure can include a misrepresentation in a document or other communication, which would reasonably be expected to affect the share price, or a failure to make timely disclosure of material changes.[67] The plaintiff must have bought the securities while the misrepresentation was uncorrected and without knowledge of the misrepresentation, but need not show reliance on the misrepresentation.

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[64] *OSA, supra* note 2, s. 138.8(1).
[65] *Ibid.* at s. 138.3(1) and (2).
[66] *Ibid.* at s. 138.1 When used in relation to directors who are not officers of the issuer, core documents are: a prospectus, a take-over bid circular, an issuer bid circular, a directors' circular, a rights offering circular, management's discussion and analysis, an annual information form, an information circular, and annual financial statements of the responsible issuer. When used in relation to directors who are also officers of the issuer, core documents are: a prospectus, a take-over bid circular, an issuer bid circular, a directors' circular, a rights offering circular, management's discussion and analysis, an annual information form, an information circular, annual financial statements, interim financial statements, and a report required by subsection 75 (2), of the responsible issuer.
For non-core documents there is a reduced standard of care. A person (other than an expert) is not liable for a misrepresentation unless the plaintiff proves that the person either: (1) had knowledge that the document or statement contained a misrepresentation at the time the document was released or the statement was made; (2) deliberately avoided acquiring such knowledge (at or before the time the document was released or the statement was made); or (3) was guilty of gross misconduct in connection with the release of the document or the making of the statement (through action or failure to act).
[67] *Ibid.* at s. 138.3; The distinction between "material fact" and "material change", also found in s. 130 of the *OSA* (and defined in s. 1 of the *OSA*), was critical to the appeal ruling in *Kerr,, supra* note 55**,** where the court confirmed that "material fact" is intended to be defined more broadly than "material change" in the Act. The Court of Appeal agreed with the trial court that the impact of unseasonably warm weather did not constitute a "material change" in Danier's business or operations.

Generally, the court will determine each defendant's responsibility for the plaintiff's losses, and each defendant will be liable for his, her or its proportionate share of the damages.[68] However, defendants who act knowingly in a violation may be fully liable, jointly and severally, for all damages.[69] A director's total liability to all plaintiffs for the same violation is capped at the greater of $25,000 or 50 percent of his/her compensation from the issuer.[70]

Several defences are available, including:

- the change in the value of the securities is not related to the misrepresentation (onus on defendant to show);[71]
- the defendant relied on an expert report;[72]
- the defendant relied on another publicly filed report;[73]
- the defendant conducted a reasonable investigation, or for a failure to make timely disclosure, if the defendant can prove that he or she or it did not know of the change;[74] and
- an exemption on misrepresentation of "forward-looking" information, provided that the document or public oral statement contains cautionary language relating to the forward-looking information, identifies material factors that could cause actual results to differ materially, and states the material factors or assumptions that were applied in making a forecast or projection in the forward-looking information.[75]

There is also a whistle-blowing defence available if the following criteria are satisfied: the contravention was made without that defendant's knowledge or consent; upon becoming aware of the misrepresentation the defendant promptly notified the board of directors of the issuer of the matter; and if no correction or subsequent disclosure was made, the defendant promptly provided the Ontario Securities Commission [OSC] with written notification of the misrepresentation.[76]

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[68] *OSA, supra* note 2, s. 138.6(1).
[69] *Ibid.*, s. 138.6(2).
[70] *Ibid.*, s. 138.1.
[71] *Ibid.*, s. 138.5(3).
[72] *Ibid.*, s. 138.4(11).
[73] *Ibid.*, s. 138.4(14).
[74] *Ibid.*, s. 138.4(6).
[75] *Ibid.*, s. 138.4(9).
[76] *Ibid.*, s. 138.4(15).

British Columbia has proposed legislation (Bill 38) implementing a similar regime,[77] but the implementation of this legislation has been put on hold.[78] No other province currently has such legislation.[79] However, given that there is a commitment on the part of most provinces and territories, including British Columbia, to harmonize and streamline securities laws across Canada, it is likely that the other provinces and territories will adopt a secondary market civil liability regime.[80]

ii. Other Regulatory Regimes - Provincial Securities Commissions

Provincial securities commissions also have broad powers to enforce securities laws through the imposition of administrative orders in the public interest. Included among the long list of possible administrative sanctions is the ability of commissions to impose a penalty, if at the hearing it is determined that a person or company has contravened or failed to comply with any provision of the securities legislation.[81]

In addition, the securities commissions can apply to the court for a declaration that a person or company has not complied with a provision of the securities act. On application by a commission, the court may make any order, including:

1. the imposition of a penalty or an order to require current directors or officers to be removed and replaced;
2. requiring a person or company to compensate or make restitution to an aggrieved person or company;
3. requiring a person or company to pay general or punitive damages; and

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[77] See B.C. Securities Commission, online: <http://www.bcsc.bc.ca/instruments.asp?id=1894#moving> for details.
[78] B.C. Securities Commission, online: <http://www.bcsc.bc.ca/release.asp?id=2944>.
[79] Miller Thompson, "Update: Ontario and British Columbia Implementing Civil Liability for Secondary Market Disclosure" e-Securities Notes (5 August 2005), online: < http://www.millerthomson.com/mtweb.nsf/ web_files/dlii6f4nzx/ $File/eSecurities%20Notes%20%20August%202005.pdf?openelement> at 1.
[80] *Supra* note 77.
[81] *OSA, supra* note 2, s. 127(1)10 (up to $1 million); *BCSA, supra* note 2, s. 162 (up to $250,000 for individuals and $500,000 for persons who are not individuals); *ASA, supra* note 2, s. 199 (up to $1 million); *MSA, supra* note 2, s. 148 (up to $100,000 for an individual and $500,000 for persons who are not individuals); *SSA, supra* note 2, s. 135 (up to $100,000); *QSA, supra* note 20, s.273 (up to $1 million); *NBSA, supra* note 2, s. 186 (up to $750,000); *NSSA, supra* note 2, s. 135 (up to $100,000).

4. requiring a person or company to pay the Provincial Treasurer any amounts obtained as a result of non-compliance with any provision of the securities act.[82]

Standard Trustco Ltd. et al.[83] is an example where the OSC staff sought administrative sanctions against the reporting issuer and the directors. The OSC found that the financial information contained in the company's press release was materially misleading and that the directors therefore acted contrary to the public interest by not making sufficient inquiries before releasing the interim financial results. Criticizing the directors for inappropriately approving financial statements and disseminating the information publicly, the OSC also noted that directors who are members of the audit committee should bear more responsibility than other directors for a compliance deficiency in the corporation's financial statements.

iii. Other Regulatory Regimes - RS

Market Regulation Services Inc. (RS) is an SRO recognized by the securities commissions in Alberta, British Columbia, Manitoba, Ontario and Quebec as a market regulation provider for the trade exchanges and trading systems in Canada. RS administers the Universal Market Integrity Rules [UMIR].[84] Section 10.16 of UMIR provides a set of reporting obligations for directors as gatekeepers of market participants. Directors of market participants are obligated to report trading violations to the compliance department of the participant.

Section 10.3 of UMIR allows for a finding of liability for a market participant through the actions of their directors, officers, partners or employees. Similarly, a director or partner may be found liable for the actions of the firm and face personal sanctions.

Section 10.5 of UMIR provides a broad power to the market regulator to impose sanctions for violations of UMIR. These include:

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[82] *OSA, ibid.*, s. 128; *BCSA, ibid.*, s. 157; *ASA, ibid.*, s. 197; *MSA, ibid.*, s. 152; *SSA, ibid.*, s. 133; *NBSA, ibid.*, s. 187; *NSSA, ibid.*, s. 133; *NFSA, ibid.*, s. 128.1; see also *QSA, ibid.*, s. 269.2 (the QSA specifies only damages as possible remedies); *PEISA, supra* note 2, s. 19; *YSA, supra* note 2, s. 19; *NWTSA, supra* note 2, s. 22.
[83] (1992), 15 OSCB 4322 #38/92.
[84] See Regulation Services, "Universal Market Integrity Rules", online: <http://www.rs.ca/en/pdf/UMIR.pdf> [UMIR].

(a) a reprimand;
(b) a fine not to exceed the greater of:
  (i) $1,000,000, and
  (ii) an amount equal to triple the financial benefit which accrued to the person as a result of committing the contravention;
(c) the restriction of access to the marketplace for such period and upon such terms and conditions, if any, considered appropriate;
(d) the suspension of access to the marketplace for such period and upon such terms and conditions, if any, considered appropriate;
(e) the revocation of access to the marketplace; and
(f) any other remedy determined to be appropriate under the circumstances.[85]

iv. Criminal and Quasi-Criminal Liability

Quasi-Criminal Liability

Anyone who authorizes permits or acquiesces in a contravention of the provincial securities acts may be liable for a fine of not more than $5 million and/or imprisonment for a period of up to five years less one day in Ontario, British Columbia and Alberta.[86] In Saskatchewan, Manitoba, Prince Edward Island, Newfoundland and Nova Scotia the maximum penalty is two years or $1 million.[87] In New Brunswick the maximum penalty is five years or $1 million.[88] Quebec has maximum penalties of fines of $10,000 and imprisonment for six months (for first offences), of fines of $20,000 and imprisonment for two years (for subsequent offences).[89] Given the provincial nature of securities law, the default mens rea requirement is one of strict liability.[90] Only a due diligence defence will be afforded a director who has authorized, permitted or acquiesced to the company's violation of securities law.

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[85] *Ibid.*
[86] *OSA, supra* note 2, s. 122(3), *ASA, supra* note 2, s. 194(3), *BCSC, supra* note 2, s. 155(3). In Ontario, for example, s. 122 of the *OSA* makes it an offence to make a materially misleading or untrue statement or material omission in any document required to be filed or furnished under Ontario securities legislation.
[87] *SSA, supra* note 2, s. 131(3.1)(5); *MSA, supra* note 2, s. 136(3); *PEISA, supra* note 2, s. 28(2); *NLSA, supra* note 2, s. 122(4).
[88] *NBSA, supra* note 2, s. 179(2).
[89] *QSA, supra* note 20, s. 102.
[90] *R. v. City of Sault Ste. Marie*, [1978] 2 S.C.R. 1299.

Under the CBCA and parallel provincial corporate law statutes, a person who makes or assists in making a report, return, notice or other document required by this Act or the regulations to be sent to any person that:

(a) contains an untrue statement of a material fact, or
(b) omits to state a material fact required therein or necessary to make a statement contained therein not misleading in the light of the circumstances in which it was made, is guilty of an offence and liable on summary conviction to a fine not exceeding $5,000 or to imprisonment for a term not exceeding six months, or both. In addition, if the corporation itself does any of the above, any director or officer of the corporation who knowingly authorized, permitted or acquiesced in the commission of the offence is a party to and guilty of the offence, and is liable on summary conviction to a fine not exceeding five thousand dollars or to imprisonment for a term not exceeding six months or to both, whether or not the body corporate has been prosecuted or convicted.[91]

A due diligence defence is provided under the corporate statutes such that no person is guilty of a quasi-criminal offence if the person did not know, and in the exercise of reasonable diligence could not have known, of the untrue statement or omission.[92]

Criminal Liability

Under s. 400 of the Criminal Code of Canada (CC), it is an offence to make, circulate or publish a prospectus that is known to be false in a material particular with intent to induce persons to become shareholders or partners in a company; to deceive or defraud the members, shareholders or creditors of a company; or to induce any person to entrust or advance anything to a company, or enter into any security for the benefit of a company.[93] The offence under s. 400 of the CC is an indictable offence liable for imprisonment for a term not exceeding 10 years.

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[91] *CBCA, supra* note 12, s. 250; *ABCA, supra* note 12,s. 251; *SBCA, supra* note 12, s. 300; *NBBCA, supra* note 12, s. 175; *NFCA, supra* note 12, s. 504; *YBCA, supra* note, at s. 251; *NWTBCA, supra* note 12, s. 252; see also *OBCA supra* note 12, s. 256 (liability in Ontario is $2,000 or imprisonment for 1 year, or $25,000 for a corporate body); *BCBCA, supra* note 12, s. 427 and 428 (liability in B.C. is $10,000 for an individual, or $25,000 if not an individual). Note that *QCA*, *supra* note 20, ss. 108 and 201, creates liability for untrue entries in the corporate books $100 per entry and liability for damages and *PEICA*, *supra* note 19, s. 54 creates liability for damages stemming from misrepresentations in the corporate books. There does not appear to be quasi-criminal liability under the *NSCA*.
[92] *Ibid.*
[93] *Criminal Code*, R.S.C. 1985, c. C-46, s. 400 [CC].

Under s. 382, the CC creates an indictable offence liable to imprisonment for a term not exceeding 10 years for entering transactions that create false or misleading appearances of market activity or a misleading appearance as to the market price of a security.[94]

Section 380(2) of the CC extends the prohibition against fraud to any deceit, falsehood or fraudulent practice that affects the public market price of stocks or shares and creates an indictable offence liable to imprisonment for a term not exceeding 14 years.[95] It is also an offence to make false documents with the intention of affecting a stock's price (s. 383).[96] When they are not the party who actually commits the offence, directors may also be held liable for aiding and abetting.[97]

For example, in *R. v. Fell* the sole director and directing mind[98] of the corporation was aware of and participated in the creation and distribution of marketing materials, which contained misrepresentations.[99] The Court of Appeal for Ontario expressed that "the fact that the acts of the respondent were, at law, those of the corporation for the purpose of imposing liability on it did not prevent the conviction of the respondent as a principal or as an aider and abettor as the facts might warrant".[100] Martin J.A. also cited the following passage from Professor Gillies' *The Law of Criminal Complicity* (1980):

> … where the criminal act is committed by a senior officer who is capable of so representing the company as to make his act its own, and the offence is such that either the company or the officer is capable of committing it as a principal offender, the classification of each party may be arbitrary. They may be viewed as being principal and accessory (so that the officer aids or counsels the company or vice-versa), or alternatively, as being joint principals.[101]

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94 *Ibid.*, s. 382
95 *Ibid.*, s. 380(2).
96 *Ibid.*, s. 383.
97 *Ibid.*, s. 21(1).
98 The term "directing mind" has now been replaced in the CC. The primary purpose of the term was to attribute liability to the corporation for actions of its representatives. Now, all that is necessary is that a "senior officer" was implicated in the criminal activity. For a complete discussion see: Darcy L. MacPherson, "Extending Corporate Criminal Liability?: Some Thoughts on Bill C-45" (2004) 30 Man. L.J. 253.
99 (1981) 34 O.R. (2d) 665 (C.A.).
100 *Ibid.*
101 *Ibid.*

A new section 380.1, enacted in March 2004, establishes four aggravating circumstances that a court can consider when imposing a sentence for market fraud offences:[102]

- the amount involved in the fraud exceeded $1 million;
- the offence adversely affected (or had the potential to adversely affect) the stability of the Canadian economy or financial system or any financial market in Canada or investor confidence in such a market;
- large numbers of victims were involved; and
- the perpetrator took advantage of his or her elevated status or reputation in the community in committing the offence.

The presence of these factors will enable a court to impose tougher penalties. A new section 425.1, also enacted in March 2004, creates a general criminal offence in relation to employer reprisals against employees who provide information with respect to the violation of any federal or provincial law.[103]

[102] CC*, supra* note 92, s. 380.1.
[103] *Ibid*, s. 425.1.

3. Lawyers

Lawyers can act as gatekeepers to capital markets in several ways. With the increasing complexity of financial regulation, lawyers serve as “critical facilitators” for their clients. Due to this relationship, the lawyer can detect and potentially disrupt wrongful conduct. The ongoing nature of the relationship, and the high cost to both parties of ending it, has to potential to constitute lawyers as particularly effective gatekeepers. Lawyers can and do collect information from their clients that would be difficult or impossible for regulators to collect on their own. Lawyers are also in a position to advise clients about both the letter and the spirit of the law.

i. Civil Liability

a) Common Law

The Ontario courts have ruled that a lawyer may owe a duty of care to an investor in the corporation with which the lawyer has been retained. In *Filipovic v. Upshall*,[104] it was held that investors could proceed with a claim against such a lawyer, based on the finding that “the [lawyers] stood in a sufficient relationship of proximity with the plaintiffs to engender a duty of care on their part. That duty or obligation flowed through the company to the shareholders, but did not arise independent of the company itself. It required the defendants to carry out their duties as corporate lawyers in a reasonably professional and competent manner and with the utmost good faith”.[105]

However, the relationship necessary to create liability in tort for negligent or fraudulent misrepresentation or for breach of the fiduciary duty of care is difficult for investors to establish. Furthermore, once established, the courts are relatively unlikely to find negligence or breach of duty of care giving rise to damages. For example, in the case of *Dupuis v. Pan American Mines*[106] the corporation’s lawyer had prepared a prospectus containing a false statement that the defendant owned certain mining properties. The lawyer had relied on false certifications made by another lawyer (based in Arizona where the mines were located), hired by the corporation. It was held that there “was some negligence and naiveté on the part of [the corporation’s Quebec solicitor], but none such as to engage his liability towards this or any

[104] [1998] O.J. No. 2256 (Gen. Div.) (QL) [*Filipovic*].
[105] *Ibid.*
[106] (1979), 7 B.L.R. 288 (Qué. S.C.) [*Dupuis*].

other plaintiff".[107] Using a similar form of analysis to *Dupuis*, in *Filipovic*, the lawyer was also not found liable.

In *CC&L Dedicated Enterprise Fund v. Fisherman* (*CCL*), a motion in the Ontario Superior Court of Justice to amend a statement of claim to include lawyers of the defendant corporation as new defendants,[108] Justice Cumming provided an analysis of the current state of the common law liability of lawyers as gatekeepers to capital markets that is worth examining in some detail. In this case, the lawyers (Cassels) provided expert advice in a prospectus for YBM Magnex International Inc. (YBM). They also provided consent to the securities regulatory authorities, stating that they believed there were no misrepresentations in information derived from their opinions. It was not asserted that the opinions were misrepresentations, but rather that the lawyers breached a common duty of care to the investors by failing to prevent the corporation from filing a prospectus when they were aware of criminal investigations that were not disclosed in the prospectus.[109] Justice Cummings was unwilling to dismiss this cause of action as untenable, despite a disclaimer restricting appropriate usage of the consent to securities regulators, because it "[was] arguable that by Cassels permitting the name of the law firm to be referred to in the 1997 Prospectus that potential investors would believe that Cassels was implicitly representing, at the least, that the firm had no reasonable grounds to believe that the Prospectus contained any material misrepresentation".[110] Justice Cummings went on to hold that it was reasonable for the plaintiff investors to rely on this misrepresentation. He cited *Kerr v. Danier Leather Inc*.[111] as evidence that "silence can constitute a misrepresentation when the silent party knows or should reasonably know that someone else is relying upon that silence to constitute a representation that 'full, true and plain' disclosure of all material facts has been made".[112] As discussed above, while the Court of Appeal for Ontario eventually held that there was no breach of duty by Danier, this was based on a ruling that the OSA did not impose a duty to disclose a material fact and the financial projections were not unreasonable at the time of their disclosure based on the business judgment rule.[113]

In *CCL*, Justice Cumming also addressed the concern of indeterminate and unlimited liability for lawyers if a duty of care to investors is found. Noting that "the specific purpose of the legal services provided by Cassels and Wilder to YBM as known to them, was to enable YBM to raise more than $100 million from

[107] *Ibid.* at para. 115.
[108] (2001) 18 B.L.R. (3d) 240 (Ont. Sup. Ct. J.) [*CCL*].
[109] *Ibid.* at para. 61.
[110] *Ibid.* at para. 58.
[111] [2001] O.J. No. 4000 (Ont. Sup. Ct. J.) (QL)..
[112] *Ibid.*
[113] *Kerr., supra* note 55.

the investing public through the 1997 Prospectus",[114] Justice Cummings concluded that it was within the lawyer's contemplation that his representations would allow the prospectus to be receipted and thus allow the misrepresentations to be made to the investing public.

Justice Cumming also touched upon the issue of conflicts of interest as a policy concern, noting that "where a lawyer acts for a party in an arms-length transaction his/her normative duty is to his/her client and not to any party who has an interest adverse to that of the client… something more must be established before a duty is imposed on one party to care for the purely economic interests of another".[115] He cited two British Columbia decisions, *Elms v. Laurentian Bank of Canada* (*Elms*) and *Midland Mortgage Corp. v. Jawl & Bundon* (*Bundon*), as two contrasting examples of how this tension has been addressed by the courts.[116] In *Elms*, the court was unwilling to dismiss a claim that the lawyer had a duty to investors to alert them of insufficient security from the lender because he had performed work normally done by an investor's lawyer.[117] It appears the Court was willing to accept that a lawyer may withdraw services (note the rules of professional conduct discussed below) or take action to correct the conduct of their client, without biasing the interests of the client.[118] In *Bundon*, the Court held that no duty of care could exist if the application of that duty would create a breach of an antecedent duty to the client.[119] The Court also noted that there can be a duty to a beneficiary of a client, but only through a breach of duty to the client itself.[120]

The *CCL* motion thus stands for the proposition that a prima facie duty of care exists when a lawyer makes representations to the investing public for the purpose of furthering the investments in their client. This duty will only be negated through policy considerations if the factual situation shows no reasonable alternative action by the lawyer that would not bias the client. The motion also holds that this duty may be breached through a failure to prevent misrepresentations by the client or failure to withdraw services in the face of fraudulent activities.

The above analysis thus leads to the conclusion that lawyers can be held accountable in common law for failure to perform their gatekeeper function in preventing misconduct of their client corporation. If

[114] *CCL, supra* note 107 at para. 70.
[115] *Ibid.* at para. 71.
[116] [2001] B.C.J. No. 1284 (C.A.) (QL) [*Elms*]; (1999) BCCA 464 [*Bundon*].
[117] *Elms, ibid.* at para. 26.
[118] *Ibid.* at para. 24.
[119] *Bundon, supra* note 115 at para. 20.
[120] *Ibid.* at para. 10.

lawyers' actions place them in a relationship of proximity to the third party stakeholders, such that there is reasonable reliance by the stakeholders on the representations of the lawyer, a prima facie duty of care is established. This prima facie duty of care may be negated through the existence of policy considerations in the specific case, such as the existence of a conflict of interest between the duty to the third party and the duty to the client, or unlimited liability. As evidenced by *Elms*, it is important to note that the British Columbia courts have shown an increasing willingness to find a duty of care to third parties by failing to find a conflict of interest, despite the obvious implication that a withdrawal or correction would jeopardize the investment of lawyers in their clients.

b) Statutory Liability

Securities Statutes

The Court of Appeal for Ontario has ruled that the OSC can exercise jurisdiction over lawyers practicing within the OSC's area of jurisdiction. The OSC's role is to protect investors and the proper functioning of the capital markets; in doing so, it can regulate lawyer's practices as well. However, the Court of Appeal added the caveat that solicitor-client privilege must be maintained.[121] It appears that this jurisdiction is not disputed in other provinces.[122] It must be noted that the power of the securities commissions to sanction and reprimand lawyers does not necessarily extend to the ability to place remedial sanctions limiting lawyers' ability to practice in the securities area in the future. This would bring the commission into the role of regulating the practice of law, an area reserved for the law societies.[123] The British Columbia Securities Commission has proposed a regime allowing the Commission to prohibit professionals (including lawyers) from practicing in the securities area, but this suggestion is being vigorously opposed by the Law Society of British Columbia.[124]

[121] *Wilder v. Ontario Securities Commission* (2001), 53 O.R. (3d) 519 (C.A.).
[122] See *e.g.* Law Society of British Columbia, *Submissions to the Securities Commission* (April 2002), online: <http://www.bcsc.bc.ca/uploadedFiles/BCN2002-12_Law_Society_BC.pdf> at 5 ("Law Society Submissions"). See also, *In the matter of Colin Henderson*, (2000) 9 ASCS 3570, #9/37 (Alberta Securities Commission) for an example of a securities commission disciplining a lawyer for violations of the *Securities Act*. I found no case law suggesting that the authority of securities commissions over lawyers had been challenged outside of Ontario in *Wilder*.
[123] See *Henderson v. Alberta Securities Commission*, 2002 ABCA 264 and *Ainsley Financial Corp. v. Ontario Securities Commission* (1994), 121 D.L.R. (4th) 79 (Ont. C.A.).
[124] See Law Society Submissions, *supra* note 121.

Primary Market Liability

Like directors, lawyers may be liable for violations of securities acts for their actions in the primary market. Section 130(1) in Ontario and the parallel sections in other jurisdictions, detailed above, include "expert" opinions from individuals such as lawyers, and attribute liability for misrepresentations in their statements. As discussed above regarding directors, a misrepresentation that triggers this section will create joint and several liability with any other party listed in s. 130(1). The defences for experts include filing of the prospectus without consent, withdrawal of consent upon discovery of a misrepresentation, notification of the securities commission and the public of the misrepresentation, or due diligence.[125]

Secondary Market Liability

Under s. 138.1 of the OSA, detailed above, lawyers may be liable to purchasers of securities in the secondary market, as experts, if their report containing a misrepresentation is used in a public statement (written or oral).[126] An investor can sue an "expert" in connection with any written or oral misrepresentation, however made, provided the following three conditions are met:

- the misrepresentation is also contained in a report, statement or opinion made by the expert (Expert Report);
- the document or statement includes, summarizes or quotes from the Expert Report; and
- the expert consented, in writing, to the use of the Expert Report in a document released or statement made by someone other than the expert.

Experts have no statutory liability for failure to make timely disclosure. The defences available to experts, as detailed in the above section on directors, include: a due diligence defence; no expectation of disclosure; reliance on another publicly available document; forward-looking statements; and the whistle-blowing defence. Experts' liability is limited to the greater of $1 million or the amount of revenue raised from the responsible issuer within the last 12 months.[127]

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[125] *Supra* notes 70-74.
[126] *OSA, supra* note 2, s. 138.3.
[127] *Ibid.*, s. 138.1.

ii. Other Regulatory Regimes - Provincial Securities Commissions

The provincial securities commissions' ability to impose administrative sanctions and seek remedial powers of the court as discussed above are applicable.

The securities commissions do not appear to have successfully extended liability to lawyers acting merely in their role as gatekeeper: something more is required. For example, in *Re Orsini*,[128] a lawyer prepared a financing scheme breaching various provisions of the OSA. It was held that the lawyer's role was more than mere lawyering and that he was responsible, along with the client, for the breaches of the Act. It should be noted, however, that in this situation, the lawyer was closely involved in developing the scheme, and benefited materially from the sale of shares. The lawyer in *Re Orsini* also received a six-month suspension from the Law Society of Upper Canada.[129]

In contrast, *Henderson v. Alberta (Securities Commission)* involved a situation where a lawyer had met with potential investors and did not deliver them the required documentation.[130] There were other significant deficiencies in the offering documentation, and the company did not meet the requirements for the prospectus exemption the investors had relied upon. The obligation to rectify these breaches of securities law lay with the company itself, but the Alberta Securities Commission found the lawyer had a positive obligation to take steps to ensure statutory compliance. To the extent that he failed to do so, the commission deemed his actions to be an "omission" in furtherance of trading, and thus subject to sanction as an illegal trade. The Alberta Court of Appeal reversed this decision with a short comment:

> Apart from the allegations of unauthorized representations which are not under appeal, we are not satisfied that Mr. Henderson's proven activities were proscribed by the Securities Act. In this we note that there are inconsistent findings of Henderson's actual "trading". At worst, Henderson was a dupe of Cholach and those who were in step with him. Mr. Henderson's dealings with the stock were carried on in good faith.[131]

These two cases suggest that innocent - though negligent - failure to prevent a client from committing a violation of securities law does not create a violation giving rise to administrative sanctions against

[128] 2 B.L.R. (2d) 271, 14 O.S.C.B. 4820.
[129] *In the matter of the Law Society Act, and in the matter of Andrew Bishop Tulk*, LSUC Disciplinary Decision of Convocation, February 25, 1993.
[130] [2002] A.J. No. 1360 (C.A.) (QL).
[131] *Ibid.* at para. 1.

lawyers. Sanctions will not be imposed unless the lawyer personally performed an action, which triggers an offence.

iii. Other Regulatory Regimes - Law Societies

The provincial law societies govern the conduct of lawyers through the use of their respective rules of professional conduct.

a) Dishonest Conduct

In Ontario, Rule 2.02[132] of the *Rules of Professional Conduct* governs a lawyer's responsibilities when he or she confronts a client that intends to act dishonestly, fraudulently, criminally or illegally. In March 2004, Rule 2.02(5) was amended to state:

> (5) When advising a client, a lawyer shall not knowingly assist in or encourage any dishonesty, fraud, crime, or illegal conduct, or instruct the client on how to violate the law and avoid punishment.[133]

The comments to this rule indicate that a lawyer has an obligation to investigate any suspicions both prior to and during a retainer. *Law Society of Upper Canada v. Di Francesco* holds that an objective test using a "reasonably wary lawyer … in the circumstances" is to be used to evaluate a lawyer's compliance with this rule.[134] In March of 2004, Rules 5.1 and 5.2 were added to give additional guidance for lawyers of organizations where it is known that the client is currently, had previously, or will engage in dishonest, fraudulent, or illegal conduct with respect to the retainer. In such situations, the rules compel a lawyer to inform representatives of the organization "up the ladder" to the board of directors, and withdraw from acting in the matter should corrective action not be taken.[135] The commentary to this rule makes it clear that the described acts include both acts of commission and acts of omission. The commentary explicitly recognizes the gate-keeping role played by the lawyer. Ontario is the only jurisdiction with such explicit upward reporting requirements.

In British Columbia, Chapter 4, Rule 6 of the *Professional Conduct Handbook* states that a lawyer must

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[132] Law Society of Upper Canada, *Rules of Professional Conduct*, Rule 2.02 and Commentary [LSUC].
[133] *Ibid.*
[134] [2003] L.S.D.D. No. 44 at para. 7.
[135] LSUC, *supra* note 131, Rules 5.1 and 5.2 and commentary.

not engage in any activity that the lawyer knows or ought to know assists in or encourages any dishonesty, crime or fraud, including a fraudulent conveyance, preference or settlement.[136] However, there is no requirement to bring forward in the chain of command knowledge of an intention to act dishonestly as there is in Ontario.

Alberta's rules also contain specific instruction to corporate counsel that they must not implement instructions of a corporation that would involve a breach of professional ethics or the commission of a crime or fraud.[137]

In Saskatchewan, Chapter 2 Rule 7 of the Code of Professional Conduct states that when advising his or her client, a lawyer must never knowingly assist in or encourage any dishonesty, fraud, crime or illegal conduct, or instruct the client on how to violate the law and avoid punishment. The lawyer should be on guard against becoming the tool or dupe of an unscrupulous client or of persons associated with such a client.[138] Manitoba's rules include these instructions, but go farther:

> "Before accepting a retainer or during a retainer, if a lawyer has suspicions or doubts about whether he or she might be assisting a client in dishonesty, fraud, crime or illegal conduct, the lawyer should make reasonable inquiries to obtain information about the client and about the subject matter and objectives of the retainer, including verifying who are the legal or beneficial owners of property and business entities, verifying who has the control of business entities, and clarifying the nature and purpose of a complex or unusual transaction where the purpose is not clear. The lawyer should make a record of the results of these inquiries".[139]

Nova Scotia, Prince Edward Island, New Brunswick and Newfoundland only contain general directions about avoiding dishonesty, requiring lawyers to discharge with integrity all of their duties.[140]

The Quebec Code of Ethics of Advocates provides for a modified "up-the-ladder scheme", requiring

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136 Law Society of British Columbia, *Professional Conduct Handbook*, Chapter 4, Rule 6 [LSBC].
137 Law Society of Alberta, *Code of Professional Conduct*, Chapter 14, Rule 2a [LSA].
138 Law Society of Saskatchewan, *Code of Professional Conduct*, Chapter 2, Rule 7 [LSS].
139 Law Society of Manitoba, *Code of Professional Conduct*, Chapter 3, Rule 7 [LSM].
140 Nova Scotia Barristers' Society, *Legal Ethics Handbook*, Chapter 1 [NSBS]; Law Society of Newfoundland, *Code of Professional Conduct*, Chapter 1 [LSNL]; Law Society of New Brunswick, *Code of Professional Conduct*, Chapter 1 [LSNB]; Law Society of Prince Edward Island, *Code of Professional Conduct*, Chapter 1 [LSPEI].

notification up the hierarchy of the organization when an advocate becomes aware that the client has not remedied an unlawful situation involving any breach of law if it is likely to lead to a serious consequence for the client, and in all cases "a material breach of securities law or any law for the protection of security holders or members of a partnership or legal person".[141] The Quebec Code also deems "helping the client to perform an act which he knows to be illegal or fraudulent or providing advice or encouragement inducing the client to perform such an act" to be "derogatory to the dignity of the profession of advocate".[142]

b) Confidentiality

In Ontario, Rule 2.03[143] governs confidentiality between lawyers and clients. Generally, confidentiality is protected across the board, meaning there is little room for whistle-blowing in particular. Rule 2.03(2) and (3) outline the areas of justified disclosure; the commentary confirms that when a lawyer becomes aware that a client that may commit a fraudulent, criminal, dishonest or illegal act, he or she is prevented from passing any confidential information to the correct authorities, though he or she must follow the procedures outlined above in Rule 2.02. The confidential information provisions in all other provinces except Alberta and Saskatchewan also prevent lawyers from whistle-blowing on corporate wrongdoing.[144]

Some provinces allow prospective whistle-blowing by allowing disclosure of information necessary to prevent a crime if the lawyer has reasonable grounds for believing that a crime is likely to be committed,[145] though the lawyer must disclose the minimum information necessary and nothing more. The commentary accompanying the Alberta rules specifically mentions the making of a false statement in a prospectus upon which third parties are continuing to rely. If the prospective crime does not involve death or bodily harm, disclosure is discretionary.[146]

The other provinces' rules provide no such exception, allowing a lawyer to disclose confidential information only when a crime involving violence is likely to be committed.

[141] Code of Ethics of Advocates, Quebec, R.Q. c. B-1, r.1, [CEAQ] s. 3.05.18.
[142] *Ibid.* at, s. 4.02.01(g).
[143] LSUC, *supra* note 131, Rule 2.03.
[144] LSBC, *supra* note 135, Chapter 5.
[145] LSS, *supra* note 137, Chapter IV, Rule 11; LSM, *supra* note 138, Chapter 4, Rule 11; LSA, *supra* note 136, Chapter 7, Rule 8.
[146] LSA, *supra* note 136, Chapter 7, C.8.2.

c) Withdrawal

A British Columbia lawyer is obligated to withdraw as counsel if instructed by the client to do something inconsistent with the lawyer's professional responsibility, including the duty to the court.[147] Alberta's rules provide that withdrawal is mandatory when a client persists in instructions constituting a breach of ethics. For corporate counsel, withdrawal means refusing to implement the client's instructions in that matter, while continuing to advise the corporation or government in other respects or, in certain cases, resignation.[148] Chapter 9 of the rules in Alberta also insist that a lawyer must not implement instructions of a client that are contrary to professional ethics and must withdraw if the client persists in such instructions, and that a lawyer must not advise or assist a client to commit a crime or fraud.[149]

In Saskatchewan, the lawyer is obligated to withdraw if it becomes clear that the lawyer's continued employment will lead to a breach of the rules, such as, for example, a breach of the rules relating to conflict of interest. The lawyer may withdraw where there has been a serious loss of confidence between lawyer and client.[150] Nova Scotia, New Brunswick, Newfoundland and Manitoba's obligations of withdrawal are the same as that of Saskatchewan.[151] In Ontario, in addition to the obligation to withdraw after the upward reporting process, a lawyer is entitled to withdraw for a serious loss of confidence.[152] The Quebec Code allows, but does not require, a lawyer to cease representing a client in the event the client induces the lawyer to "perform illegal, immoral or fraudulent acts".[153]

d) Penalties

All law societies in Canada have the ability to discipline members through disbarment, reprimands, suspensions or conditions on practicing. Some law societies have the ability to make any order they deem appropriate for breaches of the standards of professional conduct, which would open up the possibility for fines and/or payments to third parties.[154] Fines are rarely imposed as penalties,[155] and I have found no

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[147] LSBC, *supra* note 135, Chapter 10, Rule 1.
[148] LSA, *supra* note 136, Chapter 16, Rule #2(a).
[149] *Ibid*.
[150] LSS, *supra* note 137, Chapter XII, Rules 4-5.
[151] NSBS, *supra* note 139, Chapter 11, Rules 11.1-11.3 and Commentary; LSM, *supra* note 138, Chapter 12, Rules 7-8; LSNB, *supra* note 139, Chapter 10, Rules 3-4; LSNL, *supra* note 139, Chapter 10, Rules 3-4.
[152] LSUC, *supra* note 131, Rule 2.09(2).
[153] CEAQ*, supra* note 140, s. 3.03.04(c)
[154] See *e.g. Law Society Act*, R.S.O. 1990, c. L-8, s. 35; *Legal Profession Act*, S.S. 1990-91, c. L-10.1, s. 55(2); *Legal Profession Act*, C.C.S.M. c. L107, s. 72(1); *Legal Profession Act*, S.N.S. 2004, c. 28, s. 45(4); *Law Society Act*, 1999, S.N.L. 1999, c. L-9.1, s. 48(3); and *Law Society Act,* S.N.B. 1995, c. 89, s. 51(1).

evidence of payments to third parties being ordered. Some provinces do not give law societies the ability to impose sanctions beyond disbarment, reprimand, suspensions or conditions.[156]

iv. Other Regulatory Regimes - RS

The liability imposed by aforementioned s. 10.16 of UMIR,[157] is the same for employees of market participants, as it is for directors. Accordingly, lawyers who are employed by market participants may be open to this form of liability, as discussed above.

v. Criminal and Quasi-Criminal Liability

Depending on the level of misconduct, lawyers may be liable under the CC and the quasi-criminal offences under securities and corporate legislation as discussed above. In addition, in Ontario, sections 77 and 78 of the *Provincial Offences Act*[158] would make a lawyer party to an offence under provincial securities or corporate legislation if he or she did or omitted to do anything to aid or abet a client in committing an offence, or if he or she counselled another person to commit an offence. There is similar legislation in British Columbia and New Brunswick.[159]

There are a number of examples where lawyers have become liable for a criminal action under the CC through their actions on behalf of a corporation, which may be characterized as a failure in performing their gatekeeping function. In one example, *R. v. Sahaidak,* a lawyer was held criminally liable for a fraudulent stock scheme, despite being neither the "creator" nor the "driving force" behind the scheme. However, the judge noted that "there are offences … that need lawyers in order to be committed" and found him to have been "an active participant and an important participant".[160]

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[155] Gavin McKenzie, *Lawyers and Ethics: Professional Responsibility and Discipline* (Toronto: Thompson Canada, 1993).
[156] See *e.g. Legal Profession Act*, R.S.A. 2000, c. L-8. s. 72. Some jurisdictions allow fines, but give the society no residual discretion. British Columbia allows fines up to a maximum of $20,000: *Legal Professions Act*, S.B.C. 1990, c. 8, s. 38. Prince Edward Island allows fines up to a maximum of $10,000: *Legal Profession Act*, R.S.P.E.I. 1988, c. L-6.1, s. 38(1). Quebec allows a maximum fine of $6000: *Professional Code*, R.S.Q. c. C-26, s. 156.
[157] UMIR, *supra* note 83.
[158] *Provincial Offences Act,* R.S.O. 1990, c. P. 33.
[159] *Offence Act*, R.S.B.C. 1996, c. 338, s. 85; *Provincial Offences Procedure Act*, S.N.B. 1987, c. P-22.1, s. 94.
[160] [1990] O.J. No. 2792 (Ont. H.C.) (QL).

In another example, *R. v. Shead*, a lawyer was held liable for several counts of fraud for making negligent disclosures to investors.[161] In analyzing one of the charges, Justice Krindle of the Manitoba Court of Queen's Bench held:

> "Shead possessed the requisite knowledge of all the relevant facts and that he, possessing that knowledge, aided the client in the commission of the crime by preparing and executing the documentation. He thereby becomes a party to the offence of fraud. Without that knowledge, he would not have become a party".[162]

This holding suggests a requirement of subjective knowledge of the facts to draw a legal conclusion of fraud (i.e. objectively dishonest conduct and deprivation caused by the dishonest act) and an action to aid in the commission of the crime. A lawyer is generally unable to control a corporate client from engaging in the dishonest act unless the dishonest act is reliant upon an action of the lawyer. Thus, in general, the withholding of consent should be sufficient to prevent a fraudulent act; intentional aiding of a client when there is knowledge of a criminal action will constitute aiding and abetting under the CC.

[161] [1996] M.J. No. 466 (Q.B.) (QL).
[162] *Ibid.*. at para. 130.

4. Underwriters

An "underwriter" acts as an intermediary between the issuer and investors in the distribution of securities to the public, and is defined in s. 1(1) of the OSA (and similarly in other provincial securities statutes) as, "a person or company who, as principal, agrees to purchase securities with a view to distribution or who, as agent, offers for sale or sells securities in connection with a distribution and includes a person or company who has a direct or indirect participation in any such distribution". [163]

When purchasing shares for their own account as principals and not merely as agents for their clients, underwriters act as dealers. On the other hand, when purchasing and selling shares as intermediaries or agents for others, underwriters act as brokers. Further, underwriters provide advice to issuers about how to structure financings and how to design and price securities to be issued. As such, both issuers and investors rely on securities firms for their integrity and expertise.[164] The unique position of the underwriter as an intermediary enables it to detect misconduct of the issuing company, in particular, to discover and compel disclosure of essential facts about the offering being made to the public.

i. Civil Liability

A common law action may be initiated against underwriters, similar to the actions discussed above for directors and lawyers. However, in the context of underwriters, this form of liability has become largely irrelevant in light of the more easily enforceable statutory provisions now available under provincial securities legislation.[165]

The underwriter is required to provide a signed certificate for inclusion with the prospectus with respect to the securities offered by the prospectus that:

[163] *OSA, supra* note 2, s. 1(1).
[164] Jeffrey G. MacIntosh & Christopher C. Nicholls, *Securities Law* (Toronto: Irwin Law, 2002), c. 4(B) (QL).
[165] Fasken Martineau, "Underwriters' Liability for the Contents of a Prospectus and Their Due Diligence Defence: The Danier Decision Prompts a Review and Confirms the Importance of U.S. Guidance" (October 2004), online: <http://www.fasken.com/WEB/FMDWEBSITE.NSF/AllDocPrint/B30FB1DD39E9E36585256F3C00528CC4?OpenDocument> at 4.

> "To the best of our knowledge, information and belief, the foregoing constitutes full, true and plain disclosure of all material facts relating to the securities offered by this prospectus as required by Part XV of the Securities Act and the regulations there under".[166]

Underwriters who certify the prospectus are exposed to statutory civil liability to any purchaser for damages or rescission where such purchaser buys a security offered pursuant to a prospectus during the distribution period.[167] However, in addition to the other limits imposed and defences available (as previously discussed), where an underwriter is a defendant, the underwriter's maximum liability is the portion of the distribution underwritten by the underwriter (although this limitation of liability does not exist in Quebec).[168]

Unlike s. 130(1)(b) of the OSA (and parallel provisions in the other provinces), where underwriters are included in the defendant class expressly, underwriters are not listed in s. 138.3(1).[169] For this reason and because their chief function rests in the primary market, it is unlikely that it was the legislative intent for underwriters to be subject to civil liability to purchasers of securities in the secondary market.

ii. Other Regulatory Regimes - Provincial Securities Commissions

Underwriters are subject to registration requirements under provincial securities legislation. Firms that engage in securities underwriting must be registered, under the category of registration appropriate for the particular functions carried out by that firm.[170] As a result of the mandatory registration requirement, the securities commission in each province has the power to suspend or revoke the registration of a wayward registrant.[171]

In addition, the provincial securities commissions' ability to impose administrative sanctions and seek remedial powers of the court as discussed above is applicable. The OSC's regulatory proceeding, *YBM*

[166] *OSA, supra* note 2, s. 59(1); see also *BCSA, supra* note 2, s. 69; *ASA, supra* note 2, s. 117; *MSA supra* note 2, s. 53; *SSA, supra* note 2, s. 67; *QSA, supra* note 20, s. 33.2; *NBSA, supra* note 2, s. 74(3); *NSSA, supra* note 2, s. 64; *PEISA, supra* note 2, s. 8.6; *NLSA, supra* note 2, s. 60.
[167] *OSA, ibid.*, s. 59 and 130(1)(b); see also *QSA*, *ibid.*.
[168] *Ibid.*
[169] *OSA, supra* note 2, s. 138.3(1).
[170] *OSA, ibid.*, s. 25(1); *BCSA, supra* note 2, s. 34; *ASA, supra* note 2, s. 75; *MSA, supra* note 2, s. 6; *SSA, supra* note 2, s. 27; *QSA, supra* note 2, s. 148; *NBSA, supra* note 2, s. 45; *NSSA, supra* note 2, s. 31; *PEISA, supra* note 2, s. 2; *NLSA, supra* note 2, s. 26; *YSA, supra* note 2, s. 3; *NWTSA, supra* note 2, s. 4.
[171] *OSA, ibid.*, s. 127; *BCSA, ibid.*, s. 161; *ASA, ibid.*, s. 77; *MSA, ibid.*, s. 8; *SSA, ibid.*, s. 134; *QSA, ibid.*, s. 152; *NBSA, ibid.*, s. 184; *NSSA, ibid.*, s. 33; *PEISA, ibid.*, s.3; *NLSA, ibid.*, s. 28; *YSA, ibid.*, s. 8; *NWTSA, ibid.*, s. 10.

Magnex International Inc. (Re), discusses the role of the underwriter as a gatekeeper and devil's advocate.[172] Citing *Re A.E. Ames & Co. Ltd.*, the OSC held that the underwriter must avoid specific reliance on statements of the issuer:

> "The underwriter stands between the issuer and the public as an independent, expert party in bringing new securities to the market. In a sense the underwriters and the issuer are joint-venturers, but in another and more important sense they must be adversaries. That is the underwriter must seek out and question all relevant and material facts concerning the issuer and reasonable ensure himself that these facts are fully and truly set before the investing public".[173]

Thus, as gatekeeper, there is a duty upon the underwriter to uncover all the facts. At the same time, the OSC acknowledged the limits of the underwriter's role by citing *Feit v. Leasco Data Processing Equipment Corp.*:

> "[The duty of underwriters] to investigate should be considered in light of their more limited access. Nevertheless they are expected to exercise a high degree of care in investigation and independent verification of the company's representations … the underwriter must play the devil's advocate".[174]

Thus, as devil's advocates, underwriters must challenge the issuer's disclosure with respect to any misconduct. Otherwise they may be subject to administrative sanctions in addition to civil liability as discussed above.

iii. Other Regulatory Regimes - IDA

Underwriters are also independently regulated by the Investment Dealers Association of Canada [IDA], a national SRO and representative of the Canadian securities industry, and must adhere to the IDA's by-laws, rules and regulations. The IDA's mission is to protect investors and enhance the efficiency and competitiveness of the Canadian capital markets.[175] The IDA enforces rules and regulations regarding the

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[172] *YBM*, *supra* note 28 at paras. 187-199.
[173] [1972] O.S.C.B. 98 at 112.
[174] 332 F. Supp. At 582 (E.D.N.Y. 1971) at 582.
[175] IDA, "About the IDA: Roles and Responsibilities", online: <http://www.ida.ca/About/Roles_en.asp>.

sales, business and financial practices of its Member firms and its Approved Persons, and investigates complaints and disciplines Members and Approved Persons.

IDA By-Law No. 29 deals with ethics and business conduct.[176] In particular, clause 1 provides as follows:

> "Members and each partner, director, officer, sales manager, branch manager, assistant or co-branch manager, registered representative, investment representative and employee of a Member (i) shall observe high standards of ethics and conduct in the transaction of their business, (ii) shall not engage in any business conduct or practice which is unbecoming or detrimental to the public interest, and (iii) shall be of such character and business repute and have such experience and training as is consistent with the standards described in clauses (i) and (ii) or as may be prescribed by the Board of Directors".[177]

The "Code of Conduct for IDA Member Firms Trading in Domestic Debt Markets" is outlined in IDA Policy No. 5,[178] and provides an elaboration upon IDA By-Law No. 29. In particular, section 4 of IDA Policy No. 5 deals with market conduct: s. 4.1 provides a duty to deal fairly and "act fairly, honestly and in good faith";[179] s. 4.2 provides that the public interest is held in high regard;[180] and s. 4.5 states that members shall ensure that their trading does not contravene any criminal and regulatory offences.[181] Most importantly, with regard to withholding support and services from clients engaging in misconduct, if underwriters fail to act properly, they may be held liable under s. 4.6 with regard to misrepresentation and false remarks:

> "A Member should not spread, or acquiesce or assist in the spreading, of any rumours or information that the Member knows or believes, or reasonably ought to know or believe, to be false or misleading. In addition, a Member should not disseminate any information that falsely states or implies governmental approval of any institution or trading".[182]

[176] IDA By-Law No. 29 – Business Conduct.
[177] *Ibid* at s. 29.1.
[178] IDA Policy No. 5 – Code of Conduct for IDA Member Firms Trading in Domestic Debt Markets.
[179] *Ibid* at s. 4.1.
[180] *Ibid* at s. 4.2.
[181] *Ibid* at s. 4.5.
[182] *Ibid* at s. 4.6.

Where the standard of business conduct falls below that stipulated above, subject to certain due-diligence defences, s. 5 of IDA Policy No. 5 prescribes the details of possible sanctions.[183] Such sanctions include fines of up to $1 million per offence or (in the case of a Member) triple the amount of the benefit from the breach, reprimands, suspension or termination of approval or expulsion.

iv. Criminal and Quasi-Criminal Liability

Depending on the level of misconduct, the underwriter may be liable to charges under the CC and quasi-criminal offences under securities and corporate legislation as discussed above. Where the underwriter is a firm, Bill C-45 now makes it possible to impose criminal liability under the CC on an "organization", which includes a firm, based on criminal activity of senior officers of the organization.[184]

[183] *Ibid* at s.5.3.
[184] For a more detailed discussion see Darcy L. MacPherson, "Extending Corporate Criminal Liability?: Some Thoughts on Bill C-45" (2004) 30 Man. L.J. 253.

5. Auditors

The general role of an external auditor is to control and deliver a company's financial statements, acting as a gatekeeper to ensure full and accurate disclosure of information.[185] The statutory requirement for an auditor is found in both corporate and securities statutes. It is required by National Instrument 51-102 that a reporting issuer must, within 90 days following the end of its financial year, file and deliver to the holders of its securities (who request a copy), other than debt securities, comparative financial statements relating to both the most recently completed financial year and the immediately preceding financial year, a report of the auditor of the reporting issuer.[186] In addition, the CBCA and provincial corporate law statutes (with the exception of P.E.I. and New Brunswick), require a business corporation to have an auditor, whose duty it is to review the financial records of the corporation and report to the shareholders on the annual financial statements of the corporation.[187] New Brunswick's *Business Corporations Act* does not appear to require an auditor, but rather provides the option of appointing one via s. 105 (note that s. 100(1)(b) implies the possibility of having no auditor appointed).[188] Auditors must make the examinations that are, in their opinion, necessary to enable them to report as required on the financial statements that are to be submitted to shareholders.[189] Under securities legislation, however, it should be noted that Multilateral Instrument 52-110 dealing with audit committees, adopted in every jurisdiction except British Columbia, requires that every issuer have an audit committee to which the external auditors must directly report.[190]

Auditors are accountants, and auditing is considered a form of public accounting. In Canada, there are three recognized accounting bodies: the Canadian Institute of Chartered Accountants (CA), the Certified General Accountants Association of Canada (CGA), and the Society of Management Accountants of Canada (CMA). The CA program focuses on public accounting and candidates must obtain auditing

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[185] For a more detailed discussion see Lara Khoury, "The Liability of Auditors beyond Their Clients: A Comparative Study" (2001) 46 McGill L.J. 413.
[186] National Instruments have been promulgated by the Canadian Securities Administrators, a forum of 13 securities regulators across Canada to coordinate and harmonize the regulation of Canadian capital markets, and adopted by provincial securities regulators.
[187] *CBCA*, *supra* note 12, s. 162; *OBCA*, *supra* note 12, s. 149; *BCBCA*, *supra* note 12, s. 204; *ABCA*, *supra* note 12, s. 162; *MCA*, *supra* note 12, s. 156; *SBCA*, *supra* note 12, s. 153;,*QCA*, *supra* note 19, s. 113; *NSCA*, *supra* note 17, s. 117; *NFCA*, *supra* note 12, s. 265; *YBCA*, *supra* note 12, s. 164; *NWTBCA*, *supra* note 12, s. 164.
[188] *NBBCA*, *supra* note 12, s. 105.
[189] *CBCA*, *supra* note 12, s. 169; *OBCA*, *supra* note 12, s. 153; *BCBCA*, *supra* note 12, s. 212; *ABCA*, *supra* note 12, s. 169; *MCA*, *supra* note 12, s. 163; *SBCA*, *supra* note 12, s. 155; *QCA*, *supra* note 19, s. 114; *NBBCA*, *ibid*., s. 110; *NSCA*, *supra* note 17, s. 119B; *NFCA*, *supra* note 12, s. 274; *YBCA*, *supra* note 12, s. 171; *NWTBCA*, *supra* note 12, s. 71.
[190] (2004), 27 OSCB 3267.

experience from public accounting firms; the CGA program takes a general approach allowing candidates to focus in their own financial career choices; and the CMA program focuses in management accounting. All three programs require a candidate to obtain a degree and practical accounting experience before certification.

While the definition of a public accountant and who may perform the auditing function is regulated by the provincial accounting acts, the actual licensing and regulation of conduct is left to the accounting bodies. Most public accountants in Canada are CAs; however, CGAs are also authorized by provincial legislation to practice public accounting and auditing in all Canadian provinces, except in Quebec as of 2005.[191] In Ontario, as of November 1, 2005, CAs, CMAs and CGAs may now perform audits. In Quebec, only CAs are permitted to audit public companies.[192] In British Columbia and Prince Edward Island, both CAs and CGAs may perform audits of public companies.[193] In the rest of Canada, CAs, CGAs and CMAs may perform audits of public companies.[194] It should be noted that in May of 2004, the Canadian Institute of Chartered Accountants and CMA Canada entered into formal discussions to merge the two professional bodies. This attempt was ultimately unsuccessful and discussions were terminated in March of 2005.[195]

i. Civil Liability

a) Common Law

While it has been argued that the relationship between auditors and shareholders is contractual, courts have generally refused to recognize such a claim. Rather, the position the courts have adopted is that the contract exists between the corporation and the auditor.[196]

Similarly, while it is possible for investors to have a common law claim in tort against auditors, this ability has been largely limited following the Supreme Court of Canada decision in *Hercules*.[197] In

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[191] Certified General Accountants Association of Canada, "*Public Accounting Rights for Certified General Accountants in Canada*", May 2005, online: http://www.cga-canada.org/web/ca_rep_2005-05_pa_issue_brief.pdf.
[192] *Public Accounting Act*, 2004, S.O. 2004, c. 8; s.3(1), s.4(1), s.(5)(1) and s.1 (definition of "authorized designated body"); *Chartered Accountants Act,* R.S.Q. c. C-48, s.24; see also *Report of the Article 1716 Panel Concerning a Dispute by The Certified General Accountants Association of New Brunswick with Quebec Regarding Quebec's Measures Restricting Access to the Practice of Public Accounting*, at 5, online: http://www.intrasec.mb.ca/en/dispute/10_2005/CGANB-Quebec%20Panel%20Report-Final.pdf.
[193] *BCBCA, supra* note 12 at s.205*; Public Accounting and Auditing Act,* R.S.P.E.I. 1988, c. P-28.1, s.5(1).
[194] *Supra* note 190 at 7-9 (for summary of relevant legislation).
[195] *Ibid.*
[196] See *Hercules, supra* note 9, and *Roman Corporation Ltd. et al. v. Peat Marwick Thorne et al.* (1992), 11 O.R. (3d) 248 (Gen. Div.).

Hercules, the shareholders and investors alleged that the audit reports they relied on, found in the corporation's audited financial statements, were negligently prepared. As a consequence of relying on these reports, they lost money. The Supreme Court of Canada agreed that it is reasonable for a corporation's shareholders to make investment decisions by relying on the correctness of the corporation's audited financial statements. The case clarified the application of the two-part *Anns/Kamloops* test to negligent misrepresentation actions. Justice La Forest defined the "proximity" requirement in the first prong of the test to mean: "(a) the defendant ought reasonably to foresee that the plaintiff will rely on his or her representation; and (b) reliance by the plaintiff would, in the particular circumstances of the case, be reasonable".[198] The second prong of the test addresses policy considerations, which would negative the finding of a prima facie duty of care. The primary concern is that the defendant might be exposed to indeterminate liability from an indeterminate class. To limit the potential scope of liability, the Court held that a duty of care for negligence only arises when the claimants are known to the defendant as a clearly defined class, and that the usage of the representation be for the primary purpose for which the representation was created.[199] Based on the second prong of this test, it was held in *Hercules* that the corporations' auditors did not have a duty of care to the shareholders and investors.[200]

b) Statutory Liability

Securities Statutes

Under s. 130(1) of the OSA and equivalent securities legislation in the other provinces auditors may be liable, as their consent may have been filed with respect to reports, opinions or statements included in the prospectus, but only with respect to the specific reports, opinions or statements made by them. Quebec's

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197 *Hercules, ibid.*
198 *Ibid.* at para. 24.
199 *Ibid.* at para. 46; see also *Bow Valley Huskey (Bermuda) Ltd. v. Saint John Shipbuilding Ltd.*, [1997] 3 S.C.R. 1210 at para. 62.
200 Although, *Hercules* limits the common law right against auditors for negligent misrepresentation, this limit only reaches so far. In *Kripps v. Touche Ross*, [1997] 6 W.W.R. 421, 33 B.C.L.R. (3d) 254 (C.A.) (leave to appeal refused (1997), 225 N.R. 236n (S.C.C.)) [*Kripps*] (note: although *Kripps* was decided before the *Hercules* case, leave to appeal was denied after *Hercules*), investors who purchased debentures issued by a mortgage company that went bankrupt sued the auditors. The investors claimed the auditor's report was a negligent misrepresentation since the financial statements had not accurately reflected the company's financial position. The plaintiff investors argued that they had relied on the auditor's report and the auditors should have been aware that the investors would rely on the auditor's certification that the mortgage company's financial statements were accurate. Unlike in *Hercules*, the British Columbia Court of Appeal held that the auditor was liable. Although the auditors complied with applicable accounting and auditing rules, they allowed the company to understate its losses in a fashion that could mislead investors. At the time of the events in *Kripps*, there was no statutory civil liability for auditors under the British Columbia *Securities Act*. In contrast, in *Hercules*, since financial statements were only part of the company's annual financial disclosure then, for policy reasons, the auditors were not held liable for negligent misrepresentation.

act does not explicitly limit the liability to the specific reports, opinions or statements in s. 219.[201] In addition, under s. 138.3 of the OSA, an auditor may be open to secondary market civil liability as an expert: an auditor falls within the definition of "expert" under this section.[202] The defences available for primary market misrepresentations, and under s. 138.1 for experts discussed in the above sections, are equally applicable to auditors.

Corporate Statutes

The corporate statutes do not set out auditors' duties to investors. In *Hercules,* the court held that auditors owe a duty of care to the corporation and not the individual shareholders. Accordingly, the shareholders would have to act collectively to bring an action against auditors and would have to rely on the derivative action found in most corporate statutes (discussed above in the section on directors) because of the rule in *Foss v. Harbottle*. The possibility also exists for an oppression action (also discussed above in the section on directors) to be brought by shareholders against auditors for negligently prepared financial statements. However, an attempt in Ontario was rejected because it is the "corporation or any of its affiliates" that must have acted oppressively and auditors were found to fall outside of this realm.[203]

ii. Other Regulatory Regimes - Provincial Securities Commissions

The provincial securities commissions' ability to impose administrative sanctions and seek remedial powers of the court as discussed above is applicable.

iii. Other Regulatory Regimes - Provincial Institutes of Chartered Accountants

The Provincial Institutes of Chartered Accountants *Rules of Professional Conduct* [*Rules*] form the professional obligations of CAs whom perform audits.[204] With the exception of the Quebec *Code of Ethics*, the *Rules* are substantively equivalent across all provinces. Most importantly, Rule 213 of all the

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[201] QSA, *supra* note 20, s. 219.
[202] *OSA, supra* note 2, s. 138.3 and s. 138.1.
[203] *Budd v. Gentra*, [1996] O.J. No. 3515 (Gen. Div.) (QL), aff'd (1998) 43 B.L.R. (2d) 27 (Ont. C.A.). In the appeal decision, the oppression claim against the officers and directors was also struck because it contained no allegation of specific acts done by them.
[204] ICAO *Rules of Professional Conduct*; ICABC *Rules of Professional Conduct*; ICAA *Rules of Professional Conduct*; ICAM *Rules of Professional Conduct*; NBICA *Rules of Professional Conduct*; ICAN *Rules of Professional Conduct*; ICANS *Rules of Professional Conduct*; ICAPEI *Rules of Professional Conduct*; Ordre des comptables agréés du Québec *Code of Ethics of Chartered Accountants*; ICAS *Rules of Professional Conduct*; ICANT *Rules of Professional Conduct*.

Rules of Professional Conduct, explicitly state that "a member, student or firm shall not knowingly associate with any unlawful activity".[205] As such, upon detection of client misconduct, an auditor may be explicitly obligated to withhold support and services.

However, client misconduct often falls into a grey-zone and may not be considered outright unlawful. As such, other rules which pertain to the auditor's liability as gatekeeper include as follows: Rule 201.1 provides that "a member, student or firm shall act at all times in a manner which will maintain the good reputation of the profession and its ability to serve the public interest"; Rule 202 provides that "a member, student or firm shall perform professional services with integrity and due care"; and Rule 205 provides that "a member, student, or firm shall not sign or make false or misleading documents and oral representations".[206] In particular, Rule 204.1, which pertains to maintaining independence in any accounting engagement, states the following:

> "A member or firm who engages or participates in an engagement:
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> (a) to issue a written communication under the terms of an assurance engagement; or
> (b) to issue a report on the results of applying specified auditing procedures;
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> shall be and remain independent such that the member, firm and members of the firm shall be and remain free of any influence, interest or relationship which, in respect of the engagement, impairs the professional judgment or objectivity of the member, firm or a member of the firm or which, in the view of a reasonable observer, would impair the professional judgment or objectivity of the member, firm or a member of the firm".[207]

Further, Rule 206 deals with professional standards and states as follows:

1. A member or firm engaged in the practice of public accounting shall perform professional services in accordance with generally accepted standards of practice of the profession.
2. A member who has responsibility for the preparation or approval of the general purpose financial statements of an entity shall ensure those financial statements are presented fairly

[205] *Ibid*.
[206] *Ibid*; see also Ordre des comptables agréés du Québec *Code of Ethics of Chartered Accountants*, rules 5, 23 and 34.
[207] *Ibid*; see also Ordre des comptables agréés du Québec *Code of Ethics of Chartered Accountants*, rule 36.4.

in accordance with generally accepted accounting principles or such other accounting principles as may be required in the circumstances.

3. A member who, as a member of an entity's audit committee or board of directors, is required to participate in the review or approval of the entity's general purpose financial statements by such committee or board, shall carry out that responsibility with the care and diligence of a competent Chartered Accountant, enhanced by the skills and knowledge derived from the member's own career.[208]

As such, the *Rules* impose an ethical standard of conduct on auditors not found in provincial securities legislation or the corporate statutes. A Professional Conduct Committee investigates all written complaints received about Institute members, students, and firms for violations of the Institute's rules of professional conduct, regulations, or bylaws. When the Professional Conduct Committee lays a charge or charges of professional misconduct against a member, student or firm, a formal hearing is held in front of the Institute's discipline committee, and if a finding of guilty is made, the discipline committee has the power to order that the member, student or firm be reprimanded; fined; charged the costs of the investigation and hearing; suspended from the Institute; struck off the register of students; or expelled from membership in the Institute. The committee may also order that the member, student or firm satisfactorily complete professional development courses, and/or examinations, and/or engage an advisor or tutor; complete a period of supervised practice; be reinvestigated by the Professional Conduct Committee; be restricted for a specified period of time; complete - or (the firm) establish - a professional training program; or establish, maintain and uphold quality control procedures for the practice. Furthermore, the committee may order discipline in such other manner as it may determine, and stipulate that its decision and order be publicized with or without the name of the member, student or firm.[209]

The CGA and the CMA regulatory bodies also have their own sets of rules of professional conduct that are similar to the *Rules* outlined above. A detailed examination of these rules is not necessary as the Canadian Public Accountability Board (discussed below) and accompanying legislation in most instances require members to follow the *Rules.*

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[208] *Ibid*; see also Ordre des comptables agréés du Québec *Code of Ethics of Chartered Accountants*, rule 19.
[209] Institute of Chartered Accountants of Ontario, "Disciplinary Process Highlights", online: <http://www.icao.on.ca/Public/ProtectingthePublic/DisciplinaryCases/print_page1395.aspx>.

iv. Other Regulatory Regimes - CPAB

The Canadian Public Accountability Board (CPAB) was established in 2004 to provide independent oversight of the public accounting profession. National Instrument 52-108 requires auditors of reporting issuers to be members in good standing with the CPAB, as a new independent public oversight system, that includes regular and rigorous inspections of auditors of Canada's public companies.[210] Firms must demonstrate suitability in their application for membership. Once a public accounting firm's application is approved by the CPAB, the firm must abide by all of the provisions of the by-laws, rules and regulations of the CPAB pertaining to the CPAB Oversight Program.

Section 300 of the CPAB *Rules* sets out the professional standards that audit firms must adhere to, which generally echoes the ethical standards imposed by the professional regulatory bodies that have jurisdiction over them. For example s. 303(a) and (b) state the following:

> "A participating audit firm and the designated professionals and other partners and employees of such firm shall comply with the ethics standards as follows with respect to an audit of the financial statements of a reporting issuer:
>
> a. Canadian participating audit firms, and designated professionals and other partners and employees of such firms, shall comply with the ethics standards of the professional regulatory bodies that have jurisdiction over them and such other standards as the Board may require from time to time
> b. With respect to auditor independence, the relevant standard for all Canadian participating audit firms and designated professionals and other partners and employees of such firms shall be the requirements of the Provincial Institute(s)/Order of Chartered Accountants in the relevant province(s). In provinces other than Quebec, the requirements are set out in rule 204 of the Rules of Professional Conduct, and in Quebec, the requirements are set out in Division 2.1 of the Code of Ethics".[211]

If a violation occurs, sanctions are prescribed on the audit firm under CPAB *Rules,* section 601 including: additional professional education for some or all of the designated professionals of a participating audit

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[210] (2004), 27 OSCB 3227 [*NI 52-108*]. For greater detail see P.Puri and A. Pritchard, *The Regulation of Public Auditing in Canada and the United States: Self-Regulation or Government Regulation* (Vancouver: Fraser Institute, 2006).
[211] *CPAB Rules*, s. 303(a) and (b).

firm; the design, adoption or implementation of policies by a participating audit firm to ensure its compliance with the CPAB *Rules*; and appointment of an independent monitor, subject to the approval of the Board, to observe and report to the Board on a participating audit firm's compliance with the CPAB *Rules*.[212]

v. Criminal and Quasi-Criminal Liability

Depending on the level of misconduct, the auditor may be liable to charges under the CC and quasi-criminal offences under securities and corporate legislation as discussed above.

[212] *Ibid*. s. 601.

6. Credit Rating Agencies

Credit Rating Agencies (CRAs) specialize in the appraisal of creditworthiness of corporations by rating the issuer, based on how likely they are to make timely payments on their debts.[213] Many federal and provincial regulatory schemes refer to ratings issued by CRAs.[214] Unlike financial analysts, CRAs do not express opinions as to whether the particular debt securities should be bought or sold, but report on the relative safety of the securities. In Canada, there are two major Canadian CRAs, Dominion Bond Rating Services and Canadian Bond Rating Services, which have recently been purchased by Standard & Poor's, while Moody's and Fitch are CRAs from the United States that also operate in Canada.

Issuers are charged fees for the rating process.[215] The CRA's analyst gathers information from issuer and non-issuer sources and meetings are conducted, in which the analyst then submits a report to the rating committee, based upon which a credit rating is then issued. Further, subsequent to the issue, the CRA continues to monitor the issuer and its securities by reviewing corporate filings, monitoring industry trends and maintaining contact with corporate management.

CRAs are intermediaries and act on behalf of both issuers and investors. On one hand, they influence investors' portfolio decisions, while on the other hand, they influence the conditions under which issuers access capital markets and the conditions of their relationships with lenders and their transactions.[216] As such, CRAs have an important role in Canadian capital markets as a gatekeeper.

i. Civil Liability

The risk of liability for CRAs to third-party users of ratings is low because under provincial securities laws, CRAs are largely insulated from statutory civil liability. For example, under s. 130(1) of the OSA, pertaining to civil liability for misrepresentation, CRAs would only be included as possible defendants under paragraph (d) if their consent had been filed pursuant to a requirement of the regulation with respect to reports, opinions or statements that had been made by them, or under paragraph (e) if the CRA actually signed the prospectus or amendment to the prospectus.[217] Even under s. 138.3 of the OSA for

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[213] Stephane Rousseau, "Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach", online: <http://www.rotman.utoronto.ca/cmi/papers/CRA_Study_Rousseau.pdf> at 5.
[214] Christopher C. Nicholls, "Public and Private Uses of Credit Ratings", online: <http://www.rotman.utoronto.ca/cmi/papers/CRA_Study_Nicholls.pdf>.
[215] *Supra* note 212 at 11-12.
[216] *Ibid.* at 7-10.
[217] OSC, *supra* note 2, s. 130(1).

secondary market civil liability, the list of potential defendants explicitly excludes CRAs by the definition of "expert" under s. 138.1(1), which does not include "an entity that is an approved rating organization for the purposes of National Instrument 44-101 of the Canadian Securities Administrators".

Defaulting to the common law, it is highly unlikely that there would be a duty of care to investors under the second stage of the *Anns/Kamloops* test (which addresses policy concerns with indeterminate liability), discussed in the previous sections of this paper.[218]

ii. Other Regulatory Regimes - Provincial Securities Commissions

The provincial securities commissions' ability to impose administrative sanctions and seek remedial powers of the court as discussed above are applicable.

iii. Other Regulatory Regimes - IOSCO

Rather than acting as a code of conduct to which CRAs are expected to adhere, the International Organization of Securities Commission's (IOSCO) *Code of Conduct Fundamentals* [IOSCO *Code*][219] contains a set of provisions that the IOSCO expects all CRAs will incorporate and give full effect to in their codes of conduct. The IOSCO's code addresses issues including how CRAs should avoid or mitigate potential conflicts of interest, improve the transparency of the ratings process, and protect their integrity and independence while dealing fairly with issuers, investors and other market participants.[220] As stated in a press release issued on September 26, 2003, the OSC fully endorses international standards as issued by IOSCO for CRAs.[221] CRAs have generally adopted the IOSCO *Code* into their own internal codes of conduct (see for example, Standard & Poor's).[222]

The liabilities of CRAs for failing to withhold their support and services upon detection of misconduct are primarily implicit. Rule 1.6 of the IOSCO *Code* deals with the quality of the rating process, and states that "the CRA and its analysts should take steps to avoid issuing any credit analyses or reports that

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[218] *Supra* note 213 at 23.
[219] International Organization of Securities Commissions (IOSCO), *Code of Conduct Fundamentals* (December 2004) [*IOSCO Code*].
[220] IOSCO, Press Release, "Task Force of Securities Regulators from Major Markets Agrees on Code of Conduct Fundamentals for Credit Rating Agencies" (3 December 2004).
[221] OSC, Press Release, "OSC Chair Endorses International Standards for Analysts and Credit Rating Agencies" (26 September 2003).
[222] Standard and Poor's, Press Release, "Standard & Poor's Releases Updated Code of Conduct" (11 October 2005).

contain misrepresentations or are otherwise misleading as to the general creditworthiness of an issuer or obligation".[223] Rules 1.11 and 1.12 of the IOSCO *Code* deal with the integrity of the rating process and outline as follows:

> 1.11 The CRA and its employees should comply with all applicable laws and regulations governing its activities in each jurisdiction in which it operates.
> 1.12 The CRA and its employees should deal fairly and honestly with issuers, investors, other market participants, and the public.[224]

With regard to independence and avoidance of conflict of interest, Rule 2.2 provides that the "CRA and its analysts should use care and professional judgment to maintain both the substance and appearance of independence and objectivity".[225]

While the IOSCO *Code* provides indications on how CRAs should conduct their business, it should be noted that currently there is no mandatory disclosure of CRAs' codes of conduct under any provincial securities legislation or explicit sanctions for non-compliance.

iv. Criminal and Quasi-Criminal Liability

Depending on the level of misconduct, CRAs (as "organizations", discussed above for underwriters) and/or their employees may be liable to charges under the CC and quasi-criminal offences under corporate and securities legislation discussed above.

[223] *Supra* note 218, r.1.6.
[224] *Ibid*., r.1.11 and 1.12.
[225] *Ibid*., r.2.2.

7. Financial Analysts

Financial analysts perform a variety of functions within the securities industry, including gathering information, assembling spreadsheets, writing reports and reviewing all non-legal pertinent information about prospective deals.[226] Sell-side analysts work at full-service investment dealers, while buy-side analysts are employed by institutional investors. Analysts may also work independently.

As outlined in the Securities Industry Committee on Analyst Standard's Report "Setting Analyst Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts" (SICAS *Report*), conflicts often arise between an analyst's duty to provide independent, objective, advice to investor clients and pressures to support investment banking revenues because of their unique intermediary role in capital markets.[227] The report outlines some potential situations of conflict, namely, the pressure to issue positive recommendations,[228] which may prevent financial analysts from withholding their support and services upon detecting client misconduct. As the SICAS *Report* ultimately concludes, there is little regulation applying specifically to analysts.[229]

i. Civil Liability

While a common law action for negligent misrepresentation by the analyst may be possible, generally only in rare cases would such an action be pursued.[230] As noted in the SICAS *Report*, a review of the Ontario Securities Act reveals no provisions specifically relating to analysts,[231] but do contain general provisions relating to civil liability for misrepresentation. For example, under s. 130(1) of the OSA pertaining to civil liability for misrepresentation, financial analysts would only be included as possible defendants under paragraph (d) if their consent has been filed pursuant to a requirement of the Act with respect to reports, opinions or statements that have been made by them, or under paragraph (e) if the financial analyst actually signed the prospectus or amendment to the prospectus, but this would be in rare circumstances.[232] However, with the new civil liability for secondary market disclosure, financial analysts are included as an "expert" as defined under s. 138.1(1) of the OSA, and may therefore be

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[226] Securities Industry Committee on Analyst Standards, "Setting Analyst Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts" (October 2001) [SICAS *Report*] at 29-30.
[227] *Ibid.* at 30.
[228] *Ibid.* at 31.
[229] *Ibid.* at 40.
[230] *Ibid.* at 38.
[231] *Ibid.* at 38.
[232] *OSA*, *supra* note 2, s. 130(1).

liable.[233] The defences available for primary market misrepresentations and under s. 138.1 for misrepresentations made by experts discussed above would be equally applicable to financial analysts.

ii. Other Regulatory Regimes - Provincial Securities Commissions

Investment firms are subject to the registration requirements under provincial securities legislation.[234] As a result of the mandatory registration requirement, the provincial securities commissions have the power to suspend or revoke the registration of a wayward registrant,[235] which may include situations where the firm fails to properly supervise the analysts (employees) at the firm.

In addition, the provincial securities commissions' ability to impose administrative sanctions and seek remedial powers of the court, as discussed above, are applicable.

iii. Other Regulatory Regimes - IDA

Investment firms are also independently regulated by the IDA and must adhere to its by-laws, rules, and regulations. IDA Members have a supervisory responsibility over their employees.[236] While they are subject to the same rules as other firm employees, financial analysts are not required to be registered. However, senior analysts are usually officers and/or directors of Member firms, and therefore, subject to additional liability.

Although there are IDA provisions that govern objectivity and accuracy of information in sales literature (see IDA Policy No. 5 - discussed under the section on underwriters), these provisions do not specifically relate to analysts. However, based on the recommendations of the SICAS *Report*, the IDA has enacted IDA Policy No. 11 on "Research Restrictions and Disclosure Requirements",[237] detailing procedures to minimize potential conflicts of interests. Rule 2(b) ensures a level of objectivity and accuracy of information:

> "Each Member shall prominently disclose in any research report:

[233] *Ibid.*, s. 138.1.
[234] *Supra* note 169.
[235] *Supra* note 170.
[236] *Supra* note 225 at 37.
[237] IDA Policy No. 11 – Research Restrictions and Disclosure Requirements.

(b) the Member's system for rating investment opportunities and how each recommendation fits within the system and shall disclose on their websites or otherwise, quarterly, the percentage of its recommendations that fall into each category of their recommended terminology".[238]

The duty to prevent any potential conflicts of interest is explicit, and Rule 11 provides that "each Member shall have policies and procedures in place to reasonably prevent recommendations in research reports form being influenced by the investment-banking department or the issuer", and prescribes the minimum standards.[239] Further Rule 17 provides that:

> "Members must obtain an annual certification from the head of the research department and chief executive officer which states that their analysts are familiar with and have complied with the CFA Institute Code of Ethics and Standards of Professional Conduct whether they are members of the CFA Institute or not".[240]

The Chartered Financial Analyst (CFA) Institute's *Code of Ethics and Standards of Professional Conduct*[241] is discussed further below.

Breach of IDA rules will lead to investigation, and if it warrants further action, a disciplinary hearing will be held. The IDA can impose penalties on both registered employees and Member firms, including: a reprimand; fines; suspension; prohibitions; termination; and expulsion of membership.[242]

iv. Other Regulatory Regimes - CFA

While many securities analysts are registered as a CFA, membership in the organization is not a requirement according to provincial securities legislation. Membership is obtained through study and completion of three levels of exams. As members of the institute, CFAs must adhere to the *Code of Ethics and Standards of Professional Conduct*, which implicitly spells out the liabilities of CFAs as gatekeepers. The *Code of Ethics* portion for CFA members outlines the following duties of financial

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[238] *Ibid*., r.2(b).
[239] *Ibid*., r.11.
[240] IDA Policy No. 11, s. 17.
[241] CFA Institute, *Code of Ethics and Standards of Professional Conduct* (2005).
[242] IDA, "Enforcement: Disciplinary Actions" (21 January 2005), online: <http://www.ida.ca/Enforcement/FactsAndStats/DisciplinaryActions_en.asp>.

analysts. They must:

- act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets; and
- promote the integrity of, and uphold the rules governing capital markets.[243]

With regard to professionalism, the *Standards of Professional Conduct* set out a guideline on misrepresentation that "members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities".[244] The guideline on misconduct states that "members and Candidates must not engage in any professional misconduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence".[245]

Violation of the *Code of Ethics* and *Standards of Processional Conduct* results in loss of membership. However, this sanction has limited force given that membership is not a requirement for industry participation of analysts.

v. Criminal and Quasi-Criminal Liability

Financial analysts may also be liable to charges under the CC and quasi-criminal offences under securities and corporate legislation discussed above.

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[243] *Supra* note 240.
[244] *Ibid*., r.I.C.
[245] *Ibid*., r.I.D.

8. MFDA Members

The Mutual Fund Dealers Association of Canada (MFDA) is a national SRO for the distribution side of the Canadian mutual fund industry, responsible for regulating the operations, standards of practice and business conduct of its Members and their representatives.[246] The IDA regulates its own members who are involved in the sale of securities including mutual funds, while the MFDA regulates the distribution side of the mutual fund industry.

i. Civil Liability

The civil liability of MFDA Members in relation to the primary market is similar to that of underwriters.[247] As such, the mutual fund dealer may be accountable at law for any statements made in or omissions from the prospectus documents. Once a fund has filed a mutual fund prospectus, the mutual fund dealer is also obliged to provide investors with financial statements and other important information on a regular basis. MFDA Members are subject to the secondary market civil liability under s. 138.3 of the OSA for improper continuous disclosure, as "investment fund" managers are included in the definition of "influential persons" in s. 138.1 of the OSA.[248] Liability for influential persons who are not individuals is capped at the greater of five percent of its market capitalization (as defined in the act) or $1 million.[249] Liability for core documents for influential persons are the same as for directors who are not officers as detailed above.[250] The defences available to directors, detailed above, are also available to influential persons.[251]

It is important to note that the recent amendment to the "material change" definition in the OSA¸ to a "market impact" standard of materiality, has not changed the definition as it applies to investment funds, which is the "reasonable investor" standard of materiality. This change for issuers other than investment funds is consistent with the goal of not using the new secondary liability scheme to impose liability on issuers and others for materiality determinations after the fact. The revised materiality test consists only of whether the fact "would reasonably be expected to have a significant effect on the market price or value" of an issuer's securities. The differential treatment of investment funds raises the possibility that MFDA

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246 MFDA Vision and Mission Statement, online: <http://www.mfda.ca/about/vision.html>.
247 *Supra* notes 164-7 and accompanying text.
248 *OSA, supra* note 2, s. 138.3, provided that the issuer is an investment fund.
249 *Ibid*., s. 138.1
250 *Supra* note 65.
251 *Supra* notes 70-74 and accompanying text.

Members will be open to more expansive civil liability under the new secondary liability regime.

ii. Other Regulatory Regimes - Provincial Securities Commissions

The mission of the MFDA is to enhance investor protection and strengthen public confidence by mandating, monitoring compliance with, and enforcing rules and practices to ensure high standards of conduct by its Members.[252] The MFDA is recognized by the provincial securities commissions in Alberta, British Columbia, Nova Scotia, Ontario and Saskatchewan, with application still pending in Manitoba and Newfoundland. The Securities Administrator in New Brunswick has made MFDA membership a condition of mutual fund dealer registration in that province.[253]

MFDA Members are mutual fund dealers that are licensed with provincial securities commissions. The registration requirements enable securities regulators to ensure that each dealer, salesperson or advisor has the basic qualifications required to act on behalf of public investors. As such, the provincial securities commissions have the power to suspend or revoke the registration of a wayward registrant.[254]

In addition, the provincial securities commissions' ability to impose administrative sanctions and seek remedial powers of the court as discussed above is applicable.

iii. Other Regulatory Regimes - MFDA

Members of the MFDA must adhere to all by-laws, and to the rules of the organization.[255] In particular, Rule 2.1.1 of the *MFDA Rules* prescribes the standard of conduct required of Members and each Approved Person of a Member, stating that each shall:

(a) deal fairly, honestly and in good faith with its clients;
(b) observe high standards of ethics and conduct in the transaction of business;
(c) not engage in any business conduct or practice which is unbecoming or detrimental to the public interest; and

[252] MFDA, Vision and Mission Statement, online: <http://www.mfda.ca/about/vision.html>.
[253] MFDA, "About the Mutual Fund Dealers Association of Canada", online: <http://www.mfda.ca/about/aboutMFDA.html>.
[254] *Supra* note 170.
[255] MFDA, Rule 2.1.2, online: <http://www.mfda.ca/regulation/rules/Rules02-27-06.pdf>.

(d) be of such character and business repute and have such experience and training as is consistent with the standards described in this Rule 2.1.1, or as may be prescribed by the Corporation.[256]

In addition, MFDA Regulation Notice 0048 outlines the "Know-Your-Product" requirements, where Members are obligated to perform a reasonable level of due diligence on products prior to their approval for sale by Approved Persons. The approval process must be independent and objective, and Members must not merely rely on representations of the issuer.[257] Further, MFDA Regulation Notice 0037 deals with the "Compliance Responsibilities", where every Member is required to designate a trading officer as a compliance officer responsible for monitoring adherence by the Member and its Approved Persons to all applicable MFDA securities and legislation requirements.[258]

Upon non-compliance, the disciplinary powers of the MFDA are prescribed in section 24 of its *By-laws.*[259] The hearing panel has power to discipline both Approved Persons (section 24.1.1)[260] and Members (section 24.1.2)[261] of the MFDA, with penalties including: a reprimand, a fine, suspension of the authority to conduct business, revocation of authority to conduct business, prohibition from conducting business and expulsion from the MFDA.

iv. Criminal and Quasi-Criminal Liability

MFDA Members (as "organizations", discussed above for underwriters) and/or their employees may be liable to charges under the CC and quasi-criminal offences under securities and corporate legislation discussed above.

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[256] *Ibid.*, 2.1.1.
[257] Member Regulation Notice 0048, Know-Your-Product, online: <www.mfda.ca/regulation/notices/MR-0048.pdf>.
[258] Member Regulation Notice 0037, Compliance Responsibilities, online: <www.mfda.ca/regulation/notices/MR-0037.pdf>.
[259] MFDA Bylaws, online: < http://www.mfda.ca/regulation/bylaw/By-law1-12-13-2005.pdf>.
[260] *Ibid.*, s. 24.1.1.
[261] *Ibid.*, s. 24.1.2.

9. Retail Investment Advisors

Retail investment advisors provide investment advice to clients and execute trades on their behalf in securities and other investment products. They stand in an agency relationship with their clients, who are often less knowledgeable and do not have the same access to information. As such, there is some degree of trust and reliance by the client on the investment advisor, and the investment advisor is thereby able to act as a gatekeeper in this position.[262]

The Canadian Securities Administrators report that investment advisors top the list of complaints received by securities regulators across Canada, with suitability, customer service and registration documented as common complaints.[263] Beyond these issues, investment advisors appear to be exposed to limited liability in their specific role as gatekeepers to capital markets.

i. Civil Liability

A common law action for negligent misrepresentation by the investment advisor may be possible, as the investment advisor likely owes a duty of care to the investor by application of the *Anns/Kamloops* test - the investment advisor's relationship with the client generally indicates a provision of professional services in accordance with industry practice and standards.[264] There may also be a contractual relationship between the client and the investment advisor, with any claim of liability dependent on the written and unwritten terms of such a contract. As well, since the investment advisor's relationship with his or her client is one of agency, the investment advisor owes a fiduciary duty to the client. Accordingly, to the extent that industry practice and standards, contracts and their fiduciary relationship requires investment advisors to suggest and sell suitable products to their clients, they may also be performing a gatekeeping function. However, the case law does not suggest that this is the focus of litigation in this area.[265]

The provincial securities acts contain no provisions specifically relating to investment advisors' gatekeeping role, but do contain general provisions relating to civil liability for misrepresentations. For

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[262] Gowlings Lafleur Henderson LLP, "Investment Advisors' Liability" (30 May 2001), online: <http://www.gowlings.com/resources/publicationpdfs/InvestmentAdvisorsLiability.pdf>.
[263] OSC, News Release, "Investment adviser practices trigger most complaints to securities regulators" (21 January 2003), online: <http://www.osc.gov.on.ca/About/NewsReleases/2003/nr_20030121_csa-complaints.jsp>
[264] *Supra* note 261.
[265] *Ibid.* The Gowlings memorandum provides an excellent overview of the case law in this area.

example, under s. 130(1) of OSA, investment advisors would only be included as possible defendants under paragraph (d) if their consent had been filed pursuant to a requirement of the regulation with respect to reports, opinions or statements that had been made by them, or under paragraph (e) if the investment advisor actually signed the prospectus or amendment to the prospectus, but this would be in rare circumstances.[266] With the new civil liability for continuous secondary market disclosure provisions, investment advisors are not directly included as an "expert" as defined under s. 138.1(1) of the OSA, and it is questionable whether they may be liable.[267]

ii. Other Regulatory Regimes - Provincial Securities Commissions

All securities firms and their employees who provide trading and advising services are subject to registration requirements under provincial securities legislation. As a result of the mandatory registration requirement, the provincial securities commissions have the power to suspend or revoke the registration of a wayward registrant.

In addition, the provincial securities commissions' ability to impose administrative sanctions and seek remedial powers of the court as discussed above are applicable.

iii. Other Regulatory Regimes - IDA

Retail investment advisors are generally employed by investment firms; who, as discussed above, are regulated by the IDA and must adhere to its by-laws, rules and regulations. In addition, investment advisors themselves must register as a Registered Representative (RR) or Investment Representative (IR)[268] and adhere to the IDA's by-laws, rules and regulations as discussed above. An RR has full registration to deal with the public and can advise on trades. An IR cannot advise on trades, although he or she can take unsolicited client orders. For both types of registration, an individual must successfully complete the Canadian Securities Course, the Conduct and Practices Handbook Exam, and a training program offered by his or her firm. For IRs, the length of the training course is 30 days, and for RRs, the length of the training course is 90 days. After registration, six months of extra internal supervision is

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[266] OSA, *supra* note 2, s. 130(1).
[267] *Ibid.*, s.138.1.
[268] Investment Dealers Association of Canada, IDA Bulletin # 2663, "Policy No. 6 – Part III the Continuing Education Program and Parameters and Guidelines for the Securities Industry Continuing Education Program" (29 November 1999), online: <http://www.ida.ca/Files/BulletinsNotices/Bulletins/B2663_en.pdf>.

required. RRs must then go on to complete an additional course (the Professional Financial Planning Course or Investment Management Techniques Course) within 30 months of registration.

In IDA Bulletin #3332, "Discipline Penalties Imposed on Alan Bruce Alexander Thomson – Violations of By-law 29.1", the IDA clearly outlined the role of a Registered Representative of its Members:

> "The panel stated that they firmly believe that a RR is required to take reasonable precautions to ensure that the security in which he or she is trading complies fully with all applicable securities laws. Furthermore a RR is required to take reasonable steps to ensure that the security he or she is selling has had a reasonable level of due diligence performed on it. Finally, a RR is required to take reasonable precautions to ensure that any transaction in which he or she is involved is transacted to the benefit of and best interests of his or her client".[269]

iv. Criminal and Quasi-Criminal Liability

Retail investment advisors may be liable to charges under the CC and quasi-criminal offences under securities and corporate legislation discussed above.

[269] Investment Dealers Association of Canada, IDA Bulletin #3332, "Discipline Penalties Imposed on Alan Bruce Alexander Thomson – Violations of By-law 29.1" (21 September 2004), online: <http://www.ida.ca/Files/BulletinsNotices/Bulletins/B3332_en.pdf>.

10. Financial Planners

Financial planners generally review and analyze clients' financial state of affairs and prepare comprehensive individualized plans to help clients achieve a desired level of financial security.[270] Areas where the financial planner may offer assistance include personal budgeting, cash and debt management, retirement planning and tax planning. Financial planners may be compensated on a fee-only, fee and commission, or commission-only basis.

Financial planners are not currently subject to provincial securities registration or direct regulation. If, however, a financial planner desires to trade in securities or advise clients on securities, he or she must become registered under provincial securities legislation. Without that registration, financial planners cannot trade securities for their clients or recommend the sale or purchase of specific securities. However, there are a number of voluntary-membership organizations representing financial planners in Canada (discussed below), all with their own standards of ethics and professional conduct.

i. Civil Liability

A common law action for negligent misrepresentation by a financial planner may be possible, as the financial planner probably owes a duty of care to the investor by application of the *Anns/Kamloops* test. Similar to the investment advisor's relationship with the client, the financial planner's relationship with the client generally indicates a provision of professional services in accordance with industry practice and standards.[271] There may also be a contractual relationship between the client and the financial planner, and any claim of liability will depend on the written and unwritten terms of such a contract. As well, since the financial planner's relationship with the client is one of agency, the financial planner owes a fiduciary duty to the client.

The provincial securities acts reveal no provisions specifically relating to financial planners, but do contain general provisions relating to civil liability for misrepresentation. For example, under s. 130(1) of OSA, financial planners would only be included as possible defendants under paragraph (d) if their consent had been filed pursuant to a requirement of the regulation with respect to reports, opinions or statements that had been made by them, or under paragraph (e) if the financial planner actually signed the

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[270] CAFP, "FAQ about Financial Planning and Planners", online: <http://www.cafp.org/FAQ.html>.
[271] *Supra* note 261.

prospectus or amendment to the prospectus, but this would be in rare circumstances.[272] With respect to secondary market civil liability, financial planners are not directly included as an "expert" as defined under s. 138.1(1) of the OSA, and it is questionable whether they may be liable.[273]

ii. Other Regulatory Regimes - Provincial Securities Commissions

The provincial securities commissions' ability to impose administrative sanctions and seek remedial powers of the court as discussed above are applicable.

iii. Other Regulatory Regimes - CFP

Certified Financial Planners (CFPs) are registered individuals who are "dedicated to a high level of professionalism in providing financial planning advice". The CFP credential ensures that those professionals adhere to certain standards of competence and ethical practice as set out by the Financial Planners Standards Council (FPSC).[274] In order to qualify as a CFP, individuals must meet rigorous pre- and post-certification standards and annual licensing requirements.

CFPs must follow a professional *Code of Ethics*. In particular, not only are CFPs required to comply with all applicable laws and regulations, CFPs must act "in an ethical and professionally responsible manner becoming of the financial profession".[275] The first principle is integrity: a CFP shall always act with integrity, demanding honesty and candour.[276] Perhaps most explicit of the CFP's role as a potential gatekeeper is Rule 101, which states that: "a CFP professional shall not engage in or associate with conduct involving dishonesty, fraud, deceit or misrepresentation, or knowingly make a false or misleading statement".[277] Further, the second principle, pertaining to objectivity, requires that a CFP shall be objective in providing financial planning to clients.[278] Rule 202 states quite clearly that a CFP shall act in the interests of the client,[279] with no reference to the interest of the issuer/company. Where there is an

[272] *OSA*, *supra* note 2, s. 130(1).
[273] *Ibid*, s. 138.1(1).
[274] FPSC, "Certified Financial Planner Credential FAQ", online: <http://www.cfp-ca.org/public/public_faq_cfpdesignation.asp>.
[275] CFP, *Code of Ethics* (April 2005), online: < http://www.cfp.net/learn/ethics.asp>.
[276] *Ibid*., Principle 1.
[277] *Ibid*., Rule 101.
[278] *Ibid*., Principle 2.
[279] *Ibid*., Rule 202.

alleged violation of the *Code of Ethics*, the FPSC will take appropriate disciplinary action, the most severe being revocation of the CFP license.[280]

iv. Other Regulatory Regimes - CAFP

The Canadian Association of Financial Planners (CAFP) is a national professional organization of financial planners, whose mission is to raise consumer awareness of the value of personal financial planning services. Membership into the organization is voluntary, with current membership at more than 2,700 individual financial planners across Canada. The CAFP supports the position that anyone who holds themselves out to the public as being a financial planner and/or a financial consultant must possess at least the professional designation CFP (see discussion above).

All CAFP members are bound by CAFP's Code of Professional Ethics, which guides the provision of financial advice and sets high standards of technical competence, morality and integrity. In their obligation to clients, CAFP members must act in the best interest of their clients and shall place the interest of their clients above their own.[281] In their professional conduct, CAFP members shall not only comply with the by-laws, rules, regulations and professional standards of the CAFP,[282] but also with all relevant laws, regulations, and standards of any governmental or other professional bodies.[283] Most importantly, CAFP members shall endeavour to place the public interest above their own and shall not do anything that would tend to bring the profession of financial planning and/or the CAFP into disrepute.[284]

v. Other Regulatory Regimes - RFP

The professional designation, Registered Financial Planner (RFP), is a professional financial planning designation. The Institute of Advanced Financial Planners grants the designation to financial planners who demonstrate a certain level of competence as demonstrated in their application, and membership is voluntary. It is expected that the RFP designation demonstrates to investors that the financial professional is highly competent and actively practices a comprehensive financial planning process.[285] RFPs, as members of the International Association of Financial Planners, follow a *Code of Ethics* and

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280 *Supra* note 274.
281 CAFP, Code of Professional Ethics Practice Standards Rules and Regulations (July 2002), Canon 1, online: <http://www.cafp.org/pdffiles/ethics-booklet-jul02.pdf>.
282 *Ibid.*, Canon 7.
283 *Ibid.*, Canon 8.
284 *Ibid.*, Canon 10.
285 IAFP, "About the IAFP & RFP", online: <http://www.iafp.ca/content.php?SectionID=1>.

Practice Standards that is very similar to that followed by CFPs,[286] and may suffer similar membership sanctions if provisions are breached.

vi. Criminal and Quasi-Criminal Liability

Financial planners may be liable to charges under the CC and quasi-criminal offences under the securities and corporate legislation discussed above.

[286] RFP, *Code of Ethics*, online: <http://www.iafp.ca/content.php?SectionID=1&ContentID=8>.

11. Venture Capitalists

Venture capitalists (VCs), like directors, can hold great power over the decisions and direction of a growing company. They are in a position to provide oversight and control of the governance of their portfolio companies. Unlike retail investors buying shares, venture capitalists are much more than passive financiers. Rather, they involve themselves in the management, strategic marketing and planning of their portfolio companies in order to foster growth.[287] When investing in companies, VCs negotiate control rights over the company and put into place extensive monitoring and advisory systems.[288] These control and monitoring mechanisms take various forms. One of the most common is for VCs to place their representatives on the board of directors of the portfolio company (perhaps even appointing a majority of the directors). Their involvement can also include frequent informal visits, meetings with customers and suppliers, and active involvement in key personnel and strategic decisions.[289] One study shows that while VCs do not generally involve themselves closely in the day-to-day management of portfolio companies between financing rounds, they do visit companies regularly and receive regular financial reports. Major reviews of progress, due diligence, and the decisions to continue funding are generally done at the time of refinancing.[290] The investigation performed by VCs at these stages in a company's growth provides an opportunity to sound an early warning signal of any governance issues with the company. This can be particularly important near the end of the VC's involvement with the company as preparations are made for an exit strategy.

Much of the existing case law in the area is American, due to the more mature American VC industry. The tendency of these claims to settle before reaching court also leads to a shortage of judicial determinations on the gatekeeper liability of VCs.

i. Venture Capitalists as Directors

The major potential area of liability for VCs arises from the role their representatives take as directors of portfolio companies. Liability will often flow back to the VC, typically through an agreement by the VC to indemnify its representatives.

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[287] National Venture Capital Association, "The Venture Capital Industry: An Overview", online: <http://www.nvca.org/def.html>.
[288] Yael V. Hochberg, "Venture Capital and Corporate Governance in the Newly Public Firm" Cornell University (4 February 2005), online: < http://www.kellogg.northwestern.edu/faculty/hochberg/htm /VCCG.pdf>.
[289] Josh Lerner, "Venture Capitalists and the Oversight of Private Firms" (1995) 50 J. Finance 301 at 302.
[290] Paul A. Gompers, "Optimal Investment, Monitoring and the Staging of Venture Capital" (1995) 50 J. Finance 1461 at 1464-65.

Under corporate legislation, this can open up a director, acting as representative of a VC, to liabilities for breach of the fiduciary duty or duty of care. Directors are also liable for breaches under securities legislation, as discussed above in the section on directors. As discussed above, there are significant substantive and procedural barriers to launching a common law claim against directors for failure to perform their gatekeeping role.

Directors' fiduciary duties are owed to the company, regardless of the other affiliations of the director. To the extent that duties are owed to shareholders, they are owed to all shareholders equally, whether or not the director represents a specific group of investors. A director's fiduciary duty would require that a director not promote or oppose a strategy in order to meet the financial interests of another organization (such as the VC they represent). There is a great potential for conflict in this arrangement. These directors often are members or principals of the general partner of a VC fund, and thus have fiduciary responsibilities to the investors in the VC fund. While in many circumstances the interests of such investors coincide with those of the company and its other shareholders, this is not always the case.[291]

VCs may try to escape directors' liability by not appointing their representatives to the boards of portfolio companies. However, their position of power (because of their control of the purse) and their many rights typically negotiated in their share purchase agreement (including veto rights, approval requirements or even anti-dilution clauses), gives them a great deal of control over any board decisions that are made. In England, the concept of a "shadow director" might be used to prevent exculpation in this manner:

> "A shadow director, by contrast, does not claim or purport to act as a director. On the contrary he claims not to be a director. He lurks in the shadows sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself".[292]

While this concept has not been imported into Canadian law, it was cited and discussed in a case of the Tax Court of Canada, though its application was not relevant to the case and was not determined.[293]

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[291] Robert D. Kraus, "When a venture capitalist is a director "(January/February 2004) 13:3 Business Law Today.
[292] *Re Hydrodam (Corby) Ltd*, [1994] 2 B.C.L.C. 180 at 182.
[293] *Parton v. R.*, 99 D.T.C. 738, 45 B.L.R. (2d) 298, [1999] 2 C.T.C. 2755.

ii. The Oppression Remedy

As discussed above, the oppression remedy exists for cases where the directors fail in their gatekeeping role.[294] One area, which has attracted several high-profile claims in the United States, is in "down-round" financing. When a subsequent round of financing dilutes the holdings of original investors, the relative value of the initial investors' investments may be diminished, leaving the directors open to a claim unless all aspects of the transaction are shown to be completely transparent (creating an independent committee, appointing directors independent of both the VC and other investors, securing approval from all shareholders, and independently validating the terms of the transactions).[295] Although investors may have personal remedies against directors approving of such maneuvers, since oppressive conduct claims can be large, the VC may provide an attractive additional target since it has deep pockets from which to seek recovery.[296] As discussed above, the courts have very broad (basically unlimited) discretion under the corporate statutes to remedy the oppressive conduct, including setting aside any transaction,[297] and ordering any person to compensate an aggrieved party.[298]

iii. Other Regulatory Regimes - Provincial Securities Commissions

The provincial securities commissions' ability to impose administrative sanctions and seek remedial powers of the court as discussed above is applicable.

iv. Criminal and Quasi-Criminal Liability

Depending on the level of misconduct, the VC (as an "organization" as discussed above for underwriters) and/or the VC's representative directors may be liable to charges under the CC and quasi-criminal liability under securities and corporate legislation discussed above.

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[294] See *Brant*, *supra* note 25. In the United States, however, it is recognized that majority shareholders may hold a fiduciary duty towards minority shareholders. See also Jeffrey M. Leavitt, "Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-up Companies" (2005) 6 N. Car. J. L. & Tech. 223 at 238.

[295] Christopher Aidun, "How VCs can Limit their Liability in a Down Round" Venture Capital J. (October 2002) 40 at 43.

[296] David Price & Sara Gerhart, "Already Risky Business" (2003) 108:3 Can. Insurance 27.

[297] See for example, *CBCA, supra* note 12, s. 241(3)(h).

[298] *Ibid.*, s. 241(3)(j).

12. <u>SROs and Industry Bodies</u>

i. Civil Liability

It is possible, but highly unlikely, that investors could have a common law claim in tort against SROs and other industry bodies discussed in this paper for the failure of the gatekeepers they regulate to perform their gatekeeping function. Applying the two-part *Anns/Kamloops* test it is likely that the proximity test could be met: it is foreseeable by SROs and industry bodies that investors will rely on their representations and this reliance is reasonable. However, the second prong of the test - addressing policy considerations - would likely negate the finding of a prima facie duty of care. To the extent that the concern is that the defendant might be exposed to indeterminate liability from an indeterminate class, the concern is even stronger with respect to SROs and industry bodies than with respect to auditors. Like *Hercules,* the claimants are not known to the defendant as a clearly defined class.

In five recent cases, the Supreme Court of Canada, Ontario Court of Appeal and an Ontario trial court have refused to recognize any duty of care owed by a supervising regulatory body to individual members of the public harmed by members of the regulated association or profession.[299] Most recently, in an Ontario case a client of an investment firm (the "Client") applied to add IDA President Joe Oliver, Chairman Terrence Salman and Vice Chairman Kym Anthony as defendants. The Client alleged that the IDA owes a duty of care to the customers of the firms it regulates so as to make the IDA liable to the Client for negligence.[300] The initial application and an appeal of that decision were dismissed. However, the IDA indicates that the plaintiffs are seeking leave to pursue the appeal in the Supreme Court of Canada.[301]

ii. Other Regulatory Regimes - Provincial Securities Commissions

It is possible that the provincial securities commissions' ability to impose administrative sanctions and seek remedial powers of the court as discussed above are applicable.

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[299] *Cooper v. Hobart*, [2001] 3 S.C.R. 537. This case, Canada's landmark decision for regulators' liability, ruled that the regulator does not hold a legal duty of care to the investing public); see also *Edwards v. Law Society of Upper Canada*, [2000] O.J. No. 2085 (C.A) (QL); *Rogers v. Faught,* [2002] O.J. No. 1451 (C.A.) (QL); *Hughes v. Sunbeam Corp*, [2002] O.J. No. 3457 (C.A.) (QL).

[300] *Morgis v. Thomson Kernaghan & Co.*, [2002] O.J. No. 4057 (Sup. Ct.) (QL), aff'd [2003] O.J. No. 2504 (C.A.) (QL) (Madam Justice Ruth Mesbur of the Ontario Superior Court of Justice dismissed Chris Morgis's July 23 application to amend his Kernaghan suit to include the regulator).

[301] IDA, online: <http://www.ida.ca/Files/Policy/IssuesComments/BCSCFinalModel_fr.pdf>.

iii. Criminal and Quasi-Criminal Liability

With the introduction of the Bill C-45 amendments to the CC, and their expansion of the scope of corporate criminal liability, SROs and industry bodies may be exposed to corporate criminal liability. However, it is unlikely that this liability would reach the criminal activity of the gatekeepers they regulate. It is equally unlikely that they would be subject to quasi-criminal liability.

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