

CANADA BUSINESS CORPORATIONS ACT:
INSIDER TRADING

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CANADA BUSINESS CORPORATIONS ACT: INSIDER TRADING*

INTRODUCTION AND BACKGROUND

Insider trading has been described as the purchase or sale of a security of a corporation by an “insider” who has knowledge of confidential information about the corporation that might reasonably be expected to affect materially the value of its securities and that is not known by other security holders or the general public. The definition of an “insider” of a corporation is very broad, and varies depending on the context. It generally includes directors, officers, and significant shareholders of the corporation, as well as others who, in general, may have access to the corporation’s “inside” information.⁽¹⁾

Trading by insiders *per se* is not illegal; most laws governing the issue allow insiders to trade in the securities of corporations with which they have a connection, provided they do not possess material confidential information about the corporation. Insider trading is proscribed, however, when the insider possesses material confidential information that may be used for his or her benefit when trading in the securities of the corporation.

There are a number of reasons why improper insider trading is regulated. Without regulation, insiders could use important inside information to their own advantage and to the disadvantage of outside investors. This could damage the corporation’s reputation and, more important, reduce confidence in the securities market in general.

This note discusses the insider trading provisions of the *Canada Business Corporations Act* (CBCA).

* The original version of this document was prepared by Margaret Smith, formerly of the Library of Parliament.

(1) The precise lists of people deemed to be “insiders” are provided in ss. 126 and 131 of the *Canada Business Corporations Act* (CBCA).

JURISDICTION TO ENACT LAWS RELATING TO INSIDER TRADING

Both the federal and provincial governments have jurisdiction to enact laws relating to insider trading. Provincial jurisdiction is based on the authority to enact laws relating to property and civil rights, while federal jurisdiction is based on the authority of the federal Parliament to create laws regulating federal corporations.⁽²⁾

At the provincial level, insider trading is regulated under provincial corporations laws and securities statutes. Companies incorporated federally under the CBCA are also subject to the insider trading provisions found in that statute. The result is a certain amount of overlap and duplication.

The overlap and duplication of the federal and Ontario insider trading requirements were the subject of a Supreme Court of Canada decision in the early 1980s. In *Multiple Access Ltd. v. McCutcheon*,⁽³⁾ the provisions of the Ontario *Securities Act* allowing compensation for loss suffered as a result of insider trading were held to apply to a federally incorporated corporation, even though the corporation was subject to similar insider trading requirements under federal law. The majority of the Court held that the insider trading provisions of both the *Canada Corporations Act*⁽⁴⁾ and the Ontario *Securities Act* were valid. Writing for the majority, Dickson, J. concluded that the impugned provisions of the *Canada Corporations Act* had a general corporate purpose and a rational, functional connection with company law.

Providing safeguards against the malfeasance of the managers is strictly within what might properly be called the constitution of the company. The proper relationship between a company and its insiders is central to the law of companies and, from the inception of companies, has been regulated by the legislation sanctioning the

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- (2) The *Constitution Act, 1867* does not explicitly give authority to the federal Parliament to make laws governing the creation and regulation of federal corporations. Rather, it explicitly empowers the provincial legislatures to make laws in relation to “the incorporation of companies with provincial objects” (section 92(11)). The equivalent federal power for companies with other than provincial objects has been implied as coming under the federal power to make laws for the “peace, order and good government of Canada” (section 91), and to some extent, the power to regulate trade and commerce (section 91(2)): *John Deere Plow Co. v. Wharton*, [1915] A.C. 330, 18 D.L.R. 353 (P.C.).
- (3) *Multiple Access Ltd. v. McCutcheon*, [1982] 2 S.C.R. 161.
- (4) The *Canada Corporations Act* was the predecessor to the CBCA.

company's incorporation... [T]he impugned provisions of the *Canada Corporations Act* are directed at preserving the integrity of federal companies and protecting the shareholders of such companies; they aim at practices, injurious to a company or to shareholders at large of a company, by persons who, because they hold positions of trust or otherwise are privy to information not available to all shareholders.⁽⁵⁾

The majority of the Court went on to find that the relevant sections of the Ontario *Securities Act* were also a valid exercise of provincial jurisdiction over property and civil rights and that these provisions did not “sterilize the functions and activities of a federal company nor ... impair its status or essential powers.”⁽⁶⁾

Thus, the majority found that insider trading provisions have both corporate law and securities law aspects. Because they considered these aspects to be of roughly equal importance, the majority felt that one did not have to prevail over the other.

The minority of the Court (three judges) took a different view, however. They concluded that the provisions of the Ontario *Securities Act* were constitutionally valid, being directed to regulating the holding and trading of securities in Ontario. The central concern of securities legislation, they observed, was not the constitution of the corporation but rather the regulation of trading in the corporation's securities.⁽⁷⁾ On the other hand, they held that the federal insider trading provisions were not essential to the constitution of a federal corporation, or to its functional aspects and were therefore invalid.⁽⁸⁾

INSIDER TRADING – CANADA BUSINESS CORPORATIONS ACT

Insider trading provisions were first introduced at the federal level in 1970 as part of the *Canada Corporations Act* and subsequently carried over into the CBCA in 1975.

There are three main components of the provisions: civil liability for insider trading, civil liability for tipping, and speculative trading offences.

(5) *Multiple Access Ltd. v. McCutcheon*, p. 179.

(6) *Ibid.*, p. 185.

(7) *Ibid.*, pp. 219–220.

(8) *Ibid.*, p. 224.

A. Civil Liability for Insider Trading

An insider who buys or sells the security of the corporation while possessing knowledge of confidential information that, if generally known, might reasonably be expected to affect materially the value of any of the securities of the corporation, is liable to compensate the person on the other side of the transaction for any damages suffered because of the transaction. As well, the insider is accountable to the corporation for any benefit or advantage received or receivable (sections 131(4) and (5) of the CBCA). In other words, a person who traded the corporation's securities with the insider may sue the insider for losses suffered, and the corporation may sue the insider for profits the insider made, as a result of insider trading.

In this context, the definition of "insider" is very broad. It includes the corporation itself,⁽⁹⁾ a director or officer of the corporation,⁽¹⁰⁾ a shareholder who owns more than 10% of the shares of the corporation, an employee of the corporation, and a person such as the corporation's lawyer or accountant who engages in, or proposes to engage in, any business or professional activity with, or on behalf of the corporation (as well as their employees).

If someone received confidential information while an insider, but subsequently ceased to hold his or her position in respect of the corporation (e.g., stopped being a director, officer or employee of the corporation), that person continues to be an insider as long as the information is not generally known. As well, even a completely unrelated person will become an insider of the corporation if that person receives the material confidential information (i.e., gets a "tip") from an insider and knows, or ought reasonably to know, that the information came from an insider⁽¹¹⁾ (sections 131(1), (3) and (3.1) of the CBCA).

The definition of "security" is also very broad. It includes any financial instrument of the corporation traditionally defined as a security (e.g., a share or bond), as well as a put, call, option or other right or obligation to buy or sell a security of the corporation⁽¹²⁾ (section 131(2)).

(9) It also includes an affiliate of the corporation.

(10) It also includes a director or officer of (a) any affiliate of the corporation; (b) a shareholder who holds more than 10% of the shares of the corporation; and (c) a person who engages in, or proposes to engage in, any business or professional activity with, or on behalf of, the corporation.

(11) Others are deemed to be insiders of the corporation for certain purposes in the context of a proposed take-over bid or business combination. See ss. 131(3) and (3.1) of the CBCA.

(12) As well, in a situation where the market price of the securities of another entity varies materially with the market price of the securities of the corporation, the securities of that other entity also are deemed to be securities of the corporation for the purposes of the insider trading rules.

A court that finds that someone engaged in insider trading can assess any measure of damages it considers relevant in the circumstances. However, if the corporation's securities are publicly traded, the court must consider how much money the plaintiff lost based on the transaction price for the securities and the average market price of the securities over the 20 trading days immediately following disclosure of the confidential information (section 131(8)).

The CBCA provides exceptions in certain circumstances. For example, if, when the insider traded the securities of the corporation, he or she reasonably believed that the confidential information had been generally disclosed, then the insider will not be liable for insider trading. Other exceptional circumstances are also set out in the CBCA and regulations.⁽¹³⁾

B. Civil Liability for Tipping

“Tipping” refers to an insider disclosing material confidential information to someone else for them to use. An insider may not tip their family members, friends, or anyone else to give them an advantage in deciding whether to buy or sell securities of the corporation. If an insider does provide a tip to an otherwise unrelated person (the “tippee”), the insider is liable to compensate any person who subsequently enters into a transaction with the tippee involving the corporation's securities. The insider may also be accountable to the corporation for any benefit or advantage received or receivable by the insider for disclosing the information to the tippee (sections 131(6) and (7)).

In addition, as mentioned above, if the tippee knows, or ought reasonably to know, that they received a tip from an insider, then the tippee also becomes an insider of the corporation subject to civil liability if he or she engages in insider trading or further tipping (section 131(1)(h)).

In tipping cases, damages are measured in the same way as for insider trading cases, and similar exceptions are provided in circumstances where, for example, the person giving the tip thought that the confidential information had been generally disclosed.

(13) See CBCA, s. 131(4), as well as the *Canada Business Corporations Regulations*, s. 42.

C. Speculative Trading Offences

The CBCA also includes two offences to prevent an insider from making a profit from a decrease in the value of the corporation's securities, which would put the insider into a direct conflict of interest.⁽¹⁴⁾ Unlike insider trading and tipping described above, an insider need not have knowledge of any corporate confidential information in committing one of these offences.

It is an offence for an insider to sell securities of a distributing corporation⁽¹⁵⁾ that the insider does not own or has not fully paid for (short selling) (section 130(1)). The CBCA provides an exception for an insider who owns another security that is convertible into the security sold, or an option or right to acquire the security sold, if the insider exercises the conversion, option or privilege and transfers the security to the buyer within 10 days of the sale (section 130(3)). It is also an offence for an insider to sell a call or buy a put⁽¹⁶⁾ in respect of a security of the corporation (section 130(2)).

For the purposes of these speculative trading offences, the definition of insider is much narrower than that used for general insider trading and tipping. "Insider" includes a director or officer of a distributing corporation or a related corporation, as well as an employee of the distributing corporation (section 126(1)).⁽¹⁷⁾

(14) Insiders, such as directors and officers of the corporation, are supposed to be working to make the corporation profitable for the shareholders. If an insider were in a position to gain personally from a decrease in the value of the corporation's securities, the insider would be in a conflict of interest.

(15) In general, a "distributing corporation" is a corporation whose securities have been part of a distribution to the public, remain outstanding and are held by more than one person.

(16) A "call" or a "put" in respect of a security of a corporation is a financial contract between the buyer and the seller of the call or put. For a call, the buyer buys the right, but not the obligation, to purchase the security from the seller within a certain time in the future at a stated price. For a put, the buyer buys the right, but not the obligation, to require the seller to purchase the security from the buyer within a certain time in the future for a stated price.

(17) More precisely, "insider" means:

- a) a director or officer of a distributing corporation;
- b) a director or officer of a subsidiary of a distributing corporation;
- c) a director or officer of a body corporate that enters into a business combination (i.e., acquisition, amalgamation or other similar reorganization) with a distributing corporation; and
- d) a person employed or retained by a distributing corporation. (CBCA, s. 126(1)).

Further provisions deem others to be insiders as well (CBCA, s. 126(2)).

An insider who commits a speculative trading offence under the CBCA is liable to a fine of up to three times the profit made, or \$1 million, whichever is greater; or to imprisonment for up to six months; or both (section 130(4)).

CRIMINAL AND PROVINCIAL LAWS

The *Criminal Code* also includes insider trading provisions.⁽¹⁸⁾ Under section 382.1, insider trading carries a penalty of up to 10 years' imprisonment. Tipping may be punished by up to five years' imprisonment. Note, however, that the definitions of insider, insider trading and tipping are slightly different in the criminal context than they are in the civil context.⁽¹⁹⁾

As discussed earlier in this paper, the provincial governments also have jurisdiction to enact laws relating to insider trading, and they have done so. Provincial business corporations statutes regulate insider trading in respect of provincially incorporated companies, which are not subject to the CBCA. In addition, provincial securities legislation provides a tertiary layer of insider trading regulation for all companies subject to these Acts, regardless of where they were incorporated.

A detailed description of the types of insider trading prohibitions contained in provincial legislation is beyond the scope of this paper. However, one notable difference that merits mention is that most provinces' securities legislation requires insiders to file insider reports. Insider reports, which are publicly available, disclose an insider's ownership of, or control over, securities of the corporation, as well as any changes in that ownership or control.

For the purposes of the insider reporting obligation, insider generally means a director, senior officer or a significant security holder of the corporation.

Insider reports must be filed within 10 days from the date a person becomes an insider of a reporting issuer⁽²⁰⁾ if the person holds securities of the reporting issuer, and then within 10 days after any trades or other changes in the person's securities holdings.⁽²¹⁾

(18) These provisions were enacted in 2004 (S.C. 2004, c. 3, s. 5).

(19) See s. 382.1 of the *Criminal Code* for a precise statement of what constitutes the criminal offences of insider trading and tipping.

(20) A reporting issuer is a corporation that has issued securities and is subject to reporting obligations under provincial securities legislation.

In most cases, insider reports may be filed electronically over the Internet using the System for Electronic Disclosure by Insiders (SEDI), a national insider reporting system. The public may search and look at information filed on the SEDI website.⁽²²⁾

Until 2001, the CBCA also included an insider reporting requirement. This was repealed to eliminate duplicative filing requirements when the CBCA was amended significantly in 2001 by Bill S-11.⁽²³⁾

(21) Certain exemptions may allow an insider to report changes in holdings later. An example would be changes resulting from an automatic share purchase plan.

(22) SEDI (System for Electronic Disclosure by Insiders) website: <https://www.sedi.ca/>.

(23) *An Act to amend the Canada Business Corporations Act and the Canada Cooperatives Act and to amend other Acts in consequence*, S.C. 2001, c. 14.