# Johnston

# Canadian Securities Regulation

Canadian Legal Text Series

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# Preface

This book is intended to provide a broad description and analysis of the principal features of securities regulation in Canada. It concentrates primarily on the provincial securities acts and the administrative agencies responsible for those acts and, within that group, on the Ontario Securities Act and the Ontario Securities Commission.

The book is not intended to be an exhaustive analysis of each provincial securities act although major differences are usually noted. The major reason for the paramount focus on Ontario is simply that I am more familiar with this jurisdiction than the legislation and its administration elsewhere. Moreover since the major reforms in securities regulation over the last two decades have frequently been initiated in Ontario and the most current reform bill, The Securities Act, 1977 (Bill 20), is presently before the Ontario Legislature, this jurisdiction is a useful starting point. I must be quick to add, however, that the other major jurisdictions have usually contributed significantly to the other Ontario reforms and followed with uniform legislation.

In an area of law which has experienced as much change as securities regulations recently it is impossible to fix a precise date from which point of time the book speaks. In general I have tried to analyze the legislation in effect and jurisprudence as at the commencement of 1976 although some of the major cases decided in early 1976 have been considered as well. A substantial portion of the book is given over to Ontario Bill 20, The Securities Act, 1977 which received first reading on April 5, 1977 and thus the analysis of reform initiative dates from this point in time. The index to all the reported decisions of the Ontario, Quebec and British Columbia Securities Commissions are complete from the beginning of publication of the reports to mid 1975.

I am indebted to a remarkable group of friends — students, colleagues at the University of Western Ontario and University of Toronto law faculties and the Ontario Securities Commission and working associates — who have made this book possible. Since I can never truly repay this debt with an appropriate description of their assistance I do not more than mention them here: Marion Morris and Kathryn O'Rourke laboured like saints with the typing of many drafts. Valerie McGarry, Fred Baxter, David Jackson, John Layton, Ronald McCloskey, Peter Mercer, Leslie Rose and Brent Swanick toiled with uncommon zeal on the background research, the preparation of numbers of manuscripts and indexing the cases. Shirley Hinterauer edited the final manuscripts with industry and intelligence in cheerful combination.

I owe a special debt to two of my colleagues on the Ontario Securities Commission — Harry Bray and Stanley Beck — with whom I also shared duties as a member of the drafting committee for the new Ontario securities legislation. They have been generous as they have been patient and stimulating in sharing their enormous fund of knowledge and experience. And in the best traditions of friendship they were always willing to return to first principles in educating their colleague. Persons interested in securities regulation in Canada will recognize the special acknowledgement to Professor John Willis whose contribution to administrative law in Canada is the stuff of which legend is made and whose insights into securities legislation — which he shared so enthusiastically with me before I had the honour to succeed him on his retirement from the Ontario Commission — always reflected his profound and pervasive wisdom and his sparkling candour. May I finally record in these tributes my gratitude to the Canada Council, the Ontario Law Foundation and the law faculties of the universities of Toronto and Western Ontario for welcome financial assistance with the research.

And having made full true and plain disclosure of my intellectual debts in the traditions of securities regulation, I leave two formal caveats to the end. First, the responsibility for errors is, of course, mine. Secondly, although I am a member of the Ontario Securities Commission the views expressed herein are mine alone and should not be taken to reflect views of the Commission.

D. L. JOHNSTON
London, Ontario
April, 1977

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# Chapter 1
# Philosophy and Scope of Regulation

## A. Philosophy of Regulation

### 1.01 Purpose

The traditional goal of securities regulation has been the protection of the investor. That statement has an appeal which is misleading in its simplicity. It focuses on only one of a number of parties to a securities transaction. Moreover, it fails to reflect the fact that the goal of protection must be achieved while taking into account a diverse range of other objectives, some of which compete with one another.

We may begin by observing that the political system which erects laws for the protection of the investor operates on the basis of a number of implicit assumptions. These may not receive the same public emphasis as investor protection but nonetheless must be taken as a "given" by any regulatory framework. Two current examples in Canada are: first, investor protection is to be achieved without an excessively heavy burden of cost or rigidity; secondly, an element of risk for private capital, with an attendant chance of loss or failure, is an inherent feature of our national economy to which both investors and business enterprises must consider themselves subject.

Besides the goal of protection, with its somewhat negative tendency to repress and restrict, the regulatory thrust is expressed positively in the attempt to ensure that Canadian capital markets operate efficiently and fairly and command a full measure of public confidence.[1]

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[1]For some recent studies of Canadian capital markets with particular emphasis on the securities industry see (complete citations in Appendix I): Atlantic Acceptance Report (Hughes Report); J.C. Baillie, "The Protection of the Investor in Ontario"; Bouchard Report, Interim 1971, Final 1972; G.R. Conway, *The Supply of, and Demand for, Canadian Equities*; D.H. Fullerton, *The Bond Market in Canada*; Gordon Report; OSC Industry Ownership Report; Kelly Report; Kimber Report; Law Society of Upper Canada Special Lectures, 1972; OSC Merger Report; Moore Report; Mutual Funds Report; E.P. Neufeld, *The Financial System of Canada*; Parizeau Report; J.R. Peters, *Economics of the Canadian Corporate Bond Market*; Porter Report; D.C. Shaw and R.T. Archibald, *The Management of Change in the Canadian Securities Industry*, especially study one, "Canada's Capital Market"; J.P. Williamson, *Securities Regulation in Canada*, 1960, and 1966 Supplement; *Studies in Canadian Company Law*, J.S. Ziegel ed., Vol. 1 (1967), Vol. 2 (1973).

An analysis of the conditions necessary to achieve this goal of capital market efficiency discloses three requirements which have particular relevance to securities regulation.[2] First, the system of regulation should encourage the most rational and sensible allocation of financial resources. Throughout Canadian history economic development has held a high priority. Domestic financial resources have been comparatively meagre. The resulting tension between supply of and demand for capital has underlined the need to ensure that financial resources are distributed prudently among different growth sectors of the economy which compete for priority.[3]

The second of the three requirements is the mobility and transferability of capital. It is important that an investor with financial resources at his disposal should be able to convert them from one form into another with a minimum of obstruction and expense. Thus, as our system presently operates, an investor with cash in hand today may purchase a share in a corporation tomorrow, knowing that in a week's time he may sell that share and apply the proceeds to the purchase of a government bond, all with minimal transfer costs and delays.

Thirdly, the goal of efficiency requires a permanent framework for the realistic pricing or evaluation of investments. Traditionally this is provided in a market economy by bringing the forces of supply and demand together in as concentrated a manner as possible and with the fullest possible current information available to the participants.

So much for the goal of efficiency. The objective of increasing and maintaining public confidence in the persons and institutions operating in the capital markets is less directly linked to the goal of efficiency than the protection of the investor. The methods employed to this end in recent years have included an attempt to ensure the honesty and competence of traders, the promulgation of rules and norms which achieve fairness and accord with the public interest and the enforced disclosure of information about issuers on terms which make it equally accessible to all investors. A concurrent objective has been to encourage more individuals to own investment securities; the assumption is that the participation by a wider group of Canadians in the ownership of the economy (a kind of "people's capitalism", as it were) will have a broadly beneficial effect from both a social and a political standpoint.

Finally, there is the objective of directing the speculative interest of Canadians into an arena that produces a significant return to the economy as a whole. It is assumed that certain individuals are willing to risk their money freely in the hopes of substantial gain, though fully cognizant of the chance of loss. It has been considered sensible to channel the funds so made available into speculative stock. This use

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[2]Kimber Report, para. 1.06.

[3]See, for example, the OSC Industry Ownership Report, which dealt with the twin issues of foreign ownership and public ownership of the Canadian securities industry. In assessing Canada's future capital needs in terms of supply to demand, it noted (para. 3.03) the conclusion of the Economic Council of Canada that annual expenditures on new plant and equipment should increase by 5.8 per cent annually during the 1970's in order to sustain satisfactory economic growth.

of the money involves at least the possibility of generating a productive business enterprise, in contrast to encouraging lotteries or other forms of gambling; the latter activities have not (traditionally at any rate) had the popularity in Canada which they enjoy in some other countries. Much of the effort by regulators in this speculative area has been to ensure that the game is played with a minimum degree of honesty.

These varied objectives outlined above are better understood by looking at the techniques of securities regulation.

### 1.02 Techniques of Securities Regulation

There are three basic regulatory techniques traditionally used in Canadian securities law. These are anti-fraud measures, registration of persons and of institutions, and registration of securities.[4]

Anti-fraud measures define fraudulent or otherwise wrongful conduct, provide civil or criminal penalities for engaging in such conduct, and create investigatory and enforcement tools to identify and suppress it. They are essentially prophylactic or preventative and usually not directly remedial. Their very presence is expected to deter, presumably in direct proportion to their effectiveness in application. An attempt is made by such measures to combat illicit activity before it has had time to achieve its objective or become well established; or at any rate to minimize damaging consequences. But what is not always realized is that anti-fraud measures only apply to wrongful conduct after it has clearly manifested itself and usually only after some loss or damage has occurred.

The registration or licensing of persons and of firms or institutions[5] participating in the securities industry is designed to ensure that active participants in the business have achieved a minimum standard of honesty, good reputation and competence, and maintain that

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[4]This conceptual framework is fully described in the seminal U.S. treatise, Loss, *Securities Regulation*, 6 vols., 3rd ed. (1960) and supplement (1969) (hereinafter cited: Loss), vol. 1, p. 33 and following.

[5]This rather awkward designation "persons and firms or institutions" is necessary because the definition of person does not include a corporation, in the Ontario Securities Act, R.S.O. 1970, c. 426 (hereinafter in the text itself and footnotes referred to as "the Act"). It includes (s. 1(1)12; s. 1(1)27 in Bill 20) "an individual, partnership, unincorporated association, unincorporated organization, unincorporated syndicate, trustee, executor, administrator or other legal personal representative". "Company" on the other hand is defined (s. 1(1)4) as "any incorporated corporation, incorporated association, incorporated syndicate or other incorporated organization." These terms will be used throughout and will have the meanings given to them by the Act when precision so requires, but normally "registration of persons" should be taken to mean the licensing of persons, firms and institutions. In *Re Skynner Lake Gold Mines Ltd.*, [1947] O.W.N. 945, [1948] 1 D.L.R. 540 (C.A.), the court permitted a corporation to appeal an OSC decision even though the Act gave the right only to a "person"; it reasoned somewhat generously that the legislature intended to give the word "person" a broader meaning when used in relation to appeals than that contemplated in the definition section.

competence together with observing minimum standards of fair dealing.[6]

More recently, the factor of competence—measured by standards which have been set progressively higher—has received growing emphasis, as the industry has achieved a professional identity. Under the ordinary registration procedure, an individual must apply for and receive a licence from the appropriate regulatory authority before engaging in some segment of the securities business. He must give evidence of competence and integrity, which must be maintained at a satisfactory level as he is expected to renew the licence on a periodic basis. In some instances the applicant must submit to an examination of his past record. The licence may be revoked temporarily or permanently if he falls below the standards as declared and amended from time to time.

The registration of firms or institutions is slightly more complex. The basic structure of regulation is the same, but the requirements embrace not only the competence and integrity of the human participants (which include in this area the capacity of senior persons to supervise employees), but also attempt to import a uniform set of standards with respect to operational strength and stability of the firm. Furthermore the ultimate sanction of the removal of recognition of the institution is weightier in the case of a firm because the consequences may impinge upon a great number of people—employees, customers and perhaps even the industry in general.

The third regulatory technique involves the registration of securities. In Canada this approach relies heavily on disclosure of information, but it encompasses a broad spectrum of administrative discretion which is not confined to requiring the release of pertinent data. A useful overview of this technique is provided by a survey of the various ways it can be used (by no means exclusive of one another) at the time of an initial issue of securities. At one end of the spectrum is mere notification. Here the obligation on an issuer is simply to notify a regulatory agency on or before the time of issue. The degree of disclosure may be minimal or somewhat more substantial, depending upon the amount of detail about the issue which must be contained in the notification statement. The effectiveness of such disclosure is in turn dependent on how the content of the statement is made available to the potential investor. There is a considerable difference between keeping the information in private files of the regulatory agency and making it available on a public file so that any interested person may have access to it; most effective of all is the requirement that data be disseminated in a document circulated to offerees.

Moving away from this purely passive form of registration one soon encounters the concept of "qualification". This essentially means that

[6]The classic and oft-quoted statement of the first two items in this list of objectives belongs to Lord Atkin in *Lymburn v. Mayland*, [1932] A.C. 318 at p. 324, [1932] All E.R. Rep. 291, [1932] 2 D.L.R. 6 (P.C.): "There is no reason to doubt that the main object sought to be secured in this part of the Act [registration of persons] is to secure that persons who carry on the business of dealing in securities shall be honest and of good repute, and in this way to protect the public from being defrauded."