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CLASS ACTION DECISION CONSIDERS SECONDARY MARKET MISREPRESENTATION ACTIONS

— Michael Beeforth. © Dentons Canada LLP.

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On July 25, 2013, Justice Belobaba of the Ontario Superior Court of Justice released his decision (2013 ONSC 4083) certifying a proposed class action brought by the Ironworkers Ontario Pension Fund against Manulife Financial Corp. and two of its former executives, Dominic D'Alessandro (CEO) and Peter Rubenovitch (CFO). Belobaba J. also granted the plaintiffs leave to commence an action for secondary market misrepresentation under s. 138 of the Ontario *Securities Act*, R.S.O. 1990, c. S.5 (the "Act").

Background

In early 2004, Manulife added a number of new guaranteed investment products (the "Guaranteed Products") to its array of segregated funds. Unlike most of its older products, Manulife decided that the Guaranteed Products would not be hedged or reinsured — any risk of equity market fluctuations would be borne entirely by Manulife. The Guaranteed Products were very successful, growing Manulife's business from approximately $71 billion in early 2004 to approximately $165 billion by the end of 2008. However, almost all (if not completely all) of that business was unhedged and uninsured. When the global financial crisis hit in the fall of 2008 and the Canadian and American equity markets fell by more than 35%, Manulife was badly overexposed.

On February 12, 2009, Manulife released its 2008 annual financial statements which disclosed that corporate profits had fallen by almost $3.8 billion from the previous year ($2 billion of which was attributable to the Guaranteed Products line) and EPS had dropped from $2.78 to $0.32. The statements also noted that Manulife had increased its reserves from $576 million at year-end 2007 to $5.783 billion because of its unhedged exposure to the equity markets. Investors reacted immediately: Manulife's share price dropped 6% on the date it released its financial statements, fell a further 37% over the following ten days and, by the end of Manulife's Q1 2009, was trading at $8.92, a 77% decline from its $38.28 trading price six months earlier.

The plaintiffs commenced a proposed class action in July 2009 based on claims of negligence, negligent misrepresentation, unjust enrichment and the secondary market liability provision of the Act. The plaintiffs alleged that while Manulife was entitled to make a business decision not to hedge or reinsure its equity market risk, it had a legal obligation to fully and fairly disclose to investors its decision to abandon such techniques and the resulting risks. The plaintiffs further alleged, among other things, that Manulife consistently misrepresented in its core disclosure documents that it had in place "effective, rigorous, disciplined and prudent" risk management systems, policies and practices.

Discussion

In certifying the action as a class proceeding and granting leave to pursue a s. 138 claim, Belobaba J. focused on two aspects integral to asserting the statutory cause of action: the test for leave to pursue such a proceeding, and the requirement under the *Class Proceedings Act*, S.O. 1992, c. 6, that the pleadings disclose a cause of action.

Leave Test under Section 138.8(1) of the Act

Belobaba J. discussed at some length the uncertainties surrounding the second branch of the leave test set out at s. 138.8(1) of the Act: that is, that there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff.[1] In Ontario, class action judges have consistently treated the "reasonable possibility" threshold as a relatively low standard, holding that the plaintiff must simply show, based on a reasoned consideration of the evidence, that there is something more than a *de minimis* possibility of success at trial. On the other hand, courts in British Columbia have viewed the test as a higher standard which is intended to do more than screen out clearly frivolous, scandalous or vexatious actions.

Belobaba J. pointed out that while his opinion was more consistent with the latter interpretation, the debate may have been decided in favour of the more lenient interpretation by the Supreme Court of Canada's recent decision in *R. v. Imperial Tobacco Canada*, 2011 SCC 42. In that decision, the Supreme Court held that under the strike-pleadings rule — which allows a claim to be struck if it is plain and obvious, assuming the facts as pleaded to be true, that the pleading discloses no reasonable cause of action — one must only show a "reasonable prospect of success", which amounts to the same thing as a "reasonable possibility of success" and may effectively render the test under s. 138.8 of the Act a *de minimis* threshold (as articulated by the Ontario courts). In any event, Belobaba J. held that he would have come to the same conclusion in favour of the plaintiffs under either interpretation of the test.

Certification under *Class Proceedings Act*

In certifying the action as a class proceeding, Belobaba J. addressed Manulife's argument that the pleadings did not disclose a cause of action claim in respect of the s. 138 claim because the action was not commenced within three years of the alleged misrepresentations (as required by s. 138.14 of the Act and the Ontario Court of Appeal's decision in *Sharma v. Timminco Ltd*., 2012 ONCA 107).

While *Timminco* is currently under review by a five-member panel of the Court of Appeal, Belobaba J. agreed with Manulife that he is bound by the current state of the law. However, he also agreed with the plaintiffs' position that *Timminco* did not deal directly with the court's jurisdiction to grant leave *nunc pro tunc*, and that case law subsequent to *Timminco* has held that the limitation period in s. 138 of the Act is subject to the special circumstances doctrine (which provides a limited jurisdiction to make orders *nunc pro tunc* that have the effect of reviving a statute-barred cause of action[2]). On this basis, Belobaba J. concluded that he could not say that it is plain and obvious that the limitation period defence applies and the statutory claim is certain to fail.

Conclusion

Justice Belobaba's decision, while uncontroversial in its application of current legal principles, stands as an interesting commentary on future potential developments regarding the threshold to be applied in the test for leave under s. 138 of the Act. Indeed, in light of *Imperial Tobacco*, it *may be inevitable that a lower standard emerges which, in Belobaba J.'s* words, renders the test for leave "nothing more than a speed bump". It remains to be seen in future case law whether his premonition proves true.

Notes:

[1] Belobaba J. held that the first branch — that the action is being brought in good faith — was easily satisfied based on the plaintiffs' argument and content of their expert reports.

[2] See, e.g., *Millwright Regional Council of Ontario Pension Trust Fund v. Celestica Inc.*, 2012 ONSC 6083 at para. 85.

CANADIAN SECURITIES ADMINISTRATORS

CSA Reviews Proxy Voting Infrastructure

The CSA has issued a consultation paper to outline and seek feedback from issuers, investors and other stakeholders on a proposed approach to address concerns regarding the integrity and reliability of the proxy voting infrastructure. The CSA has identified two issues that they intend to examine further because they have the most potential to impact the ability of the proxy voting infrastructure to function accurately and reliably. These issues are: (1) Is accurate vote reconciliation occurring within the proxy voting infrastructure?; and (2) What type of end-to-end vote confirmation system should be added to the proxy voting infrastructure?

Written comments are requested by November 13, 2013. For further information, please refer to CSA Consultation Paper 54-401, reproduced in Volume 1 of the *Canadian Securities Law Reporter* at ¶5471.

CSA Regulators Enter Into MOU With MFDA

The Ontario, British Columbia, Alberta, Saskatchewan, Manitoba, New Brunswick, Nova Scotia, and Prince Edward Island securities regulators have entered into an memorandum of understanding ("MOU") to promote a more effective and efficient system of oversight of the MFDA and to formalize current cooperation among the recognizing regulators ("RRs"). The MOU provides a comprehensive framework with respect to the coordination of the oversight reviews and activities of the MFDA by the RRs, and it sets out an agreed communication process with the MFDA, and establishes uniform procedures, in the form of a Joint Rule Protocol, relating to the review and approval of or non-objection to rule changes proposed by the MFDA, including resolving disagreement about rule changes. The MOU has been reproduced in Volume 1A of the *Canadian Securities Law Reporter* at ¶80-467.

CSA to Transition to New National Systems Service Provider

The CSA has provided additional information on the transition process to the new CSA National Systems service provider, CGI Information Systems and Management Consultants Inc. ("CGI"). On October 12, 2013, CGI will assume responsibility for the hosting, operation, and maintenance of the System for Electronic Document Analysis and Retrieval ("SEDAR"), the System for Electronic Disclosure by Insiders ("SEDI"), and the National Registration Database ("NRD"). The implementation cutover will occur over the weekend of October 12; during that time, the systems will not be available to market participants. For further information, please refer to the OSC's website.

TSX VENTURE EXCHANGE

Policies 1.1, 2.1, 4.1, 4.6, 5.1, and 5.8 Replaced

The amendments to the Policies have been incorporated in Volume 2 of the *Canadian Stock Exchanges Manual*, starting at ¶2300-001.

NEX Policy Replaced

The amendments to the Policy have been incorporated in Volume 2 of the *Canadian Stock Exchanges Manual* at ¶2700-001.

MONTREAL EXCHANGE

List of Fees Replaced

The amendments to the List of Fees have been incorporated in Volume 2 of the *Canadian Stock Exchanges Manual* at ¶3500-501.

PROVINCIAL UPDATES

British Columbia

Notice 2013/06, Advance Notice of Multilateral Instrument 13-102 *System Fees for SEDAR and NRD* and related consequential amendments was added August 29, 2013. The new notice has been incorporated at ¶223-005 in Volume 2 of the *Canadian Securities Law Reporter*.

New Brunswick

Amendment Instrument to National Instrument 41-101 *General Prospectus Requirements* was added at ¶330-088a in Volume 3 of the *Canadian Securities Law Reporter*.

Changes to Companion Policy 41-101CP to *National Instrument 41-101 General Prospectus Requirements* was added at ¶330-088b in Volume 3 of the *Canadian Securities Law Reporter*.

Changes to National Polity 41-201 *Income Trusts and Other Indirect Offerings* was added at ¶330-089a in Volume 3 of the *Canadian Securities Law Reporter*.

Amendments to National Instrument 44-101 *Short Form Prospectus Distributions* was added at ¶330-094b.1 in Volume 3 of the *Canadian Securities Law Reporter*.

Changes to Companion Policy 44-101CP to *National Instrument 41-101 Short Form Prospectus Distributions* was added at ¶330-094b.2 in Volume 3 of the *Canadian Securities Law Reporter*.

Amendment Instrument to National Instrument 44-102 *Shelf Distributions* was added at ¶330-094c.2 in Volume 3 of the *Canadian Securities Law Reporter*.

Changes to Companion Policy 44-102CP to *National Instrument 44-102 Shelf Distributions* was added at ¶330-094c.3 in Volume 3 of the *Canadian Securities Law Reporter*.

Amendment Instrument to National Instrument 44-103 *Post-Receipt Pricing* was added at ¶330-094d.1.1 in Volume 3 of the *Canadian Securities Law Reporter*.

Changes to Companion Policy 44-103CP to *National Instrument 44-103 Post-Receipt Pricing* was added at ¶330-094d.1.2 in Volume 3 of the *Canadian Securities Law Reporter*.

Changes to National Policy 47-201 *Trading Securities Using the Internet and Other Electronic Means* was added at ¶330-154 in Volume 3 of the *Canadian Securities Law Reporter*.

Ontario

OSC Staff have launched a broad review of the exempt market to consider whether the Commission should propose any new prospectus exemptions that would facilitate the raising of capital for business enterprises, especially start-ups and small and medium-sized enterprises, while protecting investors' interests. The Commission has issued a notice to provide an update on the progress of the review and to set out the Commission's direction to Staff on appropriate further work. For further information, please refer to OSC Notice 45-712, which will be reproduced in Volume 3A of the *Canadian Securities Law Reporter* at ¶490-570b in a future report.

RECENT CASES

OSC Panel Confirmed IIROC Hearing Panel Decision

Ontario Securities Commission, July 19, 2013

Staff ("IIROC Staff") of the Investment Industry Regulatory Organization of Canada ("IIROC") brought allegations of failure to comply with Universal Market Integrity Rules ("UMIR") against TD Securities Inc. ("TDSI"), Kenneth Nott ("Nott"), Aidin Sadeghi ("Sadeghi"), Christopher Kaplan ("Kaplan"), Robert Nemy ("Nemy"), and Jake Poulstrup ("Poulstrup"). (Nott, Sadeghi, Kaplan, Nemy, and Poulstrup, who were proprietary traders in TDSI's Trade Execution Group, collectively, the "TDSI Traders".) In a decision of a hearing panel of IIROC's Ontario District Council (the "IIROC Hearing Panel") released on November 30, 2010 and revised on April 30, 2011 (the "Decision"), pursuant to the Ontario *Securities Act* (the "Act"), the IIROC Hearing Panel found that, from May 2005 to October 2005, the TDSI Traders entered artificial closing bids, contrary to UMIR Rule 2.2 and Policy 2.2. However, the IIROC Hearing Panel dismissed allegations that TDSI failed to comply with its trading supervision obligations, contrary to UMIR Rule 7.1 and Policy 7.1. The IIROC Hearing Panel found that, during the period in question, TDSI implemented written policies and procedures that covered its entire business in order to comply with UMIR Rules and Policies, including those governing market manipulation. The IIROC Hearing Panel also noted that TDSI's supervision and compliance system was consistent with industry standards and practice. IIROC Staff subsequently applied (the "Application") to the Ontario Securities Commission (the "Commission") for a hearing and review of the Decision.

The Application was dismissed. The Panel considered the following issues:

- What was the Commission's jurisdiction to intervene in this matter?
- Were there grounds for the Commission to intervene in the Decision?
- Did the IIROC Hearing Panel overlook or misapprehend material evidence? Specifically, did the IIROC Hearing Panel: (a) overlook evidence that TDSI was not adequately reviewing for artificial closing bids; (b) overlook evidence that TDSI condoned or encouraged the entry of artificial closing bids; and (c) misapprehend evidence of TDSI representatives regarding what they considered to be manipulative (or indicia of manipulative) activity?
- Did the IIROC Hearing Panel err in law?

The Panel found that, under the Act, the Commission has the authority to hold a hearing and review of a decision of a recognized self-regulatory organization ("SRO") such as the IIROC and may confirm the decision under review or make another decision that the Commission considers proper. The grounds upon which the Commission may intervene in a decision of an SRO were set out in *Re Canada Malting Co*. (1986), 9 OSCB 3587 ("*Canada Malting*"). These grounds included that: the SRO proceeded on an incorrect principle, erred in law, or overlooked material evidence; new and compelling evidence was presented to the Commission that was not presented to the IIROC Hearing Panel; or the IIROC Hearing Panel's perception of the public interest conflicted with the Commission's. An applicant has to establish that its case fits within one of these grounds before the Commission will intervene.

Regarding whether the IIROC Hearing Panel overlooked or misapprehended material evidence, the Panel rejected the allegation that the IIROC Hearing Panel did not address the evidence of how TDSI's "random review approach" failed to detect artificial closing bids. The Panel noted that the Decision included an analysis of TDSI's entire supervisory structure, and it addressed how the artificial bidding behaviour could have passed undetected. Further, the Panel rejected the allegation that the IIROC Hearing Panel overlooked evidence that TDSI condoned or encouraged the entry of artificial closing bids that were in the context of the market. The Panel found that the IIROC Hearing Panel dealt with the allegation that the TDSI supervisors condoned the artificial bidding and considered the evidence relied on by IIROC Staff. The Panel also concluded that it did not find that IIROC Staff's argument concerning the position that TDSI took before the IIROC Hearing Panel relevant to its evaluation of the Decision and its treatment of the evidence. Regarding the last issue, the Panel held that the IIROC Hearing Panel did not err in law nor proceed on an incorrect principle when it dismissed the allegations against TDSI. The IIROC Hearing Panel considered the policies and procedures in place at TDSI and the requirements of UMIR Rule 7.1 and Policy 7.1, taking the standards of the industry into account. The Panel also found that the IIROC Hearing Panel did not err in finding that the TDSI Traders breached UMIR Rule 2.2 and Policy 2.2 while not making a corresponding finding against TDSI for its failure to supervise the TDSI Traders. As the Panel noted, the IIROC Hearing Panel recognized the multiple components in TDSI's system of supervision and found them to be adequate.

Re TD Securities Inc., 2013 CSLR ¶900-505

Material Change Disclosure

British Columbia Securities Commission, August 7, 2013

Andrew Lee Smith ("Smith"), Randy Smallwood ("Smallwood"), David Parsons, and Brian Lock were all directors of Canaco Resources Inc. ("Canaco"; the individuals and Canaco collectively, the "Respondents"), a reporting issuer under the British Columbia *Securities Act* (the "Act"). Smith was also Canaco's president, chief executive officer, and its "qualified person" under National Instrument 43-101 *Standards of Disclosure for Mineral Projects*. Canaco had no revenue and its focus was mineral exploration. It began drilling in Magambazi, Tanzania in September 2009. By July 2010, Canaco had drilled 66 holes and, in a news release that month, Canaco stated that hole 66 confirmed the presence of "a core of thick, high grade gold mineralization as a component of the Magambazi Main Lodes". In September 2010, Canaco had drilled 82 holes and, via a news release, stated that hole 79 proved "the continuity of the Magambazi Main Lode". Canaco also engaged in infill drilling (holes drilled in the spaces between or near previously drilled holes), which resulted in holes 84, 87, 88, 90, 93, 96, 97, and 98 (the "Infill Holes"). By November 29, 2010, Smith had the final results for the Infill Holes, which in general confirmed the results of the holes around them; this information was shared with the board who described it as "just beautiful" and "spectacular". In August 2010, Canaco completed a private placement of shares and, as a result of the transaction, could not issue any stock options until December 2, 2010. Canaco also expected to receive drilling results in early December, which could result in a trading blackout. With a narrow window for issuance, Smith presented the board with a list of proposed recipients of options and the amounts on November 23, 2010, which was approved by a board resolution dated December 3, 2010. On December 4 and 5, 2010, the board discussed whether to release the results of the Infill Holes, and it was decided to space out the disclosure to maintain news about the company in light of a road show in January and to not reopen an ownership dispute. There was no concern by the directors that the results of the Infill Holes needed to be disclosed immediately because Smith concluded that the results were immaterial. News releases about the Infill Holes were circulated on December 6, 9, and 22, 2010.

In a Notice of Hearing dated April 24, 2012, the Executive Director of the British Columbia Securities Commission (the "Commission") alleged that Canaco contravened section 85 of the Act and National Instrument 51-102 *Continuous Disclosure* ("51-102") when it failed to issue a news release and file a material change report disclosing the results from the Infill Holes. The individual respondents allegedly contravened section 168.2(1) when they "authorized, permitted or acquiesced" in Canaco's contravention of section 85 and failed to act in Canaco's best interests when they voted in favour of issuing Canaco stock options to themselves and others with the knowledge that the Canaco stock price did not include the undisclosed results of the Infill Holes (also contrary to the public interest).

The allegations were dismissed. The Commission Panel (the "Panel") determined that the crux of all of the allegations was whether the results of the Infill Holes constituted a "material change" for Canaco, with "material change" defined in section 1(1) of the Act to be "a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer". A number of cases have established principles for determining materiality (see *YBM Magnex International Inc*. (2003), OSCB 5285 and *Kerr v. Danier Leather*, 2007 SCC 44, 2007 CSLR ¶900-226), including that: materiality is determined objectively; it is "assessed in the context of the issuer's industry and the market"; market impact is assessed from the point of view of the reasonable investor — that is, would he or she have expected that the market price or value of the securities would be affected by the impugned information?; and any subjective assessments of the impugned information by the executives are irrelevant. Evidence before the Panel included the testimony of Smith and Smallwood, which was found to be credible, and reports (the "Reports") of professional geologists . The Panel concluded that the Reports supported Smith's original view, that the results of the Infill Holes would not affect the value of Canaco's shares as they did nothing but add to the understanding of what was in the Magambazi deposit. Accordingly, a reasonable investor would not have expected the results of the Infill Holes to affect the value of the Canaco shares. With respect to whether the results of the Infill Holes would affect the market price of the shares, the Panel found that given the advanced nature of the drilling at Magambazi and the publication of those results, the information about the Infill Holes only supported the existing "story" of Canaco. A reasonable investor acquainted with Canaco's previous disclosure would not have his or her perception affected in such a way to significantly affect the market price. The Panel also rejected the Executive Director's argument that the directors' discussion of the results was relevant to determining materiality. First, there was no evidence that the directors ever believed the results to be material. Second, it was irrelevant if they were of that opinion as the test for materiality, as discussed, was objective. As the results of the Infill Holes were not material changes, no breach of the Act occurred, and there was no further evidence to support the allegation that the directors acted contrary to the public interest to keep the prices of the Canaco shares low to obtain options for themselves at a favourable price by withholding undisclosed material information.

Re Canaco Resources Inc., 2013 CSLR ¶900-508

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