IN FACT AND IN LAW

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What is Privileged Information?

Forewarned is Forearmed!

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Anyone can, at some point, find himself in possession of privileged information regarding a reporting issuer, although directors and officers are the persons most likely to have such information. A reporting issuer is an issuer that has made a distribution of securities to the public and is, therefore, subject to the continuous disclosure obligations set forth in the securities legislation of the provinces or territories (the "Jurisdictions") in which it is a reporting issuer.[1]

The *Securities Act* (Quebec) (the "Act"), as well as the securities acts in the other Canadian Jurisdictions, prohibits any person in possession of privileged information relating to a company from using that information to trade in securities of such company and from disclosing that information to anyone, except under very specific circumstances that we will consider below. The purpose of these prohibitions is to maintain the integrity of the market by ensuring that all market participants have access to the same information in connection with a trade in the securities of the company.

Privileged Information

In this field and without limiting any broader definition that an issuer might give to this term, information is considered privileged if:

- it has not been disclosed to the public; and
- if it were disclosed, it is reasonable to believe that it would affect the decision of a reasonable investor to buy, sell or hold his securities by reason of the impact it is liable to have on the market price or value of the issuer's securities.

It is difficult to give specific examples of what may constitute privileged information because each case must be analyzed on its own merits. Recently, the Canadian Securities Administrators adopted National Policy 51-201, *Disclosure Standards.* This policy provides certain examples of potentially material facts or information, notably:

- reorganizations of capital, amalgamations or mergers;
- significant acquisitions or dispositions of assets, property or joint venture interests;
- the borrowing or lending of a significant amount of money, the mortgaging or encumbering of the company's assets;
- the entering into or loss of a key contract or any other fact regarding a key customer or supplier;
- a significant increase or decrease in short-term earnings forecasts;
- any material legal proceedings.

Although it is preferable not to bury the market under an avalanche of unimportant information, the Canadian Securities Administrators recommend that if there is any doubt about whether particular information is material, issuers should err on the side of materiality and release the information publicly.[2] Two factors are generally used to determine whether information is material: (1) the probability that the event will occur and (2) the scale of the event in relation to all of the company's activities. Information regarding contingent possibilities are generally too uncertain to have a material effect on the value or market price of the securities of an issuer. Information should usually be disclosed only once the possibility becomes a "probability" or "certainty".

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[1] To learn more about continuous disclosure obligations, we invite you to consult our bulletin for the month of August 2002.

[2] National Policy 51-201.

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Nonetheless, depending on its scope, even an uncertain or unlikely event may influence a reasonable investor's decision and therefore constitute privileged information. One should not lose sight of the fact that the legislature's intention is to prohibit the use of privileged information even if there is some uncertainty as to the effect its disclosure may have. Other factors such as the volatility of the company's securities and the state of the markets may also be used to determine the materiality of information.

There is no difference between "corporate" information (namely information regarding the company's affairs which originates from internal sources) and "market" information (namely information regarding the market for the company's securities which originates from external sources).

For example, a person may have privileged information to the effect that the company is about to enter into a material contract, or that a key customer of the company intends to cease doing business with the company. In the first case, the person must abstain from purchasing, and in the second case, from selling securities of the company, until a public announcement has been made. Market information may, for example, be information that a person obtains to the effect that a financial analyst will shortly publish a favourable report praising the merits of an investment in the securities of the company. A person who obtains such information must abstain from purchasing securities of the company until the report has been published.

Abstaining From Trading on the Basis of Privileged Information and Communicating Such Information

It is forbidden to trade in the securities of an issuer on the basis of privileged information before it has been disclosed to the public (either through press releases, newspaper articles or any other means of public communication).[3] Similarly, such privileged information may not be used in any other manner, for example, for purposes of trading in the securities of another company, if the market price or value of the securities of that other company is liable to be influenced by fluctuations in the market price or value of the securities of the issuer.

It is also forbidden to disclose privileged information to a member of one's family or to any other person, or to recommend the purchase or sale of a security to any person or to carry out any other transaction based upon knowledge of privileged information.

When Can One Trade in Securities on the Basis of Privileged Information and When May One Disclose Such Information?

A person who has privileged information may trade in the securities of the company if the person is justified in believing that the information has been disclosed to the public or to the other party or if the trade is made under an automatic subscription plan or any other automatic plan established by the issuer and which the person decided to join before he obtained the privileged information.

Furthermore, a person may disclose privileged information when he is required to do so in the necessary course of business[4] of the issuer if he is justified in believing that the information will not be used for the benefit of the persons to whom it is disclosed before being disclosed publicly or if he is justified in believing that the information has been disclosed to the public. This last exception applies particularly to directors and officers of the company, business partners, lenders, government agencies and rating organizations.

It is interesting to note that in Ontario and in the United States, a person may trade in the securities of a company notwithstanding the knowledge of privileged information if the transaction is effected in connection with the performance of an obligation which the person was legally bound to perform and had assumed before learning the confidential information.

Methods for Preventing the Use of Privileged Information

Certain information should not be disclosed to an employee of a company before it is publicly disseminated, unless the information is absolutely necessary for the performance of the employee's duties. For example, such information includes information relating to anticipated trades in the securities of the company, significant capital expenditures or mergers or

[3] According to National Policy 51-201, the posting of information on a company's Web site is not sufficient to fulfill the obligation to generally disclose information.

[4] According to National Policy 51-201, communications with the media, financial analysts and institutional investors are not communications in the necessary course of business.

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acquisitions. "Chinese Walls" should be established around employees working on such projects. No employee should obtain information regarding such projects unless the project coordinator authorizes it. Thus, persons inside a Chinese Wall should not discuss information regarding these projects or disclose it to employees outside the Chinese Wall. Those working inside a Chinese Wall must take security measures in order to maintain the secrecy of the information.

Appropriate measures must also be taken in order to prevent the disclosure of privileged information to third parties. Special attention should be taken to prevent the disclosure of privileged information through discussions in public places, such as taxis, elevators or restaurants, through the use of cellular telephones, through discussions with friends or by reading confidential documents in planes, trains or other places where their contents may be seen by strangers. Finally, it is strongly recommended that mechanisms be implemented to prevent the disclosure of privileged information to persons external to the company who are on its premises for conferences or other meetings.

The communication or disclosure of material information relating to financial results should take place solely through official channels, by employees with a specific authorization to do so and with the approval of the audit committee or the board of directors.[5] The Canadian Securities Administrators recommend that companies adopt a communications policy providing for "quiet periods" between the end of a quarter and the release of quarterly results. These quiet periods may vary from company to company. The purpose of a quiet period is to avoid all communications with analysts, institutional investors and other market professionals during that period.

It is also essential for companies to educate their employees as to the concept of privileged information and the possible consequences of using such information. Before trading in securities of the company based on information the employee obtained in the course of his employment or through another person, the employee should ask himself the following three questions:

(1) is this privileged information?

(2) has this information been disclosed to the public?

(3) does the other party to the transaction know this information?

Finally, it is desirable that an issuer assign a person to answer all the questions that an employee, officer or director of the company may have as to whether or not it is possible to trade in the securities of the company on the basis of information known to that person.

Penalties

Any person who uses privileged information unlawfully is guilty of an offence under the Act, which is punishable by a fine of not less than two times the profit that may be realized or $5,000 and not more than four times the profit that may be realized or $1,000,000, whichever amount is higher.

Furthermore, insiders of a corporation constituted under the *Canada Business Corporations Act* who use privileged information for their own benefit when the information is not generally known, may be liable to compensate the corporation for any direct benefit or advantage received by them as a result of the use of the information or to compensate persons having suffered direct losses, regardless of whether or not the company is a reporting issuer within the meaning of the securities legislation of the Canadian Jurisdictions.

For a corporation constituted under the *Canada Business Corporations Act*, the following are insiders:

- the corporation itself;
- an affiliate of the corporation;
- every person who beneficially owns (directly or indirectly) shares of the corporation conferring control or who has the *de facto* control of the corporation;
- every person who is an employee or consultant of the corporation or has been retained by the corporation;

[5] In this regard, we invite you to consult our September 2001 bulletin dealing with the new policy on disclosure standards.

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- every person who, while being in one of the situations described above, received such information;
- every person who receives such information from one of those persons;
- every director or officer of a person listed above that is a body corporate.

A person who assists another person in committing an illegal act is as guilty as if he had committed the act himself.

Conclusion

The unlawful use of privileged information is too common a blight on financial markets. The Canadian Securities Administrators have multiplied their efforts to prevent and put an end to this blight.

In fact, the Ontario Securities Commission[6] recently refused to approve an agreement entered into between its staff and an insider with respect to insider trading, stating that the sanction was not proportional to the breaches committed by the insider, namely the use of privileged information.

In its decision, the Commission went even further, stating that this type of illegal transaction is a cancer eating away at the public's confidence in the capital markets.

The prohibition on the unlawful use of privileged information has long been the cornerstone for interventionism on the part of the securities regulatory authorities in order to ensure the protection of the public, the proper operation of the capital markets and confidence in those markets.

If you would like to learn more on this topic, do not hesitate to contact Isabelle Lamarre at (514) 877-2995, Josianne Beaudry at (514) 877-3055 or Johanne Duchesne at (514) 877-3045.

[6] M.C.J.C. Holdings Inc. and Michael Cowpland, (February 12, 2002) O.S.C.

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