Fighting the INSIDER'S EDGE

Investor rights advocate Ermanno Pascutto thinks he has the cure for Canada's endemic problem of illegal insider trading. But will the regulators listen?

BY ALISHA HIYATE

They called it project "Toucan," and it was a deal that involved a gold major buying a gold junior with a big deposit.

Before an offer was actually made, the corporate development executives on both sides of the deal met for coffee twice a month for about a year — someplace casual, away from Hy's Steakhouse and the other downtown Toronto hotspots of Bay St. executives and bankers.

Unlike the majority of M&A activity that takes place in Canadian markets, the market didn't get a whiff of the deal — the takeover of Aurelian Resources by **Kinross Gold** (KGC-N, K-T) — before it was announced in the summer of 2008.

"There was no spike in trading before the Kinross deal," says Tim Warman, who was Aurelian's vice-president of corporate development at the time.

The offer remained confidential, Warman says, because of the many precautions both companies took to keep it so. Not just employing a code name, but meeting out of the way, and choosing advisers that they trusted not to spill the details of the takeover offer.

"There's a general expectation among companies that there's a way to do (a deal) and do it properly," says Warman, now the president and CEO of **Malbex Resources** (MBG-V).

But, while the Kinross/Aurelian deal proves it's possible to keep M&A negotiations under wraps, sometimes, and despite companies' best efforts, word slips out. And studies have repeatedly shown that it happens in Canada more than other developed nations.

A *Bloomberg*/Measured Markets study, for example, found that unusual trading occurred before 63% of M&A announcements in Canada, vs. 41% in the U.S. in 2006, and 25% in the U.K. in 2005. And a recent *Globe and Mail* investigation found that in the mining sector, suspicious trading preceded 9 of 14 mining deals looked at in Canada last year — or an eerily similar 64%.

"Everyone knows it's commonplace and everyone knows it's a problem, but it's not something that anyone seems to be doing anything about," says Ermanno Pascutto, an investor rights advocate and executive director of FAIR Canada (the Canadian Foundation for Advancement of Investor Rights).

Companies do have policies in place to prevent the spread of material, non-disclosed information like M&A negotiations. Common practices include having a lawyer present to remind board members of confidentiality requirements when a possible deal is presented to them, blackout periods on executives' trading and the establishment of an insider trading policy, as well as common sense precautions like not talking about the deal openly in the office.

But because of the number and variety of consultants and professional advisers that have to be brought in to hammer out a big financing or merger — lawyers, bankers, brokers, accountants, mining engineers, and various regulators, not to mention all their support staff — it's difficult to keep things hush hush, says Steve Vaughan, a partner at Heenan Blaikie.

"You can't do a deal and keep it confidential — it's virtually impossible," says Vaughan, a geologist who's been on numerous boards over his career. "What do you do? Go to Baffin Island, hide yourself in an igloo — two people scribbling on a piece of paper? It can't happen."

And that is exactly the problem, says Pascutto: the more people involved, the greater the danger of a leak.

"Right now, you can have dozens and dozens of people who are involved in a takeover bid before it's announced publicly," he explains, "The problem is you only need one of those to leak it, so the longer you don't disclose, the more people who get involved with it, the chances of a leak and insider trading rise exponentially."

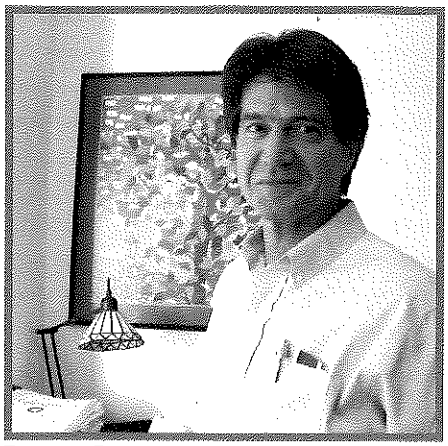
So if companies are generally failing to prevent leaks about M&A activity, what about the enforcement side? For a myriad of reasons, insider trading and tipping are extremely difficult both to detect and to prove (see Page 17), says Pascutto, a lawyer who has served as the executive director of the Ontario Securities Commission (OSC), director of the market policy division at the Toronto Stock Exchange, and vice-chair of the Hong Kong Securities and Futures Commission.

The answer, therefore, is to stop insider trading before it happens, Pascutto says.

If companies fail to keep M&A negotiations confidential, they should have to disclose them — so people who are in the know aren't trading against those who aren't.

"The solution is make early disclosure (a requirement) and you eliminate the opportunity for insider trading," Pascutto says. "Because at that point, everyone has the same information and everyone's working on a level playing field. We think we can eliminate a huge amount of insider trading that happens on M&A activity by having better timely disclosure rules."

The way to do that, Pascutto says, is for Canada to adopt the U.K.'s Takeover Code (see sidebar), which requires earlier disclosure of takeover bids — especially when there are unusual share price gains that could indicate insider trading.



Ermanno Pascutto

Firm intention to make a bid

Never mind *earlier* disclosure of M&A activity — under the current disclosure rules, Canadian companies don't have to disclose when they've received an offer, period.

Martin Eady, director of corporate finance for the British Columbia Securities Commission (BCSC) says there are good reasons our laws allow M&A bids to be kept confidential. While there may be an intention to make an offer today, "the market could change tomorrow," he says, and that intent could evaporate.

As the law stands in Canada, merger transactions don't need to be disclosed until there's a "substantial likelihood that the transaction will be completed," Eady says, and both parties are committed to seeing it through. "In general, that does not happen until people have actually made the bid, until they've ironed out all of the aspects of the transaction."

Another consideration is that under the current rules, companies are allowed to keep confidential any material change that would be detrimental to their commercial interests, Eady says, by filing a confidential material change report. That would include M&A talks where news that a deal is in the works could compromise a company's negotiating position. While that exception doesn't last indefinitely, it certainly applies when companies are in the middle of working out a deal.

"If I was a bidder. . . I would be hard-pressed to think that it wouldn't compromise my commercial interest if I was required to disclose (the offer) in advance of me actually making the bid."

The tension between the shareholders' interest and the company's is obvious and Pascutto argues both these rules should be changed for the sake of the true owners of the company.

"A takeover bid does not necessarily directly involve the company in the sense that the offer's being made not to the company but to the shareholders," he says.

What happens now means that not only do the shareholders not necessarily get the chance to evaluate offers for themselves, but the company could be in play without them knowing.

Pascutto cites the example of steelmaker Dofasco, which rejected multiple offers without informing its shareholders at the time. It later became the subject of a bidding war (it's now part of **ArcelorMittal**), and Dofasco shareholders who sold stock after the undisclosed bids and before the

UK Takeover Code

Among the conditions under which the UK Takeover Code states that an announcement is required are:

- when a board is notified of a "firm intention to make an offer" that is not conditional and from a serious source – whether or not the board supports the offer;
- when a company has been approached about a takeover and rumours are circulating about the target company OR there is "an untoward movement" (defined as 5% in one day or 10% following an approach) in the target company's share price;
- when before a company is approached, the target company is the subject of rumours or there is an untoward movement in its share price, AND the potential offeror's actions are likely the reason; or
- when negotiations are about to be extended to include a wider circle of people than those who need to know and their immediate advisers.

disclosed ones may have been trading with insiders who knew that the company was in play — an inherently unfair situation, Pascutto says.

Under the U.K. rules, a company is obliged to make a statement when the board is notified of a "firm intention to make an offer," as long as there are no preconditions on the offer and it is made by a credible source — regardless of the board's position on the bid.

Mining industry analyst Eric Coffin, one half of the junior mining newsletter HRA Advisory with his brother David Coffin, agrees that this is need-to-know information for shareholders.

"We think management should always be forced to disclose bids, even ones they disagree with or don't want to entertain," Coffin wrote in an email, adding that management sometimes rejects bids because they don't want to lose their jobs. "Shareholders are ultimately the owners of the business and it should be their decision, not management's, if a bid is accepted."

However, given the reality that junior miners are constantly talking deals, a "firm *intention* to make an offer" — ahead of an actual offer — might be difficult to pinpoint, says Malbex Resources' Warman.

Aurelian's deal with Kinross progressed slowly, over the space of about a year, he says, with a bid not materializing until the end of that period. "If I had to put a finger on a certain point when there was a firm intention of a bid, it's pretty tough," Warman says.

For most of that year, the companies simply exchanged information — on Aurelian's plans for its 13.7-million oz. Fruta del Norte gold deposit in Ecuador, the country's politics, and Kinross's views on the project. At the same time, Aurelian was having similar information-sharing meetings with about a dozen other companies with which it also had confidentiality agreements.

The emphasis on earlier disclosure to stop the opportunity of leaks also raises the spectre of "premature disclosure," where companies could announce what amount to rumours.

But Peter Bojtos, the director of two companies that are dual-listed on the TSXV and London's AIM, says codes like the U.K. Takeover Code include measures to discourage offers that aren't serious, including break fees.

"To stop frivolous intentions there are provisions that the deal has to be followed through, and if it isn't, then they can't offer again for some period of time," Bojtos wrote in an email.

Pascutto says announcements of negotiations don't have to be detailed, just a heads-up to shareholders that something — which may or may not result in a deal — is happening. If companies stick with the facts, it won't be premature disclosure, he says. "You don't say you've got a deal when you don't have one."

An "untoward" price movement

Most investors would agree that it's important an announcement be made when the word is clearly already out that a deal is in the works.

The U.K. Takeovers code requires a company to make a statement when it has been approached about a takeover if there are also rumours circulating about a deal or there is "an untoward movement" in its share price (5% in one day or 10% following an approach).

Of course, the big concern for the industry is that earlier disclosure could endanger deals or somehow change them — given how sensitive stock prices are to such news.

"The minute there's any concept of a deal, the arbitrage guys come in and all of that changes the dynamics of the discussion," Warman says.

Pascutto doesn't believe that the policy would jeopardize deals, especially given the prevalence of rumours in the market.

"For years, I have read in the media that a company was a target and that this company was the likely bidder and often that this was the expected price. And a week or two later, it turns out that it's true," he says. "So why is it better for the information to be leaked into the market and eventually make its way into the media without any kind of confirmation by the company, as opposed to a proper announcement by the company and everyone playing on a level playing field?"

While Coffin supports adopting some aspects of the U.K. Takeover Code, he says it might be tricky to identify the cause of an "untoward movement" in a sector like junior mining, where it might not be clear whether a stock's movement is due to speculation or the result of a leak — especially in times of soaring commodities prices.

"When you are dealing with a small sector that is experiencing a lot of takeover activity, it's common to see other companies that are at a similar stage of development getting priced higher because buyers (perhaps including management) anticipate a potential bid. . . or simply think the pricing of a sector takeover implies higher valuations for everyone else," he says. "This would look like insider trading if a bid materialized later, but there is a big difference between anticipating a bid and knowing in advance about the bid. One is a value judgment about the company and sector while the second is insider trading."

In the U.K., the U.K. Takeover Panel is the ultimate arbiter of determining what's behind such movements.

Coffin points out the rules would also be ineffective when management is not driving the M&A activity, as is often the case in the junior mining sector.

"(Investment banks and funds) may invest in a company they think is undervalued compared to its peer group. They may be buying the stock for that reason, then approaching potential suitors to help unlock the value they see," Coffin explains. "Management of the target company itself may know nothing about the situation until it's well under way."

Clearly, changing the timely disclosure rules is not the whole solution to the scourge of insider trading, but it does have some support, including Steve Vaughan's.

"Anything that can make the market transparent and fairer for all participants is good," he says. "Canada needs capital, the min-

eral industry needs capital and people aren't going to play in the market if they think they're getting ripped off."

Enforcement

The big question, says Al Rosen, a forensic accountant and co-author of the book *Swindlers*, is whether in Canada's relatively ineffective regulatory system, new disclosure rules would make a difference.

"This kind of stuff misses the point," Rosen says. "Unless you have strong enforcement and monitoring, it just goes nowhere. . . it's just a piece of wallpaper."

That brings us to Canada's patchwork, byzantine securities regulation regime, which includes regulators in each province and territory who have jurisdiction within their borders and can bring charges in provincial court or in a disciplinary panel; the provincial police; the RCMP and its Integrated Market Enforcement Teams (IMET), which have federal jurisdiction and the power to pursue Criminal Code charges; and self-regulatory organizations like IIROC, which oversees investment dealers and trading activity.

It's a common sentiment that the fractured system and jurisdictional scrapping that goes on between the various agencies lets many criminals elude justice.

"Prosecutions in Canada are close to zero, and it's very demoralizing if you happen to be a competent person working for a securities commission," Rosen says.

The obvious answer is the one that most of the provinces, including Quebec, Alberta and most recently, B.C., don't want to hear — a national securities regulator. Vaughan makes a persuasive case that a national regulator with criminal jurisdiction and the legal and investigative clout that it would wield are essential to the fight against white collar crime. Most securities law breaches involve criminal fraud, which under the constitution is in the exclusive jurisdiction of the federal government, Vaughan says.

"The provinces don't have any investigatory power outside the box of the province," he says. "Provincial law doesn't go one foot over the (provincial) border. But what we are seeing is securities fraud crimes which have international scope."

A national securities regulator is another of FAIR Canada's causes — aside from the Small Investor Protection Association (SIPA), FAIR is the only game in town for retail investors looking for a champion — but that proposition is as far off as ever. The federal government has asked the Supreme Court of Canada for an opinion on the constitutionality of such a regulator, and while a hearing is scheduled for April, the feds are in for a fight from the provinces regardless of the outcome.

Pascutto doesn't want to wait for that perpetual debate to be resolved before his proposal is considered, however, the irony is that without a national body, FAIR Canada's proposal could easily get mired in regulatory inertia. The proposal would need the approval of all 13 members of the Canadian Securities Administrators (CSA), and Pascutto, once a regulatory insider himself, says even if new rules are adopted, they may be watered down to achieve the necessary consensus.

The BCSC's Eady says the CSA is aware of FAIR's proposal and is interested in the idea, although not studying it formally. And Pascutto says recent talks he's had with the OSC have left him hopeful the proposal could eventually be adopted.

"I've been told that (OSC chair Howard Wetston) is interested. . . and he's asked his staff to look at the issue," he says. "To get the OSC actually to study it is an important start."

For Canadian investors, that will have to do.

Why insider trading is so hard to prove

In any jurisdiction, insider trading is difficult to detect and prosecute.

But without convictions, the regulators know the integrity of the markets they police could be seen as questionable.

"It's something that is important to deal with decisively when we come across clear examples of insider trading," says Martin Eady, director of corporate finance for the British Columbia Securities Commission (BCSC). "It's a type of violation that destroys confidence in the markets and investor confidence is why people invest."

Securities commissions across the country have identified insider trading as a priority, most notably, the Ontario Securities Commission's new chairman, Howard Wetston, who has indicated a focus on prosecuting and jailing more people for insider trading and tipping.

While Canada's 13 provincial and territorial regulators/securities commissions have a poor enforcement track record on insider trading, they have stepped up their game in recent years.

The most recent report by the Canadian Securities Administrators' (CSA) — the umbrella organization that all the regional securities regulators belong to — released last year, showed that 16 cases of illegal insider trading were concluded in 2009, up from only eight cases in 2008 and seven in 2007. That translates to more than 11% of total proceedings in 2009.

The problem is that although the provincial commissions get lots of referrals from the Investment Industry Regulatory Organization or IIROC, the self-regulatory organization that is responsible for monitoring trading in real time, those referrals don't often turn into solid cases without some help.

"The challenge is the actual time and effort required to investigate an insider trading case is very, very significant," says Eady, who has worked in enforcement at the BCSC, the primary regulator of many of Canada's B.C.-based junior mining companies. "It's very seldom that you have clearcut cases. Most of them are based on circumstance, most of them are based on some assumptions that we have to make about human behaviour, and many times successful ones come through somebody ratting somebody out, for example."

Fair Canada's executive director Ermanno Pascutto says that because trading by insiders is generally speaking, legal, it's difficult to separate the legal trades from the illegal.

"When you look at the (illegal) trading, it doesn't stand out as illegal," he says. "What you have to do is prove that the person has something in their mind, that they have knowledge in their head, and that is a very difficult thing to do."