September 26, 2014

A 'Victimless' Crime Just Lost its Perpetrators

By: Bryce Tingle

Case commented on: *Walton v. Alberta (Securities Commission)*, 2014 ABCA 273

In *Walton v. Alberta (Securities Commission),* 2014 ABCA 273 (the "*Eveready*" decision), the Alberta Court of Appeal has just decided the most important insider trading case in recent memory. It may also be the last insider trading case for a long time.

Here is how insider trading happens: a business person in possession of inside information is chatting with friends or family members. Someone asks him how his company is doing and he replies along the lines that, "I can't really tell you what is going on, but it might be a really good idea to buy some stock in the next month or so." Maybe he isn't that discrete. Maybe he actually says, on the golf course or over lunch, "listen, there is a pretty good chance we're going to be acquired in the next month or two, you might think about grabbing some stock."

Why does he do this? Well, he might feel responsible: he can help a less well-off family member without giving them something that feels like charity. But it could also be showing-off, doing a favour, of just making himself feel big. We are a species that likes being liked, that likes having people feel grateful to us, and disclosing inside information advances these objects.

It doesn't hurt that the victims in insider trading are difficult to see. The seller's decision was freely made; the trade presumably was in its interests. Perhaps the seller decided to sell because she needed the money right away. In any event, the counterparties to an insider trade usually remain forever anonymous. Some corporate law scholars debate whether insider trading should even be against the law, given that it sends valuable pricing signals to the market.

For all of these reasons there is a considerable amount of insider trading in Canada's markets. One recent study that looked at 1,859 merger and acquisition (M&A) deals in Canada and the U.S. found evidence that roughly 25% of all transactions were accompanied by abnormal trading in the options market during the run-up to the deal announcement. The odds of the trading abnormalities they identified arising by chance were "three in a trillion." Another study found aberrant trading patterns in the shares of target companies in 41% of deals in the U.S. and 63% in Canada. (America's superior performance may be due to the fact that America has the strictest insider trading laws in the world, affords a private cause of action against individuals that engage in the practice and seems to have higher rates of prosecutorial success. It also doesn't hurt that, unlike Canada, American insiders regularly go to jail for increasingly long periods of time.)

The impact of insider trading is material. In testimony to Congress one American scholar noted that, "beginning about 12 days before takeovers or a merger, roughly 30 to 50 percent of the premium that is going to be ultimately paid… is already reflected in the stock's price…" A 2009 study found that only 49% of leaked deals complete, compared with 72% of non-leaked transactions. Leaked deals also took 70% longer to complete.

Most of us feel that insider trading should be against the law, if only because it doesn't seem fair for someone to be trading with a massive informational advantage. As well, the best evidence is that vigorous enforcement of insider trading laws significantly reduces the cost of equity for all firms in a market. Unfortunately, insider-trading cases are notoriously difficult to prosecute. Unless one of the parties confesses and turns evidence against the others, or the insider trading is sufficiently organized and consistent that law enforcement authorities can mount a long-term investigation with wiretaps and microphones, there is never any direct evidence.

The instances of alleged insider trading that reach triers of fact are almost always, therefore, decided on the basis of circumstantial evidence: a suspicious trade was made, there is some connection between the buyer of the stock and an insider, there is some reason for the insider to have disclosed the information to the person making the trade. The significance of the Alberta Court of Appeal's decision in *Eveready* is that it sets the standards for making this circumstantial case so high that it is difficult to imagine it being met.

The facts in *Eveready* are typical of insider trading cases. An insider, Holtby, is accused of tipping a wide circle of associates during the run-up to an acquisition of his company, Eveready Inc. His investment advisor admitted to the Commission that he had been tipped and entered into a settlement agreement. Everyone else issued denials and provided alternative explanations for their unusual purchases of Eveready shares. Nearly all of them were found guilty by the Alberta Securities Commission, but let off by the Court of Appeal.

How they got off:

1. A statute that presents challenges – The "insider trading" offense under the *Securities Act,* RSA 2000, c S-4 (the "Act") provides in s. 147(2) that someone in a "special relationship" to an issuer commits an offense if she trades. This "special relationship" includes anyone who has learned material, non-public information from someone they know to be an insider (even if this information is communicated second-hand). There can thus be a chain of people in a special relationship connecting an accused to the original insider, like a felonious version of the children's game "telephone".

Of course, if no material fact is disclosed, or if the accused didn't know the information came from an insider, there is no crime. An insider can be prosecuted for "encouraging" others to trade in securities (s. 147(3.1)), but the recipient of this encouragement does not offend the Act if she trades. Thus, the enforcement staff of the Securities Commission must, from circumstantial evidence, prove the trade followed the communication of information by an insider and also prove that the information contained material non-disclosed facts and was not just a vague encouragement to purchase stock. This is difficult to do without wiretaps or email.

The best circumstantial evidence a prosecutor has – the timing of the conversation relative to the trade – is thus nearly valueless. As the Court of Appeal says (at para 29), "even if a certain trading pattern might be consistent with 'tipping', it might equally be consistent with merely having been 'encouraged'."

2. A high standard of proof – The Court in *Eveready* articulates the appropriate standard of proof for these cases as being very high: "given the serious consequences of a finding of culpability, clear and cogent evidence should be expected before any particular inference is drawn" (at para 29). In practice, this obviously makes any case based on circumstantial evidence very difficult prove. Inferring "knowledge of a material fact, merely because of opportunity and general motive, is weak" (at para 33).

This high standard of proof is displayed in a variety of ways throughout the decision. One accused is a "bare acquaintance" of Holtby; the Court doesn't believe Holtby would therefore bother to tip him (at para 69). There was an atmosphere of "cautious optimism" about the stock at the time an accused made his trades – that is sufficient explanation for them (at para 72). Holtby's brother made a big investment in *Eveready* shares ahead of the acquisition, but he had recently inherited some money and why wouldn't he have invested in his brother's company? His investment could have been a "fortuitous coincidence" (at para 101). His brother's close friend also made an unprecedented acquisition of *Eveready* stock, but there is no evidence he received inside information or knew Holtby was an insider of Eveready (at para 97). Holtby's accountants made a series of equally fortuitous trades ahead of the announcement, but their trades didn't happen immediately after the relevant conversations with Holtby (at para 135), and they had other explanations to do with tax planning (at para 138).

None of this is to say the Court of Appeal is wrong either in its articulation of the "clear and cogent" standard of proof or its application to the facts in *Eveready*; it is to say that it is better to be a fortuitous trader than to be employed in prosecuting them.

3. A narrow view of the purpose of penalties – All the evidence cited earlier in this post suggests that a significant amount of insider trading occurs in Canada. A casual review of the enforcement records of the securities commissions suggests that little of it is discovered and prosecuted. Worse, *Eveready* shows that successfully prosecuting it is extremely challenging.

In these circumstances securities commissions have only one tried and tested tool: large penalties. The lower the chances of something occurring, the greater the penalties must be to act as a deterrent. (Lotteries are predicated on this kind of logic: people will buy even very remote chances to win a prize, provided the prize is very large.) The Court in *Eveready* found the Securities Commission's awards against Holtby and the others too high: "The resulting penalty [$1,750,000] is very severe and one can argue that it extends well beyond what the public interest might require" (at para 160). The matter of sanctions was remanded back to the Commission for reconsideration – though with the strong implied suggestion they be reduced significantly.

What are the take-away lessons of *Eveready*? First, the Securities Commission should focus its enforcement activities somewhere else. Unless someone admits wrongdoing the chances of success are too low to justify much expenditure on insider trading cases. Second, the best advice for someone accused of wrongdoing is to deny it. Third, if we are serious about keeping insider trading a crime, we will have to rethink our enforcement practices.

Why focus on enforcement practices rather than our legislative provisions? The United States is the most effective jurisdiction in the world at prosecuting insider trading. When scaled for the relative size of our markets, the U.S. prosecutes 20 times the number of trading violations that we do. They also impose penalties 17 times greater than ours. But their insider laws, which have an element of scienter mostly absent from ours, set a higher standard for prosecutors. The difference in prosecutorial success seems most likely, therefore, to be a function of the additional tools afforded prosecutors of white-collar crime in America. These would need to be the subject of another post, but there is a reason they haven't evolved in Canada.