INVESTOR PROTECTION: A COMPARATIVE STUDY OF THE SECURITIES LAWS IN MANITOBA (CANADA) AND THE RUSSIAN FEDERATION

BY

MARET TSARNAEVA

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Investor Protection:

A Comparative Study of the Securities Laws

in Manitoba (Canada) and the Russian Federation

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Maret Tsarnaeva

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I. INTRODUCTION

This thesis presents a comparative analysis of securities regulations in Manitoba and Russia. In Manitoba, the regulation is imposed through *The Securities Act* (Manitoba)[1] and in Russia, through *The Federal Law of the Russian Federation "On Securities Markets"* [2]. The scope of this analysis is limited to the substantive provisions in the securities laws and regulations that relate to investor protection. This analysis deals with corporate securities only. In light of the most recent economic crisis in Russia in the autumn of 1998 and the ensuing implosion of their securities markets, this comparison will be instructive from a number of points of view.

First, Canadian and other foreign investors purchasing interests in Russian companies or those engaging in joint ventures in this region should be familiar with the securities laws that apply to their investments. Second, portfolio managers, institutional investors and others investing globally for purposes of geographic or risk diversification or for other reasons should be aware of securities laws that may directly apply to their purchases and subsequent divestitures. Indeed, any prudent investor should have a general understanding of the nature of the securities markets and the laws and regulations that govern their global investments. Third, foreign companies setting up operations and concurrently selling securities in the Russian Federation obviously must be aware of the laws that will apply to this activity.

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[1] Manitoba *Securities Act*, R.S.M., 1988, c. S50.

[2] Federal'nyi zakon "O rynke tsennykh bumag" [Federal Law "On Securities Market"], SOBR. ZAKONOD. R.F. 1996, No. 17, Doc.1918, translated in Economic Law of Russia, "Federal Law No. 39-FZ of April 22, 1996 on the Securities Market" (Garant-Service 1996, Doc. 6464), available in LEXIS, Intlaw Library, RFLaw File [hereinafter "Federal Securities Law" or "FSL"].

I have restricted my focus to the differences and similarities between certain aspects of securities regulation in Manitoba and Russia. These include:

(1) licensing and registration of professional participants in the securities market;

(2) registration of securities and disclosure requirements (which include requirements to file a prospectus, provisions on continuous disclosure, timely disclosure obligations and requirements for proxy and information circulars);

(3) take-over bid provisions;

(4) provisions with respect to insider trading;

(5) enforcement provisions; and,

(6) self-regulation.

It is the divergence between the two legal systems that offers the most fruitful grounds for comparison and promises to yield the most valuable insights into the workings of the two systems. This will help to guide investment decisions about whether to participate in the Russian market.

The thesis is structured on the above issues and therefore has been divided into seven chapters.

CHAPTER ONE briefly describes the development of the Russian securities market and its regulation. Particularly, a short introduction is given on the enactment of the Federal Securities Laws.[3] Establishment of the Federal Commission for the Securities Market of

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[3] The Civil Code; The Law of the Russian Federation "On Securities Markets"; instructions of the Federal Securities Commission; privatisation legislation; and The Law of the Russian Federation "On Joint-Stock Company".

the Russian Federation, as the sole authority administering these laws, was a major step in the development of the Russian market. The formation of the Russian Trading System and the National Association of Securities Market Participants (hereinafter "NAUFOR") are also important. Each of these are discussed in this chapter.

Although I do not trace the history of the Russian securities regulatory regime this chapter discusses what stimulated the rise of securities markets and regulations in Russia since the collapse of the Union of Soviet Socialist Republics and the change in Russia from a command economy to one based on free market principles. Before I move to comparisons between specific issues in the securities laws of Russia and Manitoba, the reader will be informed that it is a comparison first of all between two different systems of law: the common law system in Manitoba on one side, and the civil law system in Russia on the other. One has been based on a capitalist regime from the moment of its birth, while the other for seventy five years had been based on a communist political regime, which began to move from a command economy towards a free market economy only eight years ago.

After presenting the general legal base necessary to regulate securities markets in both jurisdictions, CHAPTER TWO examines the Federal Securities Law provisions on licensing (registration) of professional participants in its securities markets, which is one of the regulatory techniques aimed at investor protection, and compares it to the Manitoba provisions on licensing requirements. I will review, in particular, licensing requirements for brokers and dealers. This chapter concludes with a comparison of the licensing requirements in Manitoba and Russia, which will underline their differences and similarities and will suggest changes that might be made in the Russian system.

CHAPTER THREE compares the registration and disclosure requirements of the Russian and Manitoba securities laws. This chapter is divided into three sections: (1) a comparison of registration requirements in Russia and Manitoba (2) a comparison of the disclosure requirements, which includes prospectus requirements, as well as continuous disclosure requirements, and (3) a comparison of the proxy requirements in Russia and Manitoba.

CHAPTER FOUR examines insider trading provisions in the Federal Securities Law by contrasting them with the Manitoba legislation. Many differences reflect the respective economic and legal conditions in Russia and Manitoba. Specifically, lawmaking under Russia's civil code differs significantly from Manitoba's mix of statutory and judicial law making.

In this chapter, I discuss the basic elements of insider trading prohibitions in Russia and Manitoba, particularly identifying the definition of inside information, the definition of insiders, and enforcement of insider trading restrictions. This analysis illustrates that the primary motivation behind the Russian statute is a desire to conform to a growing international consensus rather than from a true concern with the economic inefficiency and ethical unfairness of insider trading. It concludes that the definition for an insider, for the purpose of liability, under Russian law is much more restricted than under Manitoba's law. Manitoba's statutory scheme is more consistent with the traditional rationale of market efficiency and fairness underlying general North American policies against insider trading.

CHAPTER FIVE provides an overview of take-over bid provisions in Manitoba and Russia. It discusses why there has been a sustained demand for the regulation of take-over bids in Manitoba and why there is no such demand to regulate acquisitions in Russia. There is a discussion on whether or not similar take-over bid legislation would be appropriate in the Russian marketplace, given its current stage of development.

CHAPTER SIX offers an overview of enforcement provisions in securities laws in Manitoba and Russia. The objective is to provide a summary of the various sanctions provided under such legislation and of administrative mechanisms for enforcement in both jurisdictions. It presents a broad view of the types of sanctions and enforcement procedures used by regulatory agencies, to ascertain what ideas and procedures might be useful in Russia, with or without modification.

CHAPTER SEVEN defines the role for self-regulation in the Canadian and Russian securities markets. Considering the absence of regulations for the largest stock exchanges that operate in Moscow, the scope of this chapter have been restricted to a presentation of general policies concerning self-regulatory organisations, specifically the Investment Dealers Association of Canada (IDA) and the National Association of Securities Market Participants of the Russian Federation (NAUFOR), which play major roles in providing protection for investors by regulating the business conduct of their members. I chose to compare the IDA and NAUFOR as examples of self-regulatory organisations (hereinafter "SRO") because they are both national in scope.

II. CHAPTER I: BACKGROUND TO SECURITIES REGULATION IN RUSSIA AND MANITOBA

A. Prerequisites to the Creation of a Securities Market in Russia

Immediately prior to and since the collapse of the Soviet Union, the Russian Federation, the largest of the former Soviet republics, has been undergoing a transition from a command economy to a market economy, primarily by means of formal legal reforms. Throughout the initial phases of this transformation, policy makers and foreign advisers focused almost exclusively on the broad economic aspects, such as the introduction of tight fiscal and monetary policies, the lifting of governmental price controls, and privatisation of state property. These components are critical for the functioning of any market system. Yet, with attention directed to opening avenues for ownership of private property and fighting inflation, reformers have largely neglected another important element of the reform equation: creation of an enforceable framework of laws and institutions to define and ensure both the rights and duties of all players in the economy.[4]

Not all participants or observers of Russian economic reform have overlooked the role of law reform. "It is certainly apparent from the recent experience in Russia and elsewhere in Eastern Europe," observed American Federal Reserve Chairman Alan Greenspan, " that the mere elimination of central planning does not in itself automatically create a

[4] Lane H. Blumenfeld, "Russia's New Civil Code: The Legal Foundation for Russia's Emerging Market Economy" (Fall 1996) 30 *The International Lawyer*, at 478.

market economy.... [A] formal legal structure which defines and protects property rights and trade through the laws of contract and bankruptcy must pre-exist before a viable sophisticated market economy can emerge from the remnants of a centrally planned one."[5] As conventional theory predicts, when the circle of property owners expands, demand for a stable set of contract rules to regulate property relations and protect the interests of the new owners will grow correspondingly.[6]

The collapse of the MMM investment fund "pyramid" scheme in the summer of 1994 illustrated the need for effective laws to stem the proliferation of financial frauds that undermine society's confidence in an emerging securities market.[7] The crisis existed not only because Russia lacked a comprehensive set of regulations, but also because the government was unable to enforce its existing regulations. Andrei Koshevarov, deputy chairman of the State Anti-Monopoly Committee, stated that he did not see "legal grounds for instituting proceedings against MMM....The legal system has too many gaps to be effectively applied...."[8]

Unfortunately, criminal law reform has not kept pace either with its civil counterpart or, more importantly, with the proliferation of "economic crimes". There is clear evidence

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[5] Greenspan, quoted in L. H.Blumenfeld, *supra* note 4, at 480.

[6] Kathryn Hendley, "The Spillover Effects of Prioritisation on Russian Legal Culture" (1995) 5 *Transnational Law and Contemporary Problems*, at 39, 46-47.

[7] MMM was the most publicised of the pyramid schemes that had proliferated in the unregulated Russian financial market. They generally attracted pensioners and others of moderate means who lacked access to more conservative investment opportunities. In a classic pyramid scheme, the fund pays dividends to early investors with the money attracted from new entrants, rather than from real investments. Therefore, as soon as confidence in the fund's ability to continue paying erodes, investors stop buying and the selling frenzy cascades until the fund runs dry, leaving most investors with worthless shares. See Carey Goldberg, "MMM Leaves Bitter Taste of Capitalism in Russia: Finance: Investor Panic After Fund's Collapse, as Shares Worth $50 Days Earlier Drop to Value of 50 Cents" *L. A. TIMES* (30 July 1994), at A10, online: LEXIS (News Library, Allnws File).

[8] Kashevarov, quoted in Mikhail Dubik, "Laws Too Vague to Take on MMM" *Moscow Times*, 28July, 1994, at 1,2.

that since 1992 economic crimes such as investment scams, money laundering, counterfeiting and bribery have increased dramatically: however, "[p]rosecuting the culprits is frequently nearly impossible," writes Michael Gulyayev of the *Moscow Times*, "because Russian law either does not envisage these types of crimes, or applies its tenets only to state officials and not to Russia's new private businessmen."[9]

In the Soviet period, white-collar crime fell exclusively within the boundaries of the penal system. By contrast, the new civil law --- in the words of Veniamin Yakovlev --- chairman of the Supreme Arbitration Court, Russia's highest commercial court, is designed to "curb the tyrannical behaviour of bureaucrats and criminal elements."[10] Thus, the Russian authorities can now at least wield the hammer of civil penalties in their attempts to break any Mafia-like grip over business and hence society as a whole.

Of all the legislation, the most important is the new Civil Code of the Russian Federation.[11] Across Russia's political spectrum, legislators and governmental officials have come to recognise the necessity for a new Civil Code to protect property and

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[9] Michael Gulyayev, "Laws Incapable of Fighting Economic Crimes" *Moscow Times* (Int'l Wkly. ed.), 6 August 1995, at 18. The Parliament has still failed to adopt a new Law on Organised Crime or revised Criminal and Criminal Procedure Codes. The most recent draft of the Criminal Code was vetoed by President Yeltsin in late 1995.

[10] "Interview with V.F. Yakovlev, Chairman of the Supreme Arbitration Court of the RF" *Izvestiya*, 6 July 1994, at 4.

[11] Grazhdanskij Kodeks Rossiyskoi Federatsii [Civil Code of the Russian Federation], Part One (30 November 1994), *Sobranie Zakonodatel'stva Rossiyskoi Federatsii* [*Sobr. Zakonod. R. F.*] 1994, N. 32, Doc. 3301 and Part Two (26 January 1996), *Sobr. Zakonod. R.F.* 1996, No. 5, Doc. 410, translated in Economic Law of Russia, "Civil Code of the Russian Federation (Parts One and Two)" (Garant-Service 1996, Doc. 7500), available in LEXIS, Intlaw Library, RFLaw File [hereinafter Civil Code, Part One came into force on 1 January 1995 under "Federal Law of the Russian Federation No. 32, Doc. 3302, translated in Economic Law of Russia, "Federal Law No. 52 of the Civil Code of the Russian Federation" (Garant-Service 1996, Doc. 7501), available in LEXIS, Intlaw Library, RFLaw File. Civil Code, Part Two came into force on 1 March 1996 under "Federal Law of the Russian Federation No. 15-FZ" (26 January 1996), *Sobr. Zakonod. R.F.* 1996, No. 5, Doc. 411, translated in Economic Law of Russia, "Federal Law No. 15-FZ of January 26, 1996 on the Enforcement of the Second Part of the Civil Code of the Russian Federation" (Garant-Service 1996, Doc. 5940), available in LEXIS, Intlaw Library, RFLaw File.

contract rights, curb white-collar crime, foster consumer confidence, and attract foreign investment. It is destined to become the core of the market legislation and will form the basis for establishing market relations in Russia. The Civil Code is also the first fundamental legal act that gives a definition to the term "securities".[12]

The transition of Russia to new economic and social relationships, the adoption of the new Constitution of the Russian Federation[13], and reformative laws on ownership and entrepreneurship have significantly altered the legal system of the totalitarian past, where the basis was a nationalised economy and suppression of the initiative of participants in property relationships. A sphere has been opened for regulation of the relationships of citizens and legal entities, on the basis of the principles of private law universally recognised in the world: the independence and autonomous nature of an individual, the recognition and protection of private property, and freedom of contract.

1. Mass Privatisation (Securities Issuers)

In the period from 1991 to 1996, as a result of profound institutional reforms, Russia has made significant progress in the formation of a market-type economy and the establishment of the basic elements of a three-tiered financial system: budget financing, bank credits and direct investment through capital markets. In terms of mobilising financial resources, the fastest developing sectors have been the government securities

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[12] The old Soviet civil law, as embodied in the Civil Code of the Russian Soviet Federate Socialist Republic [hereinafter "RSFSR"] of 1964, was quite inadequate to satisfy the requirements of an emerging market economy. Soviet Civil Code dealt mainly with relationships between state enterprises and other economic units controlled by central economic planning.

[13] Konstitutsija Rossiyskoi Federatsii [The Constitution of the Russian Federation], *Rossiyskaya Gazeta*, 25 December 1993, translated in Economic Law of Russia, "The Constitution of the Russian Federation (Adopted at National Voting on December 12, 1993)" (Garant-Service 1996, Doc. 3000), available in LEXIS, Intlaw Library, RFLaw File [hereinafter "Constitution"].

market, the market for commercial bank securities, and in 1991-94 the market for securities in surrogate securities issued by newly-founded companies, including unlicensed financial companies that raise funds from the public. In this way, the mobilisation of financial resources through the capital market by the government, by banks and, prior to 1995, by venture companies has played a dominant role in developing the markets. Issuers from other spheres of the economy, mainly privatised companies, were still involved in institutional reform and had not yet begun to attract significant investment resources through capital market mechanisms. By the beginning of 1996, the practice of using government financial instruments had become widespread in the following areas: (1) issues of government securities to finance the budget deficit: short term Treasury-Bills (GKOs), federal loan bonds (OFZs) and government savings bonds (OGSZs); (2) restructuring of the domestic hard currency debt through issues of domestic foreign currency bonds (OVVZs) ("taiga bonds"); (3) attracting cash through cash privatisation (investment tenders and competitions, loans-for-shares privatisation).[14]

The key factors that shaped the development of the capital market in the period 1991-95 were:

- Large-scale privatisation, including the issuance of privatisation vouchers as freely-circulated bearer securities.[15] The term "Privatisation voucher" refers to the various

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[14] *See* "Concept for the Development of the Capital Market in the Russian Federation", approved by decree No. 1008 of the President of the Russian Federation, 1 July 1996, *Ekonomika I Zhizn* No. 28, July 1996, at 13.

[15] The mass privatisation programs of the former Soviet Union were designed as the centrepieces of the transformation of the regions' command economies to principles of market forces. The programs were designed to distribute shares in thousands of state-owned enterprises amongst hundreds of millions of citizens for free or for nominal payment, thereby creating a revolutionary class of individual shareholders with a strong stake in the privatisation process. The general program was devised by the Russian

types of government issued vouchers, coupons of investment points which citizens received for free (or for a nominal fee) and used these to purchase shares of privatised companies or of investment funds which invest in privatised companies.

- The issuance and circulation of shares of privatised enterprises.
- Development of the practice of financing the federal budget deficit and deficits of subject entities of the Russian Federation through issues of securities, along with a restructuring of the domestic hard currency debt through securities issues.
- The non-payments crisis and the emergence, in connection with these deficits, of special financial instruments, such as treasury bills and promissory notes.
- The issuance of securities and surrogate securities by new commercial structures, including unlicensed financial companies.

Mass privatisation of state enterprises has caused an enormous number of new financial instruments - shares in privatised enterprises - to appear in the market. The rapid growth of both the market for privatised enterprises' equity and the supporting infrastructure, combined with the dynamic growth of the market for government and municipal securities, has contributed to high-risk and surrogate securities being forced off the market. There exists a huge potential for growth in the market for corporate equities, both

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Federation's government in co-operation with the World Bank and the United States Agency for International Development (USAID), and is in essence a cash-and-voucher, coupon-based model. In the privatisation program, designated state-owned enterprises are transformed into joint-stock companies, and a portion of their shares are sold at public auctions for vouchers. For information on privatization in the Russian Federation *see* Matthew J. Hagopian "The Engines of Privatization: Investment Funds and Fund Legislation in Privatising Economies" (1994) 15 *Northwestern Journal of International Law and Business* 75; see also J. R. Brown, Jr., "Order from Disorder: The Development of the Russian Securities Markets" (1995) 15 *University of Pennsylvania Journal of International Business Law* 509 [hereinafter referred to as "Order from Disorder"].

through increases in the market prices of outstanding shares of large privatised companies and through the flow of shares of medium and small-sized companies into the market.

These companies are becoming the issuers of securities, thus contributing the first building blocks of a securities market. Vouchers were freely tradeable. This quickly created a large voucher exchange market and provided an alternative to citizen's investment of their vouchers directly in investment funds or privatised companies. Investment funds, formed in the context of mass privatisation programs, accepted privatisation vouchers and cash, to invest in the shares of privatised companies.[16] The involvement of investment funds in voucher privatisation programs has helped to increase the public's general interest in vouchers and to establish organised markets for vouchers and for the shares of privatised companies. Investment funds also acted as major traders on the voucher exchanges. In addition, through their role as an intermediary in choosing shares and attracting vouchers and cash, investment funds also simplified the process through which citizens invest in the new securities market.

Under the mass privatisation model, citizens were able to combine their vouchers in investment funds and collectively bid for stakes in the enterprises. Investment funds then bid on behalf of the citizens in privatisation auctions. The investment funds represented Russia's first class of institutional investors who accumulated vouchers from individual investors and used them to purchase large blocks of shares in privatised companies.

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[16] The term "investment fund" as used in this paper generally refers to an enterprise which is owned by a large number of persons and which is primarily engaged in the business of investing in securities.

The voucher system of privatisation has created a substantial number of publicly held issuers and has spread the ownership of these companies among the members of the general public, making privatised enterprises publicly held companies. As a result, the first necessary condition for the creation of a securities market - the existence of issuers of securities - has been satisfied.

2. Financial Intermediaries

The use of auctions to distribute vouchers also stimulated the development of a secondary market and contributed to the development of some classes of market intermediaries, such as brokers, for whom vouchers represented an early and only source of business. These voucher markets eventually evolved into the markets for trading in equity securities of privatised companies.

Members of the Russian Stock Exchange trade mostly in short-term debt instruments, known as *veksels* or bills of exchange. Owing to their extensive use in privatisation, bills of exchange are traded actively. Active trading in bills of exchange in Russia helps securities professionals develop invaluable experience, which may later be used in securities trading. While Russian broker-dealers have learned the basics of securities trading through participation in the bills of exchange market, the wide use of investment funds in the Russian privatisation program has brought investment advisors and portfolio managers into existence. These categories of securities professionals learn their trade by managing the investment funds that bid for newly privatised enterprises. Even though these managers of Russian investment funds, unlike their Western counterparts, do not have to deal with all the complexities of modern investment strategies, their primary task

of compiling a financially sound investment portfolio is basically the same as that of western fund managers.

As this brief overview of the Russian securities industry indicates, Russian financial institutions are already capable of handling simple tasks associated with securities trading. In summary, the securities industry of Russia is becoming an economic reality. As it develops its expertise through trading in short-term instruments and the creation of privatisation investment funds, the industry provides a viable system for bringing together buyers and sellers of securities, thus satisfying the second condition necessary for the creation of a securities market.

3. Investors

The privatisation of state-controlled enterprises has created widespread share ownership in Russia. As a result, a class of domestic investors who may be willing to trade their shares has been created. The appearance of domestic investors on Russian markets is certainly relevant to the creation of a securities market. But the domestic investors that exist in Russia usually do not have enough savings to have a meaningful impact on the Russian securities markets. Individual foreign investors do not have the ability to obtain adequate information about Russian companies, which makes this market too risky for them. Therefore, the existence of a securities market in Russia depends to a large degree on whether global institutional investors are prepared to invest in Russia. Fortunately, during the early stages of development, the markets of the Russian Federation were an investment target for global investors looking for new markets in which to diversify their portfolios and to obtain higher rates of return. Thus, the third economic condition to the

creation of a securities market - the presence of investors who were willing to invest in Russian securities - has been satisfied.[17]

4. State Interest

Creation of a securities market depends on the existence of three groups of players in the national economy: issuers of securities, financial intermediaries, and investors. There is, however, also need for a fourth player, government, which has the power to facilitate the creation of a securities market or to prevent it. From the government's perspective, a securities market raises two issues: first, whether a country needs such a market; and second, even if the country does need such a market, how it should be regulated, if at all. The government of Russia favours creation of securities markets to improve of its national economy. The securities market was the primary means to achieve the national goal of raising capital for economic reforms. In addition to the economic benefits associated with a securities market, the market has an ability to promote social policies brought into existence by privatisation of the Russian economy. Creation of share ownership has been designed to introduce a new capitalist culture to the general population of these republics. The major goal of privatisation - transition to a market economy - cannot be achieved without developing a capitalist spirit and an understanding of values that come along with share ownership in general public. The task of educating the public about capitalism and a market economy can also be fulfilled by the introduction of securities markets, where market forces transform the meaningless price tags attached to the state-distributed vouchers into shares that have true market value.

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[17] Brown, "Order from Disorder", *supra* note 15.

Thus, the social success of privatisation is closely tied to creation of a securities market. From that perspective, the dilemma of the Russian Federation is not whether to have or not to have a securities market; rather, its dilemma is whether to regulate securities trading and, if so, to what extent so as to ensure that the regulation will successfully jump-start a viable securities market, without killing it.

As argued above, Russia has all the prerequisites for an emerging securities market and, most importantly, has large floats of stock created in the course of a comprehensive privatisation program. As such, it already has securities trading, developed with the privatisation program. In this situation, the government of Russia can either permit such a market to develop freely or impose regulations on the emerging securities industry. World experience shows that a comprehensive regulation of securities markets is the only way to assure its proper functioning, to prevent abuses and foster markets that merit and retain investor confidence.[18]

The Russian markets, which have not yet developed traditions of disclosure, can hardly be described as efficient, in terms of incorporating relevant information into securities prices. Moreover, the general public in Russia lacks an investment culture to determine what information is necessary to assess the value of a share. Under such circumstances, newly created joint-stock companies have every incentive to draw a rosy picture of their conditions and to omit all negative information, knowing that the investing public may never be able to discover the truth, until it is too late.

[18] Norman S. Poser, *International Securities Regulation: London's "Big Bang" and the European Securities Markets* (Boston: Little, Brown, 1991), at 5.

As a result, the general public, both domestic and foreign, can abandon the market, leaving it to a few large domestic players who have the power on their own to retrieve all material information from the companies for valuation purposes. The exclusion of foreign investors from the securities market may reduce the flow of capital to enterprises and consequently slow down development of the Russian economy.

In addition to the existence of fraudulent practices of misrepresentation and nondisclosure, an unregulated securities market creates ample opportunities for market manipulation by industry professionals who possess a superior knowledge of the market.

As indicated earlier, investment funds may play an important and central role in economies undergoing transformation and privatisation. However, investment funds also occupy a sensitive position in transforming economies, particularly because of the large number of privatisation vouchers that they can be expected to accumulate. Abuse of this position of trust may threaten society's faith in the privatisation program, the new securities market and the government itself.[19]

During 1991-1995, the capital market developed in a context where the federal laws that would have provided a regulatory structure for the capital market did not exist. There were no laws regulating joint-stock companies, the securities market or the investment funds. Under these conditions, a legal framework for the capital market existed on the basis of presidential decrees, governmental regulations and normative acts issued by governmental agencies. At the time, presidential decrees possessed the status of a law

[19] See "Russians No Longer Believe in Reforms Following MMM Scandal", TASS, Sept. 1, 1994, available in LEXIS, Nexis Library; also see "Russians Affected by Fraud Close Ranks", TASS, June 23, 1994, available in LEXIS, Nexis Library.

enacted by the Russian Parliament, and they were central to building the idea of investor protection in Russia.[20]

Significantly, many observers have argued that these normative acts were not implemented to the extent that they produced any level of investor protection.[21] One important feature which had a negative effect on market liquidity during this period was taxation on securities transactions. By 1996, a qualitative change in the situation had been brought about. Since then the government has taken steps to introduce comprehensive regulation of securities transactions. The most important of these steps was the establishment of regulatory authorities for the securities markets and the enactment of the basics of a codified legal system, including the *Civil Code*, which contains fundamental regulation of commercial activities, the *Federal Securities Law*, and the *Joint Stock Companies Law*. The Federal Commission for the Securities Markets (hereinafter "FSC") has replaced the Russian Ministry of Finance and become the agency primarily responsible for regulation of the securities market in Russia.[22] The tax on securities transactions has also been repealed.[23]

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[20] See, for example, the Decrees of the President of the Russian Federation: (1) Decree of April 26, 1995, No. 416 "On Measures for Ensuring the Interests of Investors and Bringing to Conformity With the Legislation of the Russian Federation the Business Activity of Judicial Persons Carried Out on the Financial and Share Markets Without the Relevant Licenses", (2) Decree of 26 July 1995 No. 765 "On Additional Measures for Raising the Efficiency of the Investment Policy of the Russian Federation", (3) Decree of 18 November 1996 No. 1157 "On Certain Measures for Protecting the Rights of Investors and Shareholders", (4) Decree of 21 March 1996 No. 408 "On Approving the Composite Program of Measures Ensuring the Rights of Investors and Shareholders", (5) Decree of 1 July 1996 No. 1008 "On the Approval of the Concept for the Development of the Securities Market in the Russian Federation."

[21] For example, the Decrees, in part, provide for the creation of "compensation funds" to reimburse investors defrauded by unlicensed financial institutions, whose widespread activities the thesis summarises. The funds were to be similar in function to the CIPF in Canada with respect to brokerage houses and insured banks respectively. Analysis of the so-called "compensation funds" indicated that little, if any, remuneration was made to defrauded investors.

[22] During the initial stages of development of the Russian securities market during 1991-1995 and prior to creation of the Federal Securities Commission, the key State agencies or structures regulating the securities

The current regulatory framework is a leap forward from the period prior to the introduction of codified legislation, during which shareholder and investor protection was limited and investments were poorly regulated. The previous environment, which promoted schemes such as the MMM pyramid investment fund, is now in its last stages.

B. Evolution Of Canadian Securities Regulation

Securities regulation in Canada has evolved through various statutes, including those relating to the incorporation of companies, the reporting of information by companies, the sale of shares, securities fraud prevention, and the licensing of brokers, with the final product of this evolution being a comprehensive set of securities acts. [24] Securities regulation in Canada is on a province by province basis. Unlike the United States, there is no federal or national securities commission in Canada. Since its emergence, securities regulation has been the preserve of provincial governments. There are thus thirteen separate securities commissions or regulatory authorities, each charged with supervision of their local markets. Even though the province of Ontario, with the lion's share of market activity, is home to The Toronto Stock Exchange, as the acknowledged principal

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market were the State Committee for Administration of State Property ("Goskomimushestvo" or "GKI") and the Ministry of Finance (also to a lesser degree the Central Bank to the extent it regulates banks). After creation of the FSC, the GKI's role as initiator of key regulations related to securities and the market has ceased (except with respect to certain matters directly connected with the privatisation process). The Ministry of Finance's role for the most part is now limited to fulfilling its responsibilities regarding the issuance and setting of terms of issuance of State securities.

[23] For a good introduction to the securities regulatory framework in Russia - *see,* P. Thompson & R. Sharipov, " Securities Regulation in the Russian Federation" (1996) 25 *Denver Journal of International Law and Policy* 95. *See also* C. Taylor, "Capital Market Development in the Emerging Markets: Time to Teach an Old Dog Some New Tricks" (1997) 45 *American Journal of Comparative Law* 71. *See* "Concept for the Development of the Capital Market in the Russian Federation", *supra* note 14.

[24] For a detailed account of the history of Canadian securities legislation *see,* J.P. Williamson, *Securities Regulation in Canada* (Toronto: University of Toronto Press, 1960), chapter 1. On the development of Canadian securities law *see* also D.L. Johnston, *Canadian Securities Regulation* (Toronto: Butterworths,

market, this thesis will focus on the Manitoba regime. With the exception of the province of Quebec,[25] securities acts and regulations in the provinces are harmonised to a large degree, with the Ontario *Securities Act*[26] now serving as the basic model.[27]

The current system of securities regulation in Manitoba is a mixture of statute, judicial decision and various policies that have developed over the course of time. For the most part, the securities legislation in Manitoba is substantively similar to that found in all Canadian provinces.

1. Historical Background

Up until the second decade of the twentieth century, securities legislation in Canada largely followed the British model, first finding its way into law by means of companies legislation. The English *Joint Stock Companies Act,* passed in 1844 was followed by additional provisions from time to time, and the 1890 English *Directors Liability Act* were the sources for the *Canada Joint Stock Companies Act*, 1869, [28] the first federal statute dealing with incorporation generally, and for corporate legislation in the provinces. During the period from 1869 to 1907, provincial corporate legislatures adopted the prospectus requirements of the English *Companies Act*, 1867, obligating a company to disclose to its potential investors some of the facts material to an investment in its securities, in the same manner as the requiring disclosure in a prospectus of contracts

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1977), at 9-18; P. Anisman, "The Regulation of the Securities Market and the Harmonisation of Provincial Laws" *The Canadian Securities Course* (Toronto: The Canadian Securities Institute, 1988) at 77-82.

[25] The substance of the regulatory regime of Quebec is very similar to that of other provinces although the actual statutory format is different. For a brief summary of Quebec law, *see* Luc LaRochelle, *et al.*, "Bill 85, Quebec's New Securities Act" (1983) 29 *McGill Law Journal* 88, 92-94.

[26] Ontario *Securities Act*, R.S.O. c. S5(1990), as amended by S.O. c. 18 S56 (1992); S.O. c. 27 (1993); and S.O. c. 11 (1994).

[27] M. Gillen, *Securities Regulation in Canada* (Toronto: Carswell,1992).

entered into by a company. Various provincial jurisdictions in Canada copied provisions of the English *Directors Liability Act* requiring financial statements being provided to shareholders; inspections; directors and promoters liability for loss and damage sustained as a result of an untrue statement in a prospectus; and the requirements for greater prospectus disclosure.

However, with the passage of "Blue Sky" laws in a number of American states, beginning with Kansas in 1911, Canadian securities law began to reflect the U.S. influences, introducing the comprehensive system of registering securities, brokers and offerings of all types of enterprises. The most enduring contribution of the Kansas model to securities regulation was the preoccupation of blue sky laws with assessing the offering's fairness.

"Blue sky" legislation (so named because it was a response to brokers who tried to sell mid-western farmers a piece of the blue sky) was a watershed in securities regulation, being adopted in Manitoba in 1912, the first province to do so.[29] The Manitoba *Sale of Share Act* initially applied only to non-Manitoba issuers, except those licensed in Manitoba, and it applied to sales of shares by shareholders as well as issuing companies. Before sales of shares were permitted, it was necessary to obtain a certificate from the Manitoba Public Utilities Board (the "PUB"). However, in 1914 the certificate requirement was extended to the securities of domestic companies, and certain documents relating to the financial status of the company were required to be filed with the PUB

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[28] Statutes of Canada, 1869, Cap. XIII.
[29] M. Macey & Miller, "Origin of the Blue Sky Laws" (1991) *Texas Law Reporter*, 70 at 420.

before a license[30] would be given.[31] By an 1914 amendment, the PUB was empowered to investigate a foreign issuer: to examine persons, books, and papers, summon witnesses, and so on.

In 1926 the *Sale of Shares Act* was incorporated into the *Municipal and Public Utilities Board Act* (the "Municipal Act").[32] The *Municipal Act* introduced comprehensive licensing requirements which applied to everyone selling securities in Manitoba, to securities issuers as well as securities salesmen. Licensing was at the discretion of the Municipal and Public Utilities Board (the "MPUB"), and even non-professionals were required to obtain permits before selling securities that they owned, though an extensive set of exemptions applied to various kinds of trades and securities. All companies, while certified to offer their securities, were required to file reports with the MPUB. It was given discretion to grant or deny licences or certificates, but an applicant had a right to be heard before the MPUB. Revocations were in the discretion of the MPUB, and a purchaser of securities sold in violation of the *Municipal Act* was entitled to rescission.

The next step in the legislation of Manitoba was adoption of the *Securities Frauds Prevention Act* in 1930, as the "uniform" securities legislation in Canada.[33] This Act introduced a list of what was declared to constitute fraud and provided for investigations

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[30] Clarification: The term "certificate" in this chapter is used in relation to shares of an issuing company whose securities are to be offered for sale; the term "license" is used in relation to companies and individuals selling securities in Manitoba.

[31] Williamson, *supra* note 24 (noting a few significant differences in Manitoba *Sale of Shares Act* from the Kansas Act), at 12-13; also D. Johnston, *supra* note 24, at 10.

[32] *Statutes of Manitoba*, 1926, c. 33: Williamson, *supra* note 24, at 10.

[33] The first province to adopt the *Securities Frauds Prevention Act* was Ontario in 1928. As a result of aroused concerns for regulation of securities trading, representatives from eight provinces met to draw up what was to be the first "uniform" securities legislation in Canada. Amongst those representatives was one from Manitoba. This form of legislation with slight variations was adopted by Manitoba as the "uniform" *Securities Frauds Prevention Act*. *See,* J. P. Williamson, *supra* note 24, at 14.

into securities frauds; however it did not deal with prospectus disclosure because it still reflected the historical split between investor protection and corporate legislation.[34] In other words, although the *Securities Frauds Prevention Act* did have issuer registration requirements, the prospectus requirements were still contained in the relevant corporate legislation.

The legislation in the securities field was thrown into disarray by the Privy Council in 1929 in *A.G. Manitoba* v. *A.G. Canada* [1929] A.C. 260 (P.C.). This decision struck down the Manitoba *Securities Frauds Prevention Act* on constitutional grounds insofar as it applied to federal companies. In response, over the next fifteen years, most of the provinces enacted a prospectus requirement applicable to all companies, to get over the federal-provincial constitutional hurdle. This approach was carried forward to today, was approved by the Privy Council in *Lymburn* v. *Mayland*, [1932] A.C. 318 (P.C.), which confirmed that both the federal and provincial governments have constitutional authority in the securities area.

The sale of securities in Manitoba was regulated by the *Securities Act*, 1954,[35] (there had not been much change from the *Securities Frauds Prevention Act* of 1930), as well as by the *Companies Act* of Manitoba,[36] which regulated the sale of securities by companies incorporated or licensed under that Act. The *Securities Act* required the filing of a prospectus before a company could issue securities. Filing is all that was required. No

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[34] The legislation did not deal with prospectus disclosure because it still reflected the split between investor protection and corporate legislation. In other words, although the *Securities Frauds Prevention Act* did have issuer registration requirements, the prospectus requirements were still contained in the relevant corporate legislation.

[35] R.S.M. 1954, c. 237.

[36] R.S.M. 1954, c. 43.

permission was needed for the issuance of securities. The act also specified the content of a prospectus and provided civil liability based on inaccuracies or omissions.

No major changes introduced in Manitoba securities legislation until the *Securities Act* of Manitoba, 1968, was enacted. It is based substantially on the *Securities Act*, 1966, of Ontario. In 1963 the Ontario Government appointed the Kimber Commission to review securities legislation.[37] As a result of the hearings and considerations of the Committee, a report was prepared and presented to the Attorney General of Ontario. This report, dated 11 March, 1965, is the basis of the *Securities Act*, 1966, Ontario. The report is divided into a number of headings, and deals specifically with insider trading, take-over bids, disclosure in financial statements, form, content and distribution of prospectuses, proxies and proxy solicitation, primary distribution through the facilities of the Toronto Stock Exchange and constitutional consideration.

Manitoba adopted requirements introduced by the Ontario *Securities Act*, which included annual and semi-annual financial disclosure by issuers, regulatory standards to govern take-over bids, mandatory proxy solicitation, and the reporting by corporate insiders of their trading, together with civil liability provisions for improper use by them of inside

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[37] *Report of the Attorney General's Committee on Securities Legislation in Ontario* (Toronto: Queen's Printer, March 1965) [hereinafter the "Kimber Report"]. The *Kimber Report* was one of several reports produced in the early1960s that addressed the regulation of securities markets. These reports generally responded to specific problems that had arisen. The *Kimber Report* got its impetus, in part, from the Shell Oil take-over of Canadian Oil, in which certain persons had used knowledge of the take-over to buy shares of Canadian Oil before the announcement of the take-over.
See the *Kimber Report*, Parts II, IV and VI. On a discussion of the provisions of the *Securities Act, 1968* of Manitoba - see, G.T. Brazzell, "The Securities Act of Manitoba" in *The Law Catches Up With Recent Legislative Changes* (Winnipeg: Isaac Pitblado Lectures on Continuing Legal Education, 1969).

information.[38] Legislation adopted in Manitoba in 1968 also established The Manitoba Securities Commission, which took over regulation of the Manitoba *Securities Act* (the "MSA") from the MPUB.[39]

Finally, in 1978 the Province of Ontario, following on the heels of the Merger Report in the mid 1970s, enacted a new *Securities Act* which, among other things, created a "closed system" for trading in securities.[40] The key to the "closed system" statute is its strong emphasis on ongoing disclosure for the purposes of secondary market trading. It allows trading among a select group of persons who are presumed not to need the protection provided by the extensive disclosure contained in prospectuses, financial statements, and mandatory proxy solicitation. However, the concept is that, if trading is to be done beyond this select group, it must be supported by these various forms of mandatory disclosure. This is a model that now dominates in Canada, although Manitoba has not yet adopted it.

2. Rule Making Authority

Given the evolution and rapid changes in Canadian capital markets in recent years, legislative change has not always been able to keep up with the markets. As a result, over time a system has evolved in which the MSA and Manitoba *Securities R*egulations (the "MSR") set forth only the basic framework of securities regulation, while much of the

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[38] The statutes of British Columbia, Alberta, Saskatchewan, Manitoba and Ontario comprise one uniform group, originating with the 1966 Ontario *Securities Act* as amended. They are called the uniform act provinces.

[39] S.M., 1968, c. 57. Bill No. 10.

[40] *Report of the Committee of the OSC on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements* (Toronto: Ontario Securities Commission, February 1970) [hereinafter the "Merger Report"].

details as to how the securities regulators generally apply and interpret the legislation is set forth in policy statements. The result has been that approximately fifty National Policy Statements and thirteen Uniform Act Policy Statements have been adopted across Canada through the Canadian Securities Administrators (the "CSA"), an informal organisation consisting of the securities regulators of all ten provinces and three territories. The subject matter of the National Policy Statements ranges from the clearance of national prospectus issues (National Policy Statement No. 1) to mutual funds (National Policy Statements No. 36 and 39).[41] Policy statements serve as industry guidelines. Although not endowed with any legislative authority, the CSA meets regularly and acts as a co-ordinating body for regulatory initiatives, most notably in the formulation of national policy statements adopted by each provincial commission.[42]

In addition to the National Policy Statements, the securities regulators in virtually all jurisdictions have adopted a number of local policy statements. These deal with matters not covered in the National or Uniform Act Policy Statements or deal with items of particular local concern.[43]

Although these policy statements are essentially a response to the increasing change and complexity of financial markets, and are an integral part of securities regulation in Canada, most jurisdictions do not explicitly authorise regulators to issue them.[44] The system was thrown into disarray by the decision of the Ontario Court of Justice in *Ainsley*

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[41] See P. Anisman, "The Regulation of the Securities Market and the Harmonisation of Provincial Laws" in R. Cumming (ed.), *Harmonisation of Business Law in Canada* (Toronto: University of Toronto Press, 1986), at 79; and M. R. Gillen, *supra* note 27, at 60-1.
[42] M. R. Gillen, *ibid.*, p. 61.
[43] P. Anisman & P.W. Hogg, "Constitutional Aspects of Federal Securities Legislation" in *Proposals for a Securities Market Law for Canada*, vol. 3, (Ottawa: Minister of Supply and Services, 1979), at 79.

Financial Corporation et al. v. *Ontario Securities Commission and Donald Page* (13 August, 1993), upheld by the Ontario Court of Appeal on 21 December, 1994. Essentially the decision held that Policy 1.10 of the OSC was a mandatory requirement of a regulatory nature and that it was outside of the OSC's jurisdiction to adopt and compel adherence to this Policy. In the relief granted, the Ontario Court of Justice, General Division, issued a declaration stating that the OSC Policy Statement 1.10 was invalid.[45]

After the trial court decision in *Ainsley*, the Ontario finance minister appointed a task force (the "Daniels Task Force") on 7 October, 1993 to provide recommendations respecting the legislative framework for the development of securities policies in Ontario. The purpose of the Daniels Task Force was to recommend a response to the fallout from the *Ainsley* decision. The recommendations made by the Daniels Task Force included the following:

1. The legislation of Ontario should be amended to authorise expressly the OSC to adopt Policy Statements, provided that they are not mandatory or prohibitory in nature;

2. The OSC should be granted rule-making power to permit the OSC to adopt rules having force of law;

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[44] L. Vincent & M. Guttormson, "Securities Law Primer" prepared for presentation to members of The Law Society of Manitoba, Legal Studies Department, in Winnipeg, Manitoba, 13 May 1998.

[45] Of interest is the fact that Policy Statement 1.10 had been adopted by the OSC in March 1993 (it came into effect on 1 June 1993) to respond to the rapidly growing problem of abuses in the "penny stock" industry. The Ontario penny stock industry was dealt with by brokers who were not members of either the Investment Dealers Association of Canada or of the Toronto Stock Exchange. Accordingly, the companies and individuals selling in the penny stock market were not required to respond to any SRO with any semblance of audit or other jurisdiction. The abuses included the employment of high pressure and unfair sales tactics, misrepresentation of information or provision of inadequate disclosure and similar abuses. Policy 1.10 required brokers in the penny stock industry to provide clear disclosure information to clients and limited the mark-ups they were permitted to take on the stocks they sold. *Ibid.*, p. 14.

3. The Ontario Cabinet should have the power to review OSC rules for the purpose of disapproval; and,

4. All policy statements and rules adopted by the OSC should be subject to a formal statutory notice and comment procedure, although requirements for the adoption of policy statements should be somewhat relaxed, as opposed to that for rules.

As a result, Ontario and then Alberta, British Columbia and Saskatchewan have given their respective commissions rule-making authority.

On 19 November, 1996, The *Securities Amendment Act, S.M. 1996, c. 50,* was passed by the Manitoba Legislature and received Royal Assent on 1 January, 1998. By this amendment the MSC is given the power to make rules.[46] The process of rule making is prescribed in the MSR.[47]

C. Comparison

By comparison, on the one side is a small but highly developed Canadian capital market, with a securities regulatory regime which is innovative in many respects. Significant developments of Canadian securities regulation appear to have begun in roughly the mid-nineteenth century, with the most significant developments occurring in the last sixty-five years. On the other side is the emerging capital market of the Russian Federation. Russian securities regulation began in 1991, but significant developments took place in the two years, 1995-1997.

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[46] *Securities Amendment Act*, S.M. 1996, c. 50.

In the Russian system, the primary responsibility for regulation of the securities market is granted to a federal commission, whereas in Canada provincial securities commissions are responsible in their respective provinces.

In examining Russian securities laws, despite apparent similarities with the western world in the structure of securities regulation in former communist countries, such regulation pursues somewhat different goals. In Canada, governmental regulation of securities traditionally has been adopted in response to abuses that had occurred in already existing markets. These were then amended from time to time to meet the demands of a changing market or of new abuses, or both. In western economies, "the regulatory activity of the government does not follow some abstract and predetermined rules, but is basically reactive to the situation in the market, both in terms of the content of regulation and the process by which they are promulgated".[48] Thus, traditional securities regulation can be characterised as responsive, for it follows and responds to market trends.

In contrast, securities regulation in Russia is being developed for the purpose of creating an orderly market out of chaotic trading in securities. Unlike "responsive" securities regulation that exists in Canada, the government of Russia has to anticipate the market in order to move it in the right direction by legislative and regulatory means.

The difference in the regulatory schemes in Canada with Russia can be seen in the rigidity of regulation. Anticipatory regulation is generally stricter than responsive regulation. The

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[47] Manitoba *Securities Regulations* 491/88R [hereinafter referred to as "MSR" or "Man. Regs."], as amended by Man. Regs. 246/97, gazetted 27 December, 1997, effective 1 January, 1998 under "Rule-Making Procedure Regulation".

[48] *E.g.*, R. Frydman & A. Rapaczynski, *Privatization In Eastern Europe: Is the State Withering Away?* (London: Central European University Press, 1994), at 10.

latter has the benefit of empirical knowledge of the market and may exempt certain economic activities from its scope. In contrast, anticipatory regulation tries to encompass as many activities as possible, just to ensure that nothing is omitted.

This difference will be seen in the following comparison of Manitoba securities laws and the Russian regulatory scheme. Securities regulation in Russia has few, if any, exemptions. Russian securities regulation tends to impose more substantive restrictions as to disclosure requirements. Manitoba securities regulators can justify non-inclusion of certain restrictions and liabilities in securities laws on the basis of empirical studies of the market. In contrast, Russian securities regulators labour under a complete uncertainty as to the future of the Russian securities market. Moreover, the ability of the Russian securities industry to develop promptly an expertise in securities fraud eliminates the possibility of a "wait and see" approach to regulation. To that end, there is no reason for Russia not to include something that has proven to be workable in the Canadian securities markets, where the goal of the Russian regulation is to anticipate and create well-functioning markets.

This is not to say that Russian regulators should include all provisions of Manitoba securities laws that have proven to be workable in the Canadian markets, however complex and technical they may be. It will be years before the Russian market will be able to match the scale and sophistication of Canadian markets. As Professor Poser noted in his study of Brazilian securities regulation, enacted to develop the capital markets in Brazil, "[t]he regulatory measures, if too far ahead of generally accepted standards, may

inhibit rather than further market development".[49] Therefore, an overly regulated market can have the counter-effect of alarming industry professionals and may ultimately destroy the market before it stabilises. This is another aspect that distinguishes an anticipatory regime from a responsive one. The proper balance between investor protection and favourable market conditions will have to be anticipated rather than deduced from market experience.

This thesis will not attempt to suggest a clear solution for striking the right balance between anticipatory and responsive regulation, partly because there may not be one. Rather, it will attempt to survey the Russian regulatory scheme in comparison to the Manitoba securities regulatory scheme. It is hoped that this survey will be useful in helping to decide how close the makers of Russian securities laws come to an ideal anticipatory regime, which could transform unorganised securities trading into orderly and attractive securities markets for investors.

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[49] Norman S. Poser, "Securities Regulation in Developing Countries: The Brazilian Experience" (1966) 52 *Virginia Law Review* at 1294.

III. CHAPTER 2: LICENSING OF PROFESSIONAL PARTICIPANTS IN SECURITIES MARKETS

A. Registration Under the Manitoba Securities Act

1. The Purpose of Registration

One regulatory mechanism in the MSA aimed at investor protection is a registration requirement imposed on dealers and certain other market intermediaries. The registration of such market professionals sets standards for entry.

The registration requirement in Manitoba essentially began in 1914 with "Blue Sky" legislation[50] and was extended in the Manitoba *Security Frauds Prevention Act* of 1930.[51] The basic objective of the registration procedure is to ensure that people involved in the securities business are honest and of good reputation, in order that the public is protected from fraudulent behaviour.[52]

The registration requirement is a comprehensive one. The objective of the legislation is to make sure that the candidate has the required skills to practice the profession, "to ensure

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[50] Adopted in Manitoba in 1912 and amended in 1914, "Blue Sky" legislation was essentially a registration statute that required a company selling securities to the public as well as brokers and salespersons to obtain licences. For more information on this, see *supra* note 29.
[51] D.L. Johnston, *supra* note 24, at 78.
[52] *Lymburn v. Mayland*, A. C. 318 (1932).

the competence, financial stability and integrity of such persons".[53] The discretion of the registration authority in terms of evaluating the suitability of the candidate is broad.[54]

Registration is also used to ensure the adequacy of the capital base of persons dealing with the public in securities; to impose operational and procedural rules considered necessary and in the public interest; and to enforce compliance with certain ethical standards.[55]

Registration seeks to protect investors against the dangers that a broker will recommend and purchase for the customer securities not appropriate to the customer's financial situation and investment objectives; that a broker, whose fee is based on a commission, will cause excessive trading in the customer's account; and, that a broker will be just plain incompetent in securing prompt and accurate executions of a customer's order.[56]

2. Activities That Require Registration

The legislation of Manitoba provides that no person shall trade in securities, underwrite issuances of securities or give advice with respect to investments in securities unless the person is registered.[57] A person who trades, underwrites or advises without registration can be subject to penal sanctions.[58] Registrants are subject to regulatory requirements and

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[53] M.Q. Connelly, "The Licensing of Securities Market Actors" in *Proposals for a Securities Market Law for Canada* (Ottawa: Ministry of Supply and Services, 1979) 1269, at 1273.
[54] MSA, s. 7(1) states: "the director shall grant registration or renewal of registration to an applicant where in the opinion of the Director the applicant is suitable for registration and the proposed registration is not objectionable."
[55] Toronto Stock Exchange, Submission to the Ontario Securities Commission on Bill 75, the Securities Act, 1974, at 34 (11 October 1974).
[56] M.Q. Connelly, *supra* note 53, at 1274.
[57] MSA., s. 6.
[58] *Ibid.*, s. 136(1)(c).

non-compliance with these requirements can lead to suspension or cancellation of registration.[59]

The MSA requires registration of persons who "trade" in securities.[60] Section 6 of the MSA provides that no person or company shall engage in trading (within the very wide statutory definition of that term) in securities,[61] unless such person or company is registered with the MSC to carry on the particular activity.

3. Who Must Register

The MSA requires registration by persons who carry out business in the capacity of a broker, investment dealer and broker-dealer. The MSA in section 1(1) sets definitions of "broker"[62], "broker-dealer"[63], and "investment dealer"[64], which refer to the first as "a member of a stock exchange in Manitoba recognised by the commission " and the latter

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[59] *Ibid.*, s. 8(1).

[60] *Ibid.*, s. 6.

[61] The definitions of "trade" and "securities" are essential to the requirement to be registered to "trade in a security". For "security", *infra* note 123. The MSA s. 1(1) defines "trade" as follows:

> "trade" or "trading" includes
>
> a) any sale or disposition of or other dealing in or any solicitation in respect of a security for valuable consideration, whether the terms of payment be on margin, instalment or otherwise, or any attempt to do one of the foregoing;
>
> b) any participation as a floor trader in any transaction in a security upon the floor of any stock exchange;
>
> c) any receipt by a person or company registered for trading in securities under this Act of an order to buy or sell a security;
>
> and
>
> d) any act, advertisement, conduct or negotiation directly or indirectly in furtherance of any of the foregoing."

[62] "Broker" means any person or company who trades in securities in the capacity of an agent and is a member of a recognised stock exchange in Manitoba.

[63] "Broker-Dealer" means any person or company recognised by the commission as a broker-dealer that engages, either for the whole or part of his or its time, in the business of trading in securities in the capacity of an agent or principal."

[64] "Investment dealer" means any person or company that is a member, branch office member, or associate member, of the Manitoba District of the Investment Dealers' Association of Canada, or any person or company recognised by the commission as an investment dealer that engages either for the whole or part of his or its time in the business of trading in securities in the capacity of an agent or principal."

"a member, branch office member, or associate member, of the Manitoba District of the Investment Dealers' Association of Canada". While the definition of "broker" is restricted to persons and companies engaging in transactions as an agent, the other two definitions, each of which includes trading as an agent and as principal, are worded identically except that "investment dealer" refers to membership in the IDA. Thus the only formal distinction between broker-dealer and investment dealer is the membership of the latter in the Manitoba district of the IDA. The intention of the legislature evidently was that all registrants in these categories would be members of one at least of these organisations, although MSA does not make such membership a prerequisite to registration. The MSC relies to a large extent on regulating such persons by the organisations of which they are members, both as to admission to the industry and as to continuing control over them as practitioners.

One should keep in mind that under the MSA there are certain dealers who hold unrestricted registrations which permit trading in its broadest forms. These are members of stock exchanges and other self-regulatory organisations which have comprehensive rules governing their conduct. Other dealers in Manitoba hold registrations restricted to certain types of trading, ranging from "distribution of mutual funds only" to "distributions of any new issue authorised for sale in Manitoba" to a restriction to a "specific issue of offering" of securities. The restrictions are determined on a case-by-case basis, depending on the qualifications, capital, bonding, etc., of the dealer.[65]

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[65] MSC Policy No. 3.02 - Notice- "Dual Registration Of Mutual Fund And Life Insurance Salesmen", dated 7 May 1990, *Canadian Securities Law Reporter* (CCH) P 270-002, at 38,520-38,521.

The MSA also provides for registration of "investment counsel",[66] "salesman", "security advisor",[67] "security issuer", [68] and "sub-broker-dealers", defined in Section 1. Sections 6(2) and 6(3) of the MSA, the substantive provision requiring registration, is wide: it requires that a person or company be registered before trading in any security or being a partner or officer or a "salesman" of any person in connection with a trade in any security, or advising persons as to investments in a security.

The Director, according to sections 7(1) - 7(3) of the MSA, is given wide discretion in granting or renewing registration, or in imposing terms and conditions on the registration. Pursuant to section 7(2) of the MSA, an applicant must be given an opportunity to be heard if an applicant's registration is refused, or if unacceptable terms or conditions are imposed.

4. Procedure for Registration

The specific procedures to be followed by an applicant, and the information required in an application for registration in Manitoba are set out in the MSR and in various policy statements.[69] Section 7 of the MSA, provides simply that "[t]he Director shall grant registration or renewal of registration to an applicant where in the opinion of the Director the applicant is suitable for registration and the proposed registration is not

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[66] MSA., s. 6(5).
[67] *Ibid.*, s. 6(6).
[68] *Ibid.*, s. 6(1). It seems that the existence of the provision for registration of security issuers makes available a selling arrangement which would deprive the public of protection afforded by sale through normal channels. However, the fact that there is no provision exempting salesmen, apart from officers of the company (section 6(8)) from registration may provide some protection.
[69] Man. Regs., *supra* note 47.

objectionable."[70] The MSA requires a person or company intending to act in one of the categories defined in Sections 6(1) - 6(7), for which no exemptions apply, to file an application on the prescribed form, accompanied by the prescribed fee.[71] Each of these forms asks a series of questions concerning the applicants in order to assess their or its financial responsibility, integrity and competence; the forms for registration as a broker, dealer, salesman, etc., each require a personal history of the activities of the applicant for the fifteen years preceding the date of the application. Where the applicant is a corporation or a partnership, the information must be given in respect of each officer and director, or of each partner. In addition, three references are required from every applicant, plus one bank reference and considerable additional financial and other information. An applicant for registration as salesman or as sub-broker-dealer must also provide a certificate from the employer as to suitability for registration; and all applications must be in an affidavit form.

Application forms require, among other things, detailed disclosure of the applicant's past record of convictions, disciplinary actions, etc. The employing firm is required to attest,

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[70] Prior to 1998, the MSC itself had no rule-making power under the MSA, see *supra* notes 46-47 and accompanying text. Instead, Section 148 "for the purpose of carrying out the provisions of [the] Act" gave to the Lieutenant Governor in Council power, in terms of great breadth, to make regulations "...(b) prescribing requirements respecting applications for registration and renewal of registration, and providing for the expiration of registrations";... "(f) designating any person or company or any class of persons or companies that shall not be required to obtain registration as investment counsel or securities adviser"; "(g) prescribing the fees payable to the commission, including fees for filing, fees for applications, fees for registration...fees in connection with the administration of this Act and the regulations";... "(j) prescribing the forms for use under this Act and the regulations", etc.

[71] MSA., s. 10. The schedule B to the MSR, *supra* note 47, sets out six forms of application for registration with the MSC:

(1) a general form for registration as broker, investment dealer or broker-dealer, (2) a form for underwriter, security issuer, investment counsel, securities advisor or mineral interest broker; (3) a form for renewal of registration in above mentioned categories; (4) a form for amendment of registration as broker, investment dealer or security issuer; (5) a form for registration as salesman or sub-broker dealer, and one for renewal of such registration; and, (6) one form in a different category, for companies applying for recognition as exempt purchasers under clause 19(1)(c) of the MSA.

on the basis of diligent enquiry, as to the veracity of the information set out in the application. The MSC has also established the practice of carrying out police checks with respect to each application.[72]

As part of the qualification process, and in addition to obtaining registration as a salesman, trading officer, etc., prospective applicants, if their employer is an SRO member, are required to be approved by those organisations (*i.e.*, the Winnipeg Stock Exchange ("WSE"), the IDA, the Toronto Stock Exchange ("TSE") and the Vancouver Stock Exchange ("VSE")).

The MSC actively encourages the overall pattern of self-regulation embodied in the by-laws and regulations of the SRO's which are recognised under the MSA. In keeping with the emphasis on meaningful self-regulation, the MSC has directed its registration staff to require that evidence of the required approval of the applicable SRO's be on file before finalising any registration under the Act.[73]

When considering the procedure outlined above, it is necessary to bear in mind the fact that each SRO, for instance, the WSE or the IDA, has requirements and procedures in place for the admission of members and of salesmen. These considerations may justify the MSC in placing reliance upon the SROs to screen out undesirable applicants in cases

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[72] See Letter to the Director of the MSC, *infra* note 73: "If there is a previous conviction it will come to light through the police checks carried out..., and even though the individual may have obtained a registration by fraudulent means, his registration will be suspended immediately. The Commission will ordinarily proceed with fraud charges under Section 136 of the Securities Act or under The Criminal Code where a false affidavit is involved, and thereafter probably convene a fitness hearing."

[73] Letter of the Director of the MSC to "Members of the Winnipeg Stock Exchange", Re: Registration of Securities Salesmen, Trading Officers, etc., dated 4 November, 1981. According to this process, applications filed with the MSC will be processed but final disposition will be held in abeyance pending receipt of advice from SRO's that their approval has been granted.

in which such applicants are concurrently seeking admission to one or more such organisations.[74]

The provision of Section 12 of the MSA gives the Director further discretion to require any additional information or material to be submitted by either an applicant or registrant within the time he specifies, and may insist upon verification by affidavit or otherwise of any information or material supplied then or previously.[75] In addition, the applicant or registrant, or any partner, officer, director or employee of the applicant or of the registrant, may be required to submit to an examination under oath. This latter discretionary power is used to test the knowledge of an applicant, and thus evaluate his suitability for securities business first hand, rather than relying solely on the course and written examination administered by external organisations.

5. Conditions of Registration

The requirements regarding conditions of registration and procedures for registration suitability have been established by the MSA, the Regulations made under the MSA and policy statements of the MSC.[76] The MSA, as a condition of registration, sets out a

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[74] In "Administration under the Securities Act of Ontario," (1958) 72 *Canadian Chartered Accountant* 525, reprinted in Canada's Investment Business, published by the Canadian Institute of Chartered Accountants, 1958, p. 25. It was stated that in such cases it is typical practice to seek the opinion of the relevant organisation before granting registration.

[75] MSA., s. 12.

[76] See, for example, MSC Policy No. 3.02, *supra* note 65; Policy No. 3.03 - Securities Salesmen "Pre-License Course Requirements" dated 1 September 1971 *Can. Sec. L. Rep.* (CCH) P 270-003, at 38,535: according to this Policy, (i) applicants for registration as salesmen with a broker-dealer whose registration permits the offering of mutual fund shares or units only or in combination with trust company guaranteed investment certificates, or other debt securities , must have successfully completed the Canadian Investment Funds Course, (ii) applicants for registration as salesmen with a broker-dealer, whose registration permits the offering of securities other than or in addition to mutual funds, must have successfully completed the Canadian Securities Course prior to applying for registration); Policy No. 3.04 - Mutual Fund Distributors Supporting Stuff & "Know Your Purchaser", dated 1 September 1971 *Can. Sec. L. Rep.* (CCH) P 270-004, at 38,535: according to this Policy,(i) "an application for registration of any sales organisation will be

residency requirement[77] and bonding in such form and amount as the Director may prescribe.[78] A variety of educational, general character, and financial qualifications are prerequisites for registration in the various categories. An extensive and detailed statement of conditions of registration and, in part, of continued fitness for registration, which are: the minimum net free capital requirement, the "know your client" rule, and requirements for professional competence, has been established by the MSC in the form of policy statements.

These aspects of the regulation of securities market actors might be partly in response to the problem of business failure. Each will be discussed generally.

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refused if it becomes apparent that the organisation does not have the qualified personel to carry out effectively its supporting and supervisory responsibilities", (ii) "the sales organisation is required to establish procedures to ensure that its salesmen make reasonable efforts to obtain sufficient relevant information concerning the client's investment objectives, financial position, personal history, etc., to enable a determination to be made as to the suitability of the proposed investment by the client"; Notice 920301 - "Registration Guidelines for Financial Institutions Distributing Mutual Funds", dated 1 March 1992 *Can. Sec. L. Rep.* (CCH) P 271-003 at 38,803-38,804.

[77] Section 14 of the MSA reads: "14(1) Notwithstanding that the applicant is otherwise suitable for registration, the director may refuse registration

a) to an individual who does not possess the usual residence qualification; or
b) to a company that does not have at least one officer or director who possesses the usual residence qualification; or
c) to a partnership or other unincorporated association that does not have at least one partner or member who is an individual possessing the usual residence qualification.

One of the major policy questions in the 1970s with regard to conditions attached to registration was resident ownership or control of registrants. Several industry studies identified the securities industry as a "key sector" in Canada requiring certain measures to be taken in order to ensure that control of the industry remains in Canada. Having this concern, Manitoba has amended its Act to give the director a discretion to refuse registration to an applicant who does not have the "usual residence qualification" as defined, R.S.M., 1972, c. 58, s. 3. For more information on this, D. L. Johnston, *supra* note 24, at 113-114.

[78] MSA., s. 7(4).

a) Minimum Net Free Capital

The minimum net free capital requirements addresses the financial stability of registrants.[79] Varying amounts have been established by the MSC for the different categories of registrants. For instance, any registrant as a broker, a broker-dealer (unrestricted) or a broker-dealer (mutual funds) must maintain at all times a minimum of $25,000 working capital (that is the excess of current assets over current liabilities calculated in accordance with "Generally Accepted Accounting Principles" (GAAP)), as well as an aggregate of $25,000 of capital and retained earnings, or such other amount as may be determined by the Director with regard for the applicant's intended business operation. In the case of investment counsel, the minimum amount is $5,000 of working capital, as well as an aggregate of $5,000 of capital and retained earnings, or such other amount as may be determined by the Director. These amounts are required to be in place at the time of application and are to be maintained at all times while registered. The intention of the minimum net free capital requirement is to ensure that registrants who begin to engage in acting on behalf of others have sufficient funds to meet obligations to clients as they develop.

b) Bond

The Director may require the registrant to post a bond in the amount that he considers necessary to provide protection to the registrant's clients.[80] By means of a bond, the registrant shall effect and keep in force insurance against losses arising through any

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[79] D. Johnston, *supra* note 24, at 109. The financial condition of security dealers is a matter of regulatory concern because the customers of a firm may be at risk with respect to their cash or securities in the event of failure of the firm.

dishonest or fraudulent act of any its employees. For instance, broker-dealers (mutual funds) are subject to bonding requirements in the minimum amount of $100,000, issued by a company authorised to do business in Manitoba.[81] The minimum security bond for brokers or investment counsellors is $25,000; the minimum amount of a surety bond for a security issuer is $5,000.

c) Know Your Client

The "know-your-client" rule is actually a post-registration requirement and designed to ensure that clients of brokers obtain objective and appropriate advice when investing in securities. Under this rule, the broker is required to establish procedures to ensure that its salesmen make reasonable efforts to obtain sufficient, relevant information concerning the client's investment objectives, financial position, personal history, etc., to enable a determination as to the suitability of the proposed investment by the client. These procedures must also provide for adequate supervision over the activities of the salesmen to ensure compliance. Failure on the part of the broker to properly supervise such procedures will bear on the fitness of the broker for continued registration. Failure on the part of the salesman to carry out the procedures also will bear on his fitness for continued registration.[82]

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[80] MSA., s. 7(4).
[81] Notice 920301, "Registration Guidelines for Financial Institutions Distributing Mutual Funds", *supra* note 76.
[82] Policy No. 3.04, *supra* note 76.

d) Competence

To obtain a registration for trading in securities as a broker, dealer or underwriter, or to act as a securities adviser, or salesperson, certain educational and apprenticeship requirements, intended to assure a minimum level of competence, must be met. The idea of requiring a minimum level of competence is to ensure that those engaged in the business have reasonable ability to run the business and are less likely to fail. This is secondary to the need to know the industry to a degree sufficient to advise clients properly, to have experience in the securities industry, and in supervisory executive capacities.

For example, a compliance officer of any financial institution that is distributing mutual funds in Manitoba must satisfy the proficiency requirements of having successfully completed The Investment Funds Institute of Canada's Officers' Partners' Directors' Examination, administered by the Canadian Securities Institute.[83] Applicants for registration as salesmen of the broker-dealer, whose registration permits the offering of securities, other than or in addition to mutual funds, must have successfully completed the Canadian Securities Course.[84] A salesman of the broker-dealer, whose registration is restricted to selling mutual funds must have successfully completed the Canadian Investment Funds Course, administered by the Canadian Investment Funds Institute.[85]

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[83] Notice 920301, *supra* note 76.

[84] See, Policy No. 3.03, clause (b), *supra* note 76. Mark Connelly, in "The Licensing of Securities Market Actors" suggests that "anyone who comprehends all the material in it is reasonably well equipped at least to start as a salesman", *supra* note 53, at 1309.

[85] See, Policy No. 3.03, *supra* note 76, clause (b).

6. Continued Fitness for Registration

It is through registration that the various regulatory requirements governing securities market actors are primarily enforced. Section 8(1) of the MSA provides that "where in the opinion of the MSC the action is in the public interest, the MSC, after giving the registrant an opportunity to be heard, shall suspend or cancel his registration". Section 8(2) gives the MSC the power to suspend the registration on an interim basis where the delay necessary for a hearing would be prejudicial to the public interest.

B. Licensing Under the Federal Securities Law of Russia

Chapter 11 of the FSL governs the licensing (*i.e.*, registration)[86] of professional participants in the securities market. Article 39 requires that all forms of professional activity on the securities market should be licensed by the Federal Commission for the Securities Market (the "FSC") or by agencies authorised by the FSC.

The FSC's authority with respect to licensing of securities market participants extends to brokers, dealers, clearing organisations, asset managers, depositories, and registrars.[87] The commentary here is limited to licensing requirements of professional activities of brokers and dealers.

The FSL does not identify the criteria necessary to obtain a license. Rather, Article 42(6) of the FSL states that the FSC determines the procedure for licensing, issues licences for

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[86] Canadian terminology differs from Russia's terminology to some extent. The licensing of securities professionals in Canada, as in Russia, is referred to as registration. The process by which securities are qualified for public distribution is not referred to as registration, but rather involves the filing of a prospectus and the issuance of a receipt by the regulatory authority, which may be withheld on statutory grounds. Reference herein to "registration" is confined to registration of securities professionals.

[87] FSL, *supra* note 2, Chapter 2, arts. 3-10.

various kinds of professional activity on the securities market, and also suspends or cancels such licenses in cases of violations of the requirements of the securities legislation.[88]

The procedures to be followed and the requirements regarding conditions for the licensing of professional activity are governed by the Regulation No. 26 "On Licensing Procedures for Different Types of Professional Activity in the Securities Market of the Russian Federation" (hereinafter Regulation No. 26).[89] This Regulation sets forth terms and procedures for the issue, suspension and cancellation of licenses for professional activities in the securities market.

1. Requirements for Licensing

According to the FSL, in order to engage in brokerage and dealing activities in Russia, brokers[90] and dealers[91] must be licensed by the FSC or by state agencies to which the FSC has granted general licensing authority. The FSC requirements establish the following conditions for licensing: (1) minimum capitalisation requirement;[92] (2) the requirement that managers, controllers, whose duty is to supervise the compliance of professional activities with the securities legislation (hereinafter referred to as

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[88] *Ibid.*, art. 42(6).

[89] Regulation "On Licensing Procedures for Different Types of Professional Activity in the Securities Market of the Russian Federation", approved by Resolution No. 26 of the Federal Commission for the Securities Market of 19 September 1997. It was approved to comply with the requirements stipulated by clauses 3 and 6 of article 42, as well as by clause 3, of article 44 of the FSL.

[90] "Brokers" are securities market participants who conclude securities transactions as agents or commission agents under an instruction or commission or a power of attorney for the account of others. FSL, *supra* note 2, art. 3.

[91] "Dealers" are securities market participants who conclude securities transactions on their own behalf, at their own expense, through public two-sided quotations. *Ibid.*, art. 4.

[92] Regulation No. 26, *supra* note 89. In Para. 3.1. the FSC sets forth the minimum amount of internal funds depending on different types of professional activities. 50,000 ECU - to obtain a license for Brokerage

"compliance officer");[93] and experts of the applicant-organisation, whose responsibilities include functions directly related to professional activities in the market, must meet qualification requirements established by the FSC;[94] (3) that there shall be no less than one specialist holding a qualification certificate, conforming to the standards set by the FSC, entitling him to conduct securities market operations;[95] (4) that legal entities engaged in professional activities in the securities market, are obliged to have on staff a compliance officer; and (5) that the organisations engaged in brokerage and dealer activity in the securities market are required to have on staff an employee responsible for internal accounting and internal reporting.[96] The last two requirements as a criteria necessary to obtain a license did not exist in Government Regulation No. 78,[97] which, before the adoption of the FSL, regulated most aspects of the securities market and provided the legal framework for conducting securities operations. Under Regulation No. 78, "investment institutions" had to obtain a license from the Ministry of Finance. To obtain a license the broker merely had to identify a certified specialist on its staff, comply with minimal capital requirements, and adhere to certain accounting provisions.

Activity; 75,000 ECU - to obtain a license for Dealer Activity; 450,000 ECU - to obtain a license for Brokerage Activity, including operations with natural person;

[93] *Ibid.*, para. 3.6.. The same paragraph provides for the list of persons that cannot be appointed to the position of the compliance officer.

[94] Regulation No. 26, *supra* note 89, para. 3.5.

[95] *Ibid.*, this requirement is in effect since 22 April 1998.

[96] *Ibid.*, para. 3.7., states that organisations engaged in the activities mentioned above shall arrange the system of internal record keeping and internal reporting, as well as supervise their compliance with legal acts of the FSC and requirements of the perspective standards of the self-regulatory organisation to which they belong.

[97] Postanovlenie Pravitelstva RF No. 78 "Ob Utverjdenii Polojenia O Vypuske I Obrashenii Tsenykh Bumag I Fondovykh Birjakh v RSFSR" [Government Resolution No. 78, "Regulations of Issuance and Circulation of Securities and Stock Exchanges"] (28 Dec., 1991), *Financial Newspaper*, 1992, No. 5, translated in *Economic Law of Russia*, "Regulations for the Issue and Circulation of Securities and for Stock Exchanges in the RSFSR of 28 December 1991 (Approved by Decision of the Government of the RSFSR, No. 78 of 28 December 1991)" (Garant-Service 1996, Doc. 5034), available in LEXIS, Intlaw Library, RFLaw File [hereinafter Regulation No. 78].

The FSC has established the qualification requirements of officers and specialists of organisations engaged in professional activities in the securities market.[98] According to the Regulation No. 28, every senior executive[99] and executive officer, controller, and specialist in order to be certified has to pass a basic qualification exam, as well as one of the specialised qualification exams in the field of professional activity in which the organisation operates. However, before admitting the candidates to the qualification exams, a prior training at the accredited training institutions is not a mandatory condition.[100]

2. The Licensing Procedures

In order to obtain a license for brokerage and dealing activities one must submit the following documents to the licensing authorities: (1) an application made in writing on a form prescribed by the Regulation No. 28;[101] (2) a notarised copy of the applicant's founding documents (*i.e.*, charter and founders' agreement); (3) its balance sheet statement, the audited profit and loss statement, the calculation of the internal funds of the applying organisation as of the latest reporting date; (4) a notarised copy of the taxpayer registration card; (5) copies of the approved internal record-keeping rules which comply with legal acts of the FSC; (6) notarised copies of qualification certificates

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[98] Regulation "On the System of Qualification Requirements to Officers and Specialists of Organisations Engaged in Professional Activity in the Securities Market, as well as to Individual Entrepreneurs - Professional Securities Market Participants", approved by Resolution No. 28 of the Federal Commission for the Securities Market of 2 October 1997 [hereinafter Regulation No.28].
[99] Regulation No. 28, para. 2.1.-2.5.
[100] *Ibid.*, para. 3.2.
[101] Regulation No. 26, *supra* note 89, para. 4.2.

entitling its specialists to deal with securities;[102] (7) a copy of its staff structure, which provides information on the internal structure of the organisation, names of employees, the departments and positions filled by them; (8) the document that confirms payment of the registration fee; and, (9) a notarised copy of a higher education diploma of the compliance officer.

When reviewing the documents of applicants, the licensing authority may require additional information on co-owners (*i.e.*, founders, shareholders, members, etc.),[103] or additional information related to the contents of documents previously submitted by the applicant.

The FSC or other licensing authority shall issue the license to the applicant or refuse, giving the applicant reasons for the refusal no later than 90 days after the required documents have been submitted.[104] The FSC may deny a license to an applicant on the following grounds: (1) incompleteness or falsification of the information contained in the application and the registration form; (2) the presence of false or incomplete information in the submitted documents; (3) non-compliance of the submitted documents with the securities legislation of Russia; (4) non-compliance of the applicant with minimal capital requirements and/or other requirements of financial status; (5) a deficiency in the applying organisation of internal record-keeping and accounting systems which meet the requirements of the FSC; (6) any current convictions for mercenary crimes of managers, compliance officers or expert specialists in the applicant organisation; and, (7) the

[102] *Ibid.*, para. 4.3.10. Copies of qualification certificates of the specialists are submitted when filing with a licensing authority, effective 22 April 1998.
[103] *Ibid.*, para. 4.3.14.
[104] *Ibid.*, para. 4.8.

detection in the process of licensing of violations of securities legislation by the applicant. The denial of a license can be appealed by the applicant to the court.[105]

C. Comparison of Licensing (Registration) Requirements

From the foregoing, the following comparison can be made between the Russian and Manitoba licensing requirements of market participants.

The purpose of registration (licensing) requirements is substantially similar in both legal systems.

Substantial differences can be found in the scope of persons required to register under the Manitoba *Securities Act* and the *Federal Securities Law* of Russia. The MSA requires registration of persons who "trade" in "securities", which covers a wide scope of persons such as broker, investment dealer, investment advisor, underwriter, security issuer, securities advisor, salesmen, partner, officer or salesmen of any person in connection with a trade in any security, or advising persons as to investments in a security. The category of registrants, those who must be licensed, under the FSL is confined to persons who carry out business in the capacity of a broker and dealer. Regulation of underwriters, investment counsellors, and investment advisors and their activities are not covered by the FSL. The lack of regulatory provisions governing the activity of such market professionals means that conduct of their business has been left uncontrolled. As a result, investors engaged in business with them are left on their own without the provision of legal means that can be used as an arsenal to protect themselves against the frauds that might occur in the securities market. The requirements regarding conditions of licensing,

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[105] *Ibid.*, para. 5.1.

such as educational, general character and financial qualifications, and procedures for licensing suitability of such market actors has to be established in Russia so that the regulatory authorities can periodically monitor their activities and enforce compliance with these standards.

The conditions for registration under the MSA, which are the minimum net free capital requirement, a bonding or insurance requirement, the "know your client" rule, and requirements for professional competence, differ from those under the FSL, which is limited to the net free capital requirement and general requirements regarding professional competence.

As to discretion in granting registration or licensing, the Director of the MSC exercises an extremely broad and unguided licensing discretion committed to him by the MSA.[106] By contrast, the FSL merely specifies the grounds upon which registration will be denied.

[106] M. Q. Connelly, *supra* note 53, regarding criticism of boundless discretion committed to licensing authorities in Canada.

IV. CHAPTER 3: DISCLOSURE REQUIREMENTS

A. Disclosure Under the Manitoba Securities Act

Another technique that the MSA uses to protect investors is disclosure of information by issuers, both in prospectuses issued in connection with initial offerings of their securities and, on an ongoing basis, through continuous disclosure obligations and mandatory proxy solicitations by management. The purpose of these provisions is to provide investors with the information necessary to make rational assessments as to whether to purchase securities and, subsequently, whether to purchase additional securities or to sell those they have.[107]

The need for increased disclosure in secondary markets was stressed in reports published in Canada in the early 1960s.[108] The *Porter Report* highlighted what it considered to be inadequacies in securities disclosure in Canada,[109] and the *Kimber Report* recommended a requirement for ongoing disclosure including the distribution of periodic financial statements, mandatory proxy solicitation and reporting of insider trading.[110] These recommendations were adopted in the Ontario Act in 1967 and in 1968 Manitoba made "roughly similar changes" to its securities legislation.[111]

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[107] For more detailed information on the reasons for disclosure requirements *see* Warren M.H. Grover and James C. Baillie, "Disclosure Requirements" in *Proposals for a Securities Market Law for Canada* (Ottawa: Ministry of Supply and Services, 1979), at 382-93.

[108] See *Kimber Report*, *supra* note 37, Part I, paras, 1.11, 1,12 and 1.16, and Parts II, IV, VI; Canada, *Royal Commission on Banking and Finance: Report* (Ottawa: Queen's Printer, 1964) [hereinafter "*Porter Report*"] at 349-52.

[109] *Porter Report, ibid.*, at 349-52.

[110] *Kimber Report*, *supra* note 37, Parts II, IV and VI.

[111] D.L. Johnston, *supra* note 24, at 242-43. See MSA, *supra* note 1, Part X "Proxies and Proxy Solicitation", Part XI "Insider Trading", and Part XII "Financial Disclosure".

The objective of disclosure is to make available, on a timely basis, all material facts the investor requires to make an informed investment judgment.[112] Disclosure implements the broad objective of creating and maintaining confidence in capital markets. The *Merger Report* said that "if securities are evaluated on the basis of complete and current information, the pricing mechanisms of the capital markets operate in a more rational and accurate fashion."[113]

As mentioned, the disclosure requirements do not stop with production of a prospectus upon the initial issuance of securities. MSR provide for continuous disclosure in the form of periodic reporting, such as that provided by annual and semi-annual financial statements, proxy circulars, and insider trading reports. Unlike Ontario's Section 75 of the OSA, the MSA does not have a section that requires timely disclosure of material changes.[114] However, reporting issuers in Manitoba are subjected to the timely disclosure requirements of the National Policy Statement No. 40 (hereinafter, N. P. No. 40).[115] This policy statement requires disclosure of material information and provides guidelines as to what may constitute material information.[116] Pursuant to the N. P. No. 40, issuers are responsible to determine what information is material.[117]

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[112] *Merger Report*, *supra* note 40, at 15.
[113] *Ibid.*, at 15-16.
[114] OSA, *supra* note 26. Pursuant to s. 75, reporting issuers are obliged to provide the investing public with material information concerning their business and affairs on a timely basis so that no investor has an information advantage over another. The dissemination of a press release through a national news service is required immediately upon the occurrence of a "material change" in the affairs of a reporting issuer. In addition, a material change report must be filed shortly thereafter (within 10 days at the latest) with the Commission. Statutory requirements concerning timely disclosure are supplemented by N. P. No. 40..
[115] N. P. No. 40 "Timely Disclosure", 27 October 1987, effective 1 December 1987; 4 June 1993, *Can. Sec. L. Rep.* (CCH) P 80-040, at 17,037-17,041.
[116] N. P. No. 40, para D. As to N. P. No. 40, it was said that,
"Where the requirements of the Policy go beyond the technical requirements of existing legislation, the securities administrators and stock exchanges request that issuers, their counsel, and market professionals regard such requirements as guidelines to follow in order to assist in the operation in Canada of an open and

The disclosure process, with respect to reports of material information, is intended to assure adequate dissemination of information so that there will not be a period during which some persons are able to trade with the benefit of advance information, while others have yet to receive it. To assure adequate dissemination, the information is to be disclosed in a period during which there is no trading. Trading should only resume after there has been adequate dissemination. Consequently, with approval of the relevant securities authorities, release of the information may be delayed until the close of trading on the relevant stock exchanges. Where the information is disclosed during trading hours, trading in the securities of the issuer may be halted for a period of time to allow for adequate dissemination of the information.[118]

1. Public Offering Of Securities

a) Prospectus Requirement

The MSA generally prohibits any person or company from trading in a security where that trading would be in the course of primary distribution to the public of such a security,

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fair marketplace which merits the trust and confidence of the investing public." N. P. No. 40 in para. A. Prudence would dictate compliance for issuers who hope to retain continued ready access to Canadian capital markets.

[117] *Ibid.*, para. D., N. P. No. 40 provides examples of developments that are likely to give rise to material information: changes in issued capital, stock splits, redemptions, dividend decisions, changes in share ownership, changes in corporate structure (such as reorganisations and amalgamations), take-over bids and issuer bids, major corporate acquisitions or dispositions, changes in capital structure, borrowing of a significant amount of funds, development of new products or resources, entering into or loss of significant contracts, firm evidence of significant increases or decreases in near term earnings prospect, significant changes in management, significant litigation, and major labour disputes.

[118] N. P. No. 40, para. E. The length of a trading halt depends on the significance and complexity of the announcement. However, the duration of a trading halt is normally less than two hours.

until there has been filed with the commission both a preliminary prospectus and a prospectus for which a receipt has been obtained.[119]

A prospectus is a document which must be given to any person interested in purchasing a security during a primary distribution. It is the document intended to provide information relevant to valuing that security, and must provide full, true and plain disclosure of all material facts relating to the security proposed to be issued, in compliance with the form and content required by the MSA and regulations.[120] The form that the prospectus must take is determined by whether or not the company is an industrial company, finance company, investment company, mutual fund or a mining company. The various forms which detail the information required to be set forth in the prospectus are contained in the regulations to the MSA.[121]

The prospectus requirements of the MSA are designed to meet two main objectives: to ensure disclosure of all relevant information concerning an issue of securities; and to ensure that this information reaches the investor at a time when he still has an opportunity to change his mind concerning a proposed purchase. However, if the information disclosed is not in understandable form, or if the prospectus containing it is not delivered to the investor, then the large part of its value will have been lost.[122]

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[119] MSA., s. 37(1).

[120] This is required by provisions of ss. 41, 52, 53 of the MSA and by virtue of the certificates which must be signed and included in the prospectus.

[121] MSA., s. 41(2). Man. Regs., *supra* note 47, Forms 9, 9A, 10, 11, 12 and 12A. "Industrial issuer", "finance company" and "natural resource issuer" are defined in Man. Regs. s.1.

[122] *Kimber Report*, *supra* note 37, stressed at page 28 that "No disclosure requirement, however, will be effective unless the resulting information is presented in a clear and understandable manner. Various professionals contribute to the information provided by companies and their technical language, combined with that of those engaged in the securities business, often results in information which is difficult for the general public to interpret. It should be the function of securities regulation to ensure, so far as practicable, that financial information is presented in a form which is understandable to the investing public".

b) Prospectus Filing Requirements

To determine whether a prospectus is required, it is first necessary to determine the meaning of "trade" and "security". If the transaction involves a "security" and a "trade" as they are defined in the MSA, then a prospectus will be required unless an exemption can be obtained.[123]

The definition of "security" in the MSA is broad. Fifteen separate branches are enumerated in the definition, which is inclusive, as follows:

"security" includes

a) any document, instrument, or writing commonly known as a security;
b) any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company;
c) any document constituting evidence of an interest in an association of legatees or heirs;
d) any document constituting evidence of an option, subscription, or other interest in or to a security;
e) any bond, debenture, share, stock, note, unit, unit certificate, participation certificate, certificate of share or interest, pre-organisation certificate or subscription;
f) any agreement providing that money received will be repaid or treated as a subscription to shares, stocks, units or interests at the option of the recipient or of any person or company;
g) any certificate of share or interest in a trust, estate or association;
h) any profit-sharing agreement or certificate;

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[123] The definition of "trade" and "security" are also fundamental concepts in Manitoba with respect to registration requirement, namely the requirement that one be registered to "trade in a security". Discussion of the registration requirement is contained in Chapter 2, where the regulation of securities dealers, underwriters and advisers is addressed; but see *supra* notes 61-64.
On the meaning of "security" see, for example, V.P. Alboini, *Securities Law and Practice*, 2nd ed. (Toronto: Carswell, 1984) at 0-24 to 0-63. For the earlier literature on the definition of "security", see J. P. Williamson, *supra* note 24, at 21-33; F. Iacobucci, "The Definition of Security for Purposes of a Securities Act" in *Proposals for a Securities Market Law for Canada* (Ottawa: Ministry of Supply and Services, 1979) at 221.

i) any certificate of interest in an oil, natural gas or mining lease, claim or royalty, or royalty voting trust certificate;

j) any oil or natural gas royalties or leases or fractional or other interest therein;

k) any collateral trust certificate;

l) any income or annuity contract not issued by an insurance company licensed under the Insurance Act;

m) any investment contract, including an investment contract as defined in Part XVI;

n) any document constituting evidence of an interest in a scholarship or education plan or trust; and,

o) any option on a futures contract in a commodity other than

(i) an option traded on the Winnipeg Commodity Exchange, or

(ii) an option traded between a member of the Winnipeg Commodity Exchange, who is recognised by the exchange as a futures commission merchant, and a customer of that member;

whether any of the foregoing relate to a person, proposed company or company, as the case may be.[124]

In considering this definition, certain things should be noted. First, the definition covers common type of securities, for example: bonds, debentures, shares, stocks and notes. Second, it covers several other specific items which are not as common, for example: any certificate in a trust, oil or gas royalties or leases. Third, it contains several terms capable of taking on a very broad meaning including, for example, clause (m) investment contracts, is quite general in nature and can encompass many transactions which may not appear to fall within the traditional notion of a "security".

The classic definition of an "investment contract" is given by the United States Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946):

> [A]n investment contract for the purpose of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it

[124] See definition, MSA, s.1(1).

> being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed by the enterprise.

In the *Howey*, the court set out a test, known as "common enterprise" for the identification of "investment contract". This test was applied in many subsequent U.S. cases and, in general, in Canadian jurisprudence. This test indicates a potentially wide scope for the term "investment contract" and thus a wide scope for the meaning of "security" and the application of securities acts. This suggests that courts are inclined to take a purposive approach to the meaning of "investment contract", finding a transaction to involve an "investment contract", and therefore a "security".

In that court's view, the definition should be interpreted broadly to meet any purpose of the MSA and should not be subverted by new security instruments designed to avoid the application of the MSA or to frustrate the purpose of it. That leads us to the fourth criteria of the definition of a "security" is that by its terms it is being only inclusive.

As with the term "security", "trade" is a key term in determining the application of the requirements to produce a prospectus under the MSA. "Trade" (and "trading") is broadly defined in the MSA. Subsection 1(1) states:

"trade" or "trading" includes:

a) any sale or disposition of or other dealing in or any solicitation in respect of a security for valuable consideration, whether the terms of payment be on margin, instalment or otherwise, or any attempt to do one of the forgoing;

b) any participation as a floor trader in any transaction in a security upon the floor of any stock exchange;

c) any receipt by a person or company registered for trading in securities under this Act of an order to buy or sell a security; and,

d) any act, advertisement, conduct or negotiation directly or indirectly in furtherance of any of the foregoing.

It is important to note that the definition includes not only "trades", but also any attempt to buy or sell a security, advertisements and other acts in furtherance of a trade.

If the transaction can be said to involve a "trade" in a "security", the next question is whether the trade in the security constitutes a "primary distribution to the public"[125]. "Primary distribution to the public" used in relation to trading in securities, means

a) trades that are made for the purpose of distributing to the public securities issued by a company and not previously distributed to the public; or

b) trades in previously issued securities of a company for the purpose of distributing those securities to the public where the securities form all or part of, or are derived from, the holdings of any person, company or any combination of persons or companies holding a sufficient number of any of the securities of that company to materially affect control of that company;

c) whether the trades are made directly to the public or indirectly to the public through an underwriter or otherwise, and includes any transaction or series of transactions involving a purchase or sale or a repurchase or resale in the course of or incidental to such distribution."[126]

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[125] *Ibid.*, see s.1(1) for definition.
[126] *Ibid.*

Accordingly, whenever a company offers a security for sale that has not been previously distributed to the public, it will constitute a primary distribution to the public and a prospectus will be required unless an exemption is available.

According to the subsection (b) of Section 1, sales of securities by a person in a position of control are also considered to be a "primary distribution to the public". This is because a position of control over the issuer may give persons having such control better knowledge of the issuer and an ability to alter the value of the issuer. A person, or persons, in a position to materially affect control of the issuer may have a tendency to manage the affairs of the issuer, or to distort or conceal information, so as to get a higher price when selling securities of the issuer. Further, if the sale involves a substantial number of securities, it may have a substantial effect on the market price of the security. It may also mean that the control person, who may have been an important factor in the success of the issuer, will no longer be controlling the issuer.[127] Thus the MSA requires the control person to produce a prospectus in order to provide information about the amount of securities sold and the effect of the sale on the control of the issuer. The prospectus disclosure is also intended to provide equal access to information necessary to assess the value of the securities being sold. The MSA does this by defining "the primary distribution to the public" to include trades in previously issued securities from holdings of any person or group of persons "holding a sufficient number of any securities of that company to materially affect control of that company".[128]

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[127] *Merger Report*, *supra* note 40, para. 4.04.

[128] Insofar as a secondary distribution by a control person is concerned, it is important to note that a control person is deemed to be a person or company, or any combination of persons or companies, holding a sufficient number of securities of the issuer company to materially affect control of that company. In that the

Numerous exemptions to the requirement to produce a prospectus are provided in the MSA and the regulations thereto, or may be available pursuant to discretionary orders of securities commissions. These exemptions are provided where the prospectus requirement is, for one reason or another, deemed to be unnecessary. The prospectus requirement, according to the securities laws of Manitoba, is often deemed unnecessary where the purchaser of the securities does not need the protection provided by prospectus disclosure. However, if such a purchaser resells the securities, the subsequent purchaser may be a person for whom the protection provided by prospectus disclosure is considered to be appropriate.

c) Preliminary Prospectus

Assuming that a distribution is contemplated and no exemption is available, a prospectus must be filed with the MSC. The MSR[129] set forth in detail the requirements for prospectuses of prospective issuers, while the statute itself sets out a requirement for full, true and plain disclosure.[130]

The actual qualification process begins with the filing of a preliminary prospectus with the MSC.[131] When the preliminary prospectus is complete, it is filed along with supporting documents, such as an auditor's comfort letter, technical reports, consent

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issue here is not control *per se*, but the material affect on that control, in the interest of providing a more objective standard the OSA provides that a holding of more than twenty percent of the outstanding equity shares in the company, in the absence of evidence to the contrary, will be deemed to materially affect control of the company. However, Manitoba does not have the twenty percent deeming provision (*see,* definition of "distribution to the public"). Some jurisdictions, such as Ontario, do (*see,* part (c) of Ontario definition of "distribution") .See, *e.g.*, Interpretation, s. 1(1) (11) (iii), *Canadian Securities Law Reporter* (CCH) P 450-001, at 55, 101 (1988). For a detailed examination of the legislation, see V.P. Alboini, *Ontario Securities Law* (Toronto: De Boo, 1980).

[129] Man. Regs., pt. II and forms 9-12.

letters, the underwriting agreement, material contracts, a resolution of the board of directors (or other governing body) approving the preliminary prospectus and the required financial statements.[132] The preliminary prospectus, as required by Section 39(1), provides the specific items of disclosure required by the relevant prospectus form as well as "full, true and plain disclosure" of all material facts.[133] It need not contain "information with respect to the price to the underwriter and the offering price to the public and other matters dependent upon or relating to those prices".[134] In addition, it must have a prescribed statement in red ink on the outside front cover page indicating that it is not a final prospectus, that information contained is subject to completion or amendment, and that no securities may be sold until the final prospectus is accepted.[135] The Director issues a receipt upon filing, although there is power to order the limited form of solicitation permitted upon such filing to cease if it appears to him that a preliminary prospectus is defective in either form and content.[136] The purpose of the preliminary prospectus is to permit prospective purchasers to study the merits of the securities to be issued and to permit underwriters to test the market for the sale of such securities.[137]

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[130] These regulations cover the items suggested in the *Kimber Report, supra* note 37, and in the *Porter Report, supra* note 108.
[131] MSA., s. 37(2).
[132] *Ibid.*, s. 50(1)
[133] *Ibid.*, s. 39(1).
[134] *Ibid.*, s. 39(2). These are matters that will be affected by prevailing market conditions that may well change in the period between the filing of the preliminary prospectus and the filing of the final prospectus.
[135] *Ibid.*, s. 39(3).
[136] *Ibid.*, s. 40(1).
[137] *Kimber Report, supra* note 37, at 46.

The MSA requires a "waiting period" of a minimum of ten days between the time when the preliminary prospectus is filed and the issuance of a final receipt for the actual prospectus, to enable information to be disseminated to the market place.[138]

During the waiting period, it is permissible to distribute notices, circulars, advertisements, or letters to prospective purchasers, as long as they identify the proposed security and its price, if determined, and they state the name and address of the person or company from whom purchases can be made and from whom preliminary prospectuses can be obtained. In addition, expressions of interest may be solicited, as long as a copy of the preliminary prospectus is provided to the intended purchaser.[139] The underwriter or other person or company distributing a security must maintain a record available for inspection by the commission of those to whom a preliminary prospectus has been distributed.[140]

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[138] MSA., s. 38(1). According to s. 38(3), the director may reduce the waiting period to a period shorter than ten days where he considers it is in the public interest to do so.

[139] *Ibid.*, s. 38(2) (a), (b), (c). There are also limitations on the kind of advertising that can be done during the waiting period. Whether the advertisements are in newspapers, or on radio or television, all they can do is identify the security, the price, where it can be purchased and otherwise solicit expressions of interest. See Uniform Act Pol. 2-13 "Advertising During Waiting Period Between Preliminary and Final Prospectuses". According to this policy, every advertisement is required to include a warning in the following context: "A preliminary prospectus relating to these securities has been filed with securities commissions or similar authorities in certain provinces of Canada but has not yet become final for the purpose of a distribution to the public. This advertisement shall not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale or any acceptance of an offer to buy these securities in any province of Canada prior to the time a receipt for the final prospectus or other authorisation is obtained from the securities commission or similar authority in such province". In *Re: Cambior*, [1986] *O.S.C.B.* 3225, the Ontario and Quebec securities commissions found that the issuer had engaged in a promotional campaign during the waiting period which contravened restrictions on activities during the waiting period. The issuer was only reprimanded, but the Ontario Securities Commission noted that it could issue a cease trade order, refuse to issue a receipt for a prospectus, or seek penal sanctions for violation of the Act. There may also be an action for rescission or damages where such promotional literature contains a misrepresentation.

[140] MSA., s. 38(4).

Any material adverse change that occurs after filing the preliminary document necessitates filing an amendment within at least ten days, which also must be sent to each recipient of a preliminary prospectus.[141]

Once the receipt for the preliminary prospectus is issued, staff of the various commissions begin to review the prospectus. The purpose of the review process is to determine whether the required items of disclosure have been provided and whether any gaps within the information are apparent from the material filed.[142]

The process could be complicated in national filings if one had to respond to comments from each of Canada's ten provinces as well as the three territories. Problems could arise with the timing and overlap of comments from the various securities administrators. In response to this problem, the CSA released National Policy No.1 [hereinafter, N. P. No. 1].[143] It establishes procedures to be followed when documents are to be cleared in more than one jurisdiction. These were agreed to by various securities regulatory authorities in order to facilitate the acceptance of a prospectus in more than one Canadian jurisdiction. An issuer contemplating qualifying an offering in more than one province must follow procedures set out in N. P. No. 1. It provides that a preliminary prospectus, together with the supporting materials listed in the policy, shall be filed, contemporaneously with the administrator of each jurisdiction in which securities are to be distributed.[144] The issuer selects one of the provinces as the principal jurisdiction and advises each of the other

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[141] *Ibid.*, ss. 40(2), 40(3).
[142] This regulatory review of the prospectus is not a passing on the merits of the securities offered nor is it a representation that the prospectus contains full disclosure.
[143] N. P. No. 1, *Can. Sec. L. Rep.* (CCH) PP 470-001, at 57, 525 (1991).
[144] N. P. No. 1, para. 1(a).

jurisdictions.[145] The principal jurisdiction will then use its best efforts to review the material and issue a first comment letter within ten days.[146] After the review process is complete, the principal jurisdiction issues a "comment letter" or "deficiency letter" that the issuer must respond to. The first comment letter will be transmitted to each of the other filing jurisdictions and the other jurisdictions will then use their best efforts to advise the principal jurisdiction of any additional comments within five days.[147] On the basis of additional comments, the principal jurisdiction will then prepare a second comment letter to be sent to the issuer.[148] When the comments have been dealt with, the principal jurisdiction will issue a notice of acceptance for filing of the final material and the issuer can then proceed to simultaneously file the final prospectus and supporting materials.[149]

d) Contents of the Prospectus

The MSA contains a skeleton guide to the contents of the prospectus. More detailed information is provided by the MSR and policy statements.[150] Only the most basic provisions will be discussed here. The typical prospectus is a narrative document giving extensive background information about the issuer and its operations, as well as a detailed description of the proposed use of the funds being solicited from the public. The MSA requires that an income statement, a statement of surplus, and a statement of changes in

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[145] *Ibid.*, para. 1(b).
[146] *Ibid.*, para. 1(c).
[147] *Ibid.*, para. 1(d).
[148] *Ibid.*, para. 1(e).
[149] *Ibid.*, para. 1(i),(j).
[150] See MSA., ss. 41-53; ss. 8 to 37 of the Man. Regs. with Forms 9 to 12; National Policy Statements No. 1, No. 12, and No. 13, *Can. Sec. L. Rep.* (CCH) PP 470-001, 470-012, 470-013, at 57, 525, 57, 573, 57, 574 (1991); Uniform Act Policies 2-01, 2-03, 2-04, *Can. Sec. L. Rep.* (CCH) PP 470-201, 470-203, 470-

financial positions for each of the last five completed years, or such shorter period as may be permitted by the Director, together with a balance sheet at a date of not more than 120 days prior to the filing of the preliminary prospectus of the issuing company, and as at the corresponding date of the previous financial year, to be included in the prospectus of an issuer other than a mutual fund.[151] Where the Director is satisfied there is sufficient justification, he may permit the omission of any financial statement required by this section.[152] As D. Johnston says "the heart of the prospectus lies in the accompanying financial statements - the balance sheet and statement of profit and loss".[153] Section 43 sets out the basic types of financial statements that must be included in the prospectus.[154] These statements provide the data which the most knowledgeable investors will use to make their decisions.

Unless expressly excepted, each financial statement must include an auditor's report which must be prepared "in accordance with generally accepted accounting principles applied on a consistent basis".[155] The auditor is given some guidance as to the contents of his report.[156] The financial statements must also be approved by the board of directors of the issuer, as evidenced by the signature of two authorised directors.[157] The Director has a

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204, at 57, 775, 57, 776 (1987). For requirements applying to statements of material facts, see ss. 45 to 57 of the Man. Regs.

[151] MSA., s. 43(1),(2), and the Man. Regs.

[152] *Ibid.*, s. 43(3).

[153] D.L. Johnston, *supra* note 24, at 172.

[154] MSA., s. 43. See also Sections 44, 45.

[155] *Ibid.*, s. 46 (1).

[156] See *ibid.*, s. 46 (3).

[157] *Ibid.*, s. 47.

discretion to require separate financial statements from a subsidiary, whether or not its financial statements have been consolidated.[158]

The MSA also provides for the filing of various consents from experts involved in preparing or certifying the prospectus. This category includes solicitors, auditors, accountants, engineers, appraisers, or any other person whose profession gives authority to his statement.[159] The auditor or accountant who has prepared the audited financial statements must also state that he has read the prospectus and has no reason to believe that there are any misrepresentations in the information contained therein, which is derived from the financial statements upon which he reported or that is within his knowledge as a result of his audit.[160] The Director has the discretion to waive this requirement if it would be impracticable or involve undue hardship.[161]

The experts involved in the preparation of the documents are required to disclose any direct or indirect interest they might have in the securities or property of the issuer or affiliates;[162] and if they anticipate election or appointment to office or employment with the issuer or an affiliate, this must also be divulged[163]. Notwithstanding such disclosure, the Director may refuse to issue a receipt for a prospectus if the expert is not acceptable to

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[158] *Ibid.*, s. 49.
[159] *Ibid.*, s. 50 (1).
[160] *Ibid.*, s. 50 (3).
[161] *Ibid.*, s. 50 (2).
[162] *Ibid.*, s. 50 (4).
[163] *Ibid.*, s. 50 (5).

him.[164] The Director has a further discretion to require a supplementary consent of the expert for any material change in the prospectus affecting the prior consent.[165]

Finally, each prospectus must contain a certificate signed by the chief executive officer, the chief financial officer, two authorised directors, and any promoter, that the prospectus constitutes "full, true and plain disclosure" of all material facts relating to the securities offered.[166] A similar certificate is required from the underwriter, although it is qualified to the extent that it is based on the best knowledge, information, and belief.[167] The director has discretion to dispense with the signatures of certain persons, to require any person who was a promoter of the issue within the two preceding years to sign the certificate, or to allow a promoter or an underwriter to sign by a duly authorised agent.[168]

e) Prospectus Delivery Requirements

The prospectus delivery requirements are contained in Section 64(1) of the MSA. The statute requires that a dealer, upon receiving an order or subscription for a security offered in the course of primary distribution to the public, must send the purchaser a prospectus before entering into an agreement of purchase and sale, or not later than midnight on the second day after entering into such an agreement. The purchaser of securities sold pursuant to a prospectus is entitled within two business days from receiving the prospectus to withdraw from the obligation to buy the securities, by giving the notice of

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[164] *Ibid.*, s. 50 (6). The grounds for refusal are not expressly limited to matters of conflict of interest of the kind which could be resolved by disclosure; as a result this section probably permits the director to refuse a prospectus on the ground of lack of confidence in the professional competence of the expert.
[165] *Ibid.*, s. 51.
[166] *Ibid.*, s. 52(1).
[167] *Ibid.*, s. 53(1).
[168] *Ibid.*, s. 52(4),(5).

the intent not to be bound to the dealer from whom the security was purchased.[169] This provision provides a period within which the purchaser has the opportunity to examine the final version of the prospectus. In addition to the statutory prospectus delivery requirements, every prospectus is required to contain a statement of the purchaser's withdrawal rights[170], and rights to rescission or damages where a prospectus, or any amendment of it, contains a misrepresentation[171].

During the period of primary distribution to the public, the prospectus is required to be amended to reflect any material changes.[172] The distribution of securities under the prospectus can continue for a period up to twelve months from the date of the receipt for the preliminary prospectus, or from the date of the last prospectus relating to the security filed.[173] After such a period further distributions of the security cannot be made without renewal of the prospectus.[174]

f) Director's Discretion

In addition to the requirements of full, true and plain disclosure, the acceptance or rejection of a prospectus by issuing or withholding a receipt is also subject to the discretion of the Director. His discretion - to accept or reject a prospectus - is enormous. The Director can refuse to issue a final receipt if it appears to him that it is not in the public interest to do so.[175] In addition, according to subsection 61(1), the Director may refuse to issue a receipt for any prospectus filed if it appears to him that certain proscribed

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[169] *Ibid.*, s. 64 (2).
[170] *Ibid.*, s. 64(9).
[171] *Ibid.*, s. 65(1).
[172] *Ibid.*, s. 55.
[173] *Ibid.*, s. 56.
[174] *Ibid.*

situations exist. These situations include: (1) non-compliance with statutory requirements, or misleading, false, or deceptive statements; (2) unconscionable consideration paid for promotional purposes or the acquisition of property; (3) net proceeds of the distribution are insufficient for the purposes stated in the prospectus; (4) failure to enter necessary escrow or pooling agreements or to lodge proceeds in trust; (5) in the case of a prospectus filed by a finance company, if the Director is not satisfied with the plan for distribution of the securities, the manner, terms, and means by which they are secured, or if it fails to meet requirements and conditions specified in the regulations.[176]

The person who files the prospectus is entitled to a hearing with respect to a refusal of a receipt for a prospectus.[177]

2. Continuous Disclosure Under the Manitoba Securities Act

Continuous disclosure provided in securities legislation falls into two categories. The first is regular disclosure, which must be made at predictable fixed intervals. It includes annual financial statements filed within a specified time from the end of the issuer's fiscal year, the interim financial report which must be published within a specified number of days from the ending of the first six months of the fiscal year, and the proxy information circular which must accompany the solicitation of proxies within prescribed times, prior to the issuer's annual general meeting of shareholders, which must itself be held within a specified number of months from the issuer's commencement of operations or the last annual general meeting.

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[175] The words "unless it appears to the Director" are indicative of this wide leeway to interpret.

The second category of continuous disclosure is irregular and somewhat unpredictable, because it is triggered by a material event or change in the issuer's affairs. The N. P. No. 40 lists several developments that are likely to give rise to material information. Such a change may occur under the issuer's control, as well as beyond its control. Examples of controlled change are the incorporation of a new subsidiary, the declaration of a dividend increase, or some types of take-over bids. Examples of uncontrolled change are an explosion destroying an issuer's plant or some types of labour disputes and lawsuits.

a) Annual Financial Statements

Section 120(1) of MSA requires a corporation to provide regular financial disclosure.[178] A corporation must file with the commission annually, within 170 days of financial year-end, audited financial statements.[179] All filed financial information is open for public inspection at the offices of the MSC during normal business hours.[180] The access to the information is facilitated through the use of the System for Electronic Document Analysis and Retrieval (SEDAR), launched in January 1997. It is a network, communications system and retrieval database in one, that makes possible the unfolding of the "virtual

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[176] Author's note: In practice if the Director has a concern, it is generally addressed through the comment process.
[177] MSA., s. 61(2).
[178] In contrast to the closed system statutes of the below listed provinces MSA in section 120(1) refers to a "corporation" which means "a company (a) that has issued equity shares that...[were] distributed in the course of a primary distribution to the public, in respect of which either a prospectus is filed with the commission and a receipt therefor obtained or a statement of material facts is filed with and accepted by the commission; or (b) any of whose shares are listed and posted on any stock exchange in Manitoba recognised by the commission": MSA., s. 118(1).
[179] MSA., s. 119.
[180] *Ibid.*, s. 134.

national commission" since filings that previously required ten separate filings now require only one electronic filing. Use of SEDAR, with a few exceptions, is mandatory.[181] Annual financial statements must be mailed by a corporation to its shareholders.[182] The annual financial statements must also provide comparative figures for the previous year and must contain an income statement, a statement of retained earnings, a statement of changes in financial position and a balance sheet.[183] Requirements as to type and content of financial statements are detailed in the regulations.[184] The annual statements must be audited and accompanied by a proper report after a full review in accordance with generally accepted accounting principles.[185]

b) Interim Financial Statements

A corporation shall file with the MSC, within sixty days of the date to which it is made, a copy of a comparative six month interim financial statement.[186] The statements must also be distributed to shareholders within sixty days of the date to which they are made.[187] However, there is no requirement that semi-annual financial statements be audited.[188] The statements need to include a statement of source and application of funds, an income statement and a statement of changes in financial position.[189]

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[181] For more information on SEDAR - see, Vincent & Guttormson, *supra* note 44.
[182] MSA., s. 130(4).
[183] *Ibid.*, s. 120(1).
[184] *Ibid.*, s. 120(1). The statements have to be prepared according to "Generally Accepted Accounting Principles" [hereinafter "GAAP"]. The MSA., ss. 121-29 sets out some specific requirements for the financial statement.
[185] *Ibid.*, s. 119.
[186] *Ibid.*, s. 129(1).
[187] *Ibid.*, s. 129(5), Man. Regs., *supra* note 47, s. 59.
[188] MSA., s. 119 (by implication). The interim statements do not have to be audited but must be prepared in accordance with generally accepted accounting principles.
[189] *Ibid.*, s. 129(1).

c) "Early Warning" Disclosure System

Under the MSA, if any person acquires ten percent or more of the shares of any class of equity or voting shares of a reporting issuer, a press release is required, and subsequently a report filed with the commission within two business days, indicating the acquirer's holdings and intentions.[190] Each time the beneficial shareholdings are increased by two percentage points, up to a twenty percent threshold, the acquirer must file a subsequent press release and file a report with the commission.[191] This disclosure obligation is known as the "early warning system". Once the twenty percent threshold is reached, a person is deemed, in the absence of evidence to the contrary, to be a "control" person, and can only acquire further shares by making an offer to all shareholders (*i.e.*, a take-over bid) or under other limited and prescribed circumstances that are designed to prevent "creeping take-overs" and take-overs in which significant control premiums are paid to some but not all shareholders.[192]

This system of disclosure has the effect of giving the target corporation an early warning of any potential take-over and can signal to others the potential gain or loss from acquiring the target. This will increase the potential for competing bids and will allow target management more time to engage in defensive tactics.

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[190] *Ibid*, s. 92(1). The form of press release and containing information therein are prescribed by s. 109 of the Man. Regs., *supra* note 47, as amended S50-159/89.
[191] MSA., s. 92(2).
[192] See Chapter 5 for a discussion on the take-over bid regulation in Manitoba.

3. Proxy/Information Circulars

a) The Need for Proxy Regulation

A proxy is a document which gives a person named therein (the "proxyholder") the power to exercise the vote of the person who signs the proxy. The proxyholder must exercise the vote in the manner indicated in the proxy. In the context of shares, a shareholder may, by proxy, appoint a person to exercise the voting rights attached to the shares held by the shareholder.

In widely held corporations it is common practice for management to solicit proxies. In other words, they would send a form of proxy, naming management's nominee as proxyholder, to shareholders and ask them to sign the form and return it. This allowed management to ensure that sufficient shares would be represented at the shareholder's meeting to satisfy quorum requirements and thus ensure that the necessary business of the meeting would be completed in accordance with its wishes. Occasionally a dissident shareholder, or group of shareholders, might seek to influence the voting by soliciting proxies.

Concerns arise with respect to the manner of solicitation of proxies by management or others. For instance, management proxy forms often only provide a space for voting in favour of management's proposed resolutions. Shareholders wishing to vote differently would have to prepare their own forms of proxy. It was also argued that those soliciting proxies often did not provide adequate information for the shareholders to make an informed decision on whether to vote in favour or against proposed resolutions.

The importance of proxy regulations is discussed in the *Kimber Report.*[193] The case in favour of the enactment of legislation governing proxy solicitation was the strong one, and the Kimber Committee made a complete set of recommendations as to the form and content of such legislation. It suggested the form of the proxy itself; the information which should be furnished by management or other shareholders prior to a meeting of shareholders, if proxies are solicited; the form in which such information should be represented; and whether or not public companies should be required to solicit proxies, that is, whether or not forms of proxy should be required to be forwarded to shareholders at the time of calling a shareholders' meeting.

The Committee's recommendations, which were followed in the MSA, dealt with three main areas: the question of whether proxy solicitation should be made mandatory on the part of management and dissident shareholder groups, the nature and detail of the proxy form itself, and the disclosure of information which should accompany the solicitation.

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[193] U.S. Federal practice with regard to proxies significantly influenced the Kimber Committee in its analysis of the Ontario scene. It cited approvingly the conclusion (para. 6.04. from Loss, vol. 2, pp. 857-8) of Professor Loss on this topic:

> "Corporate practice has come a long way from the common law's non- recognition of the proxy device. The widespread distribution of corporate securities with concomitant separation of ownership and management, put the entire concept of stockholder's meeting at the mercy of the proxy instrument. This makes the corporate proxy a tremendous force for good or evil in our economic scheme. Unregulated, it is an open invitation to self-perpetuation and irresponsibility of management. Properly circumscribed it may well turn out to be the salvation of the modern corporate system."

For quotations from L. Loss, *Securities Regulation* (2nd ed., 1961) Vol. II, p. 857, and p. 1027, dealing with the importance of the proxy rules, see the *Kimber Report, supra* note 37, paras. 6.04 and 6.17. In considering what information management of the company should make available to shareholders at the time of calling meetings of shareholders, the Kimber Committee quoted the following statement of Professor Loss, made in the context of the U.S. proxy regime which influenced the Committee's decision in making a recommendation regarding the proxy rules. He said (*ibid.*, at p. 1027):

> "The proxy rules are very likely the most effective disclosure device in the SEC scheme of things. The proxy literature, unlike the application for registration and the statutory reports, gets into the hands of investors. Unlike the Securities Act prospectus, it gets there in time. It is more readable than any of these other documents. And it gets to a great many people who *never* see a prospectus. Moreover, there are indications in both management and judicial attitudes that the indirect

The purpose of disclosure in the securities regulation area by means of proxy solicitation is to contribute to the effective use of the contractual and statutory rights which the security holder has, with respect to the issuer. The most obvious is the right of the common shareholders to elect the directors of the company. In response to these concerns, both corporate and securities laws have responded with requirements for the form of proxy and information that must be called a "proxy circular" or "information circular". Proxy solicitation requirements are designed to give shareholders the opportunity to participate in the process of voting as much as they can while not actually being present at the meeting.[194]

b) Proxy Solicitation

Part X of the MSA provides the proxy provisions for rules that apply to the same categories of companies which are the subject to continuous disclosure requirements.[195]

The method chosen to implement mandatory solicitation in Manitoba was to require that a prescribed proxy form and information circular accompany or precede management's notice of meetings to shareholders. The MSA requires management of a corporation to send a form of proxy, by prepaid mail, to security holders whose latest address as shown

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influence of the proxy rules, through their infiltration of the general law of notice to security holders, may in the long run be more significant than their direct impact."

[194] MSA., s. 104.

[195] *Ibid.*, section 100. In Part X "Proxies and Proxy Solicitation "corporation" means a company

(a) that has issued equity shares that since February 15, 1969, are distributed in the course of a primary distribution to the public, in respect of which either a prospectus is filed with the commission and a receipt therefor obtained or a statement of material facts is filed with and accepted by the commission; or

(b) any of those shares are listed or posted for trading on any stock exchange in the province recognised by the commission.

on the books of the corporation is in the province and who are entitled to vote on the matters to be decided at the meeting.[196]

In the case of solicitations by persons or companies other than management, it is only the information circular that is mandatory.[197] An information circular must be in prescribed form and follow guidelines set out in the MSA.[198] In a management solicitation of proxies, the information circular must accompany notice of the meeting, either as an appendix to the notice or as a separate document, and must be sent by prepaid mail. Any other solicitation must be sent concurrently with or prior to the solicitation.[199]

c) Form of Proxy and Information Circular

As to the form of proxy, there are certain requirements set out by the Act that have to be strictly followed. The MSR determine the content of any information circular.[200] The form of proxy must (1) indicate in boldface type whether it is solicited by management, (2) provide space for dating the form of proxy, and (3) provide means whereby the shareholder can specify in the proxy or information circular, or confer discretionary authority upon a nominee to so vote, provided that the proxy or information circular indicates in boldface type how the nominee intends to vote.[201] No proxy can confer authority to vote (1) for the election of directors unless *bona fide* nominees for those elections are named in it, or (2) at any meeting other than that specified in the notice.[202] It

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[196] *Ibid.*, s. 101(1).
[197] *Ibid.*, s. 102(1)(b).
[198] Man. Regs., *supra* note 47, Part III, s. 38. An information circular must contain the information set forth in Form 13.
[199] MSA., s. 102(1).
[200] Man. Regs., ss. 38 to 42.
[201] MSA., s. 104 (a), (b).
[202] *Ibid.*, s. 104(d).

must also indicate in boldface type that the shareholders have a right to appoint a person other than the person designated as a nominee and to contain instructions as to the manner in which this right can be exercised.[203] A proxy can confer discretionary authority with respect to amendments or variations to matters identified in the notice and in other matters which may properly come before the meeting. If the solicitor of the proxy is not aware, within a reasonable time prior to solicitation, of the new matters, a specific statement must be made in the proxy or information circular that accompanies it that the proxy is conferring that discretionary authority.[204]

No solicitation of proxies, whether by management or otherwise, may be made unless an information circular is sent to each shareholder whose proxy is solicited.[205] The form and content of this document are governed by the MSR and must contain information that is not obtained more than thirty days prior to the date of first distribution of the circular.[206] The stipulated form details items for information which must be clearly presented according to instructions contained therein. These include: revocability of proxies; persons making the solicitation; interest of directors, officers, nominees, and companies in matters to be acted upon; voting shares and principal holdings thereof; election of directors; remuneration and indebtedness of management and others; interest of management and others in material transactions; appointment of auditors; and management contracts.[207]

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[203] *Ibid.*, s. 104(f).
[204] *Ibid.*, s. 104(c).
[205] *Ibid.*, s. 102(1).
[206] Man. Regs., *supra* note 47, ss. 38-39.
[207] *Ibid.*, Form 13.

The substance of each matter to be submitted to the shareholder, apart from the approval of financial statements, should be briefly described in sufficient detail to permit the shareholders to form a reasonable judgment concerning any of the matters. These include matters such as alteration of share capital, charter amendments, property acquisitions or dispositions, amalgamations, mergers, or reorganisations. Where a reorganisation restructuring is involved, reference should be made to a prospectus form or issuer bid form for guidance as to what is material.

The information circular and any other material distributed by the soliciting party in connection with a meeting must be placed on public file with the MSC when it is first mailed.[208] The requirement to file "all forms of proxy, information circulars, notices of meetings and other communications" sent to shareholders will keep the MSC informed of all written communications between management and the shareholders, and in particular communications by groups competing for proxies.[209]

It is an offence under the MSA if the management of the corporation fails to provide shareholders with appropriate information concerning matters to be acted upon at a meeting of shareholders.[210] In addition, it is an offence if any statement made in any information circular that, at the time and in the light of the circumstances under which it is made, is a misrepresentation.[211]

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[208] MSA., s. 106(3). This requirement applies to management and any non-management group that solicits proxies.
[209] Alboini, *Ontario Securities Act, supra* note 128, at 523.
[210] MSA., s. 101(2).
[211] *Ibid.*, s. 102(4).

4. Sanctions with Respect to Continuous Disclosure Requirements

There are several possible sanctions for failure to comply with continuous disclosure requirements or for misrepresentations contained in documents filed pursuant to continuous disclosure requirements. A failure to comply with the continuous disclosure requirements[212] or, a misrepresentation in the required disclosure document, can lead to a penal sanction.[213] Compliance orders can be obtained.[214] The MSC could also issue a cease trade order.[215]

Currently, the MSA has no provisions that provide liability for misrepresentations in secondary market disclosure documents such as financial statements, proxy circulars, insider trading reports. However, there are changes being proposed to Canadian (and Manitoban) securities legislation with regard to liability for misrepresentations in the continuous disclosure documents, after the Toronto Stock Exchange in its recent report recommended that issuers of securities, and their directors and senior officers, should be liable for misrepresentations contained in continuous disclosure materials.[216] If a public company issues, for example, a press release which contains erroneous information, and investors buy or sell securities based on such erroneous information, the company, its directors and senior officers may be liable to investors for any investment losses as a result thereof.[217] The rationale for such new legislation is to provide investors with

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[212] *Ibid.*, s. 136(1)(c).
[213] *Ibid.*, s. 136(1)(b).
[214] *Ibid.*, s. 152.
[215] *Ibid.*, s. 148
[216] *Final Report of The Committee on Corporate Disclosure of The Toronto Stock Exchange* "Responsible Corporate Disclosure: A Search for Balance", [hereinafter "*The Final Report of the TSE*"] (Toronto: TSE, March 1997).
[217] *Ibid.*

realistic remedies against late, absent, misleading or false disclosure in the secondary markets, where the vast majority of trading takes place, given that continuous disclosure is so important and heavily relied on.[218] The principal difference between current common law remedies and a statutory regime is that investors would no longer have to prove that they relied on the documents or statements in question. Proving reliance is often the most difficult challenge for investors trying to sue companies in such cases.[219]

Under the proposed statutory regime, investors would be deemed to have relied on the disputed disclosure, requiring them only to prove that the disclosure itself contravened the law.[220] Issuers would be liable for core documents (*i.e.* the prospectus, circular, annual information form, financial statements, and management discussion and analysis), plus secondary documents like quarterly reports, material change reports, press releases and annual reports, plus oral information in speeches, to the media or in conference calls.[221] Total liability would be capped at $1 million or 5% of market capitalisation for companies, and $25,000 or 5% of annual remuneration for directors.[222] Extreme measures that Canadian stock exchanges undertake - halting trading or delisting a stock - often come after the fact, and the subsequent investigations take a long time and often do little good for investors. Statutory liability could provide preventive protection.[223] For one thing, while statutory liability would make it easier for issuers to be called to task, it

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[218] *Ibid.*, paras. 1.11, 1.12; p. 3.

[219] *Ibid.*, paras. 4.20-4.25. pp.33-34.

[220] *Ibid.*, s. 2(2) of the "Proposed Draft Legislation" in *The Final Report of the TSE*, *supra* note 216, p. 66.

[221] *Ibid.*, paras. 6.16-6.21.

[222] *Ibid.*, para. 2.4, chapter 6, paras. 6.57-6.62, s. 3 of the "Proposed Draft Legislation", *supra* note 220, pp. 68-70.

[223] George Koch, "Canada Closer to Tighter Disclosure" *The Investment Executive* (July 1998), at 6.

would also place strict limits on settlements. That would provide greater certainty to issuers.

B. Disclosure Under The Federal Securities Law of Russia

Issuer disclosure falls into two categories. The first involves the offering process and the required contents of the prospectus used in the distribution of shares. The second category involves continuous disclosure to the market.

1. Registration; Prospectus; Public Announcement

The ideology of the MSA is the same as that of the FSL because of its provisions for registration of securities and disclosure of essential information regarding these securities. The FSL elaborates and refines the process for the issuance of securities previously set forth in Regulation No. 78,[224] Instruction No. 2,[225] and Decree 1233.[226] The FSL, however, does not exempt any primary distributions from registration; this is one departure from Manitoba law. All issuances of securities by companies regardless of the type and the amount of an offering require registration.[227] Even if securities are not publicly offered, the issuer must nonetheless register its resolution to issue the securities

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[224] Regulation No. 78, *supra* note 97, this is the first legal act which regulated matters on the securities market prior to the adoption of the *Federal Securities Law.*

[225] Ministry of Finance Instructions No. 2 (1992) (as amended on 27 June 1993, 4 February 1993 & 15 November 1993).

[226] Decree of the President of the Russian Federation "On Protecting Interest of Investors" *Vedomosti RFFSR*, No. 1233, No. 4 (1994).

[227] The MSA and regulations adopted thereunder exempt from registration certain offerings of securities. For instance, section 19(3) states that "registration is not required in respect of a trade where the purchaser is a person, other than an individual, or a company that purchases for investment only and not with a view to resale or distribution, if the trade is in a security which has an aggregate acquisition cost to that purchaser of not less than $ 97,000." This exemption is extended to individuals under s. 90 of the Man. Regs. As the U.S. Supreme Court explained in *SEC v. Ralston Purina Co.*, (1953), 346 U.S. 119, this exemption applies

under the FSL with the FSC or an authorised registering agency.[228] This provision of the FSL is also different from Manitoba where, for example, private companies need not register their shares prior to a non-public distribution. If securities are publicly offered by a domestic issuer in Russia, the issuance will require registration under the FSL and the filing of a prospectus.[229]

Private placement and limited offering exemptions may become useful in Russia, where many potential issuers are unable to afford the registration costs of a fully registered public offering. Nevertheless, the makers of the FSL preferred to globalise the registration of securities requirements. The rationale behind this decision is not hard to find: the Russian securities market has no background in informational efficiency or full disclosure of essential information. As mentioned earlier, the FSL is designed to prohibit abuses and fraudulent practices that do not yet exist in the market but that are expected to occur once the market develops. Under the circumstances, the traditions of economic *glasnost* (*i.e.*, full and accurate disclosure of information) can be created and developed only through rigid governmental enforcement of disclosure requirements, a goal that can be achieved only through strict registration requirements with no loopholes.

It is possible that at some later stage in the development of the Russian securities market such comprehensive registration of securities requirements may adversely affect

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to private placements of securities where the purchasers of the securities do not need the protection of the registration provisions of the Act.

[228] See generally FSL, *supra* note 2, arts. 16-18. Issues of securities which have not been registered in accordance with the requirements of the present *Federal Securities Law* shall not be placed. *Ibid.*, art. 18, also art. 24. The issuer may only commence the placement of securities after their issue has been registered.

[229] *Ibid.*, art. 16. Securities issued by foreign issuers may be accepted for circulation or initial placement on the Russian securities market of the Russian Federation markets after the issue prospectus of these securities has been registered with the FSC.

expansion of the market, justifying the introduction of exemptions to registration.[230] Presently, however, the objective of preventing fraud and manipulation in the securities market at the early stages of its development may justify the rigidity of the Russian securities laws.

a) Registration

The FSL delineates the registration procedure from the issuance of securities. The issuer must register its "resolution" embodying the decision of an issuer to issue securities. To be valid, the issuer's resolution must include, *inter alia*, the name and legal address of the issuer, the date of its decision to issue securities, the rights conferred by the security on its owner, the procedure for placement of the securities, the issuer's obligation to secure the rights of the owner, and the number of securities to be issued.[231] Where securities are issued in documentary form, a sample certificate must be filed.[232] The certificate must include most of the elements of the resolution and whether or not the securities are issued in documentary form, with or without compulsory centralised storage.[233] Both bearer and registered securities may be issued.

The legal significance of a registered decision is that it certifies the rights conferred by the security on its owner. In the case of certified securities, the decision and the certificate together certify such rights. However, in case of conflict, the certificate controls.[234] This provision is designed to protect the rights of security holders in the face of changes in the

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[230] The registration requirement of securities in Manitoba was also fairly rigid. This prevented small issuers from accessing the capital markets. As a result, additional exemptions from the registration requirements were introduced into the Man. Regs. in 1986 (s. 91).
[231] FSL., *supra* note 2, art. 17.
[232] *Ibid.*
[233] *Ibid.*, art. 18.

issuer's constituent documents. A significant investor may be able to negotiate for charter amendment protections as well. When an issue of securities is registered, the issue is allocated a state registration number.[235]

If Russia wants to have an efficient primary market, one that assures the optimum allocation of financial resources in the economy and at the same time establishes the conditions and practices in the market that best serve the investing public, it is necessary for them to strengthen registration requirements for issuers and increase the accountability of issuers to investors.

Prospectuses should be publicly available to potential investors right after they are submitted for registration (*i.e.*, to forbid sale of securities before they are registered), warning potential investors that a registration process is on and that changes in the prospectus are possible. In the best interest of investors, the registration should be refused if a prospectus does not contain adequate information, and if an issuer cannot or is not willing to eliminate the material defects in the prospectus.

The only standard that the registration authority should be looking for is that the information provided in the prospectus is a full, true and plain disclosure of all "material" facts relating to the newly distributed securities, to ensure that potential investors can make an informed decision.

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[234] *Ibid.*
[235] *Ibid.*, art. 20.

b) Prospectus Filing And Approval

If securities are publicly offered by a domestic issuer in Russia, the issuance requires registration under the FSL with the FSC and the filing of a prospectus. A prospectus must be registered "if the securities are placed with an unlimited number of owners or if it is known in advance that the number of owners will exceed 500, and also in cases where the total issue volume exceeds the value of the minimum wage by 50 thousand times."[236] This constitutes a "public offering" in Russia. A prospectus also must be registered if a foreign issuer is placing the securities issuance, whether or not the securities are publicly offered.[237]

The FSC has adopted regulations that provide general guidance for registration and preparation of prospectuses by joint-stock companies.[238] The registering authority must either register the issue or to provide grounds for a decision to refuse registration not later than thirty days after the date of receipt of the relevant documents.[239] During this period, the registering agency does not conduct a merit review of the offering. Instead, it reviews the application for completeness of the information required and ensures the compliance of the prospectus as to form and content with the law.

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[236] *Ibid.*, art. 19. This represents a liberalisation of prior law, which required a prospectus for an offering to more than one hundred purchasers or for any issue of 50 million rubles or more.

[237] *Ibid.*, art. 16.

[238] Postanovlenie Federalnoj Komissii po Tsennim Bumagam No. 19 "Standarty emissii aktsiy pri uchrezhdenii aktsionernikh obshestv dopolnitelnykh aktsiy, obligatsiy I ikh prospektov emissii" [Federal Securities Commission Regulation No. 19 "Standards of the Issue Shares upon Formation of Joint-Stock Companies, Issue of Additional Shares and Bonds and Model Stock Prospectus"] (17 September 1996), *Vestnik Federalnoj Komissii Po Rynku Tsennykh Bumag*, No. 4 (22 October 22 1996) [hereinafter, Standards].

[239] FSL., *supra* note 2, art. 20. The thirty-day limit protects the issuer against bureaucratic inefficiency of the government.

A decision to refuse registration may be appealed in a court or arbitrage tribunal.[240] The grounds on which the FSC may refuse to register an issuance of securities include: (1) violation by the issuer of the requirements of the securities legislation of the Russian Federation; (2) any suggestion in the filed documents of information that the conditions of issue and circulation of the securities are in contradiction with the law, or that conditions in the issuing of the securities do not correspond to the terms of the Federal Securities Law; (3) failure of the documents presented and the information contained therein to conform to the requirements of law; (4) the inclusion in the prospectus, or the resolution to issue securities or other documents which represent the basis for the registration of the issue of securities, of false information or information which does not correspond to the true facts.[241]

c) Contents Of The Prospectus

The FSL requires the issuer to provide all qualified information about the issuer and the conditions of the issue in a prospectus.[242] The contents of the prospectus are prescribed by the FSL and by regulations of the FSC.[243] The FSL requires that a prospectus include: (1) information about the issuer's legal status, significant shareholders, management, subsidiaries and branches; (2) financial information about the issuer; and, (3) information about the offering.

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[240] *Ibid.*, art. 21.
[241] *Ibid.*, art. 21. The grounds for denial provided in the FSL are essentially the same as those set forth in Instruction No. 2, *supra* note 225.
[242] *Ibid.*, arts. 19, 22.
[243] *Ibid.*, arts. 22, 42(2).

Information about the issuer must include: the issuer's name and legal address, and the names of its founding partners; the number and date of the certificate of state registration of the issuer as a legal entity; information about holders of five percent or more of the issue's authorised capital; the issuer's management structure; the names of its directors and officers, their experience, and their interests in the issuer's authorised capital; a list of all legal entities in which the issuer owns five percent or more of authorised capital; a list of all of the issuer's subsidiaries and branches; a list of affiliated companies, the issuer's main business activities, and its material contracts.[244]

Financial information about the issuer must include: (1) the issuer's balance sheets and financial reports concerning its business, for the last three complete financial years or for a newly established company, for each complete financial year since the resolution to issue securities was made; (2) a report on the sources and the use of the assets of the reserve fund for the last three years; (4) the issuer's overdue debts to its creditors and of payments overdue to the government at the date on which the decision to issue securities was adopted; (5) information on the issuer's authorised capital (the amount, the number of securities and their nominal value) and the owners of the securities, whose shares in the authorised capital exceed the norms established by the anti-monopoly legislation of the Russian Federation; (6) a report on previous issues of securities by the issuer, including the types of the securities issued, the number and date of the state registration,

[244] Standards, *supra* note 238, attachment 3, paras. 26-30.

the volume of the issue, the number of securities issued, the terms on which dividends are paid and other rights of owners.[245]

The same article requires inclusion in the prospectus of the following information about a forthcoming issue: a description of the securities, including the form and type of securities offered, indicating the procedure for storage and the accounting of rights in the securities, the total volume of the issue, and the quantity of securities in the issue; the date on which the resolution to issue securities was made; the restrictions on prospective owners, where they can obtain the securities, the title and legal address of the depository if the securities certificates are stored, if an accounting of rights in the securities is conducted in a depository; the dates on which the placement of securities begins and ends; the price and procedures for payment for securities offered; the name and address of the professional securities participants who will distribute the securities; the procedure for the payment of dividends, if they are to be paid, and the method used to calculate dividends; and the name of the agency which registered the issuance of the securities.[246] The prospectus is required to include information on securities transfer restrictions, risk factors, and where the securities may be purchased.[247]

Surprisingly, the FSL itself does not say specifically that the financial statements have to be audited and that the prospectus shall include risk factors. However, provisions of Russia's *Joint-Stock Companies Law* require that all financial information disclosed by a joint stock company, including the issuer's balance sheet and profit and loss statement,

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[245] FSL, *supra* note 2, art. 22.
[246] *Ibid.*
[247] Standards, *supra* note 238, attachment 3, paras. 45-52.

must be certified by an independent auditor approved by the issuer's shareholders.[248] This provision fills the gap.

The information in the prospectus must be accurate as of the effective date of the registration. There is no direct requirement in the Law to update the disclosure in the prospectus if there are any changes. However, the requirement to disclose any changes concerning the issuer's securities and his financial and economic activity within five days of their occurrence,[249] covers that deficiency.

The disclosure requirements of the FSL are a good start toward creating an efficient securities market. However, there is also a contrary view. On the basis of his studies of the Russian securities market, Professor Brown has suggested that no legal reform will bring order to the markets.[250] As an example, Brown uses the public offering by the All-Russian Automobile Alliance (AVVA).[251] The AVVA prospectus "contained no specific discussion of the use of proceeds, true risks of the investment, the time frame for when automobile production would begin, and the controlling shareholders of the shell company." It was, nevertheless, filed with the Russian Ministry of Finance and was declared effective. Consequently, even under the new disclosure requirements of the issuance, the FSC could not deny the registration of such securities pursuant to Article 21 of the FSL, because imprecise information in the prospectus is not indicated as a ground for a refusal to register an issue of securities. Professor Brown suggested that the

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[248] Russian Federation Law No. 208-FZ "On Joint Stock Companies" of 26 December 1995, arts. 86, 88 [hereinafter, JSC Law]. A statutory audit is required for all open and closed joint stock companies that plan to make a public offering of their securities. *Civil Code*, *supra* note 11, art. 97.

[249] For a discussion of the provisions of the FSL that require issuers of publicly offered securities to file a current report on occurrence of significant events, see Section 6 "Continuous Disclosure Requirements" of this Chapter.

[250] Brown, "Order from Disorder", *supra* note 15, at 556-57.

disclosure requirements contained in Russian regulations, especially with respect to financial disclosure, are "inadequate".[252]

Article 20 states that both the issuer and those of its officers responsible for the registration submissions are liable for the completeness and accuracy of the submissions.[253] Experts and other persons who prepare the prospectus and related publications are not obliged to certify it and accordingly they do not share responsibility with the issuer if it is determined that the standards for filing a prospectus have not been followed. The form of responsibility is not provided for in any legal acts. Thus, investors have no causes of action if they become victims of dishonest and negligent companies.

The registration demands, but does not guarantee, that investors receive true and full information. Prospectuses of the Russian companies abound with "the absence of the presence"[254], with ill/unfounded promises, and with ambiguous phrases. It would be impossible to provide complete investor protection from dishonest issuers, but it is possible to strengthen such protection by binding those who assisted in the preparation of the prospectus to certify it. It would make sense to oblige issuers to involve outsider specialists --- auditors, underwriters, engineers, geologists --- to assist in the preparation of the prospectus and at the same time to oblige those specialists to sign and seal the opinion given by them on the matter of the examination, to provide for their responsibility.

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[251] *Ibid.*, at 540.
[252] *Ibid.*, at 539.
[253] FSL, supra note 2, art. 20.
[254] B. Alehin, "Pravovie Shlusi na Puti Emissii" ["The Legal Floodgates on the Way of Issuance"], *Economica I Zhizn*, No. 45 (November 1994) at 8.

d) Delivery And Publication Requirements

Once the FSC approves the registration application, it is a matter of public record. In offerings requiring a prospectus, within five days after registration of its prospectus, the issuer must make a public announcement of the offering. The FSL does not specifically require circulation of the prospectus itself, but only that the issuer "provide access to the information" contained, in addition to publishing a notice about how such access is to be provided, in a publication with a circulation of at least 50,000 copies.[255] The public announcement must state where potential investors may obtain copies of the prospectus. In practice, the issuer makes a prospectus available for review at the place of the selling agent.

Placement must be completed within one year from the date of commencement of the issue process, but may not commence until two weeks after all prospective investors have received access to the information about the issue which should have been disclosed under the terms of the Federal Securities Law.[256] Thus, the statutory scheme contemplates that securities may be sold no earlier than two weeks after the effectiveness of the registration of the issuance, assuming that the issuer made the public announcement after the registration and made the prospectus available to potential investors. The price of an issue need not be established until the day that placement commences.[257] This two-week waiting period, combined with the earlier thirty-day period, compels an issuer to wait for

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[255] FSL., *supra* note 2, art. 23.
[256] *Ibid.*, art. 24.
[257] *Ibid.*

a total of forty-five days. During this waiting period, the FSL does not permit any publication concerning the issue to condition the market for receipt of the securities.[258] However, it is unclear from the FSL whether or not the issuers may make oral offers to purchasers during the waiting period.

Under the recently issued regulation of the FSC, an issuer is obliged to publish information or notify the existing shareholders of its decision to issue securities a month before the issuer submits the documents to the FSC for registration. The purpose of such a requirement is to give potential investors and existing shareholders time to participate in the placement of securities and to let investors/shareholders file a complaint if the terms and conditions of the distribution were contravened by the issuer (*e.g.*, the price was lower than the market price, or securities were sold to insiders). These measures are designed to prevent violations of investors and shareholders rights during the public distribution, to resolve complaints before the registration takes place rather than to void the issuance after it was registered, to protect investors from abuses during distribution and generally to decrease the risk of voiding the issuance of securities. According to the new regulation, an issuer is obligated to publish information on every stage of the distribution process of securities: (1) on corporate resolution of an issuer to issue securities, (2) on registration of securities, and (3) on completion of the distribution. The information on the corporate resolution of an issuer to issue securities should contain, *inter alia*, the quantity of securities in the given issue and an indication as to whether arrangements for certain potential investors to have any advantage over others in

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[258] *Ibid.*

acquiring securities will be exercised (*i.e.*, the existing shareholders are exercising their pre-emptive rights).

The FSL, in the case of a public offering or circulation of an issue of securities, forbids arrangement for certain potential investors to have any advantage over others in acquiring the securities, excluding: the issue of state securities; a joint stock company where the existing shareholders are exercising their pre-emptive rights; and, the introduction by the issuer of restrictions on the acquisition of securities by non-residents.[259] Such an "equality provision" is an underlying theme of Manitoba securities legislation.

After the public announcement is made, the issuer may advertise the public offering. The new law codifies already established prohibitions against the overly optimistic advertising that made MMM famous. Article 34 specifically prohibits advertising in bad faith, including inclusion of untrue information about the issuer or its securities, projections of anticipated income, and unfair competition in the form of aspersions on competing issues.

In accordance with Article 25, the issuer must present a report with the registering agency on the results of the issue, including revenues and the number of shares placed, within thirty days of completion of the offering. The registering agency may review the report for up to a period of two weeks after its filing. If it finds no violations of law, it will register the report.

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[259] *Ibid.*

2. Continuous Disclosure Requirements

The FSL requires issuers of securities to report periodically to their shareholders, the FSC, and the public. Oddly, the contents of the reports are set forth in two different places in the FSL, Articles 23 and 30. The two versions are not inconsistent, but neither are they identical. Both articles impose continuous reporting requirements on issuers of publicly distributed securities, to disclose information concerning its securities and its financial and economic activities in the form of quarterly reports, and reports on significant events or developments of financial and economic activities.[260] The FSC has not yet prescribed the forms or other requirements concerning quarterly and current reports. In addition, the FSL does not expressly contemplate an annual report.

a) Quarterly Reports

Issuers of publicly offered securities must prepare quarterly reports that contain the following: (1) information about the issuer, including (i) a list of directors, officers and their shareholdings and the issuer's subsidiaries, branches, and dependent companies; (ii) a list of the issuer's shareholders with more than twenty percent of its authorised capital; and, (iii) information concerning the reorganisation of the issuer, its subsidiaries and dependent companies; (2) information about the issuer's financial and economic activities, including (i) its balance sheets and profit and loss statements for the preceding three years[261] and for the reporting quarter; (ii) facts resulting in an increase in the

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[260] FSL, *supra* note 2, arts. 23, 30.

[261] *Ibid.*, see art. 30 (2), It does not seem rational to require the submission of balance sheets and profit and loss account statements for the last three complete years in quarterly reports. There is no easy way to interpret the necessity of such a requirement.

issuer's net income or losses of more than twenty percent during the reporting quarter; (iii) information about the formation and use of the issuer's reserve fund and other special funds; and (iv) information about significant transactions; (3) information on the issuer's securities, including the classes of securities issued during the quarter and information about dividends; and, (4) other information, in particular, the minutes of shareholder general meetings during the quarter.[262]

Quarterly reports must be prepared within thirty days after the end of each quarter[263] and submitted to the FSC or the registering agency. An issuer must provide its quarterly report to shareholders who request the report; however, the issuer may charge requesting shareholders for "the cost of producing the brochure".[264]

b) Current Reports

Issuers of publicly offered securities also must file a report within five days if significant events affecting the financial and economic activity of the issuer occur.[265] These events include: (i) any change in the list of members of the issuer's management, (ii) any change in management's shareholdings in the issuer, its subsidiaries and dependent firms, and changes in management's shareholdings in entities in which management owns more than

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[262] *Ibid.*, art. 23.
[263] *Ibid.*
[264] *Ibid.*, art. 30. Regulation No. 78, *supra* note 224, required joint-stock companies to "publish quarterly and circulate to stockholders the balance sheet of the company, the profit and losses account, and other current information." The Regulation, however, contained few specifics about how to disseminate the information or the contents of these reports. Presidential Decree 1233, *supra* note 226, addressed the issue in June 1994 at Item 6. The Decree required open joint-stock companies who traded their shares to publish quarterly financial information, specifically the disclosure of balances and profit-loss accounts, in "the popular press". The Decree specified that the information had to be published in a particular type of printed medium and freely distributed throughout the territory where the company was registered. For companies with more than 5000 shareholders, the medium had to have a circulation of at least 50,000 and be freely distributed throughout the Russian Federation. *Ibid.* at Item 7. The precise publication was to be determined by the company's board of directors.

twenty percent of the share capital, (iii) any change of control of the issuer with respect to shareholders who own twenty percent or more of the issuer's share capital, (iv) any change in the list of legal entities in which the issuer owns twenty percent or more of the authorised capital, (v) any reorganisation of the issuer, its subsidiaries and dependent companies, (vi) all dividends declared, accumulated or paid on the issuer's securities, (vii) the redemption by the issuer of its shares, (viii) issues of securities which are invalidated or suspended, (ix) the acquisition of more than twenty-five percent of any class of the issuer's securities, (x) any increase or decrease by more than ten percent in the value of the issuer's assets, net income, or net loss or a single transaction completed by the issuer that involves consideration valued at ten percent or more of the issuer's assets at the date of the transaction, (xi) establishment of a record date for the exercise of shareholder rights with respect to a particular matter, (xii) acquisitions or dispositions of entities in which the issuer owns twenty percent or more of the share capital, (xiii) the acquisition by a shareholder of more than twenty-five percent of any class of the issuer's securities, or (xiv) any increase or decrease by more than ten percent in the value of the issuer's assets, net income, or net loss or a single transaction completed by the issuer that involves consideration valued at ten percent or more of the issuer's assets at the date of the transaction.[266]

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[265] FSL., *supra* note 2, arts. 23, 30.

[266] *Ibid.*

The report of significant events must be filed by the issuer with the registering agency and also published in printed mass media with a circulation "large enough to make them available to the majority of the shareholders"[267], within five days of its occurrence.[268]

The disclosure requirements on a timely basis by issuers of publicly distributed securities in Russia are different from those found in Manitoba. Filing reports on a quarterly basis *versus* annual and semi-annual reports in Manitoba, provide more timely disclosures for investors. The required information in quarterly reports is more extensive than that in semi-annual reports under the MSA because the former includes more than mere financial (*e.g.*, shareholdings of directors and officers of the issuer; a list of shareholders with more than twenty percent of issuer's authorised capital; facts resulting in an increase in the issuer's net income or loss of more than twenty percent; etc.).

Besides the quarterly reporting, and in contrast to the MSA, the Russia's FSL provides continuous disclosure through reporting upon the occurrence of significant events affecting financial and economic operations of the issuer.

"Significant events" (in Manitoba referred to as "material information") are expressly specified in the FSL (*e.g.*, increase or decrease by more than ten percent in the value of the issuer's assets, net income, or net loss or a single transaction completed by the issuer that involves consideration valued at ten percent or more of the issuer's assets at the date of the transaction), while under the N. P. No. 40, it is a responsibility of the reporting issuer to determine what information is material and therefore should be reported. The N.

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[267] Neither the FSL nor regulations of the FSC determines what constitutes "large circulation".
[268] FSL., *supra* note 2, art. 23.

P. No. 40 lists several developments that are likely to give rise to material information. It notes, for example, changes in issued capital, redemptions, dividend decisions, changes in share ownership, changes in corporate structures (such as reorganisations and amalgamations), take-over bids and issuer bids, major corporate acquisitions and dispositions, and changes in capital structure. Being less specific is more encompassing. An event that merely missed being reported because it did not meet the quantitative threshold of the FSL would be reported under the broader definition of the "material change" and "material fact" under the N. P. No. 40, which applies in Manitoba.

c) Disclosure Related to Shareholdings

Under the FSL, a person must report to the FSC information concerning its ownership of an issuer's securities, if it acquires twenty percent or more of any class of an issuer's securities or, after acquiring twenty percent or more of any class of securities, there is a material change in such ownership.[269] In this context, a material change is the increase or reduction in ownership involving five percent or more of any class of an issuer's securities.[270]

The owner must disclose this information, which includes the name and title of the owner, the type and state registration number of the securities, the title of the issuer and the number of securities owned. The report must be filed within five days after the occurrence of the event or events triggering the reporting requirement.[271]

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[269] *Ibid.*, art. 30.
[270] *Ibid.*
[271] *Ibid.*

Russia previously had no system of ownership disclosure.[272] Large shareholders had no obligation to disclose their interests after crossing ownership thresholds.[273] This meant that large, sometimes controlling, blocks of stock could be acquired secretly. This was not a desirable practice. Shareholders lack sufficient information to make a rational assessment whether to purchase securities and, subsequently, whether to purchase additional securities or to sell those they have.

d) Disclosure by the Securities Market Participants

According to the FSL, professional participants in the securities market are obliged to disclose information concerning their operations with securities in any case where a securities market participant has concluded transactions concerning all of an issuer's outstanding securities of one class, or concluded a specific transaction involving at least fifteen percent of all of an issuer's outstanding securities of one class.[274] A professional participant must file a report with the commission within five days, either of the end of the relevant quarter or of the specific transaction, as the case may be.

By the same article, a professional participant is required to disclose all of the publicly available information in his possession which has been disclosed by the issuer of these

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[272] The JSC Law also includes provisions designed to protect shareholders of widely-held joint stock companies, *supra* note 248, art. 80. These protections apply to companies with more than 1,000 common stockholders. See *infra*, Section B "The Russian Securities Laws With Respect Take-Over Bids" of Chapter 5.

[273] See Regulation No. 78, *supra* note 97; provisions of this Regulation were in effect before the *Federal Securities Law* was passed. The existing legal disclosure requirements were with the government and were not public. For example, "Purchasers of 15 % of the shares of joint-stock companies in Russia must file with the Ministry of Finance. Those acquiring more than 35% of a company or where the shares represented more than 50% of the total voting shares, are required to seek permission prior to purchase of the RSFSR State Committee for Price and Support for New Economic Structure." For more details *see* Brown "Order From Disorder", *supra* note 15.

[274] FSL, *supra* note 2, art. 30.

securities; or to indicate that he is not in possession of this information at the moment when he either proposes and/or declares the price for the purchase or sale of securities.

Dissemination requirements in the previous and current legal acts have little force without a mechanism for insuring an adequate level of disclosure. In the context of both primary offerings and secondary trading disclosure, the system has lacked qualitative standards designed to maximise the usefulness of the information to investors. The existing regulatory regimes have little impact until effective standards have been developed. For this to happen, however, demand must exist in the market. And as Brown fairly notes, "this meant that dynamics in the market had to exist to promote proper disclosure. Investors had to appreciate and want the information and companies had to see the benefits of disclosure."[275]

Article 23 states that, during a primary distribution, the issuer and professional participants in any securities market involved in the distribution of securities, have an obligation to provide any prospective purchasers with access to disclosed information before they purchase these securities. This requires issuers to take practical steps to make certain that all purchasers have an equal opportunity to obtain a copy of a current prospectus. Exactly how issuers and professional participants discharge their respective Article 23 obligations has to be developed by the FSC urgently.

3. Liability with Respect to Continuous Disclosure Requirements

There is no liability for failure to file or for misrepresentations in continuous disclosure documents under the *Federal Securities Law*. Given that continuous disclosure is so

important and relied on so heavily, and these requirements are central to the regulatory system and investor confidence, it is necessary to have a mechanism for enforcement of disclosure requirements. Russian lawmakers should create issuer's civil liability for continuing disclosure. The investor's right to rescind a contract of purchase of a security, if the prospectus or other disclosure documents contain a misrepresentation, could be a powerful means of investor protection. Similar provisions are found in the MSA.[276] However, considering the Russian *Civil Code* provision which puts the onus of proving that disclosure documents contain a misrepresentation upon the plaintiff,[277] this provision will not have expected results, unless it follows the application of the same provisions provided in the MSA. It is important that, by providing for the right to rescind on the basis of a misrepresentation, the lawmakers exclude the burden of proof of misrepresentation from the purchaser-plaintiff.[278] Currently proposed draft legislation in Canada (and Manitoba) would provide for a statutory liability for misrepresentations in

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[275] Brown, *supra* note 15, at 548.

[276] Section 65(1) of the MSA provides a right of rescission where the prospectus received by a purchaser or his agent contains an untrue statement of a material fact, or a failure to state a material fact necessary to make a statement not misleading in the circumstances. D. Johnston, *supra* note 24, commented on the provision of section 65: "At common law, reliance on a misrepresentation would ordinarily be necessary to give rise to a right to rescind. It seems that reliance on a misrepresentation need not be proved by a plaintiff in the section 65 action. It would be helpful if the statute expressed the concept of deemed reliance as it does in the parallel provision, section 142. However, s. 65(7) expresses that the statutory right is in addition to and without derogation from any other right the purchaser may have at law. Moreover the right seems to be automatic on the condition of misrepresentation being satisfied. Finally, the polar extreme of deemed reliance - actual knowledge of the misrepresentation by the purchaser - is stated as a defence to rescission."

[277] This applies because the FSL does not have a deemed reliance provision.

[278] As B. Alehin said "if the court proves that the prospectus contain an untrue statement ... or omits to state a material fact...then a purchaser... has a right to rescind and to be compensated. And investors of Russian Securities Market would welcome such a right. But all courts of the world will not be enough to settle the legal proceedings on an investors' actions. (There are 60 million shareholders in Russia, which is 10 million more than those in the U.S.)", *supra* note 254.

continuous disclosure documents[279]; and, this could be a starting point for Russian lawmakers. The rationale for a provision for an issuer's civil liability for misrepresentations in continuous disclosure is that the Russian emerging market has no background in informational efficiency or full disclosure of essential information. Under the circumstances, the traditions of full and accurate disclosure of information can be created and developed through the rigid enforcement of disclosure requirements. The threat of civil liability would have the effect of deterring misrepresentations in continuous disclosure and failure to disclose.

4. Russian Legislation with Respect to Proxies

There is no comprehensive proxy regulation framework in Russian corporate or securities regulation. Although the Russian *Joint-Stock Companies Law* contains provisions permitting the use of the proxy in dealing with various procedural matters, these are largely restrictive in nature and confined to such matters as the provision of adequate notice of meetings and the fixing of the time for closing the list of proxies deposited.[280] The law is silent regarding even such a basic question as whether proxy solicitation should be required at all, as well as when and how it should be carried out. As a result, the proxy commonly used is deficient as a form of ballot and provides an alarmingly slim base of information upon which the absentee voter is to form a judgment. In view of the importance of the proxy system in a period when large widely-held companies are dominant, this is a highly unsatisfactory state of affairs: Article 50 provides for voting on

[279] For a discussion of the provisions of the "Proposed Draft Legislation" in the *Final Report of the TSE*, see, *supra* notes 216-222 and accompanying text.
[280] JSC Law, *supra* note 248, clause 2 of articles 48; article 50, article 52.

general meetings in a company by virtue of a form of ballot, the form and context of which, according to Article 60, are "to be prescribed by the Board of Directors".[281]

C. Comparison of Disclosure System

From the foregoing, the following comparisons can be made between the Russian and Manitoba disclosure systems in the securities markets:

1. Both have as their primary goal disclosure of sufficient information to enable investors to evaluate risks of investment. In other words, an issuer is permitted to sell securities even if the securities are extremely risky and unlikely to be profitable investments after such facts are disclosed.

2. The Manitoba system more clearly distinguishes between public and private offerings and sales of securities, allowing a greater degree of flexibility for issuers and investors while preserving reasonable protections for the "unsophisticated" investor (*e.g.*, exemptions of private offering from registration). By contrast, the Russian legal system does not provide for a meaningful distinction between private and public offers/sales; and, for purposes of registration of securities, disclosure requirements during the offering and periodic reporting, although this distinction is gradually being introduced.

3. The MSA delineates the obligation to send by prepaid mail, or to deliver the prospectus to the purchaser upon receiving an order or subscription for a publicly offered security, either before entering into an agreement of purchase or sale resulting

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[281] *Ibid.*, art. 60.

from the order or subscription, or not later than midnight on the second day after entering into such an agreement. The Manitoba's system may not be truly effective; therefore it should provide other alternatives to facilitate the access of investors to the disclosed information such as by electronic means (internet, email, etc.) The FSL does not specifically require circulation of the prospectus itself, but only that the issuer is to "provide access to the information" and publish a notice about how such access is to be provided. The FSL should establish a detailed procedure for making the prospectus "publicly available".

4. The FSL contrasts with the MSA in that it has no provisions binding experts who were involved in preparing a prospectus to certify it. Accordingly they do not share responsibility with the issuer in case legal standards for filing a prospectus have not been followed. In order to strengthen investor protection from dishonest issuers, it is recommended that an issuer involve outsider specialists - auditors, underwriters, engineers, geologists - to assist in the preparation of the prospectus and to oblige them to sign and seal their opinion on the matter of examination, as is provided in the MSA. Experts and other persons who prepared the prospectus and related publications are not liable for errors in these documents, which substantially differ from the broad range of liability provisions provided by Section 136(1) of the MSA.

5. The other fundamental difference of the FSL from the MSA is that the FSL has no provision for the purchaser's right to rescind the contract while still the owner of the security, if the prospectus contains misrepresentation. Inclusion of the right for rescission in the FSL (and the requirement that every prospectus shall contain a

statement of that right of rescission) would provide a certain degree of investor protection.

6. The absence of the obligation to update a prospectus for material changes during the offering period is a deficiency of the FSL in terms of providing investors with up-to-date information, which should be addressed by the law.

7. In comparison with the FSL, which is unclear about whether or not the issuers may make oral offers to purchasers during the waiting period, Section 38(2) of the MSA does not prohibit oral offers during the waiting period. Also, in recognition of the fact that the prices of securities change rapidly and cannot be known in advance, the MSA allows issuers to deliver a preliminary prospectus. This complex scheme of the MSA, as to delivery of the preliminary prospectus and publication requirements, is not contemplated by the FSL. Presumably any communication with prospective purchasers of a security during the waiting period is illegal. This outcome was probably justified at the early stages of the development of a securities market when fraudulent practices, rather than convenience of the issuers, should be the main concern of the regulators.

8. As to continuous disclosure, the MSA requirements are different from those of the FSL, in that the first requires a filing with the MSC of annual (audited) and semi-annual (unaudited) financial statements that have to be mailed to the shareholders; while the FSL goes further in requiring the issuer of publicly offered securities to file quarterly reports on financial and economic activities of the issuer (unaudited) and reports on the occurrence of any "substantial events affecting financial and economic activity of the issuer". The continuous disclosure under the FSL has its benefits,

compared to those under the MSA, for the following reasons: (1) the required information is more extensive (quarterly reports other than financial statements contain additional information, *e.g.*, changes in an issuer's directors, officers' shareholdings, etc.); (2) disclosure is more timely (*e.g.*, quarterly disclosure compared to annual and semi-annual reporting); and, (3) reporting includes occurrences of significant events affecting economic and financial activities of an issuer is provided. Quarterly filings are more appropriate in Russia because of the greater need for disclosure in emerging markets.

9. While financial statements are required to be mailed by the issuer to shareholders under the MSA, the quarterly reports, under the FSL, are required to be provided by the issuer to the "requesting" shareholders, charging them for "the cost of producing the brochure". It should be recommended that Russia oblige the issuer to mail reports to its shareholders, as does the Manitoba Act, or to provide the access through electronic means (internet, e-mail), in order to provide investors with an equal opportunity to gain access to up-to-date information in the marketplace.

10. The early warning report requirement is somewhat similar to the disclosure requirements related to acquisitions under the FSL, where an acquirer must report ownership of an issuer's securities if it acquires twenty percent or more of any class of an issuer's securities. After acquiring twenty percent or more of any class of securities, any increase or reduction in ownership involving five percent or more of any class of an issuer's securities must also be reported. Both, the Russian and Manitoba reporting requirements on acquisitions of an issuer's securities keep investors apprised of the

activities of an acquirer who may be buying or selling a controlling interest. Although the Russian context does not require a declaration of the acquirer's intentions, the Manitoba law does.

11. In contrast to the proxy rules under the MSA, the Russian securities legislation does not address proxy regulation provisions at all. Recommendations should be proposed that substantive proxy regulation in the version of Manitoba's proxy rules be included in Russian securities legislation, as a part of a composite package of reforms emphasising continuous disclosure: namely, the form of the proxy itself; the information which should be furnished by management or other shareholders, if proxies are solicited; the form in which such information should be represented; and, the requirement that forms of proxy are to be forwarded to shareholders when calling the shareholders' meeting. Such matters must be established in the law itself, rather than left to "the board of directors to determine".

12. By contrast, the Manitoba securities legislation provides for penal sanctions for a failure to comply with the continuous disclosure requirements, as well as for misrepresentation in the required disclosure documents. In addition, changes are proposed for statutory liability for misrepresentations in continuous disclosure documents. The Russian securities legislation has no enforcement arsenal to use against those who fail to comply with continuous disclosure requirements.

V. CHAPTER 4 - INSIDER TRADING REGULATION

This chapter examines the principal policy considerations behind insider trading legislation, and it reviews the relevant laws of Manitoba and Russia in detail. The common features of these laws are identified, as are the principal areas in which the laws of the two jurisdictions diverge. It identifies lessons that Russia can learn from Manitoba insider trading regulation.

Insider trading "is generally used to denote purchases or sales of securities of a company effected by or on behalf of a person whose relationship is such that he is likely to have access to relevant, material information concerning the company which is not known to the general public."[282]

"The ideal securities market", said the *Kimber Report*, "should be a free and open market with the prices thereon based upon the fullest possible knowledge of all relevant facts among traders. Any factor which tends to destroy or put in question this concept lessens the confidence of the investing public in the market place and is, therefore a matter of public concern."[283] Insider trading was considered by the Kimber Committee to be a "factor, which tends to destroy or put in question the concept of a "free and open market"." The Kimber Committee proposed a number of changes to the Ontario insider trading laws, including adoption of a broad definition of an "insider" and increased

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[282] *Kimber Report, supra* note 37, para. 2.01.

[283] *Ibid.*, Part II. para. 2.01. The Kimber Committee conducted a thorough study of the law in the United States and many of its recommendations were derived from the Securities and Exchange Act of 1934. The American approach adopted was to utilise two branches to guard against improper insider trading. Insiders were required to report all trading under the first branch and the second established a liability for certain types of insider trading. The Kimber Committee recommended enactment of legislation to deal with both the reporting and liability aspects of insider trading, to provide fairness and transparency in the market.

remedies for insider trading.[284] Subsequent changes to the Manitoba law in 1968 followed the example of the Ontario law.[285]

The Manitoba insider trading legislation is based on the view of the *Kimber Report*, which stated:[286]

> "[I]n our view it is improper for an insider to use confidential information acquired by him by virtue of his position as an insider to make profits by trading in the securities of his company."

The philosophy of the *Kimber Report*, in part, is that if securities legislation improves the interests of investors, the securities industry will benefit from increased public confidence. To the extent that the securities industry becomes an effective and efficient part of the economy, the general public will benefit.

The notion on which the prohibition of insider trading is based is that trading should be based on equal access to information. Thus trading and informing with respect to knowledge of material information is only prohibited where that information has not been generally disclosed.

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[284] S.O. 1966, c. 142, Part XI, in force 1 May 1967.

[285] R.S.M. 1970, c. S50, as am. S.M. 1970, c. 23; 1971, c. 31, 1972, c. 58.
On the subject of insider trading generally, J. Williamson, *Securities Regulation in Canada*, Supplement (Ottawa 1966) at 351; D. Johnston, *supra* note 24, at 275; E. Hretzay, "Market Morality: A Developmental Analysis Of Insider Trading Legislation in Manitoba", (1975) 2 *Manitoba Law Journal*; M. Yontef, "Insider Trading" in Anisman P., *et al.*, (eds.) *Proposals for a Securities Market Law for Canada*, 3 vols. (Ottawa: Consumer and Corporate Affairs Canada, 1979); J. Lewtas, "Directors', Officers and Insiders' Liability," in Law Society of Upper Canada, (1972) Special Lectures: Corporate and Securities Law 183. On the developments and influences of common law, and American law, which shaped the law relating to insider trading, culminating in the *Kimber Report* whose recommendations were enacted in the 1966 Ontario *Securities Act*, *ibid.*, at pp. 259-65; Davies, "Canadian and American Attitudes on Insider Trading," (1975) 25 *University of Toronto Law Journal* 215; Hawes, Lee & Robert, "Insider Trading Law Developments: An International Analysis", (1982) 14 *Law and Policy International* 335.

[286] *Kimber Report*, *supra* note 37, at para. 2.02.

In comparison with Manitoba, where the law of insider trading has developed over the past thirty years,[287] the regulation of insider trading in Russia has no history because insider trading has not historically been subject to regulation.

The first question one should address before comparing different regulatory approaches toward the trading of securities is whether insider trading should be regulated at all.[288] The ethical rationale offered in favour of prohibiting insider trading is that allowing a select group of investors to acquire pecuniary advantages simply by virtue of their inside status is inherently unfair. Furthermore, some fairness arguments suggest that all investors owe a moral obligation to others in the marketplace to negotiate openly and on an equal footing. The economic rationale for regulating insider trading is that unequal access to information will undermine the confidence of investors, the integrity of the market and deter prospective investors from entering a risky and capricious market.

A number of commentators have also argued that insider trading should not be prohibited.[289] Some authors have criticised the underlying fairness rationales as based only on the moral proposition that "it's just not right".[290] Attempting to remove the moralistic tinge from insider trading, these commentators shift the focus to market

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[287] *See* E. Hretzay, *supra* note 285, at 257 (noting that anti-insider trading regulations originated in the U.S., and the U.S. law has been used as a model in Canada). On this subject, *Kimber Report, supra* note 37; P. Anisman, *Insider Trading under the Canadian Business Corporation Act*, in Meredith Memorial Lectures 1975, at 170-75 (hereinafter referred to as "P. Anisman, *Insider Trading*).

[288] "One of the truly intriguing aspects of the entire problem of insider trading is the fact that, despite its having been widely written about and discussed for many decades, few have paused to consider why insider trading should be regulated": B. Bergmans, *Inside Information and Securities Trading* (London: Graham & Trotman, 1991), at 99.

[289] H. Manne, "In Defence of Insider Trading" (1966) 44 *Harvard Business Review* 113.
For the extended summary of a different opinion on regulation of insider trading *see*, Meeka Jun, "New Capital Markets and Securities Regulations in Hungary: A Comparative Analysis of the Insider Trading Regulation in Hungary and the United States" (1993) 19 *Brooklyn Journal of International Law* at 1068-70.

efficiency rationales. For example, it has been argued that because inequalities are inherent in a capitalist market economy, and because unequal access to information is but one aspect of the risk factor, efforts to eliminate insider trading and equalise the availability of material information tend to destabilise the very essence of capitalism.[291]

Despite this academic debate, the international condemnation of insider trading has survived,[292] and the anti-insider trading policy, long established in the United States, has since been adopted in Canada, Japan, France, Hungary, Russia and elsewhere in the international community.[293] Interestingly, the policy behind most restrictions has linked the fairness and economic efficiency rationales, reasoning that unequal access to information undermines the confidence of investors, which in turn adversely affects the market. When enacting its FSL, Russia included a prohibition on insider trading. It remains unclear whether the purpose of including this prohibition in the law was to

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[290] Gary Lawson, "The Ethics of Insider Trading" (1988) 11 *Harvard Law Journal and Public Policy* 727, 730-31, quoting H. Manne, *Insider Trading and the Stock Market,* (providing the first attempt to combine corporate law and ethical philosophy in the context of insider trading).

[291] A. Rider & H. Leigh French, *The Regulation Of Insider Trading,* (Dobbs Ferry, N.Y., Oceana Publications, 1979), at 9-24.

[292] Meeka Jun, *supra* note 289, at 1070.

[293] E. Hretzay, *supra* note 285, at 257-268 (on insider trading regulation in Manitoba); M. Jun, *supra* note 289; J.J.A. Burke, "The Estonian Securities Market Act: A Lesson For Former Republics Of the Soviet Union" (1994) 27 *Vanderbilt Journal of Transnational Law* 545; G. Polcary, "A Comparative Analysis Of Insider Trading Laws: The United States, The United Kingdom And Japan - The Current International Agreements On Securities Regulation" (1989) 13 *Suffolk Transnational Law Journal* 167-199; H. Pitt & D. Hardison, "Games Without Frontiers: Trends in The International Response to Insider Trading" (1992) 55 *Law and Contemporary Problems* 199-227 (on insider trading regulation in Australia, France, Germany, Japan and Mexico).

The relative novelty of anti-insider trading legislation around the world suggests a deeper uncertainty of the extent to which insider trading is inefficient or unfair. *See* M. G. Warren "The Regulation of Insider Trading in the European Community" (1991) 48 *Washington and Lee Law Review* 1037, 1052-58, arguing that in spite of supporting the "market function objective", there is little underlying thought behind the EC Directive. "The linkage between fair play, enhanced confidence, and improved market function does not appear to have been intensely analysed by the drafters of the directive. Apparently, the linkage was intuitively self-evident to the Commission."

protect domestic investors or to attract foreign investors.[294] However, given the acute need for foreign investment and the relative inexperience with a functioning securities market, it appears that Russia has adopted an insider trading ban as part of larger economic reform which requires international recognition.

A. Definition of Insider for Reporting Purposes

Insider trading legislation in Manitoba is found in Part XI of the MSA,[295] Sections 108-117. The insider trading rules in Manitoba have two aspects. First, insiders must report to the MSC any trade they make in securities of the corporation in which they are insiders. Secondly, insiders, "in a special relationship" with the corporation for securities law purposes, may be liable if they trade in securities of that corporation with knowledge of a material fact or material change that has not been generally disclosed. In addition, insiders may incur liability if they pass that information to someone else, commonly referred to as a "tipee", who trades with knowledge of the information. The reporting requirement effectively provides the public and the securities regulators with a method of monitoring whether or not a breach of the insider trading rules has taken place. It also gives the public an opportunity to see whether and which insiders are buying or selling the securities of the corporation.

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[294] One would believe that the restrictions were enacted with the conviction that the two crucial driving forces behind a developed securities market are the openness and confidence of prospective investors.
[295] MSA., ss. 108-117.

The term "insider" is defined in the MSA.[296] An insider of a company is (a) any director or senior officer of a corporation as defined,[297] or (b) any shareholder (excluding underwriters in the course of primary distribution) beneficially owning, directly or indirectly, equity shares of an issuer carrying more than ten percent of the voting shares of the corporation for the time being outstanding, or (c) a person or company exercising control or direction over securities of a corporation carrying more than ten percent of the voting rights of the issuer's outstanding voting securities.[298] Every director or senior officer[299] of a company, which is itself an insider of a corporation, constitutes an insider.[300] Affiliated companies, which are sister companies, or parent and subsidiary companies, are included in the definition of insiders for reporting purposes.[301]

The definition of "insider", for the purpose of reporting, excludes lesser executives, employees and professionals because the Kimber Committee felt that lesser employees or professional advisors would be subject to internal discipline by their supervisors or by their professional bodies, respectively.[302] However, for the purpose of liability against

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[296] MSA., s. 108(1).

[297] "Corporation" is defined in s. 108(1) of MSA to mean a company "(a) that has issued equity shares that are distributed in the course of a primary distribution to the public, in respect of which either a prospectus is filed with the commission...", or (b) any of whose shares are listed or posted for trading on any stock exchange in the province recognised by the commission, or (c) which is a corporation as defined in The Corporations Act and has for the purpose of the Act, made a distribution to the public of equity shares, other than a bank...".

[298] MSA, s. 108(1) (a), (c).

[299] "Senior officer" is defined to mean (a) the chairman or any vice-chairman of the board of directors, the president, any vice-president, the secretary, the treasurer or the general manager of a company or any other individual who performs functions for the company similar to those normally performed by an individual occupying any such office; and (b) each of the five highest paid employees of a company (including the persons referred to in clause (a)). MSA., s. 1(1).

[300] MSA., s. 108 (2)(a).

[301] *See, e.g.*, the Canada Business Corporations Act, s. 100(2)(d). A subsidiary company would be deemed to own the securities held by its parent.

[302] It was difficult task for the Committee to determine how far down the chain of employment and how far outside the link of permanent employment the legislature should go in designating insiders. The Kimber

insider trading, the definition of "insider" does include employees or officers under the phrase: "a person in special relationship with a corporation".[303]

In order to guard against improper insider trading, the legislation provides that the public must be informed currently of the market activity of insiders in the security of a company.[304] For that purpose the MSA requires an insider to report to the Commission: (1) a person or company upon becoming an insider of a corporation must file a report with the commission within ten days after the end of the month in which he becomes an insider of the corporation,[305] (2) insiders must report on their acquisitions of beneficial ownership, control or direction over securities of their company (that is, to disclose the

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Committee chose a limited and more certain ambit and the Act reflects this choice. The Committee's reasons where these:
"The Committee considered the position of other employees who receive confidential information in the course of their employment, and who might use the information to their private advantage by trading in the securities of the company which employs them. While the use of such confidential information is improper, we do not recommend any legislative rules with respect to this trading. As with junior officers, the policing of any such abuse can be left to management." (*Kimber Report*, *supra* note 37, at para. 2.08.)
"A similar conclusion was reached in regard to professional persons, such as lawyers, accountants and financial agents. The improper use of confidential information by professional advisers cannot be condoned, but the disciplining of such persons, who abuse the confidence placed in them, must be left to the companies who retain them and the professional bodies to which they belong. The Committee is prepared to assume the principles of the proposed legislation are at present or will be incorporated in the ethical codes of the bodies governing such professional advisers." (*Kimber Report*, at para. 2.09).

[303] MSA., s. 112(5)(c). *Cf. infra*, Section B. "Definition of Insiders for Liability Purposes".

[304] It was felt that the insider who knows that his trading will become public knowledge will be less likely to engage in improper trading, and such disclosure will also lead to greater investor confidence in the securities market. See *Kimber Report*, *supra* note 37, at para. 2.04.

[305] MSA., s. 109(1). When a person who holds securities of that corporation is appointed to the board of that corporation, for example, or when an existing insider acquires securities of the corporation for the first time, that person must file an initial report. [Observation: What is the value to having insiders file "Nil" reports since there is no benefit to knowing that an insider owns no securities?] To trace the arguments, see, *e.g.*, D. Johnston, *supra* note 24, at 291 and P. Anisman, *Insider* Trading, supra note 287, at 109, n. 3. It is submitted that the costs of obtaining "Nil" reports far exceed the benefit of knowing who the insiders are. *See* M. Yontef, *supra* note 285, for a comparison on reporting obligations by insiders between Canada, the U.S. and the Commonwealth countries, at 641-43.

insider's holdings of securities of the company),[306] and (3) insiders must report any changes in their holdings within ten days of the month following the change.[307]

The MSC is required to maintain reports on transactions of insiders and to make these reports available for public inspection.[308] The MSC is also responsible for publishing summaries of those reports.[309]

B. Definition of Insiders for Liability Purposes

The second way chosen to guard against improper insider trading is that the law imposes liability for certain types of insider trading. The MSA prohibits a person or a company that is "in special relationship with a corporation" to (i) trade in securities of the corporation with knowledge of a material fact[310] or material change[311] that has not been generally disclosed[312] or (ii) inform others of a material fact or material change with respect to the corporation before it has been generally disclosed (known as "tipping").[313]

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[306] MSA., s. 109(2).
[307] *Ibid.*, s. 109(3).
[308] *Ibid.*, s. 110(1).
[309] *Ibid.*, s. 110(2). In order for an observer to determine insider trading activity promptly, he must attend at the office of the MSC and examine the reports. Those who are interested but more passive may await the periodic publication of results in reports of the MSC or rely on the limited and selective summaries of insider reports published by the financial press.
[310] MSA., s. 108(1). "material fact" means a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of securities issued or proposed to be issued.
[311] *Ibid.*, s. 108(1) "material change" means a change in the business, operations or capital of the corporation that would reasonably be expected to have a significant effect on the market price or value of any securities of the corporation and includes a decision to implement such a change made by the board of directors of the corporation or by senior management of the corporation who believe that confirmation of the decision by the board of directors is probable.
[312] *Ibid.*, s. 112(1).
[313] *Ibid.*, s. 112(2), (3).

Persons "in a special relationship with a corporation" are considered to be those likely to have access to confidential information about the corporation.[314] Thus, the definition of "a person or company in a special relationship with a corporation" includes (i) an insider, affiliate or associate of the corporation;[315] (ii) an insider, affiliate or associate of a person proposing to make a take-over bid or proposing to become a party to a reorganisation, amalgamation, merger or arrangement or similar business combination with the corporation, or to acquire a substantial portion of its property; [316] (iii) a person or company that is engaging or proposes to engage in any business or professional activity with or on behalf of the corporation, or with or on behalf of a person or company that is proposing to make a take-over bid or proposing to become a party to a reorganisation, amalgamation, merger or arrangement or similar business combination with the corporation, or to acquire a substantial portion of its property;[317] (iv) directors, officers or employees of the corporation engaged in such business or professional activities, specified above;[318] (v) a person who acquired knowledge of material information with respect to the corporation while in any of the relationships described above;[319] and (vi) "tippees", that is, a person who knows of material information with respect to the corporation from another person who was in a special relationship and where the tippee knew, or reasonably ought to have known, that the person communicating the information was in a special relationship with the reporting issuer.[320] The definition is such that even

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[314] *Ibid.*, s. 112(5).
[315] *Ibid.*, s. 112(5)(a)(i).
[316] *Ibid.*, s. 112(5)(ii) and (iii).
[317] *Ibid.*, s. 112(5)(b).
[318] *Ibid.*, s. 112(5)(c).
[319] *Ibid.*, s. 112(5)(d).
[320] *Ibid.*, s. 112(5)(e).

a tippee of another tippee can be a person "in a special relationship with the corporation."[321]

C. Enforcement Of Insider Trading Regulation in Manitoba

The prohibition of insider trading or informing is enforced through a wide range of sanctions. The MSA provides for penal sanctions, administrative sanctions, and civil actions for damages or for accounting to the corporation.

1. Penal Sanctions

Any person or company who is convicted of an offence under Section 136(1),[322] except where the conduct constitutes an offence under Section 111,[323] is liable to a fine of not more than $1,000,000 or to imprisonment for a term of not more than two years, or both. Every director or officer of a company or of a person other than an individual who authorises, permits or acquiesces in a subsection 136(1) offence is also guilty and on conviction liable to a fine of not more than $1,000,000 or to imprisonment for a term of not more than two years, or both.[324]

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[321] The definition provides that the other person from whom the information was acquired could be a person who had more direct access to the information, such as a director or officer, or a person who obtained the information by way of a tip.

[322] For information on provisions of section 136(1) of the MSA, see, *infra* Chapter 6 "Enforcement of Securities Regulation", notes 420-432 and accompanying text.

[323] MSA., s. 111(1) provides that every person or company that fails to file a report under s.109 is guilty of an offence and is liable to a fine of not more than $1,000., and where a company fails to so report, every director or officer of the company who authorised, permitted or acquiesced in the failure is also guilty of an offence and is liable to a fine of not more than $1,000. Section 111(2) provides that every person or company that files a report under s. 109 that is false or misleading by reason of the misstatement or omission of any material fact is guilty of an offence and is liable to a fine of not more than $1,000.; and, where a company files a false or misleading report, every director or officer of the company who authorised, permitted or acquiesced in the filing is also liable to a fine of not more than $1,000.

[324] *Ibid.*, s. 136(3).

Where a person or company has contravened provisions of subsection 112(1),[325] (2)[326] or (3)[327] and as a result of it made a profit, the lower limit of the fine to which the person or company is liable is the profit that was made, and the upper limit of the fine is the greater of $1,000,000 or triple the amount of profit made by such person or company by reason of contravention.[328]

2. Civil Actions

The MSA provides for an action for damages against a person trading on material insider information by the person with whom the trade was made.[329] It enunciates that an insider who traded in securities using material information with respect to the corporation that has not been generally disclosed is liable to compensate the seller or purchaser of the

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[325] *Ibid.*, s. 112(1) states that: "No person or company in a special relationship with a corporation shall purchase or sell securities of the corporation with the knowledge of a material fact or material change with respect to the corporation that has not been generally disclosed".

[326] *Ibid.*, s. 112(2) states that: "No corporation and no person or company in a special relationship with a corporation shall inform, other than in the necessary course of business, another person or company of a material fact or material change with respect to the corporation before the material fact or material change is generally disclosed."

[327] *Ibid.*, s. 112(3) states: "No person or company that proposes,
(a) to make a take-over bid, ...for the securities of a corporation; (b) to become a party to a reorganisation, amalgamation, merger, arrangement or similar business combination with a corporation; or (c)to acquire a substantial portion of the property of a corporation,
shall inform another person or company of a material fact or material change with respect to the corporation before the material fact or material change has been generally disclosed except where the information is given in the necessary course of business to effect the take-over bid, business combination or acquisition."

[328] MSA., s. 136(4). For the purposes of provisions of subsection 4, "profit" means, "(a) if the accused purchased securities in contravention of subsection 112(1), the average market price of the security in the 20 trading days following general disclosure of the material fact or material change less the amount that the accused paid for the security; (b) if the accused sold securities in contravention of subsection 112(1), the amount that accused received for the security less the average market price of the security in the 20 trading days following general disclosure of the material fact or material change; (c) if the accused informed another person or company of a material fact or material change in contravention of subsection 112(2) or (3) and received any direct or indirect consideration for providing such information, the value of the consideration received". *Ibid.*, s. 136(5).

[329] *Ibid.*, s. 113(1).

securities for damages as a result of the trade.[330] The Act provides for a defence of reasonable belief that (a) the material information had been generally disclosed, or (b) the material information was known or ought reasonably to have been known to the seller or purchaser.[331]

Similarly, the Act provides that an action for damages can be brought against a person who informed another of the inside information.[332] The action for compensation for damages can be brought by anyone who sold securities to or purchased securities from a person who obtained the inside information from the informer.[333]

3. Administrative Sanctions

There are also administrative sanctions provided by the Act that might be applied in the context of insider trading or informing, such as cease trade orders.[334] A temporary order can be made pending a hearing on a cease trade order for a longer period.[335]

The insider as well as his associates and affiliated companies also could be liable to persons who have suffered through the use of "specific confidential information" in a securities transaction. This is a double liability since the MSA specifies that insiders as

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[330] *Ibid.*

[331] *Ibid.*, s. 113(1) (a) and (b). There are also specific exemptions from liability in situations where the insider can generally be said not to have taken advantage of the information. The circumstances in which persons are exempt are set out in Man. Reg. at s. 44.1.

[332] MSA., s. 113(2)

[333] *Ibid.*, s. 113(2)(a),(b),(c).
The defences are the same as those that apply to an action for damages against a person trading on inside information, with the additional defence that the information was given in the course of business of the issuer or, in the context of a proposed take-over bid, business combination or acquisition, where the information given was necessary to effect the take-over bid, business combination or acquisition. *See*, s. 113(2) (d) to (g).

[334] MSA., s. 148(1) according to which, "The commission may, where in its opinion the action is in the public interest, order...that trading shall cease in respect of such securities...".

[335] *Ibid.*, s.148(2).

well as associates and affiliated companies are accountable to the company whose securities was the subject of the transaction. In other words, both personal and corporate rights of action arise from the same wrongful act.

D. Insider Information And Insider Trading In Russia

Russia, in 1996, joined the quest for fairness in the stock market by prohibiting insider trading.[336] Legislation restricting insider trading was first adopted in Russia in 1991,[337] but failed to provide a significant deterrent to insider trading. The FSL extended and refined the prohibitions on insider trading set forth in Regulation No. 78[338], which applied to holders of "confidential information".[339] Insider trading is governed primarily by three articles of chapter 8 of the FSL that contain provisions designed to prevent trading on the basis of inside information.[340] Inside information is defined as "any information about the issuer and its securities that is not generally available and gives the person that possesses it an advantage over other persons involved in the securities market, because of their employment, their responsibilities at work, or because of a contract."[341] For the purpose of the law, insiders include (1) members of the management bodies of the issuer or of a

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[336] FSL., *supra* note 2, arts. 31-33. No explanations among scholars have been offered for the lack of concern with insider trading or for demands for restrictions on insider dealing in Russia. It is commonly believed that widespread insider trading in Russia was making the nation's markets unattractive to foreign investors and was discouraging small investors from investing in securities. Insiders were able to engage in insider trading in Russia with no risk of prosecution or conviction. To make its markets attractive for foreign investors, Russia extended and refined the prohibitions on insider trading in the *Federal Securities Law* formally banning insider trading, but failed to provide for enforcement of these rules: Michael McFaul, "Why Russia's Politics Matter", *Foreign Affairs*, (Jan./Feb. 1995), at 87, 89 ("[U]nregulated stock markets have led to abuses. In Russia's nascent stock markets, insider trading is the rule, not the exception.").

[337] Regulation No. 78, *supra* note 97.

[338] *Ibid.*

[339] FSL., *supra* note 2, arts. 31-33.

[340] *Ibid.*, art. 31 ("insider information"), art. 32 ("On persons in possession of insider information"), art. 33 ("Transactions concluded using insider information").

[341] *Ibid.*, art. 31.

professional participant of the securities market who are "connected by contract with the issuer";[342] (2) individuals who are professional participants of the securities market;[343] (3) the auditors of the issuer or the auditors of the professional participants who are connected by contract with the issuer; or (4) employees of state agencies who have access to the inside information of the issuer by virtue of their authority, including the authority to inspect and supervise.

Persons in possession of insider information may not use it to conclude transactions or pass it to third parties.[344]

It would seem that the insider trading regulations were set forth in the law for the sole purpose of making the nation's securities markets attractive to foreign investors. In other words, the perception was that, without insider trading regulations, foreign investors would be reluctant to invest in Russia.[345]

The securities legislation has failed to provide a significant deterrent to insider trading. Insiders are able to engage in insider trading in Russia with little risk of prosecution or conviction, because there are no sanctions provided against insider trading. The law merely states that persons who violate the provisions prohibiting insider trading are responsible "under the law of the Russian Federation", without any specifics as to which

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[342] *Ibid.*, art. 32, para.5. "By members of the organs of management of the issuer and of a legal entity which is a professional participant in the securities market are meant persons permanently or temporarily employed in the legal entities indicated in posts involving organisational responsibility and also individuals fulfilling such responsibility by special authority."

[343] *Ibid.*, article 32 in this part probably is intended to mean professional participants who have access to inside information of the issuer by virtue of a contract with the issuer. This defect must be corrected.

[344] *Ibid.*, art. 33

[345] My personal experience as a member of the legal team which directly participated in drafting securities laws in Kyrgyzstan gives me the basis to make such a statement. The policy of the Kyrgyz Government was to attract foreign investors into its market. The same approach was taken in other republics of the Commonwealth of the Independent Republics ("CIS"), including Russia.

law. The application of these provisions has yet to be established. [346] It is apparent that the failure to enforce insider trading regulation is a problem which persists under existing legislation.[347]

E. Comparison Of Insider Trading Regulations

1. Definitions

In comparing different insider trading laws, defining what sort of information raises confidentiality concerns, is as significant as delineating the scope of insiders who are prohibited from using or disclosing that information. Briefly, the FSL defines inside information as "any information about the issuer and securities issued by him which is not generally available".[348] In contrast, the MSA requires that the information be valuable in some way and must "reasonably be expected to have a significant effect on the market price or value of a securities."[349] Both definitions require that information should not be publicly known or available.

The difference between the two jurisdiction's definitions of inside information is that in Manitoba the definition lies in an evaluation of materiality. In contrast in Russia, "any

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[346] As a result of the law prohibiting insider trading in Russia being so recent, the application of these provisions has not yet been established by the judiciary. There is no clear pattern developed by the judiciary as to what elements have to be proved in order to convict someone alleged to be in contravention of insider trading rules. The results of the research on the subject of enforcement of insider trading rules shows that no prosecution for insider trading under the *Federal Securities Law* has yet taken place.

[347] The interpretation of insider dealing provisions enacted in the Russian law requires separate academic research. What constitutes inside information besides just "any information about an issuer and securities ...which is not generally available"? There is no definition of what constitutes the offence of insider trading. To be successful, the Russian scheme of insider trading regulation requires enactment of clarifying rules and regulations.

[348] FSL, *supra* note 2, art. 31.

[349] MSA., *supra* note 1, s. 108(1).

information" appears to be over-inclusive. The FSL law should explicitly indicate that inside information should constitute that information which may have significant influence on the market price or value of the securities.

The consequences of a broad or vague definition of insider trading may be exacerbated in an underdeveloped market economy such as Russia's today.[350] The need for clear standards may be especially vital to the successful development of this emerging market.[351]

2. Identifying the Scope of Insiders

The scope of insiders is defined in the securities acts of Manitoba and Russia. Russia identifies insiders only for the purpose of liability, whereas the MSA identifies two categories of insiders: one for the purpose of reporting, the second for the purpose of liability. There is no comparable provision in Russia to the reporting obligations for insiders in Manitoba.

In contrast to Manitoba law, the scope of insiders for the purpose of liability under the Russian law is limited to persons who possess inside information by virtue of their

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[350] "A vague definition of inside information may produce unpredictable patterns of exoneration and liability, which may themselves discourage investors from entering the market. It may also inconsistently deter the cautious and honest while encouraging the risk-takers and dishonest to make inside deals. Finally, inconsistencies may hinder fair and effective enforcement, and vague standards are unfair to honest and naive investors who may be vulnerable to liability without notice" in S. Salbu, "Regulation of Insider Trading in a Global Marketplace: A Uniform Statutory Approach" (1992) 66 *Tulane Law Review*, at 856.

[351] Meeka Jun, *supra* note 289, at 1073 (stating that "a proper capital market will never re-emerge unless the framework is first in place").

employment, their responsibilities at work, or contracts.[352] Because provisions of this article require the existence of some sort of working contact with the issuer, which gives them access to non-public information, the provision is roughly analogous to the fiduciary duty approach; but it expands the scope of liability by not requiring that the relationship be one of trust and confidence between the insider and the issuer. The requisite link that is contemplated by the statute is to establish the presence of some level of trust shared between the insider and the issuer, as for example the issuer does with auditors, tax consultants, and employees of state agencies, all of whom routinely review confidential documents.

Manitoba extended the scope of insiders to persons who are in a "special relationship with the issuer" and who obtain confidential information in any manner and knowingly have access to inside information. This element, which covers *anyone* in possession of inside information which he knows is not public, is missing in the Russian law when determining the scope of insiders.

By limiting the scope of insiders to those who are in working contact with an issuer, Russia leaves out a large group of insiders who have access to information from the issuer, such as beneficial owners of ten per cent or more of the securities in question, a person or company exercising control or direction over equity shares of the issuer, a person or company that is affiliate or associate of the issuer, or a person or company that learns of inside information about the issuer from any other person who has, by virtue of contact with the issuer, come to the possession of inside information.

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[352] FSL, *supra* note 2, art. 32. Its legislative history does not contain any theoretical discussion justifying the

Russia, under the scope of insiders, includes employees of state agencies who have access to inside information by virtue of their authority, including authority to inspect and supervise.[353] Nothing of this sort exists in Manitoba's insider trading regulations. Even though it should be expected from the regulators to rely on the state agencies to control their employees, as it is in Manitoba.

Both the FSL and MSA acknowledge that persons with a special relationship with the issuer should be defined as insiders and prohibited from trading on the basis of information obtained by virtue of their relationship with the company.

However, the foregoing comparison shows that the scope of insiders encompassed by the Manitoba definition is broader than that of Russia.

3. Enforcement

Persons found guilty of insider trading in Manitoba face criminal fines and imprisonment.[354] Even though Russia subjects insider trading violators to responsibility, as the FSL states, "in accordance with the law of the Russian Federation", penalties for violations of the insider trading provisions have not yet adopted in the *Criminal Code* of Russia.[355] Therefore insiders in Russia cannot be charged with criminal liability for such violations.

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limitation of the scope of insiders to only those who come to possession of inside information, by way of their employment with the issuer, responsibilities at their work place or a contract with the issuer.

[353] *Ibid.*, art. 32, para. 5. To explain the purpose of this provision would require separate research.

[354] MSA., s. 136(1),(2).

[355] The absence of publicity surrounding possible insider trading violations in Russia, makes it impossible to judge whether the criminal sanctions against insider trading are urgently necessary at this point.

Another difference between enforcement of insider trading laws in Russia and Manitoba is the absence of civil liability for insider trading in Russia. The Russian law does not expressly grant a private cause of action against persons who have breached the insider trading prohibitions. It merely states that violators of an insider trading regulation are subject to liability "under the existing legislation." Conversely, the MSA specifically provides for an action for damages against a person trading on material inside information by the person with whom the trade was made.[356] Although the deterrence value of civil liability would improve the effective enforcement of securities regulations in Russia, it is highly unlikely that courts in a civil code system like Russia's would have the discretion necessary to create derivative private rights of action. An express cause of action for insider trading should be established by the FSL. Penalties for violations of the law must be explicitly established by the *Civil Code*. It certainly would facilitate the enforcement of insider trading prohibition.

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[356] MSA., s. 113(1). As with the penal sanction, the elements that the plaintiff must show are: (i) the defendant was in a "special relationship" with the corporation, (ii) the defendant purchased or sold securities of the corporation , (iii) the defendant made the purchase or sale with knowledge of material information ("material fact" and "material change" together constitute "material information") about the corporation, and (iv) that the material information had not been generally disclosed: M. Gillen, supra *note* 27, at 277. This private right of action is complicated by differing judicial standards of the elements that must be proved: materiality, reliance , causation, and *scienter*. For more information on problems of proof: M. Yontef, "Insider Trading", *supra* note 285, at 679-695.

VI. CHAPTER 5: TAKE-OVER BID REGULATION

This chapter briefly analyses the existing take-over bid regulations in Manitoba and rules with respect to take-over bids in Russia. In Manitoba, a "take-over bid" constitutes an offer to acquire outstanding voting or equity securities made to any person or company in Manitoba, or to any security holder of the offeree issuer whose last address as shown on the books of the offeree issuer is in Manitoba, where the securities which are the subject of the offer, when taken together with the offeror's presently owned securities which are the subject of the offer, will exceed twenty percent of the outstanding voting securities of the company.[357]

A take-over bid can be either a "share exchange offer", a "cash offer", or a combination of a share exchange and a cash offer. In a share exchange offer, the offeror offers shares of the offeror in an exchange for shares of the offeree. In a cash offer, the offeror offers to pay cash for shares tendered under the bid. It is also possible to have a combined cash and share offering in exchange for shares of the target.

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[357] MSA., Part IX, s. 80(1). The definition of "take-over bid" given in section 80 (1) of the MSA is similar to the one specified by the Kimber Committee. The Kimber Committee defined take-over bid as "...an offer (other than by way of private agreement or by way of purchase on a stock exchange or in the over-the-counter market) made to any number of the holders of any class of outstanding voting shares of a company, other than a private company, to purchase a number of such shares which, together with the number of such shares beneficially owned, directly or indirectly, by offeror and any other person or company associated with the offeror at the time of making such offer, will amount in the aggregate to more than 20 percent of the outstanding voting shares of such class." See *Kimber Report, supra* note 37, para. 3.11., p. 23.

A. Take-Over Bids Under the Manitoba Securities Act

1. Purpose of Legislation

The primary objective of the statutory regulation of take-over bid transactions in Canada is the protection of the *bona fide* interest of shareholders in the target company. The secondary objective is to provide a regulatory framework within which take-over bids may proceed in an open and orderly environment.[358]

The Kimber Committee[359] suggested problems associated with cash take-over bids that fall into the following categories:

Corporations and their shareholders need to be protected from corporate raiders and looters who seize control of and often liquidate corporations.

- Offeree shareholders lack sufficient information to decide whether they should tender their shares
- The shareholder can, by tendering early in the offeror period, have his shares locked-up such that he could not deal with the share until the offeror, under the terms of the offer, decides whether to take up the shares tendered.
- The shareholders need time to assess the information that should be provided by the offeror.

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[358] National Policy No.38, "Take-Over Bids - Reciprocal Cases Trading Orders", *Canadian Securities Law Reports* (CCH) P 470-038, at 57, 670-57, 671 (1990); also, *Kimber Report*, *supra* note 37, at para. 3.10.
[359] For a detailed review of the reasons for the take-over bid regulation, see *Kimber Report*; also M. Gillen, *supra* note 27, at 308-312.

- The practice of taking up tendered shares on a "first-come, first served" basis as a technique for encouraging the early tendering of shares was considered to be inequitable by offeree (target) shareholders.

- The practice of increasing the offer price as the offer period progressed in order to attract the tendering of further shares, and then only paying to the increased price on those shares tendered after the increase in price, was seen as inequitable to the offeree shareholders.

- In other contests for control, such as share exchange offers, the offeror was required to make a disclosure of information. The lack of disclosure in cash take-over bids represented a gap in regulations.[360]

The concerns expressed focus on the protection of target shareholders, and legislation which would protect shareholders with respect to these concerns was recommended. [361]

In Manitoba, the legislative response to concerns for protecting target shareholders is in Part IX of the MSA and Part XIV of the MSR.[362] The legislation provides for: disclosure requirements; time to assess that information; the preclusion of first-come, first-served

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[360] *Kimber Report*, *supra* note 37, at para 3.10.

[361] *Ibid.* Take-over bid regulation responded to problems raised in those situations where the acquirer would make a hostile take-over bid which was open for only a short period of time. The hostile take-over was often made in a manner euphemistically referred to as a "Saturday Night Special". Notionally, the idea was to make a bid on a Saturday night when the market was closed and say that tenders under the bid would be accepted only until 12:00 Monday morning. The acquirer's broker would open a book for the receipt of tenders on the Monday morning. Those shareholders who had tendered their shares by 12:00 would have their shares taken up. While bid periods were not typically this short, they were commonly not open for more than a few days. This had two main advantages for the acquirer: (i) it cut out competing bids; and (ii) it precluded target management from engaging in defensive tactics designed to prevent the take-over. All cash offers were typically used to avoid the delay that would be caused by the need to clear a prospectus in order to offer shares in a share exchange offer.

[362] MSA., *supra* note 1, Man. Regs. 491/88 R (as amended by Man. Reg. 159/89, s. 5) (C.C.S.M., c. S50).

offers; rights of withdrawal of tender by target shareholders, to avoid the lock-up of shares; and provisions for equal treatment of target shareholders.

2. Disclosure Requirements

a) Take-Over Bid Circular

First, the MSA requires that a disclosure document, referred to as a take-over bid circular containing information specified in the MSA and MSR be circulated to all holders of securities subject to the bid who are in the province.[363] The take-over bid circular must also be filed with the commission and sent to the offeree issuer.[364] A take-over bid circular must contain the information prescribed in Form 29 of the Regulations.[365]

This information includes: *inter alia*, beneficial ownership of the offeree company securities held by the offeror, its associates, directors, and senior officers, and insiders; the terms and conditions of the offeror; the method and time of payment for the shares and rights for withdrawal; whether the offeror is aware of any material change in the financial position or prospects of the target company since its last filed financial statement; whether the offeror intends to purchase shares subject to the bid in the market; rights of appraisal and acquisition; if there are any arrangements between the offeror and directors and officers of the offeree issuer; valuations if required or included; a statement

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[363] MSA., ss. 86(a), 89 (1), 90(1) and Man. Regs., s. 101 and Form 29. It should be noted that there is similar take-over bid legislation in all provinces and territories of Canada.
[364] MSA., s. 91. "Offeree issuer" means an issuer whose securities are the subject of a take-over bid or an offer to acquire. *Ibid.*, s. 80(1).
[365] Man. Regs., *supra* note 362, s. 101.

of the right to rescission or damages for misrepresentations contained in the circular; and, appropriate prospectus information needed if it is a share exchange offer.[366]

Contents of the circular must be approved by the directors of an offeror, and no expert reports may be used therein without their written consent.[367] In addition, the chief officers and two directors must sign a certificate to the effect that full, true and plain disclosure of all material facts relating to this take-over bid has been made, which must be included in the circular.[368]

An offeror cannot sell any of his shares which are the subject of the bid during the period of the bid,[369] and if it offers to pay a price that exceeds the offer, the bid is deemed to be varied by increasing the consideration to the higher price.[370] Where a significant change has occurred in the information contained in the circular, or where the terms of the bid are varied, a notice of the change must be sent to all offerees whose shares have not been taken up. In such a case the period during which securities may be deposited shall not expire before ten days after the notice of variation has been delivered.

b) Directors' Circulars

Upon receipt of a take-over bid circular, the directors of the target company must prepare a response and circulate it to the target's shareholders within ten days. This document is called a "directors' circular". In adding comments about the bid, it must recommend that

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[366] *Ibid.*, s. 89(7).
[367] *Ibid.*, Form 29, item 22.
[368] *Ibid.*, form 29, item 24.
[369] MSA., s. 85(8).
[370] *Ibid.*, s. 88(3).

the shareholders either accept or reject the take-over bid and the reasons therefor.[371] The contents of the circular, which are prescribed in Form 31 of the Regulations, must be approved and the delivery thereof authorised by the directors.[372]

Within the circular, the directors must disclose their direct and indirect beneficial ownership in the offeror and offeree companies, whether any director, senior officer or their associates, or insiders of the offeree company, has accepted or intends to accept the offer and the number of securities involved, the existence of remuneration or compensation agreements to be entered into as a result of a successful bid, details of trading by directors and officers in securities of the offeree company, and particulars of any material change in the financial prospects or operations of the target company, since the last published interim or annual financial statement. Considerations must be given to the making of a recommendation to accept or reject a take-over bid, with reasons disclosed, even where the directors cannot make a recommendation. If the offerees are advised not to tender until further communication is received, then that communication must be made at least seven days before expiration of the bid.[373] In addition, an individual director or officer may recommend the offeree's acceptance or rejection of the take-over bid, if a circular similar to the directors' circular is delivered.[374]

3. Procedural Requirements

The MSA details various provisions applicable to all take-over bids, including: delivery of the bid, the minimum time for which a bid can be open (twenty-one days); restrictions

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[371] MSA., s. 90(1), (2); Man. Regs., *supra* note 362, s. 103 and Form 31.
[372] Man. Regs., Form 31, Item 16.
[373] MSA., s. 90(5).

on taking up the securities; rights of withdrawal (before twenty-one days and after forty-five days and an additional ten days whenever the terms of the bid are varied); *pro rata* take-up in the event of over-tendering; effect of market purchases on the bid; take-up provisions and timing of payment; restrictions on extensions of the bid; and required press release where all terms and conditions of the bid are complied with or waived.[375]

Section 86(c) of the MSA provides that securities can be deposited under a take-over bid for a minimum of twenty-one days from the date of the bid, with the bid period's extension by ten days after the notice of variation has been delivered, where there is a variation in terms of the bid.[376] However, where the variation is simply a waiver of a condition on a bid for which the consideration consists solely of cash, there is no mandatory extension of the bid period.[377]

Where the bid is for less than all the outstanding securities of the class of securities subject to the bid, and where a greater number of securities than requested are deposited under the bid, they must be taken up *pro rata*.[378] For example, if the bid was for 1,000 shares and 2,000 shares were tendered, then half of the shares tendered by each shareholder would have to be taken up, regardless of when shares were tendered.

To protect those shareholders who tender early, there is a withdrawal right rule to prevent lock-ups of shares. Shares deposited within the twenty-one day period can be withdrawn at any time prior to the end of that period.[379] If there is a variation in the bid,[380] the

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[374] Man. Regs., Form 32, Item 13.
[375] MSA., s. 86.
[376] MSA., s. 89(5)
[377] *See* MSA., s. 89(6).
[378] *Ibid.*, s. 86(g).
[379] *Ibid.*, s. 86 (d)-(f).

withdrawal right is extended by ten days, unless the shares have already been taken up[381] or the variation is simply an increase in the consideration offered,[382] or a waiver of a condition on a cash bid.[383]

In response to the concern that a controlling shareholder or group of shareholders might be made an offer to the exclusion of others, the MSA requires that a take-over bid be made to all holders in the province of the securities sought.[384] The MSA also requires that equal consideration be offered to all holders of securities of the class sought.[385] Where the consideration under the bid is increased, it must be paid on all securities taken up, whether deposited before or after the increase.[386]

Similarly, the bidder, or anyone acting jointly or in concert with the bidder, is not allowed to enter into a collateral agreement, commitment or understanding with any shareholders of securities of the offeree issuer, the effect of which is to give one or some shareholders a greater consideration than other shareholders would receive.[387] For example, in a take-over bid, an offeror is not allowed to offer a principal shareholder a consulting contract in addition to the compensation for the shares, which may effectively constitute a consideration greater than that offered to remaining shareholders.

The take-over bid legislation also provides some protection to shareholders of a target company/corporation against a forced take-over sale of their shares at less than fair

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[380] *Ibid.*, s. 89(5).
[381] *Ibid.*, s. 86 (e)(i).
[382] *Ibid.*, s. 86 (e)(ii).
[383] *Ibid.*, s. 89(6).
[384] *Ibid.*, s. 86(a).
[385] *Ibid.*, s. 88(1).
[386] *Ibid.*, s. 88(3).
[387] *Ibid.*, s. 88(2).

market value, by way of requiring that a "formal valuation" of the offeree issuer be provided in the bid circular.[388] A formal valuation is required in two circumstances: (1) where the offer anticipates that "a going private transaction" will follow a take-over bid, and (2) where the offeror in a take-over bid is an insider of the issuer or any associate o the offeree issuer.[389]

The "formal valuation" is a valuation carried out by an independent valuer as of a date more than 120 days before the date of the take-over bid, with appropriate adjustments for material intervening events and without any downward adjustments to reflect the fact that the offeree shareholders do not or will not form part of a controlling interest.[390] This allows the offeree shareholder to compare the bid price to the price that might be offered in a post-take-over amalgamation.

The concerns that offeree shareholders may end up as creditors of an offeror, who has failed to finance adequately a take-over bid that includes cash consideration, is addressed by requiring that the offeror make adequate arrangements, prior to the bid, to ensure full payment for all securities that the offeror has to acquire. [391]

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[388] *Ibid.*, s. 94(2).

[389] In these circumstances, referred to as "insider bids", there is concern that minority shareholders may be unfairly dealt with due to a conflict of interest or informational or other advantage that the offeror may have, by reason of a relationship to the issuer.

[390] Man. Regs., *supra* note 362, s. 94(4). The formal valuation can be made up as of a date more than 120 days before the take-over, as long as the valuer has no reasonable grounds to believe there has been any intervening event materially affecting the value of the securities: *ibid.*, s. 94(5).

[391] MSA., s. 87.

The potential for delinquent take-up of and payment for tendered shares is dealt with by a requirement that shares be taken up within ten days of the expiry of the bid.[392] Shares are to be paid for not more than three days after they are taken up.[393]

To assist target shareholders in assessing the likelihood of a successful bid, and to prevent the bidder from influencing the success of the bid through open market purchases, the bidder's purchases of shares during the bid period is restricted. The bidder can only purchase a maximum of five percent of the outstanding offeree issued shares of the class subject to the bid. The intention to make such purchases must be announced in the take-over bid circular, the purchases must be made through the facilities of a recognised stock exchange and a press release with respect to the purchase must be made at the close of business at the exchange on each day on which shares have been purchased. This control over and disclosure of purchases permits the market and target shareholders to keep track of the bidder's ownership of offeree issuer shares, thus facilitating assessment of the likelihood of success of the bid.[394] To allow the market to adjust after announcement of the take-over bid, the bidder cannot commence purchases until the third day following the date of the bid.[395] To deal with concerns about sales during the bid period, bidders are restricted during the bid period from selling, or tendering under a competing bid, shares taken up under the bid.[396]

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[392] *Ibid.*, s. 86(i).
[393] *Ibid.*, s. 86(j).
[394] *Ibid.*, s. 85(2).
[395] *Ibid.*, s. 85(3).
[396] *Ibid.*, s. 85(8).

4. Defensive Tactics

As a result of take-over activity, some Canadian public corporations have adopted schemes, called "shareholders rights" plans, characterised by those who oppose them, and now generally known, as "poison pills". As one of a number of defensive tactics available to directors and management of a target corporation, this is designed to ward off hostile take-over bids. There are numerous shareholders' rights plans available to the directors and management of a target corporation. For instance, an arrangement where managers of a target corporation are compensated if the take-over succeeds ("golden parachutes"), seeking so-called "white knights" or "white squires" (an acquirer who is more acceptable to the target often because the white knight will not replace target management), issuing warrants as a dividend to shareholders that give them the right to buy additional shares at a bargain price in certain circumstances (poison pills), issuing shares with multiple voting, subordinate voting or no voting rights, providing staggered terms for directors, issuing shares or options (the "lock up" arrangement), the target may attempt to discourage the bidder by selling off the assets or the assets which the bidder is primarily seeking (the "scorched earth" or "crown jewel" defences), or taking similar defence of action commonly known as "shark repellent" tactics.[397]

A common purpose stated by a board of directors in adopting poison pills is to protect shareholders from coercive, abusive or unfair take-over tactics and to encourage potential bidders to make "permitted bids" or negotiate take-over proposals with the board of

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[397] M. Gillen, *supra* note 27, pp. 332-334; also, M. Lipton, ed., *Take-over Defences and Director's Liabilities* (Philadelphia: American Law Institute, 1986) at 95-96; For a policy discussion on poison pill plans see, for example, G. Coleman, "Poison Pills in Canada" (1988) 15 *Canadian Business Law Journal.*,

directors of the target company. Some poison pills effectively empower the directors of the target company to veto a hostile take-over bid by giving existing shareholders, other than the hostile offeror, the right to acquire additional shares at a fraction of the market price, *e.g.*, fifty percent. The right is triggered when a person, who by design is excluded from the shareholder rights plan, acquires a threshold percentage of the corporation's shares, *e.g.*, five percent, fifteen percent, twenty percent, etc. If the rights are exercised the results would be a substantial dilution of share values, making a take-over bid uneconomical. Exclusion of the acquiring person from the rights may possibly be discriminatory and subject to attack under the oppression remedy in corporate legislation in many provinces.

Some consider that management has a conflict of interest in the face of a take-over bid: the interest of management and the directors in retaining their positions *versus* the interest of shareholders in maximising their share value and making their own decisions concerning the take-over bid.

On the other hand, there are commentators who support the idea that the directors should be able to assess a take-over bid and, if in their business judgment it is not adequate, to bargain with the potential offeror with a view to improve the offer for the benefit of the shareholders, or to seek a "white knight" to obtain a better offer.

It would be wrong here to agree with one notion and unquestionably disagree with another, because both are based on positive and negative practices that have occurred as a result of the use of defensive tactics by management of target companies. To agree with

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at 1-2; J. G. MacIntosh, "The Poison Pill: A Noxious Nostrum for Canadian Shareholders" (1989) 15

the first idea would deprive the target companies' shareholders of professional assistance from their management as to offers made in the course of take-over activities. And I am opposed to that. To reduce the possibility of directors misusing "poison pills", even beyond the fiduciary standard required of directors by corporate law, I recommend that regulators develop general principles as to how to deal with requests by take-over offerors to put an end to the operation of the poison pill as regards a particular bid.

Most poison pills are structured with "permitted bid" provisions whereby, if the bid meets certain criteria (*e.g.*, no shares may be taken up until ninety days following the bid, the bid is made to all shareholders wherever resident, etc.), the dilutive effect of the right to purchase additional securities (or other defensive tactic) would not be triggered. In some instances shareholders, other than the offeror, may be given the right to vote to decide on acceptance or rejection of the bid. A permitted bid is designed to meet a predetermined set of criteria, the effect of which is to give the directors of the target company time to consider alternatives. With respect to the poison pill itself, shareholder approval will likely be required by the relevant securities regulator.

An offeror faced with a poison pill, must either negotiate the terms of the bid with the target company directors (who are invariably given authorisation to waive the pill), make a permitted bid, or commence proceedings to have the pill dissolved on the basis that the directors of the target company have breached their fiduciary duties to shareholders, by not letting them make their own decision; and on the basis that, in relation to the offer, the pill is discriminatory, oppressive and unfairly prejudicial, and also that the directors acted for an improper purpose, *i.e.*, to entrench their control.

C.B.L.J. at 276.

The CSA have enacted a policy which deals with take-over bids and defensive tactics.[398] The policy confirms the fiduciary standard required of directors of a target company by corporate law. In addition, the policy identifies the inappropriateness of developing a specified code of conduct in take-over bid situations for directors of the target company.[399]

However, the administrators identify specific defensive tactics which will be scrutinised in a take-over bid situation, which include: the issuance or the granting of an option on, or the purchase of, securities representing a significant percentage of the outstanding securities of the target company; sale or acquisition, or granting of an option, or agreeing to sell or acquire, assets of a material amount; and, entering into a contract other than in the normal course of business.[400]

The policy concludes by stating that administrators realise that defensive tactics, including those that are specifically subject to scrutiny, may be legitimately taken by a board of directors in genuine search of a better offer. It is only those tactics that are likely to deny or severally limit the ability of the shareholders to respond to a take-over bid or competing bid, that may result in action by the administrators, according to the policy.

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[398] National Policy No.38, *supra* note 358.
[399] *Ibid.*, s. 2, at 57, 671.
[400] *Ibid.*, s. 3, at 57, 671.

5. Recent Decisions on "Poison Pills"

With the increased adoption by public corporations of Shareholder Rights Plans, they have been the subject of much discussion.[401] An analysis of the decisions made by the OSC on three cases (*Jorex*,[402] *Lac Minerals Ltd.*,[403] *Regal Greetings and Gifts Inc.*[404]), and a recent case decided in 1997 before Manitoba Court of Queen's Bench (*United Grain Growers Ltd.* v. 3339351 *Canada Ltd.*[405]), all dealing with "poison pills", give the business community and its advisors some guidance as to how the regulators are likely in future to deal with requests by offerors to put an end to the operation of the "poison pill" as regards the bid.[406] Each case involved a challenge by a bidder to a "poison pill" shareholder rights plan, by way of application for a cease trade order to prevent the continued operation of the plan in the context of a contested take-over bid. The following

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[401] Robert Yalden, "Controlling the Use and Abuse of Poison Pills in Canada" (1992) 37 *McGill Law Journal*. See also P. Anisman and C. McCall, "Poison Pill Rights Plans: A Checklist of Current Issues" Vol. 6, No. 5, *Corporate Governance Review* (Aug./Sept. 1994); M.R. Gillen, "Economic Efficiency and Take-Over Bid Regulation" (1986) 24 *Osgood Hall Law Journal* 919; E.J. Waitzer, "Rights Plans - Separating the Poison from the Pill" (1994) 17 *Ontario Securities Commission Bulletin*, at 4630.

[402] *In the Matter of Canadian Jorex Ltd. and Manville Oil & Gas Ltd.* (1992) 15 *O.S.C.B.* 257.

[403] *Lac Minerals Ltd.* (1994), 17 *O.S.C.B.* 4104, No. 39/94.

[404] *Regal Greetings & Gifts Inc.* (Re) (1994), 17 *O.S.C.B.* 44971, No. 42/94.

[405] *United Grain Growers Ltd.* v. *3339351 Canada Ltd.* (1997) 117 Man. R. (2d) 267, or [1997] M. J., No. 111.

[406] In both *Lac* and *Regal*, the OSC concluded that the Shareholder Rights Plans could not continue in place indefinitely and that it was appropriate that they be terminated. In *Lac*, the OSC was not prepared to allow the pill to survive in the event that all of the conditions of either of the two outstanding bids were met and, in particular, in the event that 66 2/3% of the *Lac* shares were deposited to either bid. In *Regal*, the OSC was prepared to allow the pill to continue in place for a three-week period beyond the stated expiry of a single outstanding offer to enable the directors of the target to develop an alternative transaction. The reasons do not suggest that the directors of the target, in either case, were acting improperly or failing to fulfil their statutory and fiduciary mandates. The reasons do not comment on the legality of the rights plans, deferring to the courts in that regard, and are confined to a discussion of when it is in the public interest for securities regulators to intervene to terminate a plan. See, *McCarthy Tetrault Legal Update*: "OSC Releases Reasons in Poison Pill Cases" (November 1994): A current commentary published by The Securities Law Group of McCarthy Tetrault in *Legal Update* pp. 26-302 to 26-304. Also, John A. Geller, Q.C., OSC Vice-Chairman, "Shareholders Rights Plans" (Remarks to the Annual Dinner of the Canadian Institute of Chartered Business Valuators) 30 November 1994, (2 December 1994) 17 *Ontario Securities Commission Bulletin*, 5759.

important principles may be of general application after the findings in the aforementioned cases:

A shareholder rights plan will not survive indefinitely in the face of a bid that is not supported by the target board.

The regulators will defer to the legal and fiduciary duties of the target board and will allow a rights plan to continue to operate for a reasonable period of time, where there is a substantial possibility that an alternative transaction can be developed to enhance shareholder value unless:

- it is clear that a majority of shareholders oppose the plan; or
- it is likely, and not merely possible, that an existing offer will be withdrawn.

The more advanced the bid process, as evidenced by the number or age of outstanding offers, the more likely the regulators will be to impose an immediate cease trade order on the basis that the shareholder rights plan has outlived its purpose.

The reasons in the decided cases make it clear that the regulators will only interfere with the judgment of the target board where there is evidence that the interests of shareholders could be harmed by the continued existence of the plan, or where shareholders appear to want the plan terminated.

In determining whether to cease trade a shareholder rights plan, the regulators will weigh answers to the following questions:

1) Is it likely that a better offer will emerge within a reasonable period of time, if the pill is not terminated prior to the expiry of the current offers?

2) Is it likely that an existing offer will not be extended for that period, thereby depriving shareholders of the opportunity to elect between that offer and a transition that may or may not emerge?

3) Do the majority of shareholders have a view as to the continued application of the rights plan?

6. Civil Liability in Take-Over Bids

The MSA provides civil liability for violation of take-over bid provisions. The MSA provides for the right of action for rescission or damages against the offeror, in case the take-over bid circular contains a misrepresentation.[407] It is similar to defences as to the right of rescission given to purchasers of securities in the course of distribution to the public.[408] The law introduces a liability provision with respect to directors' circulars, thereby providing for an action in damages against every director or officer who signed the circular that contained the misrepresentation.[409] The remedy is confined to damages and the range of potential defendants is restricted to directors and officers of the offeree company. The offeree company itself is not liable. Apart from this, there is no difference in the rules applicable to the two types of circulars. Similar defences, as the analogous action for material false statement in the prospectus, are provided in this section.

The MSA provides that, where a take-over bid circular contains a misrepresentation, every offeree is deemed to have relied on the misrepresentation and has a right of action for rescission or damages against the offeror, or a right of action for damages against

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[407] MSA., s. 97(1).
[408] *Ibid.*, s. 65(1).

three possible categories of parties: the offeror, the directors of the offeror at the time the circular was signed, and all other persons who signed a certificate in the offending circular.[410]

B. The Russian Securities Laws With Respect to Take-Over Bids

Currently, the FSL has no binding rules governing the take-over process in Russia, although other provisions of the federal legislation have some impact in this area. Article 80 of the Russian *Joint-Stock Companies Law* includes provisions designed to protect shareholders of widely-held joint-stock companies.[411] These protections apply to companies with more than 1,000 common stockholders.[412]

Article 80 provides that if a person acting alone or jointly with affiliates intends to acquire thirty percent or more of the outstanding common shares of a company, such person must notify the company in writing at least thirty days before the acquisition takes place.[413] Once a person has acquired thirty percent or more of outstanding common shares of the company, it must offer to purchase all common shares of the remaining shareholders at an average price per share calculated on the basis of the company's share price for the preceding six months, unless the disinterested shareholders amend the

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[409] *Ibid.*, s. 97(2).
[410] *Ibid.*, s. 97(1).
[411] See Law "On Joint-Stock Companies", *supra* note 248, art. 80.
[412] *Ibid.*, art. 80, clause 1.
[413] *Ibid.*

company's charter to provide otherwise.[414] The offer has to be made to all holders of common shares in writing and contain the name and address or business location of the person making the offer, as well as the quantity and the price offered to the shareholders, and the period designated to perform the acquisition.[415] The offerees have thirty days to accept the offer from the date that they receive it. The original transaction and the offer to the shareholders must be completed within 120 days after the acquiring party's written statement to the company.[416]

There is no liability provided for violation of this rule except that, as stated in clause 7 of Article 80: "if a person acquires 30 percent or more of the outstanding common shares of a company without complying with provisions of this article, it may only exercise its voting rights at shareholders' general meetings with respect to thirty percent of the voting shares of the company". In other words, an acquirer-shareholder who fails to comply with provisions of the article would have voting rights restricted to thirty percent of voting shares, regardless of the number of shares he actually holds.

Considering that the provisions of this article apply to companies with more than 1,000 common shareholders, then the shareholders of smaller companies are not afforded the same protection as those of large companies.

The "30 percent rule" is the only provision that could be seen to parallel the Manitoba legal technique of acquiring control of the company. In fact Russia's rule is even more rigorous than Manitoba's take-over bid rules. In Russia, once you have a controlling

[414] *Ibid.*, art. 80, clause 2.
[415] *Ibid.*, art. 80, clause 5.
[416] *Ibid.*, art. 80, clause 6.

interest in a company (30%), you have to offer to purchase all of the other shares, which gives all shareholders of a company the opportunity to sell their shares. In this case, all shareholders are in an equal position. This certainly discourages anyone from accumulating a large stake in a company, which may be the intention of the rule.[417]

Unfortunately, there is no material available to illustrate the frequency of occurrences of take-over bid types of transactions nor the application of the "acquisition of 30 per cent" rule in practice.

At this stage of development in the Russian securities markets, when take-over bids remain less common than in Canada,[418] making their regulation patterned after provisions in Manitoba might be a less urgent concern. However, acquisitions are occurring and are likely to increase in both size and frequency in the future; therefore take-over bid regulation is required.

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[417] It should be noted that securities regulation in Russia is largely patterned after U.S. securities laws and any omissions from the U.S. regulatory scheme that can be found in the Russian regulations prove to be damaging for understanding the purposes for which some rules were laid down in laws. Thus, I cannot tell precisely what is the intention of requiring from a person who acquires thirty percent or more of a company shares to make the offer to buy the rest of the shares. I suspect, however, that the primary objective of lawmakers was to provide all shareholders with an equal opportunity to decide what they want to do with their shares, whether to sell them for the fixed price or hold on to them and see if they can benefit more in the future. It is difficult to suggest what are the other intentions of such a requirement. As to the absence of special legislation with respect to take-over bids, in the U.S., as suggested in the *Kimber Report* there appear to be "...three reasons: first, a take-over bid which takes the form of a share exchange offer is subject to the elaborate registration statement and prospectus requirements of the Securities Act of 1933; secondly, section 10(b) of the Securities Exchange Act of 1934 and the rules promulgated thereunder have been held to be applicable to the take-over bid type of transaction (for the contents of section 10(b) - see, *Kimber Report*, *supra* note 37, para. 3.05. p. 21); and, thirdly, the disclosure requirements of the United States federal securities legislation and, in particular, the provisions requiring disclosure of security transactions by directors, officers and substantial shareholders of corporations subject to such legislation, have prevented the vexing question of insider trading...from becoming a controversial issue". For more information with respect to the absence of special legislation on take-over bids in the U.S. see, *ibid.*, para. 3.05.

[418] Information about how the process of taking over control of companies in the Russian markets works in practice is not available; therefore, it is impossible for me to state how frequently the process of take-overs occurs, and how efficient the rule of article 80 of the JSC Law on "acquisition of 30 per cent of outstanding common shares" is.

C. Comparison of Take-Over Bid Regulation

From the foregoing, the following comparisons can be made between the Manitoba and Russian regulatory systems for take-over bids:

1. Whereas the MSA contains comprehensive take-over bid rules, the Russian FSL does not address the regulation of such transactions.

2. Although the Russian *Joint-Stock Companies Law* sets forth provisions as to the acquisition of thirty percent of a company's shares, their application is limited to companies with more than 1,000 shareholders, which presents a regulatory gap for abuses of shareholder's interests in companies with fewer than 1,000 shareholders. The information that an acquirer is obligated to provide shareholders is not sufficient for shareholders to decide whether to sell their shares. As a result, the current Russian legislation is deficient to govern take-over bids in any form of transactions. This provides an alarmingly slim base of information upon which the offeree is to form a judgment. In view of the development of the Russian securities market, when acquisitions are likely to increase, Russia needs comprehensive regulation of take-over bids (1) to provide protection of shareholders in the target company, and (2) to provide a regulatory framework within which take-over bids may proceed in an open and even-handed environment. In order to do that, Russia should adopt all attributes of the Manitoba take-over bid regulatory scheme, which are: (1) define of a take-over bid, (2) set forth procedural and disclosure requirements, and (3) prescribe the form of a take-over bid circular and the information contained therein, as well as the form of a

director's circular and the information contained therein. the FSL must also stipulate the liability measures to promote the enforcement of take-over bid regulations.

VII. CHAPTER 6: ENFORCEMENT OF SECURITIES LEGISLATION

"Only if the standards of conduct laid down by the Act are obeyed will the goal of investor protection and other related objectives be attained."[419]

The objective of this chapter is to provide a comparative summary of the various sanctions provided under securities legislation in Manitoba and Russia, with an overview of the respective administrative mechanisms for enforcing securities laws. It presents a broad view of the types of sanctions and enforcement procedures used by regulatory agencies, to ascertain which procedures might be useful in Russia, with or without modification.

A. Enforcement Under the Manitoba Securities Act

1. Sanctions

Enforcement of the provisions of securities legislation in Manitoba, and in Canada generally, is achieved through a variety of techniques. These include penal sanctions, administrative sanctions, and statutorily created civil causes of actions.

The primary focus of penal and administrative proceedings are deterrence and prevention of wrongdoing. The primary purpose of civil liability is compensation to investors for harm suffered, but the availability and likelihood of civil remedies may also deter improper conduct. All of these means may thus serve, in part at least, to encourage issuers

and others to comply with statutory requirements of securities laws. Thus, I believe, all regulatory proceedings taken as a whole are likely to improve the quality of compliance with the securities laws, as well as the protection of investors. These types of proceedings have complementary goals.

a) Penal Sanctions

Securities legislation in Manitoba expressly specifies a range of offences for which penal sanctions are provided.

(i) False Statement

According to the MSA, it is an offence if a person[420] or a company[421] makes a statement in any material, evidence or information required to be submitted or given under the MSA and its regulations, to the commission, its representatives or director, or to a person appointed to make an investigation or audit, that, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact or that omits to state any material fact, the omission of which makes it false or misleading.[422]

(ii) Misrepresentation

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[419] D.L. Johnston, *supra* note 24, at 357.
[420] "Person" means an individual, partnership, unincorporated association, unincorporated organisation, unincorporated syndicate, trustee, executor, administrator or other legal personal representative, see MSA., s. 1(1).
[421] "Company" means any incorporated corporation, incorporated association or other incorporated organisation, see MSA., s. 1(1).
[422] MSA., s. 136(1)(a).

Making a statement in any application, report, prospectus, return, financial statement or other document required to be filed or furnished under the MSA or regulations that, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or that omits to state any material fact, the omission of which makes the statement false or misleading, also constitutes an offence. [423]

(iii) Contravention of Act or Regulations

Any contravention of the MSA or its regulations constitutes an offence.[424] The provisions, contravention of which constitutes an offence, include, for instance, the failure (a) to register for trading, underwriting or advising, (b) to comply with restrictions on registrants such as calling or telephoning at a residence or making prohibited representations, (c) to file a prospectus as required, (d) to report material changes or provide insider trading reports, (e) to comply with the take-over bid requirements, or (f) to solicit proxies as required or to send required proxy circulars.

(iv) Failure to Comply with a Decision Made Under the MSA

The MSC is given a wide range of powers to make decisions. The MSA sets out that a failure to observe or comply with any order, direction or other requirement made under the Act is specified as an offence.[425]

b) Sanctions

The MSA at the same time expressly provides for penal sanctions, including fines and,

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[423] *Ibid.*, s. 136(1)(b).
[424] *Ibid.*, s. 136(1)(c).
[425] *Ibid.*, s. 136(1)(d).

in case of individuals,[426] imprisonment.[427] Any person or company convicted of an offence under Section 136(1) of the MSA, except where conduct constitutes an offence under Part X[428] or XII[429] or Section 111[430], is liable to a fine of not more than $1,000,000. or to imprisonment for a term of not more than two years, or both.[431] No minimum penalty is provided under the same section. Provision of serious penalties indicates that public policy emphasises the importance of complying with securities regulation in Manitoba. There has been a shift in these policies in Manitoba. *The Security Frauds Prevention Act*, 1930 provided for injunctions, penal sanctions of up to $ 2000 for individuals and $ 25,000 for companies and the seizing of assets of offenders. Since then the limits of penalties as well as the size of average fines have been increased. Although the seriousness of the $ 1,000,000. fine for companies has some inherent limitations (because such liability, if imposed on the company, will ultimately be paid at least in part by other investors, most of whom are not culpable), the availability and likelihood of a fine and up to two years of imprisonment for individuals, I believe, should deter potential violators from contravening these regulatory requirements.

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[426] "Individual" means a natural person, but does not include (a) a partnership, unincorporated association, unincorporated organisation, or unincorporated syndicate; or (b) an executor, administrator, or other personal representative, or a trustee, acting in that capacity, see MSA., s. 1(1).
[427] MSA., s. 136(1).
[428] Subsections 101(2), 102(3), 102(4) of Part X of the MSA specify offences and provide sanctions for a failure to comply with the provisions regulating proxies and proxy solicitation or for misrepresentations contained in the filed, or required to be filed documents.
[429] Part XII of the MSA sets out financial disclosure requirements and provides liabilities for a failure to comply with any provisions of this Part.
[430] Part XI sets out requirements for insider trading. Section 111 of Part XI specifies offences and provides liability for a failure to file reports that are required to be filed, s.111(1), or for a filing a reports that contain a false or misleading information.
[431] *Ibid.*, s. 136(1).

The statutory offence provisions also provide that, where a company or a person other than an individual commits an offence under the Act, every director or officer of the company that authorises, permits or acquiesces in the commission of the offence, prescribed in Section 136(1), is also guilty of an offence and on conviction liable to a fine of not more than $1,000,000. or to imprisonment for a term of not more than two years, or both.[432]

For an offence committed by a company, the statutory provisions provide double-sided liability of a company itself and its directors and officers, unless the "did not know or could not have known" defence is available to the accused individual.

c) Due Diligence Defences

The MSA provides for due diligence defences to some of the specified offences.[433] The prosecution has the burden of proving that a statement made in the material, evidence or information submitted to the commission, its representatives, investigators and auditors, appointed by the commission, in an application, report, prospectus return , financial statement or other document required to be filed or furnished, is false or misleading.[434] If established, the accused is guilty of an offence unless he can prove that he "did not know and in the exercise of reasonable diligence he could not have known that the statement was false or misleading"; and if, "upon becoming aware that the statement was false or

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[432] *Ibid.*, s. 136(3).
[433] *Ibid.*, s. 136(2).
[434] *Ibid.*, s. 136(1)(a), (b).

misleading, he forthwith took steps to notify the commission that the statement was false or misleading".[435]

d) Limitation Periods

The MSA also generally provides for limitation periods that apply to the enforcement of the offence provisions. According to the law, proceedings to prosecute a person or company for an offence under the MSA may be commenced at any time within two years after the facts upon which the proceedings are based first come to the knowledge of the MSA; but proceedings to prosecute a person or company for an offence under the Act shall not be commenced after eight years after the date on which the offence was committed.[436]

e) Administrative Sanctions

Under the MSA the MSC is given the power to make a wide range of orders to enforce compliance with the securities act or regulations.

(1) Compliance Orders

Under the MSA, where any person or company has failed to comply with or is violating any provision of the MSA and its regulations, or any order of the commission, notwithstanding the imposition of any penalty in respect of non-compliance or violation, the commission may apply to the Court of Queen's Bench for an order directing the

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[435] *Ibid.*, s. 136(2).

person or company to comply with the provision or order, or may apply for an order restraining the person or company from violating the provision or order. The court may grant the order or such other order as the court thinks fit.[437]

(2) Cease Trade

The MSC may, where in its opinion the action is in the public interest, order that all persons, class of persons, or any particular person must cease trading in specified securities.[438]

(3) Denial of Exemptions

Important exemptions are provided from application of the MSA with respect to registration, prospectus filing requirements and take-over bid regulations. The MSC has the power to remove these exemptions "where in its opinion such action is in the public interest", with respect to the persons specified in an order by the commission.[439] The removal of these exemptions can have a significant impact on, for instance, the business of a registrant, on financing by an issuer, on a person or persons involved in private placement, or on persons engaged in acquisition.

(4) Suspension, Cancellation, or Restriction of Registration

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[436] *Ibid.*, s. 137.
[437] *Ibid.*, s. 152(1).
[438] *Ibid.*, ss. 62(1), 63(2) "orders to cease trading".
[439] *Ibid.*, s. 19(5).

The MSA makes certain provision for imposition of administrative sanctions. These may be imposed either in conjunction with criminal or civil proceedings, or alone, which the MSC may impose on broker-dealers and other persons, ranging from an order that a registrant be reprimanded to a person's registration being suspended, cancelled or restricted. The MSC has the power to order that a person's registration be suspended, cancelled or restricted where in its opinion to do so is in the public interest.[440] Generally the MSC may, under this section, impose sanctions after notice and opportunity for hearing.

The administrative orders noted above can generally be made on a temporary basis without a hearing, where the commission considers that the length of time required to hold a hearing could be prejudicial to the public interest. The application of a temporary order is limited to fifteen days in both situations, but the commission can order an extension of the order until the hearing can be held. A hearing is required before the imposition of any final order.[441]

f) Civil Sanctions

In Manitoba, civil damage actions are regarded as a necessary means of enforcing the securities laws.

The MSA sets out extensive provisions concerning civil damage actions such as right of action for rescission of a contract and damages for a misrepresentation in a prospectus.[442]

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[440] *Ibid.*, s. 8(1), s. 7(3).
[441] *Ibid.*, s. 148(2).
[442] *Ibid.*, s. 65(1) (right to rescind a contract on the base that a prospectus contains an untrue statement of a material fact), s. 141 (civil right of action for damages if a prospectus contained a false or misleading material information).

The MSA gives a right of action for rescission and damages in connection with misrepresentations in a take-over bid circular.[443] The action lies against the offeror, its directors at the relevant time and each person who signed a certificate in the circular. Liability in damages is also stipulated against every director or officer who signed a director's circular sent to the offerees of an offeree company.[444] Note that in Section 98 a security holder has a right of action for rescission or damages against the offeror who failed to deliver required circulars when a take-over bid is made. There are also civil actions for compensation or an accounting[445] in respect of insider trading[446] or informing.[447] There is an action for rescission with respect to a failure by a registered dealer to make required disclosure in the context of margin contracts, or a failure of a registered dealer to make required disclosure with respect to acting as the principal in a trade.[448]

2. Investigations and Audits

Provisions under the MSA are made for investigations and audits to facilitate the administration and enforcement of the securities laws. The MSC is given the power to make or by order to appoint a person to conduct an investigation and make a report on the

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[443] MSA., s. 97(1) (a right of action for rescission or damages against the offeror if a take-over bid circular contains a misrepresentation), s. 97(2) a right of action for damages if a directors' circular distributed to a holders of securities contains a misrepresentation).
[444] *Ibid.*, s. 97(2).
[445] *Ibid.*, s. 113(4) (accountability of an insider to a corporation for any benefit or advantage received by him as a result of transactions conducted with knowledge of a material information that has not been generally disclosed).
[446] *Ibid.*, s. 113(1) (an insider is liable to compensate the seller or purchaser of a securities for damages if he trade with knowledge of a material information with respect to a corporation that has not been generally disclosed).
[447] *Ibid.*, s. 113(2) (liability of insiders to compensate for damages for tipping).
[448] *Ibid.*, ss. 77(1) and 71(1) respectively.

result thereof.[449] Section 22 of the MSA sets out broad authority, powers, rights and privileges that are given to the MSC or investigators appointed by it to conduct their investigation, including summoning and enforcing the attendance of witnesses, compelling witnesses to give evidence under oath and to produce documents and records,[450] as well as seizing and taking possession of any documents, records, securities or other properties of an investigated person or company.[451]

3. Orders To Freeze Property

The MSC has the power to direct any person or company to hold any funds, securities or other properties that it has on deposit and which belongs to the person subject to an investigation, order or proceeding.[452] The MSC can also direct a person or company, which is subject to the investigation, order, or proceeding, to refrain from withdrawing any funds, securities, or other properties or to hold all funds, securities or other properties of clients or others in trust for an interim receiver or trustee[453], appointed by a judge of the Court of Queen's Bench, upon application made by the MSC.[454]

B. Enforcement of The Federal Securities Law of Russia

In general, the FSL neither provides remedies for statutory violations, nor does it provide definitions of offences against provisions of its law. It relies on criminal, civil, and

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[449] *Ibid.*, ss. 22, 23, 25.
[450] *Ibid.*, s. 22(4).
[451] *Ibid.*, s. 22(6).
[452] *Ibid.*, s. 26(1).
[453] *Ibid.*, s. 26(1).
[454] *Ibid.*, s. 27.

administrative remedies outside the law to enforce violations of its provisions.[455] The reliance on other laws to provide remedies for statutory violations has its roots in past Russian legal practices. However, this is an unfortunate policy choice with regard to its securities laws. The decision to place the remedies for civil and criminal violations of the FSL in the appropriate sections of the civil and criminal codes requires a level of co-ordination among diverse statutes that is unlikely to occur during Russia's period of legal reform. The revised civil, administrative, and criminal codes do not address market offences. Many articles of the FSL refer to the criminal, administrative, and civil codes for penalties for violations of its provisions. For example, the wording of Article 18, paragraph 8 is that "the issuer is liable for any divergence between the information contained in the certificate of the security and the information contained in the decision to issue securities, in accordance with the law of the Russian Federation", or the wording of clause 4 of Article 51 "the officers of the issuer who have taken a decision to issue securities which have not undergone state registration bear administrative and criminal liability in accordance with the legislation of the Russian Federation".[456] These references do not contain specific citations to the civil, administrative, and criminal codes and, as a result, do not help identify the range of penalties and remedies. The reference is absent because the present law does not contain expressly provided remedies for securities violations.

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[455] FSL., *supra* note 2, clause 1 of art. 51 states that persons bear responsibility for violations of the FSL and other legislative acts concerning securities in the cases and to the extent specified by civil, administrative or criminal legislation.

[456] *Ibid.*, art. 18 and art. 51, respectively.

The FSL should be amended with penalty provisions for market offences and at the same time to ensure that the *Civil Code*, *Administrative Code* and *Criminal Code* contain a full statement of liability provisions consistent with provisions of the FSL. The absence of comprehensive liability provisions is a problem for the FSL or, more precisely, for investors. The securities laws of Manitoba, that expressly specify both criminal and civil liability for violations of its provisions, can be a guide regarding penalty provisions.

The FSC enjoys broad regulatory powers enumerated in Articles 44 and 51 of the Law. Under Article 44, the FSC is empowered to develop and present to the Parliament (Duma) any legislation on securities and conduct registration of newly issued securities. It also oversees industry professionals by issuing broker-dealer and other professional licenses, establishing necessary qualifications for securities professionals, and controlling the industry through periodic reports by industry members. In that respect, the powers of the FSC are much like those of the MSC.

1. The powers of the FSC in the enforcement area are, however, more limited than those of the MSC. The FSC has no prosecutorial power under the Law. The FSC has a right to conduct investigations, after which it may either bring a civil suit against violators of the securities laws or, where the violations are criminal in nature, report the violation to the prosecutor.[457] Unlike the MSC, the FSC of Russia in the course of conducting an investigation, has no authority to enforce the attendance of witnesses and compel them to give evidence on oath, or to produce documents, records, and artefacts, as is vested in the MSC.[458] If a person under investigation fails or refuses to

[457] *Ibid.*, clause 3-7 of article 51, clause 8 of art. 44.
[458] See section 22(4) of the MSA, *supra* note 1.

attend, to answer questions, or to produce documents or records in his custody or possession, he, according to Section 22(4) of MSA, is liable to be committed for contempt by a judge of the Court of Queen's Bench. Although the licensing and registration authorities of the FSC of Russia imply the power to deny, suspend or revoke the license of any industry member[459] or deny the registration of securities,[460] as well as compulsory liquidation of the participant who fails to obtain a license within a prescribed time period,[461] this probably is all that the FSC can do to fight violations of its securities laws. Unlike the MSC's authority to assess monetary penalties, the Russian legislation does not give the FSC direct ability to fine violators of the securities laws. Without that power, the FSC will have to refer every infraction, however small, to the prosecutorial organs or to litigate every violation of its securities laws. For purposes of efficiency and heightened respect for the agency, the FSL should be amended to add these important powers to the FSC's enforcement arsenal. Proper enforcement of the Russian securities regulation is crucial for the orderly development of a securities market.

1. Private enforcement of the Securities Laws

Certain liabilities and remedies can be found in the new *Civil Code* of the Russian Federation.[462] The FSL also expressly recognises the possibility of civil liability for violations of securities legislation in such cases and to the extent allowed by the *Civil*

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[459] FSL, *supra* note 2, art. 42 clause 6 and art. 44 clause 4, respectively.
[460] *Ibid.*, art. 21.
[461] *Ibid.*, art. 51, clause 6.

Code.[463] However, the presence of suitable legislation does not guarantee securities enforcement in the Canadian style. Unfortunately, there is not sufficient information about the Russian court system to predict the attitude of the Russian judiciary toward enforcement of securities laws.

Because Russia is a civil law country, all remedies and liabilities are created by statutes. Under Chapter 1 of the *Civil Code*, a person whose rights have been violated is entitled to fully recover losses, unless provided otherwise by contract or law.[464] A person is entitled to be indemnified for expenses incurred in enforcing his rights as well as losses for damages to his property and lost profits; in the wording of the *Civil Code*: "expenses that a person whose right has been violated has incurred or must incur in order to restore the violated right, the loss or impairment of his property [actual damages], as well as income that this person could have received under ordinary circumstances of civil intercourse if his right would have not been violated [*i.e.*, lost profits]".[465] In determining the affected person's lost profits, courts are to consider the profit made by an alleged violator as a result of the alleged violation.[466] Chapter 59 of Part Two of the *Civil Code* concerns liability for damages.[467]

It is clear that the right of defence for any violation of securities laws arises out of specific legislative provisions that expressly give an individual such a right. The question remains, whether under the Russian civil law system, the right of defence may arise for those

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[462] *Civil Code*, *supra* note 11.
[463] FSL, *supra* note 2, art. 51(1).
[464] *Civil Code*, *supra* note 11, art. 15(1).
[465] *Ibid.*, art. 15(2).
[466] *Ibid.*
[467] See *ibid.*, art. 1064.

provisions of the FSL that do not expressly give a private plaintiff a right to sue, but simply make unlawful certain activities that have injured the plaintiff.

For the purposes of this chapter, all provisions that may give rise to liability are discussed.

A so-called "dishonest issue" of securities, *i.e.*, one that violates the procedures for an issuance under Section III of the FSL,[468] may result in the issue being declared invalid or the issuer being stopped from completing the placement of the issue.[469] Violation of the issuance procedures also is a ground for refusing to register an issue.[470] The FSL limits the remedies depending on the character of the violation in question. Thus, if procedural violations are discovered, the registering agency may stop the placement of the issue until the procedural violations are remedied, and then may decide to resume the placement.[471] According to the broad definition found in Article 26 of the FSL, an issue is invalid if the issuer violates any Russian law during the issue or if the issuer's registration material is inaccurate. However, Article 51 follows a narrower approach. Thus, if in connection with a dishonest issue, the purchasers are significantly misled or if the objectives of the issue conflict with a fundamental principle of law, or are immoral, the FSC may apply to a court for the issue to be declared invalid. When an issue is declared invalid, the issuer

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[468] FSL., *supra* note 2, arts. 16-29 (Section III of the Federal Securities Law describing the manner in which an issue of securities must be effected by a company, including registration, prospectus content requirements, procedures for the disclosure of information about an issue, continuous disclosure reporting requirements, and requirements affecting placement).
[469] *Ibid.*, art. 26.
[470] *Ibid.*
[471] *Ibid.*

must refund all proceeds received from the purchaser of its securities.[472] The FSC may seek an injunctive order to compel refund if an issue is declared invalid.[473]

Unfortunately, requirements of this clause have limited force because the securities legislation does not provide a procedure for recovering the money in such a case. Rather, it leaves itself limited by reference to Article 24, paragraph 4, that states "when an issue is invalidated funds are returned to investors under the procedure established by the Federal Commission for the Securities Market". "Procedures" are yet to be established.

Going back to Articles 26 and 51, which provide that an issue may be invalidated, clause 3 of Article 12 of the *Civil Code*[474] by implication gives purchasers of securities, the issuance of which is invalidated by the court, standing to sue the issuer for rescission, a remedy similar to that contained in Manitoba. Provisions of Articles 51, para. 5, and 26, para. 5, do not expressly provide for a private cause of action; but such an action can be found if those articles are read in conjunction with Articles 8, 9 and 12 of the *Civil Code.* A combined reading demonstrates that Articles 51 and 26 give rise to civil rights and duties that can be effectuated through the right of defence, exercisable in part by bringing a lawsuit for damages.

The FSC's resources for oversight and enforcement are limited, and its staff's efforts are more concentrated on the regulatory aspects of its mission than on enforcement. The FSC is much less experienced in the enforcement of securities law than in Manitoba. Also, the

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[472] *Ibid.*, art. 26, 51(5).
[473] *Ibid.*, art. 26.

[474] The wording of article 12, clause 3 is: "Civil rights are protected by means of: ...- declaring a voidable transaction to be invalid and imposing the consequences of the invalidity of a void transaction". *Civil Code, supra* note 11, art. 12, clause 3.

FSC is faced with a tremendous regulatory task. The whole regulatory scheme is yet to be created. Under these circumstances, the FSC's enforcement activities will either be limited or done at the expense of regulatory work.

If the liability of issuers in primary distributions is more or less provided under the law, the civil liability of securities professionals for misconduct in secondary trading is limited. An industry professional may lose his license for violation of the trading rules;[475] but revocation of a license is of little value to the defrauded investor who has lost his money. Besides, the enforcement abilities of the FSC are certainly not enough to uncover and investigate each and every case of securities fraud. There is a need for various private remedies to provide relief to those harmed by a securities law violation. More importantly, the existence of a private remedy is a powerful incentive for individuals and companies to comply with the securities laws. Certainly, clear delineation of the express civil liabilities of market participants in the law would be helpful, and the law should be amended to that effect. In the meantime, the articles of the FSL that outlaw certain activities should be interpreted as authorising private rights of action.[476]

The FSL does not specifically grant a private right of action against market participants; but it contains limitations on a market participant's activities. These limitations relate mostly to insider trading.

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[475] FSL, *supra* note 2, art. 5, clause 2.

[476] The absence of applicable material does not allow me to illustrate instances of the application of such requirements of the laws. There are no authoritative commentaries and interpretations of record made by the Supreme Arbitration Court and by the Plenum of the Supreme Court of the Russian Federation on the application of the legislation for the securities market, which is a traditional technique for the use of the legislation in a civil law system country.

As noted, the law does not expressly grant a private cause of action against insider trading. It merely states that violators of an insider trading regulation are subject to liability "under the legislation of the Russian Federation".[477] A private cause of action can be found, however if the article is read in conjunction with Articles 8, 9, 11 and 12 of the *Civil Code.*

Russian securities regulators should not rely on generic civil liabilities, but rather should add anti-manipulative and anti-fraud provisions to the FSL, specifically tailored to fight securities fraud and market manipulation in the secondary market. Russia needs to define and outlaw specifically, rather than in general terms, manipulative and fraudulent practices in its securities industry.

a) Limitation Periods Under the Russian Civil Code

The discussion of remedies and liabilities under the FSL would be incomplete without mention of limitation periods. The *Federal Securities Law* itself does not contain any statutory limitations, but the general limitations period under the *Civil Code* is three years.[478] The parties may not, by any agreement or otherwise, change the duration of the limitations period. The commencement of the limitations period is subject to a discovery rule: the limitations period begins to run when a person knew or should have known that his or her rights were violated. Thus, a limitation period under the Russian *Civil Code* may be longer than most limitation periods under the MSA.[479]

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[477] FSL, *supra* note 2, art. 33.
[478] *Civil Code*, *supra* note 11, art. 196.
[479] See MSA., s.137. See *supra note* 436 (on limitation periods under the MSA) and accompanying text.

2. Criminal Offences and Sanctions

The *Criminal Code*, which came into effect on 1 January 1997,[480] provides for criminal sanctions for specific violations of securities legislation.[481] These violations and related sanctions include: (1) unlicensed activities on the securities market authorising penalties up to 500 times the minimum wage;[482] (2) wilful misrepresentation in a prospectus subjecting the issuer and its officers and directors to penalties up to 500 times the minimum wage;[483] (3) fraud during share issues allowing penalties of fines or compulsory labour;[484] and, (4) fabrication of counterfeit banknotes or securities, which is punishable by imprisonment from five to eight years.[485]

The *Criminal Code* does not, however provide for violations of the FSL provisions as they are, although under the FSL the issuer must state true and accurate information in its prospectus.

Speaking about administrative sanctions of a monetary nature, there exists in the Moscow Law, "On the administrative liability for violations in the sphere of securities market" [hereinafter , the Moscow Law], penalties applicable only in Moscow region.[486] It

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[480] Ugolovnyi Kodeks Rossiyskoi Federatsii [Criminal Code of the Russian Federation], *Sobr. Zakonod. R. F.* 1996, No. 25, Doc. 2954 [hereinafter, Criminal Code].

[481] The *Criminal Code* of 1964 did not have such provisions, since at the time of its adoption Russia did not have, and did not expect to have, any securities market.

[482] *Criminal Code*, *supra* note 480, art. 171.

[483] *Ibid.*, art. 177.

[484] *Ibid.*, art. 185.

[485] *Ibid.*, art. 186.

[486] Zakon goroda Moscva "Ob Administrativnoi Otvetstvennocti za Pravonarusheniya v Sphere Rinka Tsennih Bumag" [Law of Moscow City on Administrative liability for Violations of the Securities Law"] (11 June 1997) No. 17, *Ekonomika I zhizn* No. 20, 4 July , 1997 pp. 6-7. The Federal Securities Law contains fundamental (basic, primary) prohibitive norms. For instance, the prohibition of combination of certain types of professional activities on the securities market (art.10); the prohibition of the issuance of securities in excess of the number declared in the issue prospectus (art. 26). However, the norms that provide enforcement of these prohibitive provisions provided in the FSL are absent. The norms which

provides for sanctions in relation to organisations violating the securities market, which are:

- a warning with an order to eliminate an uncovered (detected) violation by the time appointed in the order;
- a warning with an order to eliminate an uncovered violation, followed by publication in the mass media;
- fines.

Other sanctions provided by legislation of the Russian Federation and by the Moscow Law could be imposed on organisations for violations on the securities market. According to Article 3 of the Moscow Law, "cases of violations, provided for by the present Law, are considered by official persons of the Moscow regional division of the Federal Commission to the extent specified by the present Law and legal acts of the Moscow regional division of the Federal Commission for the Securities Market.... The chairman of the Moscow regional division and his deputies appointed by him have a right to investigate violations on the securities market and to impose sanctions on behalf of the Moscow regional division".

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guaranty the performance of provisions of the FSL partially are provided in the new *Criminal Code*. As to administrative liabilities, the FSL provides for one and only form of punishment for violations of the established rules of the conduct of professional participants and of the rights of investors, which is revocation of the license of a professional participant in the securities market (art. 44(4)). All of these are, of course, extreme measures. They allow "to retaliate" but not "to educate" (prevent). The primary objective should be, on the one hand, to caution the possible violations, on the other hand, to promote elimination of detected infringements. The FSC made corresponding proposals to the State Duma to amend the *Administrative Code*, and unfortunately none has come into effect so far. For this exact reason the Government of Moscow and the Moscow municipal Duma, with direct participation of the Moscow regional division of the FSC, took appropriate measures to provide the Moscow securities markets with the Law on administrative liability for violations in the securities market. According to this Law, the Moscow regional division of the FSC is in charge of consideration of cases in order that administrative measures may

The Moscow Law provides for certain types of offences in the sphere of the securities market, such as a violation by the issuer of procedures and standards for issuance of securities (Art. 7); illegal combinations of various types of professional activities on the securities market (Art. 8); accomplishment of deals with securities in violation of the requirements of the legislation (Art. 13); the use of insider information (Art. 15); evasion from providing the disclosure of compulsory information or reports by professional participants filed with the Commission (Art. 17); and, infringement of the procedure of information disclosure (Art. 19). Thus, this law specifies practical sanctions for violations of provisions of the FSL, though only in the city jurisdiction of Moscow, which means that investors whose investments are placed outside of Moscow are deprived of the protection provided by the Moscow Law.

The subject of administrative liability according to provisions of the Moscow Law is against the issuer itself. Penalties are imposed on the issuer, not on persons whose default led to breach of the law. This means that an issuer takes the burden of liability when a responsible person has escaped from liability. In my opinion, the Moscow Law should be amended in order to limit the imposition of sanctions to a particular person who fails to comply with it, who authorises, permits or acquiesces in the commission of the offence, rather than to the entire issuer-company, so that harm would not be done to innocent shareholders of that company.

Law reform proposals should be made to provide sufficient penalties for misrepresentations in a prospectus and insider trading. There are stringent, strict liability

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be taken against violators, such as by a declaration of warning, with an order to eliminate detected violations, and by the imposition of penalties.

crimes in the Manitoba statute book, generally made subject to due diligence defences and this seems a suitable precedent upon which to act.

The same strict liability approach should be advocated in respect of other serious violations of important regulatory provisions and obligations, such as the duty to supervise salesmen and others working for a registered person. Again, the activities of such persons are crucial to the maintenance of an orderly market. Where duties of supervision are commonly neglected, opportunities to defraud investors will be taken. This seems to be another area in which Russian legislators ought to provide for adequate penalties. It is, of course, not necessary that a fine or imprisonment be imposed in every case, for example, for failure to supervise. Most cases can no doubt be dealt with administratively.

Where, however, there appears to be an unexplained and serious neglect of supervisory responsibilities, criminal proceedings may well be thought appropriate. In relation to registration offences, there ought to be strict liability in order to enforce an affirmative duty. There ought to be a due diligence defence. There ought to be the possibility of imprisonment in cases where the failure to supervise is egregious. Such cases would include those where management was, in fact, aware of circumstances which ought to have caused it to discharge its supervisory responsibilities.

Such provisions are significant to the scheme of regulation and ought to be regarded as fundamental. A deterrent structure of potential penalties should be provided. In respect to particularly serious infractions, this would prove to be a meaningful approach to the problem.

In addition, Russia should provide for a judicially imposed disqualification of persons from acting in the securities industry or acting in the management of a company, where the person concerned remains presently in default of the reporting requirements of securities or joint-stock companies legislation. Power to apply for a disqualification should rest in the FSC. The power could be exercised by the court either consequent upon conviction or upon imposition of an administrative sanction by the FSC.

C. Comparison of Enforcement Provisions

From the foregoing, the following comparisons can be made between the Russian and Manitoba systems of enforcement of securities legislation:

1. While in Manitoba the primary responsibility for regulation is granted to provincial securities commissions, in Russia the regulation of the securities market is a responsibility of the federal commission.

2. The MSC is granted broader powers to issue normative acts and ensure compliance with securities legislation through administrative proceedings and other means.

3. In contrast to the MSC, which is given broad powers in the enforcement area, the FSC's powers are limited. Whereas the MSC's powers include: (i) to apply to the Court of Queen's Bench for an order directing a person or company to comply with the provision or order of the commission, or for an order restraining the person from violating the provision or order, (ii) to order to cease trade where in its opinion the action is in the public interest, (iii) to remove exemptions, and (iv) to impose administrative sanctions in the form of cancellation, suspension, or restriction of a

person's registration where in its opinion to do so is in the public interest. Presently the powers of the FSC are limited to the authority to suspend, cancel, or restrict a person's registration on the grounds laid down in the law. Unlike the MSC, the FSC currently has no direct ability to impose monetary penalties on violators of securities laws, unless by amending the *Administrative Code* of Russia, the FSC will be authorised as a body to impose monetary penalties for violations in the market. The FSC does not enjoy the broad authority, powers, and rights that are given to the MSC in conducting investigations and audits, such as: (i) summoning and enforcing the attendance of witnesses, (ii) compelling witnesses to give evidence under oath, and (iii) seizing and taking possessions of any documents, records, securities and other property of an investigated person or company. Under the Russian legal system, these powers are available only to the courts and the prosecutorial organs. The FSC's rights as to investigations are confined to "requiring issuers and professional participants to present documents required to resolve questions..." (Art. 44, clause 7) and to bringing a civil suit against violators or where violations are criminal in nature, report a violation to the prosecutorial organs. The authoritative power of the FSC should be extended in order to facilitate enforcement of provisions of the Federal Securities Law.

4. While the MSA expressly provides the range of offences, as well as to penal, administrative, and civil sanctions, the FSL itself neither provides for remedies for statutory violations, nor does it provide definitions of market offences. For the most part this difference is the result of the Russian civil law system under which all remedies and liabilities are created by statutes (*i.e.*, the Civil, Criminal and Administrative Codes).

5. Unlike the MSA, which provides extensive provisions concerning civil damage actions such as: right for rescission for failure to deliver the prospectus, or when there is misrepresentation in a prospectus, or in a take-over bid circular; rights for rescission and damages in connection with misrepresentation in a take-over bid circular, etc., the FSL does not contain such provisions. However, under the Russian civil law system the right of defence may arise out of those provisions of the FSL that expressly give a person a right to sue. Therefore, clearer delineation of the express civil liabilities of market participants should be provided in the Russian law.

VIII. CHAPTER 7: SELF-REGULATION

"Self-regulation" is a system under which all or a major portion of the responsibility for policing the conduct of participants in an industry is undertaken by an industry organisation, rather than directly by a governmental agency.[487]

Why has self-regulation, which is found in few other industries, been so pervasively accepted by governments and participants as well, in the securities field?[488] The answer, D. Ratner believes, lies in the nature of secondary trading in securities. Unlike other goods produced and marketed by competing enterprises and consumed by their purchasers, securities, once marketed, continue to trade actively from hand to hand in a secondary market.[489] To make this market efficient, there must be a central facility through which the securities can be quoted and traded. That facility must have rules to govern the conduct of individuals and firms entitled to use it. Stock exchanges began providing these facilities, and imposing these rules, almost two hundred years ago in the United States and almost a hundred and fifty years ago in Canada, long before governmental regulatory commissions came into existence.[490]

This rationale has been enunciated for preferring a system of supervised self-regulation to direct regulation. It is assumed that self-regulation is less expensive and more flexible than governmental regulation, and that it can be more effective in controlling undesirable

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[487] D. L. Ratner, "Self-Regulatory Organisations", (1981) 19 *Osgoode Hall Law Journal*, p. 368.
[488] P. Dey & S. Makuch, "Government Supervision of Self-Regulatory Organisations in the Canadian Securities Industry" in P. Anisman, *et.al.*, (eds.) *3 Proposals for a Securities Market Law for Canada* (Ottawa: Minister of Supply and Service, 1979) [hereinafter *3 Proposals*] at 1433-35.
[489] D. L. Ratner, *supra* note 487, at 368.
[490] *Ibid.*

practices. Furthermore, people administering the system should have both a better understanding of how the business works and a pecuniary interest in eliminating unfair methods of competition. Self-regulation has real advantages for the public at large. For one, it is much less costly than governmental bureaucracy. Right now the industry shoulders the high cost of regulation and compliance. If it did not pay these costs, the taxpayer would have to. Secondly, it generally works better. Those who know the markets are more able to make practical rules and are more aware of potential loopholes and compliance problems. In turn, the industry is more likely to comply with rules of its own making.

Some people will always be suspicious of self-regulators who may depend on their view of a particular practice, and whose rules and enforcement activities may be tainted by a self-interest in eliminating competition and protecting their own way of doing business.[491] However, all regulatory responsibilities are carried out under the watchful eye of industry regulators. Every by-law and rule created by a self-regulatory organisation ("SRO") is reviewable by provincial securities commissions.[492] This ensures that the public interest

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[491] P. Dey & S. Makuch, *supra* note 488, at 1439-40.

[492] *E.g.* MSA., s. 139(2)(re: stock exchanges); OSA s. 20(2) and s. 23(2).
The provincial securities commissions may also review and make decisions on the procedures or practices of a SRO or stock exchange, or may review and make decisions on the manner in which a stock exchange carries on business, the trading of securities on or through the facilities of a stock exchange, a security listed and posted for trading on a stock exchange, or issuers whose securities are listed and posted for trading on a stock exchange to ensure that issuers comply with the securities acts and regulations. While a securities commission enjoys regulatory and supervisory powers over the stock exchange within its jurisdiction, a commission will generally not interfere with the normal operations of the exchange. *E.g.*, MSA, ss. 32, 33, 139; and Conflicts of Interest: Statements of Policies, s. 22, *Can. Sec. L. Rep.* (CCH) P 450-324, at 55, 125; *Ibid.*, s. 22(3), P 450-323, at 55, 125-55, 126.

is paramount. In addition, public governors sit on the boards of directors or governors of all the SROs to monitor the public interest.[493]

To protect the public, SROs have two major responsibilities: to oversee the markets and to oversee the brokers and investment dealers who operate in the respective markets. They do that in a variety of ways. First, they create standards that participants must meet prior to employment. They also create rules governing how markets must operate and they extensively investigate suspected infractions. And, they audit brokerage firms and dealers on a regular basis to ensure that firms are solvent and following the rules.

There are several self-regulatory organisations[494] whose rules, policies and decisions are an important part of securities regulation, which include the Toronto Stock Exchange ("TSE"), the Montreal Stock Exchange ("ME"), the Vancouver Stock Exchange ("VSE"), the Winnipeg Stock Exchange ("WSE") and the Alberta Stock Exchange ("ASE"), as the five principal exchanges, and the Investment Dealers Association of Canada (IDA).[495] These exchanges are non-profit organisations created by statutes to facilitate trading in securities through members of each exchange. The exchanges pass by-laws and rules to govern admission of new members and continued fitness of members, set out requirements for the listing of securities of issuers, the conditions to be met by listed

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[493] *E.g.*, s. 10.1. By-law No. 10 of the IDA "Board of Directors, National Advisory Committee and Meetings", s. 13.4. of by-law No. 13 "Election of Officers of the Association and of District Council Members": s. 2.01 of by-law No. 2.00 "Board of Governors" of the Winnipeg Stock Exchange.

[494] The subject of self-regulation is more fully detailed in D.L. Johnston, *supra* note 24, 386-403. See R. Lachcick, "Canadian Securities Law", (1992) 20 *Denver Journal of International Law and Policy*, at 360-61; R. Goulet, *Public Share Offerings and Stock Exchange Listings in Canada*, (CCH Canadian Limited, 1994) 89-91. See also Self-Regulation Generally, s. 19, *Can. Sec. L. Rep.* (CCH) P 450-491, at 55. 124 (1987); *Ibid.*, s. 20, P 450-492, at 55, 124 (1987); *ibid.*, s. 21, P 450-294, at 55, 124 (audit requirements).

[495] R. Lachcick, "Canadian Securities Law", *supra* note 494, at 358. See also M.R. Gillen, *supra* note 27, at 72.

issuers to maintain their listing, and govern the manner in which trading in listed securities is to be conducted by members.[496] These by-laws and rules of the exchanges are important sources of applicable securities regulations for issuers who have their securities listed on the exchange and for members of the exchange. Their function is to ensure that the qualifications, financial conditions, and standards of business and corporate conduct of both members and listed issuers are sufficiently maintained so that the market in listed securities is both fully informed and orderly. Exchanges also issue policy statements providing guidelines as to how they will exercise the discretion left to them by their by-laws or rules. These stock exchange policy statements are also important sources of information for listed issuers and exchange members.

Apart from establishing rules providing for disciplining members for violations of the applicable legislation or by-laws, the important role of the exchanges is to regulate the trading that occurs on their floors or "through their facilities" (*i.e.*, electronic trading is becoming more popular). To place public investors on an equal footing, the stock exchanges require, in conjunction with the securities commissions, timely and continuous public disclosure of material information concerning a listed company and its securities. The exchanges make stock quotations available for publication by quotation services and the financial media. The exchanges also look to the quality of management of applicants for listing, monitor members of the exchange and conduct market surveillance with a view to integrity and fairness in trading.

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[496] See, *e.g.*, Toronto Stock Exchange Act, S.O. ch. 27 (1982), as amended; General Bylaw, IV *Can. Sec. L. Rep.* (CCH) P 801-001.

The procedures and standards for recognition of an SRO with the commissions are not formalised.[497] There are no formal criteria to be applied in determining whether an SRO meets requirements for registration. The securities legislation in each province in which a stock exchange exists prohibits a person or company from carrying on business as a stock exchange in the province unless it is recognised in writing as such by the securities commission of the province in which it is based.[498] Every stock exchange must employ an auditor acceptable to that province's securities commission.[499] As for the IDA, the MSA expressly "recognises" the IDA only for purposes of auditing their members' financial affairs.[500] Any such recognition may be granted if the province's commission is satisfied by the particular organisation and subject to its terms and conditions.

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[497] The MSA does not define "self-regulatory organisation". For the definition see Section 1(1) of the OSA, according to which "self-regulatory organisation" means a person or company that represents registrants and is organised for the purpose of regulating the operations and the standards of practice and business conduct of its members and their representatives with a view to promoting the protection of investors and the public interest.

[498] For example, according to s. 139 of the MSA, a stock exchange, must be "recognised in writing as such by the commission". The Winnipeg Stock Exchange is the only recognised stock exchange in Manitoba.

[499] MSA., s. 32 states:

> "Each stock exchange in the province recognized by the commission, and the Manitoba District of the Investment Dealers' Association of Canada, shall
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> a) select a panel of auditors, each of whom is satisfactory to the commission and shall be known as a panel auditor or members' auditor; and
>
> b) employ an exchange auditor or a district association is subject to the approval of the commission."

[500] MSA., s. 32. Section 33 states:

> "Each stock exchange in the province recognized by the commission and the Manitoba District of the Investment Dealers' Association of Canada shall cause each member of such class or classes of their members as the commission may designate in writing to appoint an auditor from the panel of auditors selected under section 32, and such auditor shall make the examination of the financial affairs of such member as called the by-law, rules or regulations applicable to members of such class or classes and shall report thereon to the exchange auditor or district association auditor, as the case may be.

Section 33(2) of the MSA provides that,

> "The by-laws, rules and regulations of every stock exchange in the province recognized by the commission and the rules and regulations of the Manitoba District of the Investment Dealer's Association of Canada in respect of the practice and procedure of the examinations under subsection (1) and the actual conduct of the examinations, and any amendments thereto, shall be satisfactory to the commission."

A. The Investment Dealers Association of Canada

The IDA is an example of a SRO that is national in scope, thus comparable to the Russian NAUFOR, which is also national in scope.

The IDA is the Canadian investment industry's major national trade association and is a SRO.[501] Formed in 1916, it is an unincorporated, non-profit, decentralised national organisation which is further divided into regional District Councils in various provinces. Business is conducted through an extensive structure of national and regional committees, composed of industry members representing a diversity of business and geographic perspectives. In particular, a cross-country network of ten District Councils, representing each of the provinces, is invaluable in providing regional insight and input into a national decision-making process.

The IDA exists to protect the investing public and its members by: (1) establishing financial requirements for its members; (2) promoting and maintaining high standards of business ethics, conduct, and competence; (3) organising and administering educational courses for members, employees, and the public; and (4) sponsoring the Canadian Investor Protection Fund ("CIPF").[502] The IDA brings together under one roof the

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[501] As the industry's national trade association, the IDA represents approximately 115 member firms - big and small - employing more than 23,000 people in all provinces and abroad. As the industry's national SRO, the IDA regulates the activities of its member firms in all parts of the country. The IDA was formed in 1916, but had its genesis in 1911 when a group of Toronto bond dealers created the Bond Dealers' Section of the Toronto Board of Trade. They believed that, by associating on a formal basis, they could improve the savings and investment process and provide protection to the investor. As well, they could enforce the discipline of self-regulation and take responsibility for investor education. Over the past eighty years, these principles have remained intact.

[502] The four principal stock exchanges together with the Toronto Futures Exchange and the IDA sponsor the Canadian Investor Protection Fund. CIPF protects, within limits, public investor clients of a sponsor who suffer financial losses due to the insolvency of a member firm of one of the sponsors. The current loss limit by the CIPF in a client's general account is up to $500,000 in cash and securities, with a $60,000 cash limit.

member regulation functions of SROs. Consolidation ensures a uniform approach to the development and enforcement of rules. Its members handle most of the securities trading in Canada. The IDA seeks to maintain high ethical standards in the securities industry to protect the investing public and to promote a framework which encourages the raising and effective allocation of capital and efficiency of capital markets. It makes investment education available to industry members and to the public, interacts and co-operates with securities commissions, regulates capital and performance standards for its members, and makes public policy representations to government. In its Policy No. 2, issued on 1 March 1993, the IDA established minimum industry standards for retail account supervision. The Policy No. 2 deals with establishing and maintaining procedures by a member of the IDA, opening of new accounts, supervisory standards and client complaints. One principle of the Policy is to provide supervisors with a check-list to monitor compliance by registered representatives with the "know-your-client" rule and the suitability of a client's investments.

The IDA has a constitution, by-laws, regulations and policies that, among other matters, require its members to maintain adequate capital and insurance, and to meet prescribed standards of conduct. Members are required to file interim and audited annual financial statements with the IDA. The IDA has the right to examine and investigate the affairs or conduct of any member, officer, directors and salesperson, and may fine, suspend or expel a member or sales representative for due cause. A number of provincial Securities Acts specifically authorise an appeal to the securities commission from a SRO decision and empower the securities commission to recognise a SRO and to make binding decisions in

a number of respects, subject to court appeal. The MSA, however, does not cover an appeal to the commission of a decision of a SRO.[503]

Member regulation involves formulating national regulatory policies and rules, and then enforcing these standards. Financial compliance is carried out by the IDA's Compliance Department, while conduct of business compliance is performed by its Investigations Department. In turn, the IDA's regulatory actions are reviewed by provincial securities commissions.

The Compliance Department audits investment dealers on a regular basis, to ensure that firms are maintaining adequate capital in accord with the nature and volume of business they conduct. If a firm suddenly cannot meet its minimum capital requirement, the IDA can require action to correct the deficiency or suspend the member's trading privileges.

The IDA, as a further safeguard, screens all investment advisors who are employed by its members, to ensure those entering the industry are of good character and have successfully completed all the required industry courses.

Providing educational programs to improve the professional competence of employees of member firms' drives another critical stream of the IDA activities, which is also designed to protect investors and improve marketplace integrity. Historically, the IDA has been involved in educational matters, developing the industry's first professional courses in the

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[503] MSA., s. 29, states that: "Any person or company affected by a direction, decision, order or ruling of the director given or made under this Act or any other Act of the Legislature may....request and be entitled to a hearing and review thereof by the commission." Section 33.1. of the By-law No. 33 "Review by Securities Commissions" of the IDA states that: "Any Member or other person directly affected by a decision of the Board of Directors or a District Council...may request any securities commission given jurisdiction in the matter under its enabling legislation to review such decision and notice in writing of such appeal shall be given forthwith to the Secretary." Therefore, decisions of a SRO that directly affect any member or other person are not subject for review and appeal by the MSC under the MSA.

1940s. In 1970, the IDA, with support of the TSE, ME, VSE and ASE, created the Canadian Securities Institute ("CSI"), a major public education initiative, to offer courses to both the industry and the public. For example, a person wishing to become registered to sell securities in a Canadian province must take the CSI's Canadian Securities Course and pass an examination based on the CSI's textbook, entitled *Conduct and Practices Handbook for Securities Industry Professionals*.[504]

The IDA has also established the Investor Learning Centre which is a charity devoted to improving the public's knowledge about investing. The goal of this project is to make high impact educational programs available to the general public, programs that will build basic understanding and confidence in the investment process and explain, among other matters, how capital markets work, the basics of the fixed income and stock markets, and the safeguards provided by the self-regulatory system.

Beyond education, the IDA's communication with the public, governments, regulators and other related bodies, at home and abroad, plays an important part in developing and maintaining confidence in the integrity of the Canadian marketplace, and in subsequently encouraging participation in the savings and investment processes. As a result, the IDA maintains on-going contact with the news media on substantive industry issues, and releases relevant information to reporters, such as the industry's quarterly profitability reports and any disciplinary decisions taken by the IDA.

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[504] Over the past thirty years, over 150,000 Canadians, both in and out of the industry, have enrolled in the Canadian Securities Course, which is required for registration to sell securities in all provinces of Canada.

B. Self-Regulation In the Russian Securities Markets

The Federal Securities Law also provides for a system of self-regulation, somewhat different from that of Canada.[505] According to the FSL and regulations enacted by the FSC, SROs established by the professional market participants exercise their activity on the basis of a license issued by the FSC.[506] The FSC has established procedures for issuing licenses to exercise activity as a SRO.[507]

Under the FSL, SROs regulate professional securities market participants, protect their clients, and determine rules and standards for securities transactions that will enhance market efficiency.[508]

Each SRO must adopt rules and regulations governing its operations and its members. Such rules must provide for professional qualifications of certain persons associated with the SROs' members, minimum capital requirements, standards of conduct, price manipulation prohibitions, sanctions of SRO members and persons associated with members, and non-discriminatory procedures for the application of sanctions.[509] The rules and regulations must be submitted to the FSC and form a base on which the FSC may grant a permit authorising the formation of an SRO.[510] SROs are primarily concerned with policing their members and persons associated with their members, adopting rules governing trading in securities, and settling disputes among their members. For the most

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[505] FSL, *supra* note 2, Chapter 13, arts. 48-50.
[506] *Ibid.*, arts. 48-50, and "Regulation on Self-Regulatory Organisations - Professional Participants of the Securities Market", approved by Resolution No. 24 of the Federal Securities Commission (1 July 1997).
[507] "Regulation on Licensing of Self-Regulatory Organisations - Professional Participants of the Securities Market", approved by Resolution No. 24 of the Federal Commission (1 July 1997).
[508] FSL, *supra* note 2, art. 48.
[509] *Ibid.*, art. 50.
[510] *Ibid.*

part, SROs are not concerned with disclosure requirements nor with substantive regulation of the companies traded by their members. Each SRO establishes the requirements for listing on its exchange and, in the case of the NAUFOR,[511] for quotation outside the stock exchanges.

In the summer of 1994, securities firms in Moscow formed the Professional Association of Stock Market Participants (PAUFOR).[512] The incentive was that securities firms recognised the need to organise and differentiate themselves.[513] They also began to see the advantages of the retail markets and the need to attract more investors. The organisation developed rudimentary forms of self-regulation: the trading rules and disciplinary measures for violations of the trading rules were developed and an electronic trading system was put in place.[514] By early 1996, PAUFOR had enlisted 180 member firms.[515] Self-regulation arose in part out of fear of a more onerous bureaucratic solution. It also occurred as securities firms realised the growing sophistication of investors and the

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[511] Until recently, NAUFOR was known as the Professional Association of Securities Market Participants, or PAUFOR. See Adam Smith Institute, Capital Market Report 2, 2 p. 12 (4 July 1996).

[512] Liam Halligan , "Russia Comes in from the Cold" *Euromoney*, Sept/ 1995, available in LEXIS, WORLD Library, ALLWLD File.

[513] Exchanges in Russian market were not well-regulated and abuses by brokers went unchecked. As a result the exchanges for the purpose of governing conduct of brokers became largely irrelevant; securities firms executed most stock transactions over-the-counter. This developmental process had other adverse consequences. In general, passive investors had limited interests in the markets. Those investing sought to accumulate substantial, sometimes controlling, blocks of shares. Securities firms acquired shares for specific investors, taking them into inventory and reselling them as a block. They therefore acted more like dealers than brokers. As a result, securities firms paid little attention to the retail market, ignoring the simple matching of buyers and sellers that is a prerequisite for an active secondary market. By mid-1994 the picture had begun to change.
For more information on the subject of unregulated brokers' activities and on the motives of the establishment of the PAUFOR, see J.R. Brown, "Of Brokers, Banks and The Case for Regulatory Intervention in The Russian Securities Markets", (1996) 32 *Stanford Journal of International Law*, at 190-93. See also P. Thomson & R. Sharipov, "Securities Regulation in the Russian Federation", (1995) 25 *Denver Journal of International Law and Policy*, at 113; M.I. Steinberg, "Emerging Capital Markets: Proposals and Recommendations for Implementation", (1996) 30 *The International Lawyer*, 715-738.

[514] *Ibid.*

importance of reputation in attracting clients. In effect, PAUFOR was a group of prominent securities firms that wanted to signal to investors, both foreign and domestic, that they adhered to higher standards of behaviour.[516] Becoming organised had practical advantages as well. An increasing percentage of trading took place over the electronic trading system. Consequently, transactions settled more quickly. The typical transaction settled in days instead of weeks or months, as was formerly the case.[517] By late 1995, Russian capital markets were becoming increasingly organised, suggesting the possibility that Russia would develop a central trading market. A NASDAQ-style electronic system, the Russian Trading System used by PAUFOR, has gradually become more effective since a faster version was installed in the summer of 1995.[518] It allows firms to conduct negotiations over the computer screen. More important, by making the system more effective, the trading association has developed a mechanism for ensuring improved behaviour by members. To the extent members engage in unacceptable conduct, they can be forced out of the association and denied access. Because the biggest part of the trading volume takes place within the system, expulsion threatens a significant loss of business.[519]

The unification of brokers in professional associations was taking place not only in Moscow but also in other regions. A number of regional investment companies in

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[515] Natasha Mileusnic, "Bust Looms for Brokers as Market Slows", *Moscow Times*, 20 February 1996, available in LEXIS, WORLD Library, ALLWLD File. Initially the system linked in one network the four big over-the-counter markets in Russia: at Moscow, St. Petersburg, Novosibirsk and Ekaterinburg.
[516] Neela Banerjee, "Russian Securities Trading: A Business with a Past, Best Future on Regulation", 8 *Wall Street Journal*, February 1995, at All.
[517] Peter Lee, "Sitting Out the Russian Winter", *Euromoney*, January 1996, at 50-55.
[518] See generally, Julie Tolkacheva, "RTS to Speed, Spread Trade", *Moscow Times*, 21 June 1995, available in LEXIS, WORLD Library, ALLWLD File.
[519] *Ibid.*

Novosibirsk, St. Petersburg and Ekaterinburg formed associations, analogous to PAUFOR. Working together similar trading rules in time brought together PAUFOR and the independent regional organisations of brokers. In the Autumn of 1995 it was obvious that the unification of all associations of brokers in Russia into one nation-wide association would allow better co-ordination of their joint efforts. Consequently, on 30 November 1995 representatives of the four regional associations of Russia gathered and declared the foundation of an interregional association of securities market participants with PAUFOR, a prototype of the future nation-wide self-regulatory organisation in Russia known as NAUFOR.[520] The introduction of the Russian Trading System, a computerised quotation system operated by NAUFOR, has provided the natural impetus for self-regulation and made the OTC market more similar to a stock exchange.

NAUFOR, an SRO with authority over its members, is analogous to the IDA in Canada. It has rules and regulations that govern the conduct of its members and aim at the protection of investors. One primary objective of NAUFOR activity is the organisation of professional education and training of securities markets' participants, as well as participation in accrediting of securities market's specialists programs.

Until recently, NAUFOR combined two functions, as a SRO and an organiser of the over-the-counter market. In 1996, when the FSL and the interim resolution of the FSC "On Requirements to Organisers of Trading on the Securities Market" came into force, the NAUFOR was required to separate the two functions and to obtain licenses for each professional activity separately. In order to fulfil these requirements, in 1997 NAUFOR

[520] Presently, the NAUFOR combines 860 companies situated in ten regions of Russia and has its branches in St. Petersburg, Novosibirsk, Ekaterinburg, Vologgrad, Nyghnii Novgorod and Rostov-na-Donu.

excluded all matters concerned with the organisation of trading in securities from the jurisdiction of NAUFOR and delegated authority over these matters to a newly established non-commercial partnership: "The Russian Trading System" ("the RTS"). In March of 1997 "the non-commercial partnership "RTS" was granted a license and it became the first officially recognised organiser for over-the-counter market trading.

Any securities market participant with capitalisation over $100,000 U.S. may become a NAUFOR member.[521] Admission decisions are made by the NAUFOR board of directors upon recommendations of an existing member and the NAUFOR membership committee.[522] A nominal admission fee for new membership[523] with a recurring, nominal monthly fee is required.[524] Members may be expelled on the following grounds: payment default of membership fees during any three-month period, violation of the NAUFOR Membership Rules, or dissolution of the membership. Expulsion requires a seventy-five percent majority vote of the NAUFOR board of directors.

All NAUFOR members must submit disputes among themselves related to securities operations to the NAUFOR arbitration tribunal. Any operation agreement between members must include an arbitration provision.[525]

According to Article 39 of the FSL, a stock exchange must be licensed by the FSC upon its written application and formed as a non-commercial partnership.[526] The FSL requires

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[521] NAUFOR Membership Rules as approved on 21 April 1995, art. 1.1 [hereinafter, NAUFOR Membership Rules].
[522] *Ibid.*, arts. 2.2, 2.3, 3, 4.1, 4.3.
[523] U.S. $5,000 is payable within five days after the decision of the board of directors. *Ibid.*, art. 5.1.
[524] All members of the association are also required to make periodic payments in the amount of U.S. $500 per month. *Ibid.*, art. 5.2.
[525] *Ibid.*, art. 6.3.

a stock exchange to adopt trading rules and listing requirements[527] and to maintain and publish a pricing system.[528] Also, pursuant to Chapter 3 of the FSL and Article 9, a stock exchange is required to adopt and enforce regulation of its members, and may impose monetary penalties for the violation of these regulations.[529] It also may suspend or revoke membership of a violator on the basis of its internal rules and procedures.[530]

As mentioned above, in addition to the regulation of stock exchanges, the FSL provides some framework for a system of self-regulation in the securities industry.[531]

In order to acquire a license issued by the FSC, the FSL explicitly requires the SRO to submit its rules and regulations to the FSC, which must include the following: (1) the professional qualifications of personnel (excluding technical personnel); (2) the rules and standards for engaging in professional activity; (3) rules limiting the manipulation of prices; (4) documentation, accounting and financial reports; (5) the rules governing the admission to membership of a professional participant in the securities market, and also his withdrawal or exclusion; (6) the protection of the rights of clients, including procedure for review of a client's complaints by members of the organisation; and, (7) sanctions and other measures applied to members of the organisation, and many others enumerated in this article.[532]

The system of self-regulation adds efficiency to the enforcement of the securities laws. The SROs are most closely involved in the day-to-day running of the market and

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[526] FSL., *supra* note 2, art. 11, para. 2.
[527] *Ibid.*, art. 13, para. 4.
[528] *Ibid.*, para. 5, and art. 9.
[529] *Ibid.*, para. 3.
[530] *Ibid.*, art. 12, para. 1.
[531] *Ibid.*, Chapter 13, arts. 48-50.

therefore are best situated to perform the bulk of securities regulation. Even though the SROs can potentially be biased in favour of industry members, proper supervision by the governmental agency should assure a disinterested position.[533]

C. Comparison Of Self-Regulation

From the foregoing, the following comparison can be made between the Russian and Canadian systems of self-regulation:

1. Both systems of self-regulation have the same objectives and goals.
2. In both systems, securities commissions have the power to review and make decisions respecting the by-laws, rules and other regulatory instrument or policies, or a direction, decision, order or ruling made under a by-law, rule, regulation, or policy of a self-regulatory organisation or stock exchange.
3. An important feature of the FSL with respect to SROs is that it formalises the procedures and standards for registration of an SRO with the FSC,[534] establishing criteria to be applied in determining whether an SRO meets requirements for registration. This contrasts with the present situation in Manitoba, where the MSA provides simply that a stock exchange must be "recognised in writing" by the MSC, and expressly "recognises" the Investment Dealers Association of Canada only for the purposes of auditing their members' financial affairs.
4. The FSL provides a finite list of grounds for refusal to issue a license to SROs, unlike the MSA.[535]

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[532] *Ibid.*, art. 50.
[533] See N. Poser, *International Securities Regulation: London's "Big Bang" and European Securities Markets*, (Boston: Little, Brown, 1991) at 83-90 (discussing the Gower Report, *see* L.C. Gower, "Review of Investor Protection" (1984), and the British government's "White Paper".
[534] FSL., *supra* note 2, art. 50.
[535] *Ibid.*

IX. CONCLUSION

A fundamental policy objective underlying securities regulation is "the protection of the investing public".[536] While the intention is not to provide a paternalistic level of protection for the investor, every effort must be made to ensure that the public understands the normal business risks associated with investments in securities.[537]

"[t]his is not to suggest that the public must be protected against itself; rather, it is a matter of ensuring that the investing public has the fullest possible knowledge to enable it to distinguish the different types of investments activity available. In such circumstances, the public would have reasonable assurance that its losses are genuine economic losses, just as its gains are genuine economic gains".[538]

Thus the investor is to be permitted to incur a loss. However, the loss should be a genuine economic loss. In any case, the price at which an investor purchases or sells a security should be a fair estimate of the value of the future cash flows it will generate.[539]

However, the goal of protection must be achieved while taking into account a diverse range of other objectives, such as development of financial institutions which assure rational and sensible allocation of financial resources in the economy,[540] promoting confidence in the market.[541]

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[536] *Kimber Report*, *supra* note 37, at para. 1.06.
[537] M. Gillen, *supra* note 27, at 60.
[538] *Kimber Report*, *supra* note 37, at para. 1.12.
[539] M. Gillen, *supra* note 27, at 63.
[540] *Kimber Report*, *supra* note 37, at para. 1.06.
[541] *Ibid.*, para. 1.11.

The history of modern capitalism analysed by Robert Clark has several stages.[542] In the first, the economy was dominated by entrepreneurs who managed their own capital.[543] This stage lasted into the twentieth century, characterised by enactment of general incorporation statutes and "enabling" laws.[544] As western economies developed further, new ventures required extensive instruments of capital in amounts beyond the resources of even the richest entrepreneurs. At this point, "the entrepreneurial function was split into ownership and control," and capitalism entered its second stage of professional management.[545] This stage "required the legal system to develop stable relationships between professional managers and public investors, ostensibly aimed at keeping the former accountable to the latter, but also at placing full control of business decisions in the managers hands."[546] The third stage has further separated ownership into capital and investment and professionalized investment management.[547]

The development of free market capitalism in Russia does not fit this model. Although capitalism is undergoing the early stages of development, the lines between these stages are blurred and the transition from one stage to another is occurring with near lightning speed. Today we already see a growing class of people who have accumulated significant capital and are now willing to invest this capital by using the services of professional managers. Governments of former communist countries do not have the luxury of evolutionary, slow-going development. The speed with which capital flows between

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[542] R.C. Clark, "The Four Stages of Capitalism: Reflections on Investment Management Treatises", (1981) 94 *Harvard Law Review* 561, 562-69.
[543] *Ibid.*, at 562.
[544] *Ibid.*
[545] *Ibid.*, at 563.
[546] *Ibid.*
[547] *Ibid.*, at 564.

competing investment opportunities does not allow for evolutionary development in any emerging market, including Russia's. Russian capitalists did not get a chance to learn the basics from their own experience, so they have scores of academic works and dozens of mentors available. And these Western mentors teach them not only the principles of honest business and fair dealing, but also the tricks, legal fictions and deceptive devices perfected throughout the history of capitalism. In fact, fraud and deceit are so common among these new capitalists that the government of Russia cannot afford mere responses to economic changes; they have to anticipate these changes and act accordingly.

For that reason, securities regulation in Russia must be developed as quickly as possible. It is true that Russian securities regulators and the Russian judiciary do not have sufficient expertise and exposure to handle complex securities matters. Countless regulations need to be adopted to assure proper functioning of the market. For example, regulations on take-over bids, insider trading, proxies and enforcement are all needed now. All these problems must be resolved before, not after, the securities market in Russia has reached its full capacity. In other words, the Russian securities legislation must be proactive rather than reactive.

In a short period of time, compared with the developed securities market of Canada, Russia has successfully provided the beginnings of the framework necessary for the proper functioning of their securities market. Basic, essential legislation is in place. Certainly, the Russian market has a great deal to offer to both western and domestic investors. Whether this potential will be realised depends to a large degree on the market regulators. Investors want to have a high degree of confidence in a market, and only

governmental or effective self-regulation can give them that confidence. To induce investors to enter these markets, an oversight authority must be in place to help engender much needed confidence in market integrity. Where questionable practices prevail, or are so perceived, mechanisms must be implemented to enforce the applicable law and to deter fraud. Nobody expects the government to guarantee the economic value of investments; but at the very least, investors want to be sure that they will not be cheated out of their life savings by crooked brokers running sham operations. This assurance is something that government can provide.

At present, the Russian securities market and its regulation is becoming a reality. Russia is ready, willing, and able to undergo the process of transformation from a securities market in theory to a securities market in reality. The process may take a long time, but the basic legislation reviewed in this paper demonstrates that Russia is moving in the right direction.

The securities markets in Canada were initiated by merchants; government intervened only decades later. In the process of studying Russia, we observe a completely different phenomenon. The governmental regulation of securities in Russia is designed primarily from the centre of power to develop and build the market. Whether or not this experiment will succeed remains to be seen.

Even a cursory look at the FSL shows that it lays down basic rules for any emerging securities market. At the very least, the law gives an investor in the Russian market the ability to purchase a registered security, accompanied by a disclosure statement through a licensed securities professional, where both the issuer of a security and the securities

professional are subject to liability for fraudulent acts. Even though these rules may be imperfect, they do bring a basic form of investor protection. Without that protection, a securities market in Russia would be impossible, regardless of its economic conditions.

The rules of the Russian securities market have been developed, however enforcement measures remain unfulfilled. A system of sanctions for infringement of securities laws, legal procedures of administrative proceedings, criminal proceeding against market participants who violate the law and civil liability for violation of stock market laws are urgently needed.

Having analysed the substantive provisions of the MSA and securities legislation in the Russian Federation that relate to investor protection, we can see that Russia, in a short period of time has provided a general legal framework for its securities market. Without enforcement of such provisions it is doubtful that an adequate regime for protecting investors and creating investor confidence can be achieved in the next century.

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