CHAPTER ONE

FOUNDATIONAL CONCEPTS

I. INTRODUCTION: KEY DEFINITIONS

Securities legislation imposes considerable substantive obligations on those subject to its ambit. Accordingly, it is important to have as clear an understanding as possible of when the legislation and accompanying rules and policies apply. As we will see in this chapter, the basic building blocks of securities law are characterized by significant ambiguity and open-endedness. In most provinces, the three most significant of these basic statutory concepts are "security," "trade," and "distribution." However, while the Québec *Securities Act*, CQLR c V-1.1 (QSA) employs the term "security," s 1 notes that the Act applies to "the following forms of investment." The QSA does not contain a definition of "trade." A tiered form of analysis is usually used to determine whether and to what extent securities law applies. Thus, if the item being bought or sold is not a security, the law in this area does not apply. If a security is not being traded, there are no registration or disclosure requirements. If the trade does not amount to a distribution or an offering of securities, there is no question of a prospectus requirement or an exemption to this requirement. This progressive definitional approach is useful to begin the analysis of when and how substantive securities law applies, though regulators have rendered it more complicated through their decision-making. See the Ontario Securities Commission's (OSC) decision in *Re Albino* (1991), 14 OSCB 365, below.

A further objective of this chapter is to introduce several other basic concepts that will be referred to in the chapters to follow. These concepts are necessary to understand the interaction between legal and finance or economic principles in this area. One of these is the concept of "efficiency." Another is the finance concept of "valuation." And a third is the notion of "materiality," which, as we will see, triggers the disclosure requirements imposed by the legislation. Finally, we also introduce the concept of "systemic risk," which has become the subject of much debate since the global financial crisis (GFC).

II. WHAT IS A SECURITY?

Many people think of company shares or bonds as quintessential examples of securities. Indeed, these types of financial instruments are specified as securities by clause (e) of the definition of security in the Ontario *Securities Act*, RSO 1990, c S.5, s 1(1) (OSA), which refers to, for example, "any bond, debenture ... share, stock, unit." We will examine the language of the definition of security in provincial statutes below. Before doing so, however, let us look at some examples of more specialized financial transactions engaged in by business entities, financial institutions, or entrepreneurs. They are, admittedly, rather complex, but provide real-world examples of transactions where the analyst must consider the application of securities regulation principles. The issue is, therefore, how would we decide whether securities law, requiring disclosure of information and the possibility of sanctions, should apply to these transactions? Keep in mind that you are considering whether the legislative definition of a security, as interpreted by the courts and discussed below, helps us to decide. Let us look first at a type of financial instrument that has grown in popularity and in which various regulators have been interested.

A. SEGREGATED FUNDS

A form of investment that is popular in Canada is an investment in an individual variable insurance contract (IVIC), also known as a segregated fund. This product is sold by insurance agents in Canada, and sales are overseen by insurance regulators, who enforce guidelines promulgated by the Canadian Life and Health Insurance Association (CLHIA). According to the CLHIA website, there are $446 billion held in segregated fund assets in Canada as of the end of 2023 (*Canada Life & Health Insurance Facts* (Toronto: CLHIA), online: <http://clhia.uberflip.com/i/1526931-canadian-life-and-health-insurance-facts-2024-edition/3?>). An IVIC is defined in CLHIA guidelines (incorporated by reference into Ontario Regulation 132/97 (*Variable Insurance Contracts*)) as follows:

"individual variable insurance contract" means an individual contract of life insurance, including an annuity, or an undertaking to provide an annuity, as defined by provincial and territorial insurance statutes and by the Civil Code of Québec, under which the liabilities vary in amount depending upon the market value of a specified group of assets in a segregated fund, and includes a provision in an individual contract of life insurance under which policy dividends are deposited in a segregated fund.

A brochure for consumers issued by CLHIA provides further detail about the benefits of investing in segregated funds (*Key Facts About Segregated Funds Contracts* (Toronto: CLHIA), online: <http://clhia.uberflip.com/i/405148-key-facts-about-segregated-fund-contacts>). These include the facts that guaranteed death benefits and potential creditor protection are included. The brochure notes that "in addition to these special contractual features" segregated funds offer diversification through a selection of growth, income and balanced funds, flexibility to switch between funds offered within the same contract, and liquidity allowing the investor to "promptly redeem all or part of your investment" (at 2). Ontario Regulation 132/97 prescribes material that is required to be filed by insurers with the Financial Services Regulatory Authority of Ontario (FSRA) and defines what constitutes unfair or deceptive practices with respect to the sales or marketing of IVICs or the treatment of segregated fund assets.

Another genre of investment opportunity has been considered by the OSC.

B. VIATICAL SETTLEMENTS

RJ Herron, "Regulating Viatical Settlements: Is the Invisible Hand Picking the Pockets of the Terminally Ill?"

(1995) 28:4 U Mich JL Ref 931 (footnotes omitted)

One such technique, the "viatical settlement," was developed in the late 1980s as a response to the financial needs of PWAs [people with AIDS] and other terminally ill people. In a viatical settlement, a terminally ill policyholder (the viator) assigns the death benefit of his policy to a viatical settlement provider (the company), in exchange for an immediate payment of less than the expected death benefit of the policy. By the terms of the agreement, the entire death benefit is paid to the viatical settlement provider upon the viator's death. Although viatical settlements theoretically could be available to anyone with a dramatically shortened life expectancy, the vast majority of viatical settlements have been undertaken by PWAs, with terminal cancer patients comprising much of the remainder.

From the viator's perspective, the viatical transaction itself is fairly simple. The applicant contacts as many viatical settlement providers as he wishes and fills out detailed application forms, typically consisting of a questionnaire, an authorization to release medical records, and an authorization to release insurance policy information. Once the viatical provider has received all of the information, its panel of physicians evaluates the applicant's records and renders an opinion to the provider as to the applicant's prognosis. If the provider finds that the applicant has a sound insurance policy and, in consultation with its physicians, finds that the applicant has a qualifying condition that results in a life expectancy of less than two years, the provider then calculates a purchase price and makes an offer to the applicant. The offer typically amounts to between fifty and eighty percent of the policy's face value. If the applicant accepts the offer, the provider and applicant (now a viator) sign the purchase documents, which include a purchase agreement for the policy, a change of ownership form, and a change of beneficiary form. The latter two forms

then are forwarded to the viator's life insurance company, which records the information, files the documents, and sends a confirmation to the viator. Once the viatical provider receives confirmation of the changes, it pays the viator, in a lump sum, the full amount of the viatical settlement, either by cashier's check or wire transfer. The entire process can be completed in three to six weeks.

C. CRYPTO

Since 2008, there has been enormous public and regulatory interest in the arrival on the financial scene of a genre of asset known as "crypto" or digital assets. The excerpt below explains the foundations and development of this market.

Lev Breydo, "The Broken Token Problem: Why Crypto Classification Remains Elusive"

(2024) 55:1 Seton Hall L Rev 67 (footnotes omitted)

A. Technology and Terminology

The contemporary crypto sector can trace its start to a seminal 2008 paper proposing a system where "online payments [could] be sent directly from one party to another without going through a financial institution." Blockchain is the fundamental technology underlying that system; Bitcoin, a cryptocurrency launched in 2009, is the associated unit of account. While Bitcoin remains the best-known and most valuable crypto asset, the sector now encompasses thousands of instruments with aggregate value exceeding $1 trillion as of 2023, down from a $3 trillion peak in 2021.

Blockchain's "complex technology" achieves the straightforward utility of "providing a distributed yet provably accurate record." In simplest terms, blockchain can be analogized to an advanced database technology. That observation is intended to contextualize rather than trivialize blockchain's significance—after all, "[m]odern life consists in large part of entries in databases." The technology's potential benefits and use cases encompass a wide range of transactions, optimizations, and business models—though the financial sector's dependence on layered intermediation renders it particularly susceptible to prospective disruption through blockchain adoption.

"Cryptocurrency" is defined as "a form of digital money secured not through the backing of a state or financial institution, but through cryptography." The structural relationship between crypto and blockchain is that permissionless (public) ledgers—open systems available to anyone—use "their currencies to incentivize activity," typically in the form of so-called utility tokens, as described below. This feature is one of the factors driving the proliferation of crypto assets. Permissioned ledgers (closed systems), in contrast, do not require such incentives, and thus do not require cryptocurrency.

B. Sector Growth Phases

Between Bitcoin's 2009 launch and the present, the crypto sector experienced vast growth tempered by high volatility. The sector benefitted considerably from broad-based themes of the 2010s inter-crisis decade, including favorable macroeconomic conditions, rapid technological growth, and residual distrust towards "powerful institutions." Echoing these dynamics, crypto adoption has been strongest with

groups historically marginalized by the traditional financial system, including communities of color. Socio-culturally, crypto became as much about equity and inclusion as technology and finance.

The crypto sector's development can be described through five distinct phases ...

Phase one formally began in 2009 but truly took off with the 2014 launch of the Ethereum blockchain—described as a "decentralized computer" that can be utilized by "all users [who] can access the code and operate it as a form of decentralized application akin to running 'apps' on a cellphone." Ethereum significantly expanded crypto use cases, quickly becoming the sector's quasi-infrastructure and technological foundation for many crypto assets.

Phase two, the 2017 initial coin offering (ICO) wave, was characterized by a proliferation of new crypto assets, largely developed on Ethereum's infrastructure. The year 2017 saw over 200 ICOs—essentially an unregulated cross between crowdfunding and an initial public offering—followed by thousands more in subsequent years. This period largely established the foundation for the space as it exists today ...

Extensive ICO market abuses led to a regulatory crackdown, ushering in the third phase: "crypto winter," from December 2017 until March 2020, which saw Bitcoin prices fall nearly 73 percent. Most consequentially, this period marked a shift in policymakers' perspectives, with increased crypto skepticism amongst some regulators, including the SEC in particular.

Crypto's "COVID bull market" began in March 2020, as unprecedented global stimulus pushed risk assets to record levels, with Bitcoin jumping nearly 1200% and total sector value exceeding $3 trillion. Crypto became top of mind like never before, leading to further proliferation of new assets and increased sector sophistication through traditional finance tools like leverage and derivatives.

By early 2022, the boom turned to bust, with a $2 trillion collapse of crypto value, cascading failures of many of the largest players—including FTX, Celsius, and Voyager—and widespread findings of fraud and "Ponzi-like" activities. Nonetheless, many "everyday investors" still "believe digital currencies are their best chance at building significant wealth," with 39 percent keen to buy more.

A deeper dive into the properties of bitcoin specifically is provided in the following excerpt.

Janis Sarra & Louise Gullifer QC (Hon), "Crypto-Claimants and Bitcoin Bankruptcy: Challenges for Recognition and Realization"

(2019) 28:2 International Insolvency Rev 233 (footnotes omitted)

2.1 The Context—Cryptocurrency Generally

Although the idea of electronic payment denominated in fiat currency is not new, the generation and holding of value not so denominated, by the use of public ledgers operating blockchain technology, has developed rapidly over the last few years. Value is set by the "market" price, whereas the market includes all participants, not just those participants that are nodes. It also includes those individuals and entities that buy bitcoin for fiat currency and those who accept it for goods and services, even if they themselves are not nodes but do their transactions through intermediaries. Value is recognized by agreement within the community of users of the virtual currency.

Cryptocurrencies can take many forms, and as a group, they share few common characteristics. A cryptocurrency is a digital asset designed to act as a store of value or medium of exchange in the digital economy. Cryptocurrencies are not controlled or regulated by any single authority and can, in some circumstances, be issued without any major approval process. There is no centralized issuer of such products or a trusted third party that manages them, and until very recently, they have been independent of central banks and other financial institutions. In addition to being used for the "money-like" functions of being a method of payment and a store of value, issues of digital "coins" are frequently used as a means of raising financing. One of the difficulties in defining cryptocurrencies such as bitcoin is that the holder of the cryptocurrency does not physically "hold" the coin. Unlike money, which is either in physical form or takes the form of a right against a trusted third party such as a deposit-taking bank, or securities, which are rights against the issuer and are either materialized or held by trusted intermediaries regulated by securities law, the coin holder has neither anything physical nor a right against an intermediary. Instead, at least in the case of bitcoin, the coin holder has the ability to transfer bitcoin that are recorded as being held by a particular "public key" by use of a "private key."

2.2 The Role of Blockchain in Bitcoin and Other Cryptocurrencies

Blockchain technology is critical to bitcoin and other cryptocurrencies. A blockchain is a distributed ledger containing a record of all transactions. The term "blockchain" was crafted as shorthand for a "chain of blocks of transactions" that are part of the bitcoin system. Blockchain technology provides a way of holding information in a secure way. It can be used for many purposes, ranging from the holding of medical records to registers of interests in land. However, in this article, we are concerned with its use as the record of the creation and transfer of bitcoin. Bitcoin's blockchain is public in the sense that all transactions are visible, and it is "permissionless" in the sense that any computer may participate in validating transactions and adding them to the ledger.

Blockchain technology has several components. One is that every piece of information added to it is heavily encrypted, so that it is very hard to change. Moreover, each piece that is subsequently added would have to be changed to change the previously recorded information. The practical result is that information stored in a blockchain is immutable.

Another component is that the record of transactions is held on a distributed ledger, that is, it is recorded on many computers (nodes), and the system includes a process whereby information is synchronized on all nodes simultaneously. Thus, the ledger contains every transaction ever processed. For any piece of information to be changed, the record on each computer would need to be changed, requiring all the computer users to agree. Thus, information can be held securely without the involvement of a trusted intermediary. It is also publicly available to anyone who can access the blockchain. The amount of information provided publicly does, of course, depend on the way the system is set up. Under the bitcoin system, for example, all transactions are public, but they are pseudo-anonymous in that the parties involved are only identified by their addresses, which are not linked to any real-world identification.

In addition to the security and immutability that blockchain technology provides, it also enables two other features that are important in relation to bitcoin. The first is that every transfer that is added to the blockchain is checked against all other

transactions to ensure that there is no double spending, that is, that the same currency is not transferred twice. Under existing payment systems, this function has to be performed by a trusted intermediary. The second is that the supply of bitcoin is artificially limited to those "created" when the system was originally set up.

2.3 How is Bitcoin Created and Transferred?

Bitcoin is one of the most well-known and widely circulated cryptocurrencies, although many others are now very prominent in the market. The bitcoin network was created in 2008 by one or more software developers calling themselves "Satoshi Nakamoto." As with any distributed ledger technology system, the rules of this system (the "protocol") are fixed in advance and can only be changed by whatever procedures are laid down in the protocol. The distributed network itself consists of "nodes," that is, many computers around the world, each of which hold all the relevant data at any one time, which add to this store of data by a means laid down in the protocol. The data held on this network are, in the case of bitcoin, a record of the creation and each transfer of bitcoin. The way in which the balance associated with each public key is recorded and displayed varies from network to network.

To give an example, the "balance" of bitcoin (known as the "unspent transaction output" or "UTXO") is actually just an aggregate of transfers in and out. It is not possible to transfer out part of one transfer in: the whole amount has to be transferred out and then any "change" has to be transferred back. Ethereum, on the other hand, works more like a bank account: The transfers in are mixed in what is called an "account" and transfers out come from the mixed balance in that account. The difference in these methods masks a critically important underlying point: what is actually recorded on the blockchain are the transactions and not the coins. The "coins" are merely the result of the transaction, which is why it is so difficult to say what bitcoin is. Despite this challenge, most, if not all, of the discussion of bitcoin conceptualizes it as something, usually something analogous to something in the real world, such as a physical coin or bank account, as these analogies are the only way to describe bitcoin sensibly. The following discussion will, to a large extent, follow this pattern.

All bitcoin were "created" when the system was set up and are released during the mining process, which is described below. Each unit is called a "bitcoin," but bitcoin, which are now each worth several thousand pounds, can be divided into smaller units. One bitcoin is equivalent to 1,000 millibitcoins, 1,000,000 microbitcoins, or 100,000,000 satoshis. Bitcoin are created in relation to, and can be transferred to, a unique address, which is derived from a public key: The address is a "hashed" public key and consists of 34 numbers and letters. A unique private key is associated with each public key, generated at the same time as the public key, and is mathematically related to it. The private key is a unique alphanumeric identifier, a cryptographic code that is essentially a long string of 64 numbers and letters, which is used to verify any transactions related to the public key.

As mentioned above, these transactions are what is recorded on the blockchain, and both the public key and transaction information are publicly available to anyone with access to the blockchain. The public key contains no other information, so that it is not possible to identify the person who holds that public key without more information from outside the blockchain itself. Any number of addresses can be created, and frequently, a new address is created for each transaction. It is not possible to discover the link between the public and the private key from the information available on the blockchain, and because the private key is necessary in order to transfer the bitcoin, the "holder" of the bitcoin needs to make sure that no one else has access to her private key.

There are various ways of storing the private key, such as recording it on a piece of paper, storing it in an offline cryptocurrency hardware wallet that can be held on a computer hard disk or server, printing it on a metal disc or bracelet to make a physical bitcoin, or storing it in an online or software wallet, such as an iOS wallet or an android wallet, in the cloud and accessed through an app or held by third-party servers. Secured storage is critically important because if the private key is lost, the bitcoin are lost as well.

A transfer between addresses derived from public keys is effected by the transferor issuing an instruction, which is combined with the private key to generate a signature. This signature is then combined with the public key on the blockchain, which enables the blockchain network to verify the transaction. Although the network can only see the public key and the signature, the system is set up in such a way that only a signature created with the private key will work with that particular public key. The transaction is then checked by the network against all other transactions recorded against that public key, to check that there is no double counting, an important feature of the system. The next stage is that the transaction, together with many other transactions, becomes a block and is added to the blockchain.

The system is sometimes referred to as a "pseudo-anonymous system," because although names are not used, every transfer identifies the address (public key) of the sender and the address of the recipient. The private key is therefore used to verify the transaction and is both necessary and sufficient to effect a transfer of the associated bitcoin. The person who holds (and uses) the private key thus controls (and, arguably, owns) the bitcoin associated with the public key. However, it is possible for an unauthorized person to obtain, and use, the owner's private key, in which case the transaction would be unauthorized. This reasoning is important when considering what is meant by "owning" bitcoin, and also what practical means are open to an insolvency practitioner to realize the value of bitcoin owned by an insolvent party.

The verification process and the adding of bitcoin transactions to the blockchain are done by a subset of the nodes known as "miners." The mining nodes use very considerable computing power to group transactions into blocks and to add the blocks to the blockchain according to the strict rules of the protocol. The mining nodes compete to solve a complicated mathematical problem, the answer to which is used to add the block of transactions to the blockchain. The node that solves the problem first obtains, as a reward, a certain number of bitcoin, creating incentives in the system to add another layer to the blockchain. These "new" bitcoin are actually already programmed into the system but have not yet become able to be held or transferred. Once they are "mined," they become part of the system and can be held or transferred.

2.4 Ways of Holding Bitcoin

There are different types of people and entities that hold bitcoin, although only the first two types identified below actually hold them directly. First, there are the mining nodes who have the whole of the blockchain on their computers and who perform the mining process described above. Second, there are people who download nonmining nodes onto their computer, who are split into two groups: those individuals or entities that have downloaded the whole blockchain and those who only have a limited copy. These direct holders of bitcoin can give their own instructions as to transactions. Third, there are people who do not have any of the blockchain on their computer but who store their private keys using "custodial wallets" that are often provided by bitcoin exchanges or other custodians. In a custodial wallet, the

wallet provider stores the private key for the owner and may also execute transactions for customers, including enabling them to exchange their bitcoin for fiat currency, such as USD, EUR, or GBP.

It is important to separate out the custody function and the trading function. A bitcoin exchange is an entity that matches sellers of bitcoin to buyers, charging a fee for the service, like an exchange of any tradable asset. The price for the sale can be fiat currency or other cryptocurrency. This account focuses on the former. Since the exchange matches buyers and seller, both need to be registered with the exchange. A bitcoin exchange facilitates the purchase by effecting the transfer of money in one direction and bitcoin in the other direction.

The fiat currency price is usually paid by the client either uploading fiat currency to an "account" held with the exchange, which appears to be on a title transfer basis, with the exchange holding the fiat currency in a bank account in its name, or by the client paying for a single transaction with a credit or debit card denominated in fiat currency. In the former case, the exchange will, on an authorized instruction, make the payment to the seller's account with it, or by a transfer of fiat currency into a nominated account. The transfer of bitcoin for the other leg of the purchase is also effected by the exchange, which is why clients on both sides also need to hold bitcoin in a wallet hosted by the exchange. This wallet is controlled by the exchange; in other words, the exchange controls the private key. Thus, the exchange can, on the instructions of the selling client, transfer the purchased bitcoin from the seller's wallet to the buyer's wallet.

The custodial services provided by an exchange, or an entity that only functions as a custodian, typically operate as follows. The client opens an "account" with the custodian and transfers bitcoin into its account from an external source or by purchasing it from another client (if the custodian is an exchange). The account will consist of a number of public keys, and the private keys for which are stored by the exchange. The possible legal consequences of this arrangement are discussed below. The custodian, through the software running the wallet, will make transfers to and from the wallet as instructed by the client. Some custodians will only transfer to other wallets that it holds, whereas others will transfer more widely.

Some entities function merely as a custodian, without functioning primarily (or at all) as an exchange. They also maintain accounts for clients, consisting of one or more public keys and the associated private keys. They are likely to store the private keys offline in a process known as cold storage, which is considered safer than online storage. It is, of course, possible for one single entity to offer exchange services (trading and custody services together) and pure custody services as different possible service packages for clients.

2.5 The Functions of Bitcoin

In this section, the various functions of bitcoin are briefly discussed in order to unpack what properties it may have.

2.5.1 Bitcoin as a Method of Payment

Bitcoin can serve as a method of payment for goods and services without the use of an intermediary, such as a bank or wire transfer office. One initial goal, after the height of the 2008-2010 GFC, was to create a payment system that completely removed any "trusted central authority" and replaced that trust with a "cryptographic proof." However, how much bitcoin are actually used for payment of goods and services is unknown, but it is probably infrequently. The Governor of the Bank of England has expressed doubt as to the extent to which bitcoin is actually used for

payment and whether it will become a medium of exchange because of time delays in processing transactions and volatile fees.

However, the International Monetary Fund has reported that in the Philippines and Kenya, block-chain-based intermediaries offer money transfer services via bitcoin and subsequent conversion of bitcoins back into fiat currency for withdrawal by recipients through their mobile phones or a bank account. In this usage, bitcoin as a method of payment is integrally linked to the fiat currency system, and its use is to facilitate electronic transfers in regions where physical accessibility to banks is an issue.

2.5.2 Bitcoin as a Store of Value

Bitcoin can also be used as a store of value, in the same way as investors might buy volatile currencies or commodities. However, some doubts have been expressed by central bankers as to bitcoin's suitability as a store of value, because its value is so volatile. These first two functions, method of payment and store of value, can exist simultaneously: Investors in bitcoin may use their holdings to buy goods or services directly if a market exists, or to maintain a right to obtain goods or services in the future.

2.5.3 Bitcoin as a Financing Tool

A third, rather distinct, use of bitcoin and similar cryptocurrencies is as a means of raising financing for enterprises, foundations, and other projects. Coin or token offerings can be an investment in the entity raising the funds, similar to an equity or debt investment with a view to profit. In other instances, it is purchasing tokens to obtain good or services in the future. There is a distinction between bitcoins and tokens. Bitcoins, which are an example of "native" or "endogenous" tokens, have their own blockchain platform that operates independently of any other platform, whereas tokens ("non-native" or "exogenous" tokens) are a representation of a particular fungible and tradeable asset or utility. This article only considers bitcoins and not exogenous tokens.

D. LEGISLATIVE DEFINITION OF A SECURITY

Turning now to typical statutory definitions of security, OSA, s 1(1) sets forth a long list of items that fall within the scope of the term. These are that

> "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) a bond, debenture, note or other evidence of indebtedness or a share, stock, unit, unit certificate, participation certificate, certificate of share or interest, preorganization certificate or subscription other than,
>
> (i) a contract of insurance issued by an insurance company licensed under the *Insurance Act*, and
>
> (ii) evidence of a deposit issued by a bank listed in Schedule I, II or III to the *Bank Act* (Canada), by a credit union or central to which the *Credit Unions and Caisses Populaires*

Act, 2020 applies, by a loan corporation or trust corporation registered under the *Loan and Trust Corporations Act* or by an association to which the *Cooperative Credit Associations Act* (Canada) applies,

(f) any agreement under which the interest of the purchaser is valued for purposes of conversion or surrender by reference to the value of a proportionate interest in a specified portfolio of assets, except a contract issued by an insurance company licensed under the *Insurance Act* which provides for payment at maturity of an amount not less than three quarters of the premiums paid by the purchaser for a benefit payable at maturity,

(g) any agreement providing that money received will be repaid or treated as a subscription to shares, stock, units or interests at the option of the recipient or of any person or company,

(h) any certificate of share or interest in a trust, estate or association,

(i) any profit-sharing agreement or certificate,

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

(k) any oil or natural gas royalties or leases or fractional or other interest therein,

(l) any collateral trust certificate,

(m) any income or annuity contract not issued by an insurance company,

(n) any investment contract,

(o) any document constituting evidence of an interest in a scholarship or educational plan or trust, and

(p) any commodity futures contract or any commodity futures option that is not traded on a commodity futures exchange registered with or recognized by the Commission under the *Commodity Futures Act* or the form of which is not accepted by the Director under that Act,

whether any of the foregoing relate to an issuer or proposed issuer.

For purposes of comparison, it is interesting to note that the QSA relies on somewhat more broadly based wording.

Securities Act

CQLR c V-1.1, s 1

Applicability

1. This Act applies to the following forms of investment:

(1) any security recognized as such in the trade, more particularly, a share, bond, capital stock of an entity constituted as a legal person, or a subscription right or warrant;

(2) an instrument, other than a bond, evidencing a loan of money;

(3) a deposit of money, whether or not evidenced by a certificate except a deposit received by the Gouvernement du Québec, the Government of Canada, or one of their departments or agencies;

(4) (Repealed)

(5) (Repealed)

(6) a share in an investment club;

(7) an investment contract;

(8) (Repealed)

(8.1) an option or other non-traded derivative whose value is derived from, referenced to or based on the value or market price of a security, granted as compensation or as payment for a good or service;

(9) any other form of investment determined by regulation of the Government.

Investment contract

An investment contract is a contract whereby a person, having been led to expect profits, undertakes to participate in the risk of a venture by a contribution of capital or loan, without having the required knowledge to carry on the venture or without obtaining the right to participate directly in decisions concerning the carrying on of the venture.

The text of the Ontario version contains definitions that are both broadly and specifically defined. However, both the Ontario and Québec definitions are open ended so as to be inclusive rather than definitive.

1. Specific Definitions of Security

In Ontario, the most traditional and frequently encountered clause of the definition is (e), above, which covers shares and debt instruments such as bonds and debentures. Meanwhile, the Québec definition considers that common forms of securities, such as corporate shares or bonds, are examples of a more generic category of "any security recognized as such in the trade." Equally specific, though more complicated, definitions in the OSA are found in clauses (d) and (p), which refer to options and commodity futures contracts, respectively. Chapter 3 will return to the question of how options, futures, and derivatives work. Additional information is provided in the following excerpt.

Christopher C Nicholls, *Securities Law,* 3rd ed

(Toronto: Irwin, 2023) at 20-25 (footnotes omitted)

Options

a) Options Are Securities

An option is an instrument that gives the holder the right to buy or sell an underlying asset (such as a share issued by a specific corporation) at an agreed price, on or before an agreed date, but does not obligate the holder to do so. Options to purchase or to sell securities are themselves "securities" within the meaning of Canadian securities legislation.

b) Options Issued by a Corporation

A corporation may issue options that entitle holders to buy the issuer's own securities. A "right" is a common example of such an option. A right gives the holder the option to buy an additional share, or a fraction of an additional share, of a stated issuer at a stated price, on or before a stated date. For example, a right issued on 1 January 2023 might give the holder the right to buy one share of the corporation, on or before 15 February 2024, at a price of $50. In this case, the underlying interest of the option is the corporation's common shares, and the "exercise price" is $50.

• • •

A "warrant" is essentially the same kind of share purchase option, although it may give the holder the right to exercise it over a longer period of time. Further, it will often be attached to the issuance of some other type of security, such as a bond.

• • •

d) Options Issued by Persons Other Than the Corporation

Share options need not be issued by the corporation that is the issuer of the underlying shares. Other persons or companies frequently issue options whose underlying interest is a security issued by a publicly traded corporation. The most common examples are put and call options.

A call option on a corporation's shares may be created by an option "writer" (i.e., a seller). The option writer sells the option to a purchaser for a price known as the option premium. The call option entitles the purchaser, if it so wishes, to force the writer to sell an outstanding share of a third-party corporation identified in the option contract at a specified price (the exercise price) on or before a specified date. The corporation that originally issued this optioned share takes no part whatsoever in this transaction and would not even be aware that such an option has been written on its shares.

Suppose, for example, that the price of an ABC Corp common share is $25 on 1 January 2023. The writer (perhaps an investment banking firm or an investor or speculator) may create a call option on some number of ABC Corp common shares with an exercise price of $30 to be exercised by the holder (if the holder so wishes) on or before 1 March 2023. The purchaser of the call option hopes that the price of ABC Corp's common shares will rise to more than $30 before 1 March. If it does not, the option will expire and be worthless. The premium paid by the option holder to acquire the option on 1 January will have been for nothing. Obviously, the writer of the option hopes that the price of ABC Corp's common shares will *not* rise to more than $30 on or before 1 June. In a sense, the writer and the purchaser of the option are making contrary "bets" on the future value of ABC Corp stock. As the price of ABC Corp's common shares rises and falls during the period that the option is outstanding, the value of the call option while it is outstanding is particularly important because, once issued, call options need not be held by the option holder until expiry but may be traded in the secondary market.

A put option on corporate shares also may be created by an option writer; in the case of puts, the purchaser of the option acquires the right to require the writer; in the case of puts, the purchaser of the option acquires the right to require the writer to purchase a corporate share from the option holder, if the option is exercised, at a stated price (the exercise price) on or before a certain date. Using the example of ABC Corp again, where the share price on 1 January is $25, the writer of a put option might sell the purchaser a put option, entitling the option holder to force the writer, on or before 1 March, to buy from the option holder a share of ABC Corp at an exercise price of $20. Note that at the time of issuance, the put option is "out of the money." If it expired on the date of issuance, its value would be zero. The purchaser (that is, the option holder) hopes that the price of ABC Corp will drop to an amount below $20 on or before 1 March. Of course, to exercise the put option the option holder must be able to deliver to the writer a share of ABC Corp at the time the option is exercised. If the option holder does not already own such a share, the share may be purchased in the market and then delivered to the option writer. So, for example, if the price of ABC Corp drops to $15, the option holder can enter the market, buy a share of ABC Corp at $15, immediately exercise the put option, and become entitled to resell that same share to the writer for $20, thus realizing a $5 profit. Of course, the purchaser of the option may already own a share of ABC Corp at the time of acquiring the option. In that case, the put option functions as a hedge against future loss, or a kind of insurance. If the stock price falls below the exercise price, the holder is protected against the loss that otherwise would have been suffered by holding the share alone. Alternatively, if the stock price rises in

value by 1 March, the option will become worthless, but the holder will benefit from the increased value of the share. In that case, the price, or premium, the holder paid to acquire the option may seem to have been wasted; but, it is really no more wasted that the premium paid on any insurance policy. When one buys fire insurance on one's house, one does not hope for a fire so that the premium will not be wasted. The premium is paid to provide protection against possible significant loss, and in the meantime to provide peace of mind.

e) Options May Have a Variety of Underlying Interests

An option can be written against virtually any underlying interest, financial or otherwise, whose price is subject to variation. Options can be written, for example, against a stock index such as the S&P/TSX 60, the price of a precious metal, the price of an agricultural commodity, or an index of fine art values. Given that the price of every good whose price is determined in the market can vary, the number of different types of options that can be written is almost limitless.

• • •

f) Options Issued as a Compensation Device

Corporations frequently issue call options or other similar types of options as compensation for the services of senior executives and/or directors (referred to collectively below as "managers"). Options are a useful compensation device because, among other things, they give the managers more "leverage" than simply holding shares. In order to hold shares in the corporation, the manager must invest money. When options are granted as part of a manager's compensation, no investment takes place. The manager eventually profits to the extent that the share price rises above the exercise price of the options. Such options are thought to provide managers with a high-powered incentive to increase the value of the companies they manage, although critics sometimes see such options as little more than a subterfuge for transferring corporate value stealthily from shareholders to managers.

Futures

Futures (exchange-traded) and forwards (over-the-counter, or OTC) are contracts to sell a specified asset on a stated date in the future at a stated price. They differ from options because they impose future legal obligations on both parties to the contract. One party *must* sell the underlying asset and the other party *must* buy. It is only the date on which this purchase and sale must occur that is deferred. Like option contracts, futures contracts are written against a wide variety of underlying interests, the most common of which are currencies, commodities, indexes, and interest rates.

A hypothetical futures example is a contract struck on 1 January 2023, in which the underlying interest is 5,000 bushels of wheat, the sale price per bushel is $7.78, and the settlement date is 15 March 2023. In this contract, the purchaser agrees to buy, and the seller agrees to sell, 5,000 bushels of wheat on 15 March for $7.78 per bushel. Although the sale will not take place until 15 March, both parties are contractually committed to complete the transaction when that date arrives.

Futures contracts have long been used as a risk management tool. Farmers, for example, often sell futures contracts to purchasers of the commodities they produce, even before the crop or the animals have been raised. This allows farmers to "lock in" a sale price for their products and so transfers the risk of price fluctuations in the underlying interest to the purchasers. Farmers using futures contracts in this way sacrifice the possibility that the market price at the time of delivery might be higher

than the futures price, in exchange for certainty and avoiding the risk that the market price on the date of delivery might be lower than the futures price. Purchasers of such contracts, on the other hand, may be willing to accept this underlying price risk in exchange for certainty of supply of the relevant commodities.

Futures contracts are "securities" within the meaning of Canadian securities legislation and thus fall within the domain of securities regulators. However, commodity futures contracts that are publicly traded on a commodity futures exchange are excluded from the definition of "security" because they are separately regulated under special legislation dealing with commodities futures. This legislation is nonetheless administered by the securities regulators.

Derivatives

Financial derivatives refer, broadly, to contracts that derive their value from the value of another security, asset, or other reference value, which (as noted above) is referred to as the underlying interest. Rights and warrants, as discussed above, are, thus, types of derivative securities, as are put and call options.

The term "derivative" is also used to refer to futures and forward contracts. In fact, every financial derivative, no matter how complex, can be essentially deconstructed and characterized as either an option contract, a futures (or forward) contract, or a (frequently elaborate) combination of the two. Derivative is an umbrella term used to refer to a vast range of different types of financial instruments whose values vary with the underlying interests.

Financial derivatives have exploded in popularity in the period beginning in the mid-1970s, mainly as a result of an increased demand to hedge risk in volatile currency, interest rate, commodity, and stock markets, the timely development of an elegant mathematical model for pricing such instruments, and the expanding availability of computer technology. The impact of derivatives on financial markets became the subject of controversy, first in the 1990s, and again following the great financial crisis in 2007-08. However, the usefulness of derivatives has meant that they continue to be widely used around the world. The Bank for International Settlements reported that, as of December 2021, the notional amount of outstanding OTC derivatives was almost USD$598.416 trillion. Although not all derivative instruments are "securities" within the meaning of provincial securities legislation, the securities legislation of some provinces nonetheless gives the regulators the power to regulate activity relating to such instruments.

As the excerpt above explains, the term "derivative" is not actually included in the definition of a "security" under the OSA though the most common forms of derivatives—options and futures—are so included. However, since the GFC, Canada's securities regulators, along with their counterparts in other countries, have been developing a regulatory framework for the trading of derivatives. We provide a description of this framework below.

Clauses (j), (k), and (o) of the definition also refer to specific types of investment in natural resources and scholarship plans, respectively, and their inclusion is consistent with the protective goals of securities legislation. Indeed, some clauses represent specific legislative responses to attempts to defraud investors, such as clause (c), referring to documents "constituting evidence of an interest in an association of legatees or heirs."

2. Open-Ended Definitions of Security

Clauses (a), (b), (i), and (n) of the Ontario definition are much broader. They require detailed consideration because these clauses are often where the new definitional developments take

place and where reference to the underlying policy of the legislation becomes pivotal. In this connection, it should be remembered that the issue of whether what was being sold was a security or not will likely arise from attempts to design schemes that will escape the requirements of the Act, or from attempts by purchasers to recoup on schemes that "went bad." See, for example, *Securities and Exchange Commission v WJ Howey Co et al*, 328 US 293 (1946) and *Pacific Coast Coin Exchange v Ontario Securities Commission*, [1978] 2 SCR 112, 1977 CanLII 37, excerpted below.

With respect to the "commonly known" definition, it is clear that this requirement means that the instrument is commonly known as a security, not by the uninformed person on the street but rather by sophisticated analysts or securities lawyers. An example of this interpretation of the "commonly known" wording is found in the Québec Securities Commission decision of *Geldermann*, [1972] 3 QSCWS No 65. This regulatory decision in turn relied on the decision of *Securities & Exchange Commission v CM Joiner Leasing Corp*, 320 US 344 at 352-53 (1943) that "the test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." In that case, the claims being sold were leasehold interests in property that Joiner Leasing hoped would contain oil. In soliciting the interest of the purchasers of the leasehold interests, Joiner Leasing undertook to drill test wells to confirm this potential. In *Geldermann*, the Commission des valeurs mobilières du Québec (CVMQ) concluded that "proof of common knowledge must be based on an overwhelming set of facts and conclusive evidence."

Clause (b) of the OSA is also extremely broad, because "evidence of title to … property" could mean any commodity you can buy. Here courts and regulators are likely to engage in policy-oriented analysis, using as a reference point the goals of securities regulation, to restrict the application of this otherwise all-encompassing wording. Often a key issue is whether the person acquiring the interest was *making an investment* as opposed to *buying a commodity*. *Re Ontario Securities Commission and Brigadoon Scotch Distributors (Canada) Ltd* ([1970] 3 OR 714, 1970 CanLII 436 (SC)) involved Scotch whisky warehouse receipts. They were held to be a security because the whisky was stored and then sold on behalf of investors, to blenders who used it to produce a final whisky product. The contracts featured the performance of service by others that was meant to increase the value of the product. The issue was whether the purchaser wanted the whisky itself or the profit that could be obtained from reselling it. Obviously, this leaves some room for definitional flexibility where the motives of the purchaser are mixed, as they often are. As we have seen elsewhere in this chapter, one of the complications about crypto assets is whether they are properly considered to be currencies, commodities, or investments.

The definition of a security as an "investment contract" is where much of the jurisprudential consideration of the concept has been concentrated. As we shall see shortly, the Supreme Court of Canada (SCC), in *Pacific Coast* (at 127), adopted the idea drawn from US commentators that these categories are meant to be "catchalls" that cover "arrangements that do not permit the customers to know exactly the value of the investment they are making" (at 128). In dealing with this more open-ended wording, courts and regulators have tended to take a "purposive" approach, looking through the form of the transaction in question to its substance. Here, it is assumed that the purpose in question is to protect purchasers of financial claims from those who would seek to take advantage of them. This was the case even before securities legislation began to specify the goals that regulators should achieve in administering the Act. Now what may happen is that certain of the legislative objectives of the Act become key to making the decision about whether the Act applies at all. We will see how the SCC has operationalized this approach in the leading case of *Pacific Coast*. However, the SCC's decision in *Pacific Coast* built upon jurisprudence from the United States some years before. As you read the following two US decisions, consider how the test established in *State of Hawaii v Hawaii Market Center, Inc,* 52 Haw 642 (Sup Ct 1971) differs from the US Supreme Court's decision in *Howey*. Note also the different levels of court involved in these cases. Both the

Howey and the Canadian *Pacific Coast* cases featured strong dissenting judgments, which are also included in the excerpts from the respective cases.

3. Case Law on the Definition of Investment Contract

Securities and Exchange Commission v WJ Howey Co

328 US 293 (1946)

Suit by the Securities and Exchange Commission against W.J. Howey Company and Howey-in-the-Hills Service, Inc., to restrain alleged violations of the Securities Act.

MURPHY J (delivering the opinion of the court) (Frankfurter J dissenting): This case involves the application of s. 2(1) of the *Securities Act of 1933* to an offering of units of a citrus grove development coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor. The Securities and Exchange Commission instituted this action to restrain the respondents from using the mails and instrumentalities of interstate commerce in the offer and sale of unregistered and nonexempt securities in violation of s. 5(a) of the Act ... . The District Court denied the injunction ... and the Fifth Circuit Court of Appeals affirmed the judgment ... .

... The respondents, W.J. Howey Company and Howey-in-the-Hills Service, Inc., are Florida corporations under direct common control and management. The Howey Company owns large tracts of citrus acreage in Lake County, Florida. During the past several years it has planted about 500 acres annually, keeping half of the groves itself and offering the other half to the public "to help us finance additional development." Howey-in-the-Hills Service, Inc., is a service company engaged in cultivating and developing many of these groves, including the harvesting and marketing of the crops.

Each prospective customer is offered both a land sales contract and a service contract, after having been told that it is not feasible to invest in a grove unless service arrangements are made. While the purchaser is free to make arrangements with other service companies, the superiority of Howey-in-the-Hills Service, Inc., is stressed. Indeed, 85% of the acreage sold during the 3-year period ending May 31, 1943, was covered by service contracts with Howey-in-the-Hills Service, Inc.

The land sales contract with the Howey Company provides for a uniform purchase price per acre or fraction thereof, varying in amount only in accordance with the number of years the particular plot has been planted with citrus trees. Upon full payment of the purchase price the land is conveyed to the purchaser by warranty deed. Purchases are usually made in narrow strips of land arranged so that an acre consists of a row of 48 trees. During the period between February 1, 1941, and May 31, 1943, 31 of the 42 persons making purchases bought less than 5 acres each. The average holding of these 31 persons was 1.33 acres and sales of as little as 0.65, 0.7 and 0.73 of an acre were made. These tracts are not separately fenced and the sole indication of several ownership is found in small land marks intelligible only through a plat book record.

The service contract, generally of a 10-year duration without option of cancellation, gives Howey-in-the-Hills Service, Inc., a leasehold interest and "full and complete" possession of the acreage. For a specified fee plus the cost of labor and materials, the company is given full discretion and authority over the cultivation of

the groves and the harvest and marketing of the crops. The company is well established in the citrus business and maintains a large force of skilled personnel and a great deal of equipment, including 75 tractors, sprayer wagons, fertilizer trucks and the like. Without the consent of the company, the land owner or purchaser has no right of entry to market the crop; thus there is ordinarily no right to specific fruit. The company is accountable only for an allocation of the net profits based upon a check made at the time of picking. All the produce is pooled by the respondent companies, which do business under their own names.

The purchasers for the most part are non-residents of Florida. They are predominantly business and professional people who lack the knowledge, skill and equipment necessary for the care and cultivation of citrus trees. They are attracted by the expectation of substantial profits. It was represented, for example, that profits during the 1943-1944 season amounted to 20% and that even greater profits might be expected during the 1944-1945 season, although only a 10% annual return was to be expected over a 10-year period. Many of these purchasers are patrons of a resort hotel owned and operated by the Howey Company in a scenic section adjacent to the groves. The hotel's advertising mentions the fine groves in the vicinity and the attention of the patrons is drawn to the groves as they are being escorted about the surrounding countryside. They are told that the groves are for sale; if they indicate an interest in the matter they are then given a sales talk.

It is admitted that the mails and instrumentalities of interstate commerce are used in the sale of the land and service contracts and that no registration statement or letter of notification has ever been filed with the Commission in accordance with the *Securities Act of 1933* and the rules and regulations thereunder.

Section 2(1) of the Act defines the term "security" to include the commonly known documents traded for speculation or investment. This definition also includes "securities" of a more variable character, designated by such descriptive terms as "certificate of interest or participation in any profit-sharing agreement," "investment contract" and "in general, any interest or instrument commonly known as a 'security.'" The legal issue in this case turns upon a determination of whether, under the circumstances, the land sales contract, the warranty deed and the service contract together constitute an "investment contract" within the meaning of s. 2(1). An affirmative answer brings into operation the registration requirements of s. 5(a) unless the security is granted an exemption under s. 3(b) ... . The lower courts, in reaching a negative answer to this problem, treated the contracts and deeds as separate transactions involving no more than an ordinary real estate sale and an agreement by the seller to manage the property for the buyer.

The term "investment contract" is undefined by the *Securities Act* or by relevant legislative reports. But the term was common in many state "blue sky" laws in existence prior to the adoption of the federal statute and, although the term was also undefined by the state laws, it had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed upon economic reality. An investment contract thus came to mean a contract or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment." This definition was uniformly applied by state courts to a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of someone other than themselves.

By including an investment contract within the scope of s. 2(1) of the *Securities Act*, Congress was using a term the meaning of which had been crystallized by this prior judicial interpretation. It is therefore reasonable to attach that meaning to the term as used by Congress, especially since such a definition is consistent with the statutory aims. In other words, an investment contract for purposes 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 being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. Such a definition necessarily underlies this Court's decision in *Securities Exch. Commission v. C.M. Joiner Leasing Corp.*, 320 US 344 ... , and has been enunciated and applied many times by lower federal courts. It permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of "the many types of instruments that in our commercial world fall within the ordinary concept of a security." H. Rep. No. 85, 73rd Cong., 1st Sess., p. 11. It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.

The transactions in this case clearly involve investment contracts as so defined. The respondent companies are offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. They are offering this opportunity to persons who reside in distant localities and who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products. Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment. Indeed, individual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments. Their respective shares in this enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable shares of the profits. The resulting transfer of rights in land is purely incidental.

Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed. The investment contracts in this instance take the form of land sales contracts, warranty deeds and service contracts which respondents offer to prospective investors. And respondents' failure to abide by the statutory and administrative rules in making such offerings, even though the failure resulted from a bona fide mistake as to the law, cannot be sanctioned under the Act.

This conclusion is unaffected by the fact that some purchasers choose not to accept the full offer of an investment contract by declining to enter into a service contract with the respondents. The *Securities Act* prohibits the offer as well as the sale of unregistered, non-exempt securities. Hence it is enough that the respondents merely offer the essential ingredients of an investment contract.

We reject the suggestion of the Circuit Court of Appeals ... that an investment contract is necessarily missing where the enterprise is not speculative or promotional in character and where the tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole. The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value. See *S.E.C. v. C.M. Joiner Leasing Corp.*, *supra*... . The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae.

FRANKFURTER J (dissenting): "Investment contract" is not a term of art; it is a conception dependent upon the circumstances of a particular situation.

• • •

For the crucial issue in this case turns on whether the contracts for the land and the contracts for the management of the property were in reality separate agreements or merely parts of a single transaction. It is clear from its opinion that the District Court was warranted in its conclusion that the record does not establish the existence of an investment contract: the record in this case shows that not a single sale of citrus grove property was made by the Howey Company during the period involved in this suit, except to purchasers who actually inspected the property before purchasing the same. The record further discloses that no purchaser is required to engage the Service Company to care for his property and that of the fifty-one purchasers acquiring property during this period, only forty-two entered into contract with the Service Company for the care of the property.

Simply because other arrangements may have the appearances of this transaction but are employed as an evasion of the *Securities Act* does not mean that the present contracts were evasive. I find nothing in the *Securities Act* to indicate that Congress meant to bring every innocent transaction within the scope of the Act simply because a perversion of them is covered by the Act.

Let us turn now to consider the subsequent unanimous Supreme Court of Hawaii decision, which offers a somewhat different focus for the determination of whether the transactions in question involved the distribution of a security.

State of Hawaii v Hawaii Market Center, Inc

52 Haw 642 (Sup Ct 1971)

Action by State to enjoin further promotion and execution of "founder-member purchasing contract agreements" allegedly constituting unregistered securities.

LEVINSON J: The legal issue presented by this case is whether the "Founder-Member Purchasing Contract Agreements" issued by Hawaii Market Center, Inc., one of the appellants, constitute securities within the meaning of the Hawaii Uniform Securities Act (Modified). An affirmative answer to this question would bring into operation the registration requirements of HRS s. 485-8. Before determining the nature of these agreements it is first necessary to delineate clearly the economic relationship existing between Hawaii Market Center, Inc. and persons who have contracted with it pursuant to these agreements.

Hawaii Market Center, Inc. (hereinafter referred to as HMC) is a Hawaii corporation with a capitalization of $1000.00. The corporation's expressed purpose was to open a retail store which would sell merchandise only to persons possessing purchase authorization cards. In order to raise capital for the financing of this enterprise HMC recruited founder-members. The maximum number of such members was set at five thousand.

Prospective founder members were asked to attend recruitment meetings. At these meetings a speaker explained how members would be eligible to earn (1) immediate income before the store became operational, and (2) future income after the store became operational. In order to earn such income an invitee was required to become either a founder-member distributor or a founder-member supervisor.

A person became a founder-member distributor by purchasing from HMC either a sewing machine or a cookware set (each with a wholesale value of $70.00) for $320.00. The purchaser also executed a "Founder-Member Purchasing Contract Agreement" with the corporation. This agreement states that a distributor is able to earn money in five ways. He may: (1) distribute the 50 authorized buyer's cards, which have been issued to him and thereafter earn a 10% commission on each sale resulting from the use of one of these cards in the HMC store; (2) earn a $50.00 fee each time a person he refers becomes a founder-member distributor; (3) receive a $300.00 fee as compensation for establishing a new member as a supervisor or upgrading an old member from distributor to supervisor. The fourth and fifth sources of income relate to the earning of credits which are applied to a $900.00 fee paid by a distributor to his supervisor if the distributor wishes to be upgraded.

A person became a supervisor by executing a founder-member contract and purchasing both a sewing machine and a cookware set for a total price of $820.00. A supervisor earns higher fees and commissions than a distributor. In addition, a supervisor receives an override commission if his distributor enlists a new member. He also receives override commissions on all sales made to holders of purchase authorization cards distributed by any founder-member whose entry into the organization can be traced back to the supervisor.

• • •

I. The Essential Characteristics of an Investment Contract Under the Hawaii Uniform Securities Act (Modified)

A. The Test Embodied in the Howey Case Is Too Mechanical to Protect the Investing Public Adequately

In arguing whether the interests represented by HMC's founder-member contracts constitute investment contract securities within the meaning of HRS s. 485-1(12) both the appellant and the appellee rely for guidance principally upon the Supreme Court decision in *Securities & Exchange Commission v. W.J. Howey Co.*, 328 US 293 ... (1946). That case sought to formulate a test for the existence of an "investment contract," such a contract being included within the definition of "security" under the *Federal Securities Act*. The Court concluded that an investment contract exists whenever "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." *Securities & Exchange Commission v. W.J. Howey, Co.*, supra at 299 ... .

The appellants urge us to adopt the *Howey* formula as the test to be applied in the present case. It is contended that under the *Howey* test the contracts in question are not investment contracts because founder-members in the HMC plan are expected to recruit new members and distribute purchase authorization cards in order to earn income; they do not, therefore, "expect profits solely from the efforts" of others.

The State also relies upon the *Howey* case but contends that the test enunciated therein is not to be taken literally. It argues that the efforts expected of the founder-members are minimal in nature and, as a practical matter, the founders are substantially dependent upon the management of the corporation for a successful return on their investment. Thus the State asserts, under the real meaning of the *Howey* rule, the disputed agreements are investment contracts. We agree that the present agreements constitute "securities" within the coverage of the *Hawaii Uniform Securities Act (Modified)*. We do not choose, however, to base this decision on the restrictive formula laid down by the Supreme Court in the *Howey* case.

The primary weakness of the *Howey* formula is that it has led courts to analyse investment projects mechanically, based on a narrow concept of investor participation. Thus courts become entrapped in polemics over the meaning of the word "solely" and fail to consider the more fundamental question whether the statutory policy of affording broad protection to investors should be applied even to those situations where an investor is not inactive, but participates to a limited degree in the operation of the business. In fulfilling the remedial purposes of our state act, we believe a sounder approach to securities regulation requires that courts focus their attention on the economic realities of security transactions: that is, "(t)he placing of capital or laying out of money in a way intended to secure income or profit from its employment" in an enterprise.

B. The Risk Capital Approach to Defining an Investment Contract

The salient feature of securities sales is the public solicitation of venture capital to be used in a business enterprise. This subjection of the investor's money to the risks of an enterprise over which he exercises no managerial control is the basic economic reality of a security transaction. Any formula which purports to guide courts in determining whether a security exists should recognize this essential reality and be broad enough to fulfill the remedial purposes of the *Securities Act*. Those purposes are (1) to prevent fraud, and (2) to protect the public against the imposition of unsubstantial schemes by regulating the transactions by which promoters go to the public for risk capital. HRS s. 485-10(e). Therefore, we hold that for the purposes of the *Hawaii Uniform Securities Act (Modified)* an investment contract is created whenever:

(1) An offeree furnishes initial value to an offeror, and
(2) a portion of this initial value is subjected to the risks of the enterprise, and
(3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
(4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

The above test provides, we believe, the necessary broad coverage to protect the public from the novel as well as the conventional forms of financing enterprises. Its utility is best demonstrated by its application to the facts in the instant case.

II. The Contracts in Question Constitute Investment Contracts Within the Meaning of HRS, s 485-1(12)

A. The Initial Value Subjected to the Risks of the Enterprise

Each person who executes a "Founder-Member Purchasing Contract Agreement" is required by Hawaii Market Center, Inc. to make a "one-time retail purchase" of $320.00 in order to become a distributor and $820.00 in order to become a supervisor. The record indicates that the total wholesale cost to HMC of the purchased merchandise is $70.00 and $140.00 respectively. The appellants have made no attempt to characterize these transactions as the simple purchase of merchandise, nor do we deem them such. The terms of the offer and the inducements held out to the prospects clearly indicate that the substantial premiums paid by founder-members to HMC are given in consideration for the right to receive future income from the corporation. These overcharges constitute the offerees' investments or contributions of initial value, such value being subjected to the risks of the enterprise.

It is uncontested that the recruitment of founder-members was motivated by the need to raise capital to finance the opening of the proposed Hawaii Market Center store. Inextricably bound to the success of this enterprise is the ability of the founder-members to recoup their initial investment and earn income. The recruitment fee paid to distributors and supervisors, during the pre-operational phase of the plan, rests upon the promoters' ability to sell the success of the plan to prospective members. In addition, those members who choose to rely solely on the second method of earning income, the payment of commissions based on sales, receive no return at all on their investment unless the store functions successfully. This latter point is particularly important because recruitment of members increases geometrically. Therefore, since membership is limited to five thousand, a very large percentage of founder-members will be totally dependent on sales commissions to recover their initial investment plus income. It is thus apparent that the security of the founder-members' investments is inseparable from the risks of the enterprise. The success of the plan is the common "thread on which everybody's beads (are) strung." *Securities & Exchange Commission v. C.M. Joiner Leasing Corp.*, 320 US 344 ... (1943).

B. The Promise of a Valuable Return on the Offeree's Investment

The appellants contend that because of the nature of the receipts promised to founder-members the trial court erred in finding the existence of a security. They stress that founder-members do not participate in the profits of the enterprise. They are promised fixed fees and commissions, which are payable regardless of the existence of profits. Therefore, it is argued, the essential profits sharing element of a security is lacking. Once again, this argument ignores the economic realities underlying securities regulation.

It should be irrelevant to the protective policies of the securities laws that the inducements leading an investor to risk his initial investment are founded on promises of fixed returns rather than a share of profits. The reference point should be the offeree's expectations, not the balance sheet of the offeror corporation. The unwary investor lured by promises of fixed fees deserves the same protection as a participant in a profit sharing plan. For this reason courts have avoided a narrow definition of "profits." They have recognized securities sales even where the promised benefits to the offeree were indirect, arising from an anticipated increase in the value of the property received, rather than direct payments from the offeror.

Securities & Exchange Commission v. C.M. Joiner Leasing Corp., supra, 320 US at 348-349; ... *Roe v. United States*, 287 F.2d 435, 439 (5th Cir.), cert. denied, 368 US 824 ... (1961). Thus, the fact that in the instant case HMC guaranteed the offerees amounts of money independent of enterprise profits does not undermine the investment nature of the transactions.

C. The Lack of Managerial Control Over the Enterprise

Finally, as previously stated, it is irrelevant to the remedial purposes of the *Securities Act* that an investor participates in a minor way in the operations of the enterprise. Courts should focus on the quality of the participation. In order to negate the finding of a security the offeree should have practical and actual control over the managerial decisions of the enterprise. For it is this control which gives the offeree the opportunity to safeguard his own investment, thus obviating the need for state intervention. Coffey, "The Economic Realities of a 'Security': Is There a More Significant Formula?," supra at 396-398.

In the present case the founder-members possess none of the incidents of managerial control which would preclude the finding of a security. The members have no power to influence the utilization of the accumulated capital. Nor will they have any authority over those decisions which will affect the operation of the store, if it is successfully established. Judged by an ability to protect their original investment, the offerees in this case are powerless. Thus, under the economic realities approach presently advocated, they properly belong to the class of investors falling within the remedial purposes of the *Securities Act*. Therefore we hold that the present agreements are investment contracts within the meaning of the *Hawaii Uniform Securities Act (Modified)* and must be registered with the Commission of Securities prior to distribution.

The Court in *Howey* concluded that the transfer of property was merely an incident of a larger scheme involving an investment contract and refused to be bound by the technical legal structure of the transaction as a purchase of land. In focusing on the individual motivations of the purchasers, the Court found that they were attracted by the "expectation of substantial profits." The Court also emphasized the fact that the purchasers intended their profits to accrue "solely" from the efforts of others. This emphasis suggests a level of judicial acceptance of the Marxist definition of capitalism as the exploitation of the labour of others.[1] Meanwhile the *Hawaii* case glossed both the "expectations of profits" issue and the requirement imposed by *Howey* that profits are made "solely" through others' efforts. Anticipating by some years the findings of behavioural psychologists about the phenomenon of loss aversion (that individuals act more cautiously in connection with the risk of losing what they already possess than in connection with possible additional gains), *Hawaii* is generally known as the "risk capital" case because it emphasizes the risk of loss to the investor and the lack of control of the investor over the success of their investment.

The Canadian version of these decisions is *Pacific Coast*. In this case, the Pacific Coast Coin Exchange (PCCE) operated a scheme whereby it offered bags of silver coins for sale to members of the public that could be bought either for cash or on margin. Most of the relevant purchases of bags of coins were on margin. The promotional literature for the scheme described the bags of coins as an "investment" that operated as a protection against inflation. Once the purchasers paid their deposits, the transactions could be completed either by paying the rest of the purchase price by a particular time and receiving the bags of silver or by selling the bags of coins again at the then purchase price, through PCCE. The purchaser would then make as profit or loss the difference between the price for which they had contracted to buy

1 Personal communication from Osgoode Hall Law School Professor Emeritus Harry Glasbeek.

the bags and the price for which they were later sold. PCCE was not obliged under the contract to repurchase the bags of coins, though its literature asserted that "it had never failed to make a market for its customers in the past." Specific bags were not allocated to any purchaser until such time as the purchaser paid the balance of the price if they ever did so. PCCE kept very few bags of silver in inventory to pay off these contracts, but it made its own futures contracts in bags of coins to offset its obligations to deliver them to purchasers. PCCE also earned commission on all contracts to purchase and sell. The OSC issued a cease trade order with respect to these transactions, and PCCE appealed to the courts. The dissenting and majority judgments, respectively, are excerpted below.

Pacific Coast Coin Exchange of Canada v Ontario (Securities Commission)

[1978] 2 SCR 112, 1977 CanLII 37

LASKIN CJ (dissenting): ... We are concerned here with giving meaning and application to the term "investment contract," which is one of the many kinds of "security" included within the *Securities Act*, R.S.O. 1970, c. 426, as amended and hence brought within its regulatory authority. The term, it is conceded, cannot be given a literal meaning because to do so would bring within the scope of *The Securities Act* innumerable transactions which have no public aspect. Even with respect to that, it is common ground that commodity futures contracts are not per se within the regulatory regime of the Act.

My brother de Grandpré has noted in his reasons that securities legislation in the United States has similarly left the term "investment contract" undefined, so that it fell to the Courts in various proceedings to isolate or extract a meaning consistent with the purpose of securities legislation, namely, to ensure that investors in public offerings are supplied with full information to enable them to appreciate (if they are minded to examine it) the risks involved in making an investment. The more extensive judicial experience in the United States has been regarded as useful for Canadian courts called upon to wrestle with similar problems of interpretation and application, and so it is that in the present case the so-called *Howey* test (laid down in *Securities and Exchange Commission v. Howey*, [328 US 293 (1946)]) and the *Hawaii* test (laid down in *Hawaii Commissioner of Securities v. Hawaii Market Centre Inc.* [485 P (2d) 105 (1971)]) were considered and utilized by the Courts below in determining that the appellants were dealing in securities through their commodity account agreements with their customers.

It is easy, in a case like the present one, when faced with a widely-approved regulatory statute embodying a policy of protection of the investing public against fraudulent or beguilingly misleading investment schemes, attractively packaged, to give broad undefined terms a broad meaning so as to bring doubtful schemes within the regulatory authority. Yet if the Legislature, in an area as managed and controlled as security trading has deliberately chosen not to define a term which, admittedly, embraces different kinds of transactions, of which some are innocent, and prefers to rest on generality, I see no reason of policy why Courts should be oversolicitous in resolving doubt in enlargement of the scope of the statutory control.

Although there was evidence of spot purchases of silver coins, that is purchases for cash, the issue before this Court concerns margin purchases under the terms of the appellants' standard commodity account agreements. Spot purchases are clearly outside of *The Securities Act*. The commodity account agreement is a terminable

agreement under which purchasers on margin contract for some desired number of bags of silver coins and pay by way of deposit thirty five per cent of the purchase price. Delivery in specie may be had on 48 hours' notice after paying up the balance of the purchase price plus commission, and interest and storage charges as applicable. The appellants, to honour the contracts, must either have bags of silver coins on hand or go into the market to buy futures, and they would do so to cover outstanding obligations to their customers rather than trade in silver on their own account.

The result of investment of money under the commodity account agreements was to give the appellants a pool of money—which became its money—and tied the customers to the appellants in the consummation of their purchases, either by taking delivery of bags of coins (which was rarely done) or by closing out their accounts by selling at the market price through the appellants, paying a commission on selling as well as on buying. The commodity account agreements were not assignable by the customers without the appellants' consent but, of course, the appellants could use them as bank collateral.

The appellants controlled the so-called base price; that is, the price at which investors bought bags of silver coins for future delivery was fixed by the appellants in relation to the then market price. The appellants did not, however, control the market price but were themselves subject to it, nor did they control the cost of money which would enter into a customer's calculation, along with the market price, on whether to close out his account. It was in respect of these features of the transactions with their customers that counsel for the appellants took objection to the emphasis placed by the Courts below on hedging, calling it a non-issue.

Counsel contended that it was immaterial to the customers whether the appellants hedged or not on their future obligations to them. If they did not hedge, they simply took the risk of a larger loss or a larger profit when called upon by a customer to deliver the bags of coins which he purchased or when the customer closed out his account by instructions to sell. If they did hedge, it was still for the customer to decide, irrespective of the hedging, whether to call for delivery or whether to sell out if the market price of silver made it advantageous to do so. Hedging concerned only the financial position of the appellants and, indeed, it seems to me that it was only their solvency which created any risk to the customer. Yet it was the view of the Ontario Court of Appeal, speaking through Dubin JA, that the solvency issue was not enough to bring the commodity account agreements within the scope of *The Securities Act*. I can understand the reluctance to find that solvency or insolvency is a determining factor in this case. It is equally a factor in the realization of future benefits under any commercial contracts providing for them, but there has been no suggestion that, even if there be a network of such contracts, they should be recognized by the Courts as investment contracts for security regulation purposes.

I see no more than three factors which can be said to enter into consideration of the question whether the commodity account agreement is an "investment contract" as that term is included in the definition of "security" under the Ontario *Securities Act*. There is the fixing of the base price at which customers make their purchases; there is the consequent gathering up of a pool of money by the appellants representing the required deposits under the commodity account agreements; and there is the question of the solvency of the appellants. The same factors under a similar scheme were present in *Jenson v. Continental Financial Corporation* [404 F Supp 792 (1975)], a judgment of the United States District Court, District of

Minnesota, upon which counsel for the respondents in this case placed heavy reliance. The Court in the *Jenson* case faced the same question that the Courts in this case faced, namely, whether a gamble on the behaviour of the silver market is anything more than a commodity futures transaction and hence not a security subject to regulatory legislation.

In coming to a conclusion on the *Howey* test that the commodity account agreement was within the regulatory statute, the Court laid emphasis on the pooling of investors' money in a common enterprise in which the risk of profit or loss depended solely (or perhaps substantially) on the promoters' ability to gauge the market and hence to assure its own solvency to meet its obligations to its customers. I do not see in this view of the matter anything more than solvency, because it would be the market that would determine whether and when the customer would have a profit, and he was free to close out his account or to ask for delivery in specie at his instance and not when the promoter chose to permit him to do so. Certainly, I do not see any controlling factor in managerial effort, to which the Court in *Jenson* alluded, when it is the market that determines profitability and not the promoter. The notion of managerial effort obviously came from the *Howey* case where, on the facts, the citrus grove enterprise promoted by the respondents there was managed and serviced by them. Here there is no parallel, any more than there is a parallel with a manufacturing company whose shares are purchasable in the open market.

I am not persuaded that a test stemming from a particular set of facts such as those in *Howey*, or the broader risk capital approach based on another set of facts as in *Hawaii*, can or should be generalized to fix the conclusion in yet the different set of facts present here. In *Howey* and in *Hawaii*, the Courts were concerned with schemes relating to land management and to merchandise selling respectively, under which managerial control rested in the promoters. There was no such substantial reliance on the market, outside of the promoter's control, as existed in the present case. I think it apt to refer to the dissent of Frankfurter J in the *Howey* case, at p. 302, where he objected to bringing every innocent transaction within the scope of securities legislation simply because a perversion of them is covered by it.

I would allow the appeal, set aside the judgments below and quash the prohibitory order of the Ontario Securities Commission, with costs to the appellants throughout.

DE GRANDPRÉ J (Martland, Judson, Ritchie, Spence, Pigeon, Dickson, and Beetz JJ concurring): By notice given pursuant to the provisions of sub. 1 of s. 144 of *The Securities Act*, R.S.O. 1970, c. 426, respondent informed appellant that a hearing would be held on the 24th of July 1974 "to determine whether the Commission should act in the public interest to order that all trading in the securities of Pacific Coast Coin Exchange of Canada Limited should cease forthwith pending the filing and acceptance of a prospectus and compliance with the registration provisions of *The Securities Act*." Appellant was also informed that it would be urged that such order should issue because the plan or manner of business of appellant "involves the offer and sale ... of securities to the public" in that

> 1) it constitutes "an investment contract" within the meaning of s. 1(1)22xiii of the Act; in the alternative, it constitutes "evidence of title to or interest in the capital, assets, property, profits, earnings or royalties" of the appellant within the meaning of s. 1(1)22ii of the Act.

On October 11, 1974, following the hearing, respondent did issue a prohibitory order; its reasons indicate that it relied principally on s. 1(1)22ii of the Act although it added that s. 1(1)22xiii is also applicable. The Divisional Court agreed with the conclusion reached by respondent although it did so only on the basis that the transactions entered into between appellant and its clients are investment contracts; the Divisional Court felt that these agreements did not constitute evidence of title within the meaning of s. 1(1)22ii of the Act. (1975) 7 OR (2d) 395; also (1975) 55 DLR (3d) 331. An appeal to the Court of Appeal was dismissed, that Court also being of the view that the transactions constitute investment contracts; it found it unnecessary to determine whether they are also securities within the meaning of s. 1(1)22ii of the Act. (1975) 8 OR (2d) 257; also (1975) 57 DLR (3d) 641.

The principal issue in this appeal is to determine whether the agreement between appellant and its customers is an investment contract. Should a negative answer be given to that question, it will be necessary to examine whether or not the agreement constitutes a security under s. 1(1)22ii.

The Facts

• • •

Appellant Pacific is a Canadian corporation carrying on business in the Province of Ontario and other Canadian provinces; its shares are owned by Mr. Louis Carabini and Dr. Neil Chamberlain. ... It might be noted that, at the time of the hearing, Pacific had some 12,000 customers in the United States and 226 in Canada.

Pacific commenced to carry on business in Ontario in the Spring of 1973. ...

Pacific solicits its customers primarily through newspaper advertising in which the public is invited to request information by returning a mail slip to the Company. A "literature pack" is sent to potential customers. This pack emphasizes silver coins as an "investment" and presents them as a "reliable" and "almost perfect" protection of the customer's savings and assets against inflation. The price performance of silver is compared favourably with other forms of investments, such as common stocks. The literature predicts continued rampant growth of inflation and suggests a possible return to a depression. Emphasis is placed on an inevitable increase in the price of silver notwithstanding inflation, devaluation of money and depressed stock markets.

Appellant presents two ways to invest in silver coins: the outright purchase of bags of silver coins in specie which are delivered to the investor and the purchase of bags of silver coins on margin. Margin purchases are promoted over outright purchases by means of a comparison which illustrates that a person with $10,000 to invest can purchase seven bags of silver on margin while he can only purchase two bags in specie.

Over 90 per cent of purchases are by the margin contract mode. Whichever method is used, Pacific requires the customer to enter into a "Commodity Account Agreement." As this is the only document evidencing the contract between Pacific and its customers, it must now be examined insofar as it governs the rights and obligations of the margin purchasers:

a) the commodity consists of one or more bags of silver coins;
b) the customer pays a commission of 2 per cent on the purchase price and when he sells, he is also asked to pay a second commission of 2 per cent;
c) the customer puts down a deposit (it was 35 per cent of the purchase price at the time of the hearing) and is required to maintain adequate margin in his account in such amounts as are from time to time required by Pacific;

d) Pacific is under no obligation to make delivery until the customer has paid in full therefore, which means the balance of the purchase price plus all interest (approximately 12 per cent at the time of the hearing), commission and storage charges; the customer agrees to purchase all the commodities ordered by it and pay for them in full before delivery;
e) the Agreement is terminable at the will of either party but in any event will terminate five years from the date of the last purchase under the Agreement;
f) the price at which Pacific sells to its customers is fixed by Pacific several times during the day and published by it and, in total, consists of a base price being the market value quoted by Pacific plus commissions and other charges;
g) the customer may obtain the release of any or all of the commodities credited to his account within forty-eight hours after payment in full for such commodities;
h) Pacific retains no power of attorney nor authority to direct the customer trading and maintains no control over the customer's account subject to certain security provisions to secure outstanding indebtedness by the customer to Pacific;
i) the customer obtains no specific interest in any particular bag of silver under the contract until he makes payment in full therefor and accepts delivery of the bags purchased under the contract;
j) certain events of default are provided for and remedies retained by Pacific in that event to liquidate the customer's account or realize on any commodities purchased by the customer and credited to his account to off-set any indebtedness in the event of default by the customer to Pacific;
k) the provisions of the Agreement are assignable by Pacific but not by the customer without Pacific's consent.

More than 85 per cent of all margin account purchasers close-out their account without taking delivery. When a margin account buyer closes out his account, he receives or pays the difference between the per unit price at which his position is closed-out and the amount he owes on margin, plus applicable interest, commissions and storage charges.

Although the Agreement spells out that Pacific "may, but need not at all times, make a market in commodities," Pacific in its literature points out that it has never failed to make a market for its customers in the past. Pacific will not repurchase margin contracts acquired from another coin exchange nor will other coin exchanges repurchase Pacific margin contracts.

Pacific's only obligation to margin customers is to deliver the bags of silver covered by the contract if and when the customer pays the outstanding balance. In practice, Pacific covers or hedges its obligation to margin customers:

a) by purchasing futures contracts for silver; approximately 85 per cent of Pacific's obligations to margin account customers is covered by futures contracts;
b) by maintaining a small inventory of silver coins in specie.

Pacific has a policy of covering not less than 95 per cent of its margin obligations.

Pacific obtains title to the funds paid by the margin account investors as a deposit. The pooled monies are distributed in Pacific's general funds. Some of this money is used to secure its own futures contracts and some of it is used for its own investment purposes.

In conducting its hedging operations, Pacific trades for its own account and in its own name; all purchases and sales of futures contracts are made by Pacific as principal and not as agent for a customer. As the silver futures contract comes close to delivery date, the Operations' Department, some 55 persons strong, must decide whether to pay the balance owing on the contract and take delivery of the silver, or roll the contract over by selling it and replacing it with a contract for a more distant month.

In its literature, Pacific cautions against individuals speculating in futures contracts. Such investments are not for the uninitiated or unwary:

> They are primarily for speculators who welcome extremely high-leveraged, short term situations, and for hedgers who use futures to balance their existing long or short commitments with an equal and opposite commitment. If you plan to buy silver futures, you should be prepared to spend a great deal of time studying the silver situation, staying on top of it every day.

Investment Contract

Section 35 of the Act spells out the prohibition for anyone to "trade in a security" in the absence of a prospectus. "Security" is defined in s. 1 as including fourteen categories, the thirteenth one being "any investment contract, other than an investment contract within the meaning of *The Investment Contracts Act*." It is common ground that in the case at bar, the contract is not one covered by this last mentioned statute.

The expression "investment contract" is not defined in the Act. In their search for its meaning, the Courts below have been guided by the leading US authorities and counsel have invited us to follow the same path. I agree. While the statute under consideration here does not read word for word like its US counterpart, the expression "investment contract" is found in both. In addition, the policy behind the legislation in the two countries is exactly the same, so that considering the dearth of Canadian authorities, it is a wise course to look at the decisions reached by the US Courts. This approach has also been adopted by the Court of Appeal of Alberta in *Re Regina Great Way Merchandising Ltd.* [(1971), 20 DLR (3d) 67], as well as by Nemetz J.A. in the Court of Appeal of British Columbia in *Re Bestline Products of Canada Ltd.* [(1972), 29 DLR (3d) 505].

I have alluded to the policy of the legislation. It is clearly the protection of the public as was said by Hartt J. in *Re Ontario Securities Commission* and *Brigadoon Scotch Distributors (Canada) Limited* [[1970] 3 OR 714], at p. 717:

> ... the basic aim or purpose of the *Securities Act, 1966*, ... is the protection of the investing public through full, true and plain disclosure of all material facts relating to securities being issued.

If any doubt could be entertained as to the intention of the Legislature in the present instance, that doubt should be dispelled by the very wide terms employed in defining the word "security." The fourteen subdivisions of the definition encompass practically all types of transactions to such an extent that this definition had to be narrowed down by a long list of exceptions to be found in s. 19.

At this point, reference should be made to a work by Professor Louis Loss who was called by appellant as an expert witness before the Commission. In the second edition of his *Securities Regulation* ((1961) vol. I at pp. 483, 488-489) and in the 1969 supplement thereto (vol. IV at p. 2501), Prof Loss recognizes that "the various categories in the definition are not mutually exclusive and are meant to be

'catchalls.'" This view of the definition in the United States statute is valid in our case as well.

Such remedial legislation must be construed broadly, and it must be read in the context of the economic realities to which it is addressed. Substance, not form, is the governing factor. ...

In the search for the true meaning of the expression "investment contract," another guideline must also be present in the forefront of our thinking. In the words of the Supreme Court of the United States in *SEC v. W.J. Howey Co.* [328 US 293 (1946)], any definition must permit (at p. 299):

> ... the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of "the many types of instruments that in our commercial world fall within the ordinary concept of a security." ... It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.

Which does not mean that the legislation is aimed solely at schemes that are actually fraudulent; rather, it relates to arrangements that do not permit the customers to know exactly the value of the investment they are making.

It is with all the foregoing in mind that the Supreme Court of the United States in *Howey* (supra, at pp. 298, 299, 301) laid down the following test:

> Does the scheme involve "an investment of money in a common enterprise, with profits to come solely from the efforts of others"?

• • •

In the case at bar, it is obvious that an investment of money has been made with an intention of profit. The questions before us are the following: Is there a common enterprise? Are the profits to come solely from the efforts of others? These two questions are so interwoven that I will be endeavouring to answer them together.

The word "solely" in that test has been criticized and toned down by many jurisdictions in the United States. It is sufficient to refer to *SEC v. Koscot Interplanetary, Inc.* [497 F (2d) 473 (1974)], and to *SEC v. Glen W. Turner Enterprises, Inc.* [474 F (2d) 476 (1973)]. As mentioned in the *Turner* case, to give a strict interpretation to the word "solely" (at p. 482) "would not serve the purpose of the legislation. Rather we adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." In the same case of *Turner*, the expression "common enterprise" has been defined to mean (p. 482) "one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." These refinements of the test, I accept.

Like the Courts below, I hold the view that both these questions must be answered in the affirmative. ... I will simply underline the common enterprise aspect and attempt to highlight two facets of the dependence of the customer upon Pacific, namely for the success of the venture and for the existence of a true market.

In my view, the test of common enterprise is met in the case at bar. I accept respondent's submission that such an enterprise exists when it is undertaken for the benefit of the supplier of capital (the investor) and of those who solicit the capital (the promoter). In this relationship, the investor's role is limited to the advancement of money, the managerial control over the success of the enterprise being that

of the promoter; therein lies the community. In other words the "commonality" necessary for an investment contract is that between the investor and the promoter. There is no need for the enterprise to be common to the investors between themselves.

As to the dependence of the customer for the success of the enterprise, it should be recalled that appellant in its literature underlines the danger for the ordinary investor to deal in futures; the text of the warning has been quoted earlier in these reasons. This is echoed by Professor Loss in his testimony: "The ordinary fellow isn't equipped to trade in commodity futures." Appellant now attempts to recant from that position and submits that there is nothing mysterious about dealing in commodity futures contracts. The Courts below have refused to accept that submission and have held quite rightly that the end result of the investment made by each customer is dependent upon the quality of the expertise brought to the administration of the funds obtained by appellant from its customers. If Pacific does not properly invest the pooled deposit, the purchaser will obtain no return on his investment regardless of the prevailing value of silver; there is nothing that the customer can do to avoid that result.

This dependence of the investors upon the appellant is also apparent when it is noted that the margin purchaser may only look to Pacific for the performance of his contract. Until the investor has paid the full purchase price, he has no title to any physical property but only a claim against Pacific. Should the price of silver go down, there is no possibility for the investor to finance his balance (except through his own resources) and from that moment, he is at the mercy of Pacific. This is not to say that we are looking at a pure question of solvency. As pointed out by the Court of Appeal (p. 259), the conclusion of the Divisional Court does not rest "on such a narrow basis."

The key to the success of the venture is the efforts of the promoter alone, for a benefit that will accrue to both the investor and the promoter. Thus, the nature of the relationship between Pacific and its margin customers establishes that it satisfies the *Howey* test. It matters not that the relationship was built around an object that is a commodity and which in another context could be the subject matter of transactions in the futures market that would not attract the restrictions of *The Securities Act*.

Another test to determine the economic realities of a security transaction is to be found in the decision of the Supreme Court of Hawaii in *State of Hawaii v. Hawaii Market Center, Inc.* [485 P (2d) 105 (1971)], a decision of 1971. This test is possibly still more favourable to respondent in the present instance and the Divisional Court has examined the facts in that light also and has concluded that the risk capital approach would bring about the same conclusion. I agree.

At the risk of repetition, I will underscore that the question raised by this appeal is not whether or not commodity futures contracts are investment contracts. The parties agree that they are not. What is at issue is the relationship between Pacific and its margin customers examined particularly in the light of the *Howey* and the *Hawaii* tests. ...

A last word. At the invitation of the parties, I have examined the facts in the sole light of the *Howey* and *Hawaii* tests. Like the Divisional Court, however, I would be inclined to take a broader approach. It is clearly legislative policy to replace the harshness of caveat emptor in security related transactions and courts should seek to attain that goal even if tests carefully formulated in prior cases prove ineffective and must continually be broadened in scope. It is the policy and not the subsequently formulated judicial test that is decisive.

QUESTIONS

1. How does the test from *Pacific Coast* differ from those in the US cases of *Howey* and *Hawaii*?

2. The key point of contention between the majority and minority in *Pacific Coast* revolves around the nature of the dependency exhibited by the investors on aspects of PCCE's expertise and the implications of the inequality of knowledge between the two parties. Which of the two approaches do you find more convincing and why?

3. Would the analysis engaged in by the majority concerning the "legislative policy" of the Act change now that the Ontario statute specifies a range of goals for regulators to achieve (OSA, s 1.1)? Consider in particular the fact that Iacobucci J in the SCC decision in *Committee for the Equal Treatment of Asbestos Minority Shareholders v Ontario (Securities Commission)*, 2001 SCC 37 exhorted regulators to be more cognizant of the policy goal of efficiency. See the discussion of the *Asbestos* decision in Chapter 11.

4. Note that the QSA explicitly defines an investment contract to mean "a contract whereby a person, having been led to expect profits, undertakes to participate in the risk of a venture by a contribution of capital or loan, without having the required knowledge to carry on the venture or without obtaining the right to participate directly in decisions concerning the carrying on of the venture" (QSA, s 1). Should this definition be incorporated into other provincial statutes?

4. Regulatory Consideration of the Definition of a Security

Regulators also have occasion to reflect on the meaning of "security." The OSC's decision in *Re Albino* demonstrates the importance of regulatory context as an influence on the basic decision about whether an instrument is or is not a security. The context in this instance was a concern about potential insider trading on the part of a senior executive of a Canadian corporation. The decision revolved around the fact that, as part of his compensation, Mr Albino of Rio Algom (RA) was given an incentive plan whereby he would be paid the difference between the price at which the stock of RA was trading on its award and the price at which it was trading when encashed. An incentive unit was the equivalent of one common share of RA. The gain on the incentive unit was the excess of the "defined" market value of a common share on the exercise date over the "defined" market value on the award date. The executive was not being awarded any stock, just the relevant price difference. Were these "phantom stock options" (PSOs) a security? The specific regulatory issue was that at the time Mr Albino cashed in his incentive units, he had in his possession material undisclosed information having to do with revisions of a contract between RA and Ontario Hydro for the sale of uranium, which revisions would have had negative consequences for RA.

The OSC's three-person hearing panel all made different decisions on the substance of the issue. One panel member concluded that the PSOs were not securities, another said they were, and the third did not decide that question but agreed that nonetheless the OSC had jurisdiction to sanction. Commissioner Blain, who held that PSOs were not a security, did so because PSOs were not "commonly known" in the business world as securities. Rather, this was like any other employment contract where there was an interest in the profits or earnings of the company, and these were generally not securities. There was insufficient nexus with the capital market here (even though their value was determined by the market) to make it different from the debt obligations represented by other employment or other compensation contracts. No money was paid by the executive, no trading or assignment of award units was allowed, and no stock of RA changed hands. For this commissioner, it was significant that the plan defined specific periods when award units could be cashed in and times when executives were prohibited from cashing in their award units. This was a significant restraint on the

liquidity of the shares. No shareholders were harmed—that is, the actions were "market neutral" and hurt the company only, not the capital markets.

Commissioner Salter, who held that they were securities, adopted dicta of the SCC in *Pacific Coast* that the legislation must be read broadly and purposively. The relevant context here was the prohibition against illegal insider trading, and the regulation of trading by insiders via disclosure. The PSOs here should be considered the same as other derivative securities, which draw their value from the underlying securities. For this commissioner, the encashment of award units was a "constructive sale" of the securities of RA. Looking at the economic reality of the transaction, sanctions should be applied. Also, objectives with respect to prohibiting insider trading would justify finding this to be a security.

The third commissioner (Commissioner Bennett) did not decide the issue whether these PSOs were a security or not. She concluded that there was a sufficient nexus with the capital markets for the OSC to exercise its discretionary power to sanction in the public interest (now OSA, s 127). The behaviour was "seriously prejudicial to public confidence in the capital markets." The

> economic reality of action by Albino with respect to the encashment of the award units was exactly that which the insider trading rules work to eliminate—that is, to prevent an insider profiting on the basis of material, non-public information. Further, the encashment of award units generated the same signal to the marketplace as a sale of shares. Both must be reported if the signals on insider trading are to reach the market place. (at 54-55)

See also *R ex rel Swain v Boughner*, [1948] OWN 141 (H Ct J); *Re Sunfour Estates* (1992), 15 OSCB 269; *Beer v Townsgate*, 25 OR (3d) 785, 1995 CanLII 7133 (SC (GD)); *R v Sisto Finance* (1994), 17 OSCB 2467.

5. Conclusion on Segregated Fund, Viatical Settlement, and Crypto Examples

With all of this material in mind, let us return for a moment to the examples of possible securities with which we began this chapter. Based on the definition of "security" in the OSA, do you think that a segregated fund is or is not a security? With respect to viatical settlements, an example of the OSC's consideration of this issue is the *In the Matter of Universal Settlements International Inc* (2006), 29 OSCB 7880 decision, excerpted below.

In *Universal Settlements*, a unanimous panel of the OSC concluded that the instruments being offered for sale constituted securities. Universal Settlements International (USI) was a private Ontario corporation whose business involved finding investors interested in investing in viaticals and American viators interested in selling viaticals. USI had not registered under the OSA, nor had it filed a prospectus under the Act for its viatical products. USI sold a viatical product that it called GLS-II, under which an investor would acquire a fractional interest in the death benefit of a specific life insurance policy of a specific viator. The other viatical product sold by USI, GLS, was identical to GLS-II; however, GLS also contained third-party contingency insurance that paid an amount equal to the death benefit if the viator had not died by an agreed-upon date.

When USI had accumulated sufficient funds from investors, it sought out potential viators who wished to sell the amount payable by the insurance company on their life insurance policies upon the viator's death for a price less than the full face amount. USI engaged various entities to select viators pursuant to USI's selection criteria. It matched viators and viaticals with the investment parameters set by each investor. In some cases no match could be found and USI's practice was to return the funds committed by the investor. When a purchase of a viatical was made, the investor acquired a fractional interest in the viatical. USI would then send the investor a closing package, including a copy of assignment of the interest in the death benefit

to USI's US trust, a medical review estimating life expectancy, a beneficiary designation, financial ratings of the viator's insurance company, and the contingency policy of insurance where applicable. USI monitored when the contingency policy matured and was responsible for making claims.

In the Matter of Universal Settlements International Inc

(2006), 29 OSCB 7880

• • •

[8] The key issue in this hearing was whether the viatical products USI offers to investors in Ontario are investment contracts under the definition of securities in s. 1(1) of the Act. If they are investment contracts, the prospectus and registration requirements of the Act apply.

[9] Based on the three pronged test for an investment contract set out in the leading American case of *Securities and Exchange Commission v. W.J. Howey Co. et al.*, 328 US 293 (1946) as slightly modified by later cases, the viatical products of USI would constitute investment contracts under s. 1(1) of the Act, if they involve: (i) an investment of funds with a view to profit, (ii) in a common enterprise, (iii) where the profits are derived from the undeniably significant efforts of persons other than the investors.

[10] Staff and the respondent agreed that the viatical products offered by USI involve an investment of funds with a view to profit. Therefore, the issue was whether there is a common enterprise, where the profits are derived from the undeniably significant efforts of persons other than the investors.

• • •

[91] In our case, investors do not participate in the profits of the business enterprise of USI but are promised fixed returns on their investments that, on an annualized basis, will be more or less profitable depending on the period of time funds are deployed in the common enterprise. The investors furnish the capital that is deployed to purchase viaticals in the common enterprise and that is the source of the fees and income of USI and its agents from the common enterprise.

[92] In *Hawaii*, the court stated at p. 111 that "to negate the finding of a security the [investor] should have practical and actual control over the managerial decisions of the enterprise. For it is this control which gives the [investor] the opportunity to safeguard his own investment, thus obviating the need for state intervention." Investors in the USI viatical offering cannot exercise any such managerial control over their investment.

[93] In *Securities and Exchange Commission v. Life Partners, Inc.*, 87 F3d 536 (DC Cir. 1996), the United States Court of Appeals for the District of Columbia found that a scheme for the sale of viaticals to investors by Life Partners International (LPI) resulted in sufficient commonality in which there was an investment of funds for profit. However, Justice Ginsburg, speaking for the majority of the court, found that the profits in the investment did not come predominantly from the efforts of persons other than the investors. Justice Wald dissented on this issue.

[94] In *Life Partners*, LPI offered fractional interests in viaticals. LPI performed many of the tasks that USI performs for its investors. However, unlike in our case, viaticals and viators were found and scrutinized by LPI before investors were assembled or paid their funds to LPI. Thus, in *Life Partners*, LPI evaluated the viator's medical condition, reviewed the life insurance policy, negotiated the purchase

price and prepared the legal documentation before the investor made his investment decisions.

• • •

[97] LPI structured purchases of viaticals through a trust established for that purpose and investors' funds and payments for investors went through the trust and not LPI itself. Thus the funds from investors were not commingled with the funds of LPI. Justice Ginsburg held at p. 544 that "it is the inter-dependency of the investors that transforms the transaction substantively into a pooled investment" and that "if the investments are inter-dependent it would not matter if LPI scrupulously avoided commingling investors' funds—for example by passing [investor] checks directly to the seller at closing." We concluded that in our case it is not necessary that the capital or assets employed in the common enterprise also become capital and assets of USI, subject to its solvency risk, before we can find an investment contract.

• • •

[102] Justice Ginsburg concluded that the combination of LPI's pre-purchase services as a finder-promoter and its largely ministerial post-purchase services were not enough to establish that the investor's profits flow predominantly from the effort of others. We believe that this conclusion is inconsistent with the finding that the pre-purchase activities were undeniably essential to the overall success of an investor's investment.

[103] In a strong dissent, Justice Wald held that where profits depend on the success of the promoter's activities, there is less access to key information, i.e., that specific to the promoter. The investor needs to know the risk factors attached to the investment and whether there is any reason why the investor should be leery of the promoter's promises. This need for information holds true for investors prior to purchase as much as for investors who have committed their funds. Justice Wald held that an artificial line should not be drawn between pre-purchase and post-purchase activities. To do so, Justice Wald held, elevates a formal element, timing, over the economic reality of the investors' dependence on the promoter, and undercuts the flexibility and ability to adapt to "the countless and variable schemes" that are the hallmarks of the *Howey* test.

[104] In our case, most, if not all, of the pre-purchase activities in *Life Partners*, occur after an investor makes his investment by paying the committed amount and signing the purchase agreement. Those activities in *Life Partners* that occurred before investors were assembled, occur in our case, after they are assembled.

[105] While Justice Ginsburg acknowledged that it is the length of the viator's life that is of overwhelming importance to the value of the viatical settlements marketed by LPI, Justice Wald emphasized that the realization of expected investor profits depended not on the timing of the viator's death per se but rather on whether the death occurred within the period estimated by LPI.

• • •

[109] The real issue in *Mutual Benefits* was whether the investor's expectation of profits was based solely on the efforts of the promoter or a third party. MBC relied on *Life Partners*. The court, however, specifically declined to adopt the test on this issue set forth in *Life Partners*.

[110] The court agreed with the dissenting opinion of Justice Wald in *Life Partners* that significant pre-purchase managerial activities undertaken to insure the success of the investment may also satisfy the third prong of the *Howey* test.

• • •

[111] We have two conflicting cases of the US Court of Appeals (*Life Partners* and *Mutual Benefits*) on the third prong of the *Howey* test. While we are not bound to

follow US cases, we are of the opinion that *Mutual Benefits* and Justice Wald's dissenting opinion in *Life Partners* are correct and reflect the economic reality and flexible approach endorsed by the Supreme Court of Canada in *Pacific Coast*. Furthermore, we are troubled by the inconsistency in the reasoning of the majority opinion in *Life Partners*. Even so, the facts in our case are sufficiently different from those in *Life Partners*—many of the pre-purchase activities that the majority in *Life Partners* described as "undeniably essential to the overall success of the investment" are post-purchase activities in our case [i.e., they occur after the assembling of investors and after the commitment of funds]—that based on *Life Partners* alone, we could find that USI's viatical products are investment contracts.

• • •

[115] The court [in *Siporin*] disagreed with the statement in *Life Partners* that investors' profits from viatical settlements "depend entirely upon the mortality of the insured" and that in such a situation, a potential investor's "need for federal securities regulation is greatly diminished." On the contrary, the court in *Siporin* held, at p. 99:

> The mortality of the viator is merely another factor to be considered when the seller assembles a viatical settlement agreement that will, the parties hope, be profitable for the investor upon the inevitable death of a viator. What truly determines viatical settlement profitability is the realization, over time, of an outcome predicted by the seller through its analyses of the viator's life expectancy, the soundness of the insurer, the actions needed to keep the policy in effect for the original face amount, and the insurer's unconditional liability under the policy's terms.

[116] We agree with this statement.

• • •

[123] Based on the facts, and consistent with the cases discussed above, we find that USI's relationship with its investors in GLS-II and GLS constitutes a common enterprise and that the profits of the common enterprise are derived from the undeniably significant efforts of USI and its agents. Accordingly, USI's viatical products are investment contracts, and, therefore securities under the Act.

See also *Re Pogachar* (2012), 35 OSCB 3389.

At the time of writing, there is significant uncertainty in the US financial markets as to the legal status of crypto assets and the appropriate entity to regulate them (i.e., the Securities and Exchange Commission [SEC] or the Commodities Futures Trading Commission [CFTC]). Meanwhile, in Canada, securities regulators have attempted to provide some clarity as to the regulatory approach to crypto assets. In 2020 and 2021, the Canadian Securities Administrators (CSA) and the Investment Industry Regulatory Organization of Canada (as it then was) issued Joint Staff Notices 21-327 and 21-329. The first of these established the circumstances in which securities regulators would assert jurisdiction over platforms facilitating the trading of crypto assets by users. The second notice provided more detail as to the regulatory requirements that would be imposed depending on whether a crypto asset trading platform was appropriately characterized as a "marketplace platform" or a "dealer platform." These requirements included recognition or registration, as appropriate, appropriate arrangements for clearing and settlement of trades, and custody of user assets. For more detail, see Ryan Clements, "Emerging Crypto-Asset Jurisdictional Uncertainties and Regulatory Gaps" ((2021) 37:1 BFLR 25).

Securities regulators have also launched several enforcement actions against crypto asset trading platforms. The excerpt below from the *Manticore Labs OÜ (Re)*, 2024 ONCMT 19 decision provides an example of the application of the *Pacific Coast* factors to the activities of a crypto asset trading platform. Manticore Labs was also known as Coinfield.

Manticore Labs OÜ (Re)

2024 ONCMT 19 (footnotes omitted)

[4] A threshold issue was whether this case involved "securities" as defined in the Act. For the reasons set out below, we find that the relationship between CoinField and each of the investors was an "investment contract" and therefore a "security."

• • •

[8] The Commission submits that the "crypto contracts," i.e., the contracts that the CoinField users entered into with CoinField when they deposited fiat currency or crypto assets, and bought or sold crypto assets, are securities. We agree.

[9] The Commission relies on the definition of "investment contract," which is one of the enumerated definitions of a "security" in s.1(1) of the Act. In *Pacific Coast*, the Supreme Court of Canada identified the elements of an investment contract:

a. an investment of money,
b. with an intention or expectation of profit,
c. in a common enterprise in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties, and
d. where the efforts made by those other than the investor are the undeniably significant ones—essential managerial efforts which affect the failure or success of the enterprise.

[10] The first element is satisfied, because each investor began their relationship with CoinField by investing money. CoinField described itself as a "digital asset trading platform," the terms and conditions of use of which provided that users could use their CoinField account and Manticore Estonia's payment processing services to buy, manage, exchange and withdraw their crypto assets or fiat currency.

[11] Two investors testified at the hearing and confirmed that the relationship involved an investment of money:

a. S.V. opened an account on the CoinField platform by depositing fiat currency, with which he was able to purchase digital tokens, including Ethereum; and
b. S.E. used a credit card to deposit funds into his CoinField account, and then used those funds to purchase crypto assets.

[12] The second element, an expectation of profit, is also satisfied. As CoinField's own website stated, "Whether you're new to investing or an experienced trader, you're seconds away from great returns." Investors S.V. and S.E. confirmed that they invested their funds (in one case, the proceeds of an insurance claim) expecting that their assets would grow.

[13] The third and fourth elements set out above (i.e., common enterprise, and reliance on the efforts of others) are so interwoven that they can be addressed together. We should consider those elements using a purposive approach that considers the need of CoinField's users for the protections that securities law provides.

[14] Investors deposited money and made trading decisions that were otherwise entirely dependent on the respondents. Investors relied on the respondents to provide the trading platform, to maintain proper custody of their assets, and to enable prompt transactions, including withdrawals.

[15] In some ways, the environment in which the CoinField users were operating is similar to that experienced by clients of registered dealers, trading common shares and other more traditional securities. Significantly, that more traditional

environment features wide-ranging protections that are not present here. Consistent with this Tribunal's approach in *Mek Global* and *Polo Digital Assets, Ltd.*, we heed both the Act's mandate that we consider investor protection and the Supreme Court of Canada's call for a flexible and purposive approach. We conclude that the crypto contracts between CoinField and its users embodied a common enterprise and the investors' reliance on CoinField, thereby meeting the third and fourth elements of the *Pacific Coast* test.

[16] We find, therefore, that each element of the test set out above has been met. Each crypto contract between CoinField and one of its users is an investment contract and therefore a security.

QUESTIONS

1. Do you think that the decision to apply sanctions in *Re Albino* was the right one?
2. When the first draft of a proposed provincial capital markets act (PCMA) (Government of Ontario, "Capital Markets Act—Consultation Draft" (last visited 6 October 2025), online: <https://www.regulatoryregistry.gov.on.ca/proposal/38527>) was published in August 2014, branch (f) of the proposed definition of a security read as follows:

> (f) any agreement under which the interest of the purchaser is valued for purposes of conversion or surrender by reference to the value of a proportionate interest in a specified portfolio of assets, other than, unless otherwise provided by the regulations, a contract issued by an insurance company governed by the laws of Canada or of a province which provides for payment at maturity of an amount not less than three quarters of the premiums paid by the purchaser for a benefit payable at maturity.

Compare this wording to that contained in the current branch (f) of the definition of security under the OSA. Why do you think that 7 of the 62 commenters on this proposed PCMA were insurance companies or representatives of insurance companies who took issue with this definition?

3. Who are securities regulators protecting in the viatical settlements example?
4. If the attraction of crypto assets is that they offer the opportunity to operate in an environment free of government involvement, should regulators take a "hands-off" approach to them?

III. EVOLVING REGULATION OF DERIVATIVES IN CANADA

As noted above, as a result of the GFC, securities regulators around the world began to pay attention to the need to develop a regulatory framework for the trading of derivatives. As a relatively unregulated market, the volume of trading in the derivatives markets had increased steadily in the decade before the crisis. The following extract from an article published in 2011 provides an early account of the major features associated with financial instruments grouped under the heading "derivative."

TE Lynch, "Derivatives: A Twenty-First Century Understanding"

(2011) 43:187 Loy U Chicago LJ 5 at 5-14 (footnotes omitted)

Derivatives have been a popular topic of conversation in recent years. And, indeed, they should be. The presence of derivatives in the global financial industry has grown enormously in the last two decades. Many different categories of derivatives have grown enormously too, some of which did not exist twenty years ago.

For example, the notional amount of derivatives contracts outstanding globally in 1990 was approximately $6 trillion, but by the end of 2009, this amount was estimated at $691 trillion, a one-hundredfold increase. The notional amount of outstanding credit default swaps, which were non-existent as of 1990, is estimated to have been as high as $58 trillion in recent years. The notional amount of outstanding interest rate swaps at the end of 1990 was an estimated $2.3 trillion, but by 2009, this figure had increased to an estimated $349 trillion. For foreign exchange derivatives, the figure in 1990 was $578 billion, but by 2010, it had grown to $49 trillion.

The markets for exchange-traded options and futures derivatives have also grown. As of June 2010, the outstanding notional amount of exchange-traded futures contracts was $23 trillion (with a quarterly turnover of $384 trillion), and the figures for options were comparable. More than 10 million oil derivatives contracts are traded each month on derivatives exchanges. In fact, this market is so large that the daily turnover on the International Petroleum Exchange of futures contracts on Brent crude, an oil extracted only from the North Sea, approximates twice the daily global production of oil.

Additionally, derivatives are not necessarily innocuous things. Recent history is rife with examples of firms and municipalities suffering severe and sometimes disastrous economic losses as a result of losing their derivatives bets. For example, Metallgesellschaft, formerly one of Germany's largest industrial conglomerates, lost approximately $1.4 billion in 1993 speculating in oil futures. Barings Bank went bankrupt in 1995 after losing approximately $1.3 billion in speculative derivatives, approximately half of those bets on the level, volatility and direction of the Nikkei 225 stock index. In the mid-nineties, Orange County, California lost $1.7 billion of taxpayer money on speculative derivatives, and the Sumitomo Corporation lost an estimated $2.6 billion on speculative derivatives, many of them copper futures. The hedge fund Long-Term Capital Management lost approximately $1.3 billion in 1998 speculatively selling options, most referencing European stock indices. More recently, IKB Deutsche Industribank lost approximately $4 billion in 2007, much of it speculating in derivatives referencing American subprime mortgages. In 2008, Société Générale reported that it had lost approximately $7 billion in large part due to derivatives trading. And AIG, through its subsidiary AIG Financial Products, speculatively sold hundreds of billions of dollars of credit default swaps insuring its counterparties against, among other things, losses that might be incurred as a result of a collapse in the U.S. housing market and the collapse of their third-party contractual counterparties. AIG found itself on the brink of collapse when the housing market and the economy moved against it.

Furthermore, derivatives, particularly credit default swaps and various "synthetic" securities, have been identified as culprits contributing to the current global financial crisis. Warren Buffet famously referred to derivatives as "time bombs" and "financial weapons of mass destruction."

As a result of their growth and apparent dangers, American and foreign government officials have recently turned their attention to better regulating derivatives. Unfortunately, regulatory, policy, and even legal discussions of derivatives are often muddled and demonstrate persistent misunderstandings of what derivatives are. Many people who probably should be conversant with derivatives shy away from rigorous discussion about them because they are allegedly so "complex" and "exotic."

A derivative is invariably described in words to the following effect: "a financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity," or "a financial

instrument whose value depends on (or derives from) the value of other, more basic, underlying variables." This is the definition that is almost always used in legal scholarship and in policy discussions. But for legal and policy analysis purposes, this definition is inadequate—it is imprecise, incomplete, and fails to capture the nature and scope of modern derivative transactions. The common definition is both over- and under-inclusive in that it encompasses investments that are obviously not derivatives, such as stocks and bonds, while excluding others that clearly are, such as event derivatives, insurance policies, and Super Bowl bets. As a result, policy makers and legal analysts are often less than fully informed as compared to derivatives industry groups, who often do understand their true nature.

A persistent misunderstanding of derivatives hampers our ability to differentiate between socially useful and socially harmful derivatives. The framework offered in this Article facilitates this valuable differentiation.

A persistent misunderstanding of derivatives also prolongs the use of an outdated derivatives regulatory scheme. Derivatives regulation in the United States involves a multiplicity of state and federal laws, as well as the administrative and regulatory functions of many state and federal agencies. The federal derivative legislative process is overseen by various congressional commissions, primarily (of all things!) the Senate Committee on Agriculture, Nutrition and Forestry and the House Agricultural Committee. This hodge-podge of a regulatory structure reflects the evolution of derivatives over time, appearing first as simple futures and options on agricultural commodities used for hedging purposes by producers and consumers of these commodities but morphing into such truly exotic beasts as synthetic collateral debt obligations that reference sets of credit default swaps, which themselves reference tens or hundreds of thousands of American subprime mortgages. As the scope and scale of derivatives evolved, mere patches and band-aids were placed on the then-existing regulatory scheme, the latest band-aid being the Dodd-Frank Act. At times, extensive deregulation occurred, leading to eras of explosive derivatives evolution, leaving the regulatory apparatus struggling to keep up. As a result, we are left with a derivatives regulatory regime that often appears confusing, incomplete, contradictory, greatly subject to interpretation, incapable of addressing derivatives innovation, and even at times, simply irrational or incomprehensible. The framework presented in this Article will facilitate the process of developing a modern, comprehensive derivatives regulatory regime.

Most pressingly, a persistent misunderstanding of derivatives hampers regulators' attempts to develop rational, desirable, optimal derivatives regulation as required by the recently enacted Dodd-Frank Act. In Dodd-Frank, Congress significantly altered derivatives regulations but was unable to wrestle successfully with many of the difficult issues embedded within the modern derivatives industry. Congress, therefore, left much of the difficult regulatory line-drawing to the Commodity Futures Trading Commission ("CFTC"), the Securities and Exchange Commission ("SEC"), and the Treasury Department.

Furthermore, members of the financial industry have come to appreciate the true nature of derivatives, as well as their flexibility and manipulability, which has enabled them to develop new and innovative derivatives over the course of the last two decades.

• • •

So what exactly is a derivative? At the risk of oversimplifying, all derivatives are contracts between two counterparties in which the payoffs to and from each counterparty depend on the outcome of one or more extrinsic, future, uncertain events or metrics. This means that they are "aleatory contracts" in which each

> counterparty expects the outcome to be opposite to that expected by the other counterparty. … As an initial step, it is expedient to understand that derivatives provide, in the aggregate, zero-sum payoffs to the counterparties. … There are specific ways, however, that a derivatives contract can create non-monetary value—e.g., by providing one or both counterparties a consumer or producer surplus, hedging value or entertainment value, or by creating certain positive externalities such as improved price discovery. Understanding these value-creating scenarios will help refine our definition.

The International Monetary Fund's (IMF) report on Canada's financial system in 2014 included some information about derivatives-related activity in Canada. It distinguishes between derivatives that are traded on an exchange and those traded over the counter (OTC). In order for a derivative contract to be exchange traded, its terms must be sufficiently standardized that many customers would be interested in buying and selling on those terms. Most derivatives are traded OTC, meaning that the contracts are bilateral and customized to the needs of the participants. The IMF report notes that the Montreal Exchange is Canada's financial derivatives exchange, listing equity, currency, index, and interest rate derivatives. Meanwhile the OTC derivatives market in Canada is concentrated among six Canadian banks, who trade most often with foreign counterparties (IMF, *Canada: Financial Sector Assessment Program, IOSCO Objectives and Principles of Securities Regulation-Detailed Assessment of Implementation* (Washington, DC: IMF, March 2014) at 12). More recently, the 2024 CSA Report on Capital Markets indicates that the Canadian OTC derivatives market achieved sustained growth in 2024. As of December 31, 2024, the total notional outstanding for all OTC derivative products, excluding commodities, involving a Canadian counterparty reached $107 trillion, reflecting a 21.5 percent year-over-year increase. Interest rate derivatives primarily fueled this growth, with a 21 percent increase, though all asset classes demonstrated year-over-year growth. Interest rate derivatives account for most positions measured by outstanding notional, but foreign exchange (FX) derivatives make up the majority of trading volume. Canada's share of the global OTC derivatives market has steadily increased over the past few years. In terms of global notional outstanding, Canada's share has risen from approximately 5.3 percent in 2018 to 9 percent in 2024. All Canadian derivatives asset classes have increased their share of the global market over that five-year period (CSA Systemic Risk Committee, *2024 Annual Report on Capital Markets* (Montréal: Canadian Securities Administrators, 30 January 2025), online (pdf): <https://www.securities-administrators.ca/wp-content/uploads/2025/02/English-SRC_Annual_Report_2024.pdf> (footnotes omitted)).

In this chapter, we focus on developments with respect to the definition of a derivative that could be subject to regulation under provincial securities acts. In the OSA, the analysis begins with the definition of a derivative in s 1(1). Accordingly,

> "derivative" means an option, swap, futures contract, forward contract or other financial or commodity contract or instrument whose market price, value, delivery obligations, payment obligations or settlement obligations are derived from, referenced to or based on an underlying interest (including a value, price, rate, variable, index, event, probability or thing), but does not include,
>
> (a) a commodity futures contract as defined in subsection 1(1) of the *Commodity Futures Act*,
>
> (b) a commodity futures option as defined in subsection 1(1) of the *Commodity Futures Act*,
>
> (c) a contract or instrument that, by reason of an order of the Commission under subsection (10), is not a derivative, or
>
> (d) a contract or instrument in a class of contracts or instruments prescribed by the regulations not to be derivatives; ("produit dérivé")

We can see that this definition is quite expansive, since it covers a variety of types of contract or instrument whose key features are "derived from, referenced to or based on an underlying interest." However, the definition allows for discretion to reside in the OSC to order that an instrument not be classified as a derivative, or for the regulations to prescribe a class of contracts or instruments not to be derivatives. Section 1(1) also includes a definition of a "designated derivative," which is a derivative that is designated by order of the Commission or that belongs to a class prescribed by the regulations.

OSC Rule 91-506 (*Derivatives: Product Determination* (2013) 36 OSCB 11015), which came into force on December 31, 2013, clarifies the conditions under which a contract or instrument will not be considered a derivative. These conditions include situations where the contract or instrument is regulated by gaming control legislation, or if it is an insurance or annuity contract regulated by insurance law, if it is a contract for the purchase or sale of currency or commodities with certain features that do not bring it within the scope of a derivative (including that the intention is that the contract be settled by the delivery of the currency or commodity). The Rule also purports to address situations where a contract or instrument could be considered to be both a security and a derivative.

From the perspective of substantive derivatives regulation, Ontario has also passed a trade reporting rule that creates a reporting obligation for derivatives trading where local counterparties are involved (OSC Rule 91-507, *Trade Repositories and Derivatives Data Reporting* (as amended 2022) 45 OSCB 5689). Further amendments to this rule, intended to harmonize Canadian data reporting with international requirements, were intended to come into effect in July 2025. The regulatory purpose here is to increase transparency in the market for derivatives for regulatory authorities and on an anonymized basis for the public. It also assists in the determination of whether the volume or concentration of derivatives activity could pose a systemic risk to the Canadian financial system. It has also extended the application of some of the substantive rules in the OSA, such as the registration requirements and certain market conduct requirements such as insider trading requirements or fraud, to include those trading in derivatives.

In 2023, a number of CSA jurisdictions introduced Multilateral Instrument 93-101, *Derivatives: Business Conduct* (2023), 46 OSCB 10479 (<https://www.osc.ca/sites/default/files/2023-09/csa_20230928_93-101_nop-derivatives.pdf>). In introducing the rule, the CSA indicated that MI 93-101 is a response to serious market misconduct in the global derivatives market and short-term FX market since the 2008 GFC and the inappropriate sale of financial instruments that led to the 2008 financial crisis, including "the manipulation of benchmarks and front-running of customer orders, breaches of client confidentiality, and failure to adequately manage conflicts of interest" (at 1-2). It was developed to protect market participants and reduce risks, including potential systemic risk, as well as improve transparency, increase accountability, and promote responsible business conduct in OTC derivatives markets. The IMF had reported in 2019 that Canada's "[o]ngoing reforms in the areas of conduct of business of [OTC] derivatives and duties towards clients should be completed" (at 2). MI 93-101 applies to a person or company if it meets the definition of "derivative adviser" or a "derivatives dealer," regardless of whether the adviser or dealer is registered or exempted from the requirement to be registered in a jurisdiction. A business trigger test is used to determine if the person or company is in the business of trading or advising in OTC derivatives. The person or company may be exempt from the requirements under MI 93-101 if they qualify for an exemption. Rules under MI 93-101 relate to the following: fair dealing, conflicts of interest, knowing your derivatives party (KYDP), suitability, pre-transaction disclosure, reporting of non-compliance, senior management duties, record keeping, and treatment of derivatives party assets. MI 93-101 has been converted into NI 93-101 and has been in effect since September 2024 ((2024) 47 OSCB 7519).

IV. WHAT IS A TRADE?

The definition of a "trade" is also central to the application of securities law. Several provincial securities acts provide that if there is a trade, the trader has to be registered (British Columbia *Securities Act*, RSBC 1996, c 418 (BCSA), s 34; QSA, s 148). Meanwhile the OSA now provides that those who are engaged in the business of trading are required to be registered (s 25). Several offences created by securities law require a finding that trading took place, including, most notably, insider trading. The relevant definition of "trade" at OSA, s 1(1) says:

> "trade" or "trading" includes,
>
> (a) any sale or disposition of a security for valuable consideration, whether the terms of payment be on margin, instalment or otherwise, but does not include a purchase of a security or, except as provided in clause (d), a transfer, pledge or encumbrance of securities for the purpose of giving collateral for a debt made in good faith,
>
> (b) any participation as a trader in any transaction in a security through the facilities of any stock exchange or quotation and trade reporting system,
>
> (b.1) entering into a derivative or making a material amendment to, terminating, assigning, selling or otherwise acquiring or disposing of a derivative, or
>
> (b.2) a novation of a derivative, other than a novation with a clearing agency,
>
> (c) any receipt by a registrant of an order to buy or sell a security,
>
> (d) any transfer, pledge or encumbrancing of securities of an issuer from the holdings of any person or company or combination of persons or companies described in clause (c) of the definition of "distribution" for the purpose of giving collateral for a debt made in good faith, and
>
> (e) any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of the foregoing.

Again, the definitions provided are not exhaustive, and although clause (e) of the definition is broad, there is presumably a residual area of discretion available to the regulators to decide that some other activity outside these parameters is also a trade.

The implications of pledging securities was raised in *Cormark Securities Inc (Re)*, 2024 ONCMT 26.

A. SALE FOR VALUABLE CONSIDERATION

The first clause of the Ontario definition of trade includes "any sale or disposition of a security for valuable consideration," and the wording in the BCSA is similar. It raises a series of interpretive questions. Why does the definition not apply to *purchases* of securities? What about takeover bids? Is someone who purchases a security on the basis of material undisclosed information in Ontario engaging in insider trading? Note that most definitions of trade cover both primary and secondary market trades. What about the typical requirement that the sale or disposition be "for valuable consideration"? Why are gifts excluded? What about corporations that declare stock dividends?

B. TRADES BY PROFESSIONALS

Clauses (b) and (c) of the Ontario definition of trade are directed toward the regulation of persons involved in carrying out trades on behalf of others, who have to fulfill extensive registration requirements. This definition is arguably necessary to give legal authority to the regulatory strategy of registering professional traders and is consistent with the policy objective of controlling access to the activity of professional trading in the interests of protecting investors in relation to their interactions with such professionals. Note that clauses (b.1) and (b.2) capture the entering into or amending of a derivative contract within the definition of trading.

C. TRADES BY CONTROL PERSONS

Various transactions from the holdings of "control persons" "for the purpose of giving collateral for a debt made in good faith" are considered trades by virtue of clause (d) of the definition of trading in Ontario. We will see that sales of securities from the holdings of control persons are considered distributions in many provinces. Why is the pledging of shares as collateral, where the control person might ultimately retain the securities, also singled out for specific mention? Note that such pledging by non-control holders is specifically excluded from the first clause of the definition of trade. Does it have something to do with the assumption that control persons might have superior access to information about the issuer? How are the activities of control persons relevant to other investors?

D. ACTS IN FURTHERANCE OF A SALE

The scope of the definition of "trade" is extended significantly by Ontario's clause (e) (clause (f) in the BCSA definition of trade), which incorporates any act in furtherance of a sale of a security. This might include various kinds of presale activities or sales pitches, such as providing a list of names of prospective purchasers, or placing advertisements in widely circulated publications before the incorporation of a company. The regulatory concern is that any sales pitches might include pressure tactics or misrepresentations, which would influence the buyer but not be caught by the legislation because they take place prior to the actual trade. Thus the inclusion of presale activities in the definition is intended to maintain the integrity of the markets and to protect investors. The provision has been read to exclude an entity that is not involved in the investment decision-making process. One example of this would be a firm that provided bookkeeping and administrative services to investment dealers trading in mutual fund securities. The involvement of this trust company occurred only after the trade in a security had taken place between the broker and the client. See *Re Ontario Securities Commission and CAP Ltd*, 22 DLR (3d) 529, 1971 CanLII 639 (ONSC). The OSC has held that accepting money from investors and depositing investor cheques for the purchase of shares in a bank account constitute acts in furtherance of trades (*Re Limelight Entertainment Inc* (2008), 31 OSCB 1727 at para 133). Mark R Gillen points out that it is not entirely clear whether the acts described under other clauses of the definition need to *eventually* be completed before the notion of a "furtherance" can be said to apply (*Securities Regulation in Canada*, 4th ed (Toronto: Thomson Reuters, 2019) at 227). He concludes that this would be too limited a position to take on the intent of the legislative provision. Such an interpretation might, for example, prevent an injunction being granted to forestall a trade. Thus, a broad reading of the legislation would probably prevail here.

E. JURISDICTIONAL ISSUES IN RELATION TO TRADING

It may sometimes be necessary to determine where a trade is in fact taking place in order to assess whether a particular regulator has jurisdiction over that trading. This issue has become ostensibly more complicated with the advent of Internet-based trading and will be canvassed further in later chapters. A typical example of the sort of issue that can arise is found in the *Limelight Entertainment* decision cited above, where the commission found that it had jurisdiction over the matter because several acts in furtherance of trading took place in Ontario, even though many of the investors solicited were outside the province. In *Crowe v Ontario Securities Commission*, 2011 ONSC 6918, the Ontario Superior Court of Justice upheld a decision of the OSC that it had jurisdiction to sanction several corporations and their individual officers or de facto officers where acts in furtherance of trading had taken place in Ontario, even though securities of the corporations involved were sold only to offshore investors.

Finally, we add here an excerpt from an Alberta Securities Commission (ASC) decision, *Re World Stock Exchange* (2000), 9 ASCS 658, which addressed the issue whether the ASC could sanction the promoters of an "Internet stock exchange." The World Stock Exchange (WSE) was incorporated in the Cayman Islands and its website was also located there. It solicited a number of Albertans and Alberta companies to raise money on WSE despite its not being recognized by the ASC as an exchange and the individuals involved not being registered. The ASC addressed the issue of whether the respondents traded in securities contrary to the Alberta legislation in the following manner.

Re World Stock Exchange

(2000), 9 ASCS 658

The principles expressed in *McKenzie* were applied by the Commission to telephone solicitations in *Re Cromwell Financial Service Inc. et al.* (1996, unreported) and, in our view, these same principles apply to solicitations by any method of communication, including the Internet. The Internet is revolutionary in the way it permits instantaneous communication and interactivity on a global scale, but its function in relation to securities trading remains essentially similar to the mail or the telephone. We agree with the statement in "Securities Activity on the Internet" (a *Report of the Technical Committee of the International Organization of Securities Commissions* published in September 1998), that the "fundamental principles of securities regulation do not change based on the medium."

These principles are also reflected in National Policy 47-201 Distribution of Securities Using the Internet and other Electronic Means ("NP 47-201"), which became effective January 1, 2000. Although its provisions are not authoritative in this proceeding, the following section of NP 47-201 is completely consistent with our view:

> 2.2 Trading in a Jurisdiction
>
> (1) The securities regulatory authorities generally consider a person or company to be trading in securities in a local jurisdiction if that person or company posts on the Internet a document that offers or solicits trades of securities, and if that document is accessible to persons or companies in that local jurisdiction.
>
> (2) Despite subsection (1), the securities regulatory authorities consider the posting of a document on the Internet that offers or solicits trades of securities not to be a trade or, if applicable, a distribution, in a local jurisdiction if
>
> (a) the document contains a prominently displayed disclaimer that expressly identifies the local jurisdictions and/or foreign jurisdictions in which the offering or solicitation is qualified to be made, and that identification does not include the local jurisdiction; and
>
> (b) reasonable precautions are taken by all persons or companies offering or soliciting trades of securities through the document posted on the Internet not to sell to anyone resident in the local jurisdiction.
>
> (3) Market participants are reminded that the registration requirements of securities legislation apply in connection with the posting of a prospectus or other offering document on the Internet for use in connection with a distribution in a local jurisdiction. The act of posting a prospectus or offering document in those circumstances is an act in furtherance of a trade in that local jurisdiction, and the person or company posting the prospectus or offering document must, in order to comply with the registration requirements

(a) be registered to trade in the local jurisdiction;
(b) have the benefit of an exemption from the registration requirements in connection with the distribution in the local jurisdiction; or
(c) refer all inquiries concerning the document to a registered dealer in the local jurisdiction.

It is clear that the respondents traded in the securities of the WSE. They similarly traded in the securities of the companies listed on the WSE.

See also *Asbestos* and *Sharp v Autorité des marchés financiers*, 2023 SCC 29, which confirmed that provincial jurisdiction exists where there is a "real and substantial connection" to the province.

V. WHAT IS A DISTRIBUTION?

Once a determination is made that the transaction involves a security and a trade, the next question in many jurisdictions is whether the trade in that security constitutes a distribution. Again, the importance of this determination is that a prospectus (or an exemption from the prospectus requirement) is necessary when securities are being distributed. See, for example, OSA, s 53 or QSA, s 11.

In most provincial jurisdictions, the definition of distribution is likewise broad but rather more straightforward than the definition of a security. OSA, s 1 provides:

"distribution," where used in relation to trading in securities, means,
(a) a trade in securities of an issuer that have not been previously issued,
(b) a trade by or on behalf of an issuer in previously issued securities of that issuer that have been redeemed or purchased by or donated to that issuer,
(c) a trade in previously issued securities of an issuer from the holdings of any control person,
(d) a trade by or on behalf of an underwriter in securities which were acquired by that underwriter, acting as underwriter, prior to the 15th day of September, 1979 if those securities continued on that date to be owned by or for that underwriter, so acting,
(e) a trade by or on behalf of an underwriter in securities which were acquired by that underwriter, acting as underwriter, within eighteen months after the 15th day of September, 1979, if the trade took place during that eighteen months, and
(f) any trade that is a distribution under the regulations,
and also includes any transaction or series of transactions involving a purchase and sale or a repurchase and resale in the course of or incidental to a distribution and "distribute," "distributed," and "distributing" have a corresponding meaning.

A. SECURITIES NOT PREVIOUSLY ISSUED

The first clause of the Ontario definition of distribution has to do with trades in a security of an issuer "that have not been previously issued." An "issue" here means the offer of securities for sale. An "issuer" simply means "a person or company who has outstanding, issues or proposes to issue, a security" (e.g., OSA, s 1). A person or company offering a security for sale that has not previously been offered for sale is making a distribution in Ontario, and a prospectus will be required unless an exemption is available. Another way of putting this is to say that in many provinces a prospectus is required in all circumstances involving the issuing of new securities other than those outlined in the statutory exemption sections of the act, regulations, or rules, for those provinces that can pass them. We have noted that the QSA does not contain a

definition of "trade." Accordingly, the first branch of the QSA's definition of distribution (QSA, s 5) refers to "the endeavour to obtain, or the obtaining, by an issuer, of subscribers, or acquirers of his securities."

B. REISSUE OF SECURITIES

The second meaning refers to the idea that the reissue by the issuer of securities previously issued is also a distribution. The point is that on reissue, the issuer might have in its possession material information not otherwise available to the public. Gillen points out that this clause of the definition of distribution is moot for many Canadian corporations, because both the *Canada Business Corporations Act*, RSC 1985, c C-44, s 39(6) (CBCA) and the Ontario *Business Corporations Act*, RSO 1990, c B.16, s 35(6) (OBCA) require that shares that are redeemed cannot be held for resale but must instead be cancelled. See Mark R Gillen, *Securities Regulation in Canada*, 4th ed (Toronto: Thomson Reuters, 2019) at 230.

C. SALES OF SECURITIES BY CONTROL PERSONS

In many provinces, one aspect of the definition of distribution refers to sales of securities by control persons.

1. Reasons Sales by Control Persons Are Considered to Be Distributions

1. Despite the fact that sales of securities by control persons involve sales of already issued securities, their regulation in this way is justified by a number of policy concerns. The assumption is that those in control have better knowledge of the issuer and the possibility of influence over internal and board decisions. Regulating control transactions on this basis is justified as an issue of equality of access for all investors.
2. Control persons have a superior ability to alter the value of the issuer. If the sale involves a substantial number of securities, the market price of the security may be affected and the sale itself may therefore be a "material" event.
3. Similarly, the control person themself may be an important factor in the success of the enterprise, and the sale of their shares should therefore be disclosed to other shareholders by way of the imposition of a prospectus requirement.

2. What Is a Control Block of Shares?

The OSA contains a specific definition of "control person" as follows:

> (a) a person or company who holds a sufficient number of the voting rights attached to all outstanding voting securities of an issuer to affect materially the control of the issuer, and, if a person or company holds more than 20 per cent of the voting rights attached to all outstanding voting securities of an issuer, the person or company is deemed, in the absence of evidence to the contrary, to hold a sufficient number of the voting rights to affect materially the control of the issuer, or
>
> (b) each person or company in a combination of persons or companies, acting in concert by virtue of an agreement, arrangement, commitment or understanding, which holds in total a sufficient number of the voting rights attached to all outstanding voting securities of an issuer to affect materially the control of the issuer, and, if a combination of persons or companies holds more than 20 per cent of the voting rights attached to all outstanding voting securities of an issuer, the combination of persons or companies is deemed, in the absence of evidence to the contrary, to hold a sufficient number of the voting rights to affect materially the control of the issuer;

The following elements of this definition are relevant:

1. Under the Ontario statute, the meaning of "holdings" refers to the situation where the person is in a position to exercise rights with respect to securities. Thus, it would probably not include nominees who have no right to vote or to receive dividends.
2. The only type of relevant control is that arising from the holding of voting rights attached to outstanding voting securities (that is, not being a director or creditor). The reference to the ability to "affect materially" includes less than actual control. If certain activities can be blocked (such as significant transactions like amalgamations or sales of substantially all the assets) by a holding of securities that is not large enough to actually control the issuer, the effect of the holding on control may nevertheless be material—for example, a voting agreement between a 15 percent shareholder and a 40 percent shareholder. An ability to control as well as actual exercise of control appears to be contemplated by the Ontario provision.
3. According to the definition of control person, a holding of more than 20 percent of the voting rights attached to all outstanding voting securities is deemed to represent a control block unless there is evidence to the contrary (such as evidence that the holder does not have the ability to control where another person or combination holds the majority of the voting securities or is in a position to control the election of the board of directors). As noted above, it is important to remember that less than 20 percent of the voting securities may still constitute a control block, depending on circumstances such as "the existence of sufficiently large security holdings by others, the pattern of voting behaviour by various holders, the way in which securities are distributed and, possibly, an analysis of the recent history of ownership of the securities in question" (Borden Ladner Gervais, *Securities Law and Practice*, 3rd ed (Toronto: Carswell) (loose-leaf) (BLG) at 17-115.
4. The second branch of the OSA definition is the identification of a "combination of persons or companies, acting in concert by virtue of an agreement, arrangement, commitment, or understanding, which holds in total a sufficient number of the voting rights attached to all outstanding voting securities of an issuer to affect materially the control of the issuer" (1(1)). It does not appear to be a requirement that every issuer must have a controlling shareholder or group of shareholders; however, the definition makes clear that each person or company in the combination could be a control person.

D. RESALE OF SECURITIES

Finally, most, but not all, provincial legislation controls the process of *resale* of securities sold under a prospectus exemption where another exemption is unavailable, by initially deeming the resale to be a distribution, unless the relevant substantive resale rules are satisfied. See Chapter 5 for more on this subject.

VI. WHAT IS A REPORTING ISSUER?

The statutory concept of a reporting issuer carries an enormous amount of regulatory weight because it is the mechanism whereby securities law accomplishes the objective of ensuring the obligation to continuously disclose information to investors. As we will see in more detail in Chapter 6, all provinces impose continuous disclosure requirements on reporting issuers. For example, in Québec, s 68 of the QSA says: "A reporting issuer is an issuer that has made a distribution of securities to the public; a reporting issuer is subject to the continuous disclosure requirements of Chapter II of this title."

In Ontario, a

"reporting issuer" means an issuer,

(a) that has issued voting securities on or after the 1st day of May, 1967 in respect of which a prospectus was filed and a receipt therefor obtained under a predecessor of this Act or in respect of which a securities exchange take-over bid circular was filed under a predecessor of this Act,

(b) that has filed a prospectus and for which the Director has issued a receipt under this Act,

(b.1) that has filed a securities exchange take-over bid circular under this Act before December 14, 1999,

(c) any of whose securities have been at any time since the 15th day of September, 1979 listed and posted for trading on any stock exchange in Ontario recognized by the Commission, regardless of when such listing and posting for trading commenced,

(d) to which the *Business Corporations Act* applies and which, for the purposes of that Act, is offering its securities to the public,

(e) that is the company whose existence continues following the exchange of securities of a company by or for the account of such company with another company or the holders of the securities of that other company in connection with,

(i) a statutory amalgamation or arrangement, or

(ii) a statutory procedure under which one company takes title to the assets of the other company that in turn loses its existence by operation of law, or under which the existing companies merge into a new company,

where one of the amalgamating or merged companies or the continuing company has been a reporting issuer for at least twelve months, or

(f) that is designated as a reporting issuer in an order made under subsection 1(11).

A. SECURITIES ISSUED UNDER A PREDECESSOR ACT

The first clause of the Ontario definition deals with entities that issued securities prior to the coming into force of the current Act and obtained a prospectus receipt for them. Note that this definition applies only to having issued "voting" securities. It does not include issuers whose securities were issued before 1967 and who have not subsequently qualified a prospectus in Ontario.

B. OBTAINING A RECEIPT FOR A PROSPECTUS

This is the most widely applicable of the various Ontario definitions because it refers to any issuer that has obtained a receipt for a prospectus from the regulator. Note that the specific requirement is only that a receipt was obtained for the prospectus, rather than that securities were ultimately distributed. One implication of this in Ontario is that it enables issuers who have issued securities under prospectus exemptions to qualify those securities for general resale by obtaining a receipt for a subsequent prospectus. Thus, in order to create or facilitate a broad secondary market for securities issued via exemptions, an issuer may use s 53(2) of the Ontario Act to become a reporting issuer. Clause (b.1) is now of historical interest only in Ontario, because it represents the closing of a significant loophole in the definition of a reporting issuer that formerly allowed issuers to become reporting issuers by filing a takeover bid circular, which involved the exchange of securities as consideration for the bid. This possibility created a form of "reverse takeover" that enabled businesses that were not reporting issuers to become so, with little or no scrutiny by regulators, by taking over an inactive company. However, becoming a reporting issuer by filing a securities exchange takeover bid circular is still a possibility in British Columbia. See clause (f) of the definition of reporting issuer in s 1 of the BCSA.

C. LISTING ON A RECOGNIZED STOCK EXCHANGE

For purposes of clause (c) of the Ontario definition of reporting issuer, the Toronto Stock Exchange (TSX), the TSX Venture Exchange (TSXV), Alpha Exchange Inc, the Canadian Stock Exchange (CSE), Cboe Canada Inc, and Nasdaq CXC Limited are recognized by the OSC for the purposes of this definition. However, one of the requirements for listing on CSE in the first place is that an issuer must first be a reporting issuer (or equivalent) in a jurisdiction in Canada. This meaning has been held responsible for allowing the infamous Bre-X corporation to become a reporting issuer in Ontario without ever qualifying a prospectus in that province. At the root of this analysis is the view that the listing standards of the Toronto Stock Exchange (TSE) (as it then was) were insufficiently rigorous, such that Bre-X became listed on the TSE because one of the then acceptable criteria for a listing was "prior trading on another market"—in this case, another provincial exchange in Canada. For a note of caution here, see Jeffrey G MacIntosh, "Lessons of Bre-X (?): Some Comments" (1999) 30:2 Can Bus LJ 223; see also OSC Staff Notice 51-719, *Emerging Markets Issuer Review* (2012) 35 OSCB 3004.

D. REGULATORY POWER TO DEEM ISSUERS TO BE REPORTING ISSUERS

Finally, the OSC has acquired the power to deem issuers to be reporting issuers. The power to make such an order is now in s 1(11) of the OSA and must be exercised on a public interest standard. This was intended to allow the Ontario regulator to deem reporting issuers in other Canadian jurisdictions to be reporting issuers in Ontario where Ontario residents might access their securities. Issuers might also be deemed to be reporting issuers in Ontario where their securities trade on exchanges not recognized in accordance with clause (c) of the Ontario definition of reporting issuer. See OSC Policy 12-602 (2007), 30 OSCB 2641. See Philip Anisman, "Proposed Amendments to the Ontario Securities Act: An Open Letter to the Ontario Securities Commission" ((1998) 31:2 Can Bus LJ 272) for a critique of this expansion of the regulators' discretionary power. See also Alberta *Securities Act*, RSA 2000, c S-4 (ASA), s 145 for a similar power in that province.

Now we will introduce an additional series of concepts that are thematically linked to each other and very much a part of the discourse of regulation, as well as of popular and scholarly understanding of securities markets. They are, respectively, the concepts of "efficiency," "materiality," "valuation," and "systemic risk." Only the concept of "materiality" is defined in any form in Canadian securities statutes.

VII. EFFICIENCY

The term "efficiency" is used in ordinary discourse in a number of different ways to mean a number of different things. Often it is used, by business people and citizens alike, synonymously with cost–benefit analysis. Thus, it is efficient, or cost effective, to engage in projects or activities where the benefits of the activity outweigh the costs. A number of different meanings of efficiency, including allocative efficiency, were canvassed in Professor Trebilcock's excerpt in the introduction to this book. At the rhetorical level, arguments for one or another form of policy change are often justified in efficiency terms. So a prevailing claim is that government regulation produces inefficiency and hampers the operation of the capital markets. In the scholarly literature, an important starting point in the discussion of efficiency in relation to securities trading is that there are a variety of meanings for the term. Furthermore, a very important link is posited between disclosure of information and efficient markets. The idea is that efficient markets are those that absorb information about issuers as quickly as possible and adjust prices accordingly. However, as the excerpt below makes clear, in this case, the meaning of efficiency varies according to the *type* of information (that is, historical, current, insider, etc.) assumed to affect stock prices.

Christopher C Nicholls, *Corporate Finance and Canadian Law*, 2nd ed

(Toronto: Carswell, 2013) at 169-70, 173-75, 176-77, 178-80, 184-86
(footnotes omitted)

(i) What Does "Efficiency" Mean?

Capital markets may be "efficient" in a number of ways. They may allocate financial resources efficiently; they may operate efficiently, in the sense that they impose minimal transaction costs on participants and minimize waste; they may be "dynamically efficient," in the sense that they are designed to improve over time in response to changing conditions, technologies and other advances; or they may be efficient in the sense that they operate such that information is rapidly incorporated into asset prices. When modern finance theorists refer to the efficient capital market hypothesis, they generally have in mind the fourth type of efficiency—sometimes called informational efficiency.

Efficient market theory (EMT) arose from early attempts to answer the question: Is it possible, at any given moment, to predict how the price of a capital asset, such as a share of a publicly-traded corporation, will move within the next short period of time? Studies of stock prices seemed to suggest that it was not possible to make such a prediction with any degree of certainty. It might be possible for a few able professional traders, by careful study, to identify small pricing errors or anomalies and exploit them rapidly; but the amateur investor is not likely to be able to "beat the market" with any degree of consistency. Information relative to stock values is impounded into stock prices so quickly, by the time the ambitious amateur notices any pricing anomaly, it will already have disappeared.

• • •

The significance of efficient market theory, however, is not simply the answer it attempts to provide to the question of how stock prices move, but also the explanation or the "story" it offers as to *why* the market is so difficult to beat, and the empirical research it has prompted on the actual behaviour of stock prices.

• • •

(iii) Development of the Efficient Market Hypothesis

Efficient market theory began its ascent to prominence among financial theorists in the 1950s and 1960s, owing to the work of such people as Maurice Kendall, Harry Roberts, and Eugene Fama (who appears to have coined the term "efficient markets"). Research on stock prices appeared to indicate that such prices followed no discernible pattern. Prices appeared, instead, to move randomly. Random movement does not, of course, imply arbitrary movement. In other words, stock prices don't simply move up and down regardless of the performance of the companies that have issued them, or of the economy generally. New relevant information about a stock will, naturally, have an impact on the stock's price. But new information, by definition, is unpredictable. (If it weren't unpredictable, it wouldn't be new.) Thus, although stock prices reflect relevant information about a company at any given moment, there is no way of predicting whether the next piece of relevant information to be revealed will be good or bad, and so no way of predicting whether a stock's price, in future, will move up or down. Stock prices—observed in unpredictable isolation—should not be expected to follow any pattern.

The observed *phenomenon* that the efficient market theory attempts to explain, then, is that stock prices appear to move randomly. The proposed *explanation* for this phenomenon is that relevant information is absorbed by the markets so quickly that, at any given moment, a stock's price, in effect, impounds the market's collective assessment of all available information. The *implication* of the efficient capital markets hypothesis is that we should expect shares traded in actual liquid stock markets to be fairly priced, at any given moment in the sense that their prices accurately impound all available information and so reflect the present value of the issuing firm's expected future cash flow. It should therefore be impossible, at least for the amateur investor, to find "bargains" and so beat the market with any consistency. Investors might deceive themselves into thinking they have superior investment savvy if, for example, they invest in high-risk stocks that outperform the market over the short-term. (The winners of "stock-picking" contests invariably use such high-risk investment strategies.) In fact, overtime, the abnormally high returns such investors might earn in one period will likely be offset by abnormally high losses in other periods, so that, again, on average, they will be unlikely to consistently earn above-market returns.

Many empirical tests have been conducted to attempt to confirm the efficient market hypothesis. The hypothesis has, for testing purposes, been "subdivided" into three forms:

- Weak-form efficiency. A market is weak-form efficient, if current prices reflect all historical price information.
- Semi-strong form efficiency. A market is semi-strong form efficient, if current prices reflect not only all historical price information, but also all publicly-available information.
- Strong-form efficiency. A market is strong-form efficient, if current prices reflect all relevant information about a stock—whether or not publicly-disclosed.

• • •

For some time, the weight of authority seemed to favour the view that markets were certainly weak-form efficient, probably semi-strong form efficient, but almost certainly not strong-form efficient. Recently, however, some scholars have argued that markets are not even weak-form efficient, and that there may even be exploitable share price patterns. And occasional dramatic market reversals, such as the 1987 stock market crash, the more recent turmoil driving the financial crisis or the May 2010 "flash crash" discussed in Chapter 9, are often identified by EMT skeptics as proof that this particular theoretical emperor has no clothes. Modern research, particularly in areas such as behavioural finance, have also highlighted weaknesses in EMT, but have not diminished the importance of the hypothesis as one of the landmark theories in financial economies.

• • •

More broadly, behavioural finance theorists have chronicled many irrational investor attitudes, such as so-called endowment effects, and have documented investors' underreactions and overreactions to information and so-called "momentum effects" that all seem difficult to reconcile with EMT. Defenders of EMT—in particular, Eugene Fama—have responded to behavioural finance researchers by pointing out that merely identifying isolated examples of apparent shortcomings in the EMT falls well short of putting forth a coherent alternative theory with superior explanatory power. Increasingly, however, behavioural finance has gained ground and is now regularly featured in mainstream discussions of corporate finance theory.

(iv) Efficient Market Hypothesis and the Law

(A) Securities Legislation

Because efficient market theory links the dissemination of information about issuing corporations to the market prices at which the shares of such corporations trade in the market, securities regulators have sometimes invoked the theory as a justification for disclosure-based securities laws. So, for example, when it first introduced its short-form Form S-3 Registration Statement (and the 415 shelf-registration regime), the U.S. Securities and Exchange Commission ("SEC") explicitly stated that it was relying upon efficient market theory. In Canada, too, we have seen explicit attempts to link the securities law disclosure regime to the principles of efficient market theory. Indeed, Gilson and Kraakman, writing in 1984, concluded that "the [efficient capital markets hypothesis] is now *the* context in which serious discussion of the regulation of financial markets takes place." What is not altogether clear, however, is whether efficient market theory really does support our current mandatory disclosure regime, or whether, it should, instead be seen as a theory that actually buttresses the case for dismantling that regime. Certainly securities regulators, and many leading legal academics favour the view that efficient market theory strengthens—or at least does not weaken—the case for mandatory disclosure. But some financial economists take a contrary view, arguing, essentially, that information relevant to the pricing of corporate securities would be disclosed in the absence of statutory requirements in any event; thus, securities regulation simply imposes needless costs. Although there are clearly compelling reasons to expect that corporate managers would voluntarily disclose some corporate information, it must be said that there is little in the history of corporate disclosure practices, prior to the introduction of mandatory disclosure regimes, to suggest that firms have been generous in volunteering information, or that they felt in any way compelled to make significant disclosure as a pre-condition to enjoying access to the capital markets. Though it might be argued that any disclosure inadequacies would eventually be rectified as the market disciplined firms that provide sub-optimal disclosure, it is unclear how robustly and how quickly market forces would effect change in the absence of regulation.

• • •

(II) Valuation Issues

It must be said that courts in both Canada and the United States have, in general, maintained a healthy scepticism about the efficient market hypothesis.

Courts have been urged to consider the efficient market hypothesis in cases where disputes arise as to the fair value of the shares of a publicly-traded corporation. If markets are efficient, it is reasoned, then the market price for such shares is the best indication of their fair market value. The courts need to look no further.

Yet, our courts often do look further. Chancellor Allen, of the Delaware Court of Chancery, rather eloquently articulated the judicial attitude toward efficient market theory in the takeover "premium" context, in one of the leading early Delaware hostile takeover bid cases, *Paramount Communications, Inc. v. Time*:

> This view [i.e., that markets are efficient] may be correct. It may be that in a well-developed stock market, there is no discount for long-term profit maximizing behavior except that reflected in the discount for the time value of money ... Perhaps wise social policy and sound business decisions ought to be premised upon the assumptions that underlie this view. But just as the Constitution does not enshrine

> Mr. Herbert Spencer's social statics, neither does the common law of directors' duties elevate the theory of a single, efficient capital market to the dignity of a sacred text.
>
> In a similar context (and apparently in a similar vein), an Ontario judge once endorsed the actions of the directors of a takeover bid target who "found the intrinsic value of the company was not being recognized by *those people* who trade in the stock exchange."
>
> From time to time, other U.S. judges have appeared somewhat more sympathetic to certain modern financial views on securities markets. Yet, particularly in the corporate law dissent and appraisal context, where corporate shareholders have exercised their statutory rights to dissent from certain corporate decisions and demand to be paid fair value for their shares, courts in both Canada and the U.S. seem reluctant to rely on the markets as a determinant of the value of such shares. ...
>
> All in all, then, although the efficient market hypothesis seems at times to be taken seriously by securities regulators, it is not clear that it enjoys broad support among our judges.

VIII. MATERIALITY

We have seen that for a securities market to achieve efficiency, it must receive information that can be used to adjust trading prices. While the issue whether issuers would voluntarily disclose information in the absence of mandatory requirements is a matter of lively scholarly debate, the fact remains that legislatures currently impose significant reporting requirements on those who issue securities (as well as those with power to influence issuers). The extent of those reporting requirements is discussed in detail in Chapters 4 and 6. However, at this point it is important to note that securities legislation acknowledges that issuers cannot be expected to disclose every piece of information that investors might find interesting or even significant. The threshold that distinguishes information that is legally disclosable and that which is not is expressed in the concept of "materiality." If information is material, it should be disclosed. We will see later that many provincial statutes include concepts such as "material fact" or "material change" as characterizing the nature of information that should be disclosed in specific circumstances. For now, we want to examine more generally the issue when the threshold of materiality will be considered to be met. How do issuers decide what information is material and what is not? Chapter 4 contains a useful excerpt from the final report of Ontario's Five Year Review Committee, which canvasses these issues and makes a proposal for reform. As it indicates, the current statutory standard in many Canadian jurisdictions is what is called a "market impact" test—that is, information that should be disclosed is information that would affect the "price or value" of the issuer's securities. However, the analysis employed under US securities law is the "reasonable investor" test. In the United States, information should be disclosed if there is a substantial likelihood that a "reasonable investor" would consider it important to an investment decision. Some commentators claim that the Canadian test is broader in scope than the American test; some argue the reverse; some contend that it really makes no difference. Ultimately, as we will see in Chapter 4, the Five Year Review Committee recommended that the Canadian test come into conformity with the US formulation in the interest of harmonization with US regulatory standards. For now, it is sufficient to note that the standards imposed on issuers require them to make an assessment of the "effects" of information on the market generally (or on the reasonable investor, as in the US formulation). It might also be argued that the "market impact" formulation of the standard of materiality appears consistent with the some of the definitions of efficiency that we have noted above.

For a comprehensive discussion of the judicial treatment of the definition of materiality, see Douglas Sarro, "Material Change Standards in Securities Law" (2024) 69:1 Can Bus LJ 1-32.

QUESTION

Does the material on the behavioural finance approach to analyzing investment decision-making canvassed in the introduction to this casebook create any difficulties for a "reasonable investor" standard of disclosable information?

IX. VALUE

It is claimed that information disclosed to the securities market about an issuer and its activities should, in an efficient market, have the effect of moving the price of those securities in an upward or a downward direction. However, a question we have not yet addressed is whether the market price at which a particular security is trading is the same as its value. Analysts frequently talk about securities being undervalued or overvalued. There are a number of diverse purposes for which an analysis of a security's value will be necessary—for example, pricing a new issue of securities. Another would be where a bidder intends to make an offer for the shares of a target. Still others would include situations where the securities of an enterprise do not trade on an organized securities market, or where investor remedies or regulatory enforcement actions are at issue. It can be readily seen, therefore, that issues of securities' value and techniques of valuation are implicated in the subject matter of almost all of the chapters in this casebook. The following extract discusses the approach that financing experts take to the task of valuing shares. Note the distinction drawn in the extract between the valuation of shares and the market price at which shares may trade.

William A Klein, John C Coffee Jr & Frank Partnoy, *Business Organization and Finance*, 11th ed

(New York: Foundation Press, 2010) 240 at 288-91 (footnotes omitted)

a. *Dividends.* Most publicly held corporations pay cash dividends to shareholders. Dividends are often said to be paid "out of" current earnings. In light of the fact that money is fungible, and that the word "earnings" refers to the outcome of a complex process, not to a fund, it is more accurate to say that the amount of the dividend (usually) will depend on or be limited to the amount of the corporation's current earnings. Sometimes corporations will pay dividends in amounts larger than current earnings; the excess will then usually be thought of as coming out of the previously undistributed earnings of earlier years. Typically, corporations over the long haul will pay out less than all their earnings as dividends. A portion of earnings will be retained and reinvested in the business. But all that the shareholders see is the dividend. That is their return. It is now widely accepted in the sophisticated academic financial literature that the value of shares of common stock is best thought of as a function of the dividends (including any final, liquidating dividend paid when the corporation's existence ends) that the corporation can be expected to pay out over its life. Many people consider this to be a peculiar proposition because they think instinctively about capital gain (sale price less cost) as part of the return on common stock.

The fact is, nonetheless, that capital gain must be a function of expectations about future dividends. Imagine a series of shareholders. The first shareholder pays

a given amount for the shares, based on an estimate of the amount of cash dividends plus a gain (or loss) at some time in the future. The next shareholder makes the same kind of calculation. That is, the gain, if any, will depend on the next shareholder's expectation as to cash dividends plus capital gain (or loss). And so on. If we think of the entire series of shareholders, some may have greater capital gains or losses than others, depending on the timing of their purchases and sales and on collective expectations, reflected in market prices, at the time of those purchases and sales. But the gains and losses are transfers among all the shareholders who hold the shares over the entire time that they are outstanding. Those gains or losses do not increase or decrease the total return on the shares over that time. The only return that shareholders collectively can expect over the life of the shares in which they invest is the dividends (including, as indicated above, any final or liquidating dividend) paid on those shares. It can be seen, then, that if people are rational the value of the shares at any point in time must be derived solely from the series of expectations about dividends. Any gain in the value of shares must be based on expectations concerning dividends to be paid at some point in the future.

• • •

This does not mean that the shares of a corporation that pays no dividends *currently* are worthless. Many companies have operated for years without paying dividends. Many of these have been successful, growing companies that were retaining all of their earnings in order to take advantage of attractive investment opportunities. People do, rationally, pay money for shares of such companies. They do so because they expect that at some point in the future dividends will be paid.

• • •

b. *Earnings.* If, as we have just seen, dividends alone determine value, what is the relevance of earnings (as they are defined by traditional accounting principles)? If earnings are not paid out as dividends, and assuming that earnings have not been misstated, the amount retained will be "invested" by the corporation. To the extent that earnings are retained, and invested, the value of the firm's assets should increase and its earnings and capacity to pay dividends in the future should increase correspondingly. Thus, the earnings figure is relevant in determining the value of the firm's shares because it provides information about future capacity to pay dividends. Concern with earnings is therefore entirely consistent with the proposition that the value of the shares is solely a function of dividends.

What if the retention of earnings does not produce any improvement in future earnings and dividend-paying capacity? Suppose, for example, that over a period of many years a firm reports yearly earnings of $3 per share and pays yearly dividends of $1 per share. If the earnings remain constant at $3, what is the firm doing with the $2 that it is purportedly retaining and investing each year? One possibility is that it is figuratively pouring the retained earnings down a rathole—making utterly worthless investments. More likely there is something wrong with the $3 figure. If $2 must be reinvested each year just to keep the firm at a steady level then that $2 should be regarded as part of the cost of doing business. The true earnings figure is $1 per share. Thus, by examining a firm's dividends over time, one can often gain insight into the reliability of its reported earnings figures.

c. *Dividends, Earnings, and Share Prices.* Suppose that at the beginning of the year a share of common stock of X Corporation sells for $100 and that during the year X Corp earns $10 per share. All other variables being held constant, and assuming that the earnings figure is accurate and realistic, the price of the share at the end of the year should be $110. The wealth of shareholders will be $100 per share at the beginning of the year and $110 at the end. If, at year's end, X Corp retains the

$10 per share of earnings, the price of the shares should remain at $110. If, on the other hand, the $10 is paid out as a dividend, the price should fall to $100. The shareholder will now have a share worth $100 plus $10 in cash. Their wealth will be the same as if the earnings had been retained—a total of $110 consisting of the share worth $100 plus the $10 in cash. If earnings are retained to finance an unwise investment, the value of the share will be less than $110, but that outcome is a result of the unwise investment decision, not of the decision to retain.

QUESTION

Do the principles underlying a "materiality" analysis with respect to disclosure of information seem consistent with the academic theory of valuing shares, excerpted above?

X. SYSTEMIC RISK

While the concept of systemic risk had been familiar to banking regulators before the GFC, it was added to the lexicon of securities regulators in 2008. The global effects of the sale of unregulated financial products and the activities of credit rating agencies prompted securities regulators to consider the extent to which, and how, they should monitor the presence of systemic risk in securities markets. This task is rendered more difficult by the open-ended nature of the concept. Professor Anand discusses the conceptual confusion surrounding the idea of systemic risk in the following excerpt.

Anita Anand, "Regulating Systemic Risk in Canadian Financial Markets"

(16 May 2016) 3:18 One Issue, Two Voices 9 at 9-12, online (pdf): <https://www.wilsoncenter.org/sites/default/files/media/documents/publication/ci_160516_one_issue_v3.pdf>

What Is Systemic Risk?

Most commentators agree that there is no universally accepted definition of systemic risk. It comes as no surprise, then, that a primary criticism lodged against proponents of regulating systemic risk is that the term defies precise definition: "If we cannot define it, how can we regulate it?" An examination of the academic literature, as well as writings and speeches of policy makers during and following the financial market crisis, suggests that the term systemic risk has itself evolved over time. While originally conceived as describing the failure of one financial institution that in turn causes the domino-style failure of others, systemic risk now generally describes a possibility of financial meltdown that affects an entire economic system.

Traditionally, the literature has focused on the concept of systemic risk in the financial sector alone, referring to a triggering event that causes a chain of negative economic consequences. Crockett explains this domino-style effect as follows:

For banks, this effect may occur if Bank A, for whatever reason, defaults on a loan, deposit, or other payment to Bank B, thereby producing a loss greater than B's capital and forcing it to default on payment to Bank C, thereby producing a loss greater than C's capital, and so on down the chain.

Thus, the traditional definition of systemic risk relates specifically to financial institution failure brought on by defaults in contractual relationships between and among institutions. The risk of a domino effect is central to this conception of systemic risk, as is the risk of some triggering event that occasions the fall of the first domino. To give one example, these features are apparent in the definition of systemic risk adopted by the Supreme Court of Canada:

> [R]isks that occasion a "domino effect" whereby the risk of default by one market participant will affect the ability of others to fulfill their legal obligations, setting off a chain of negative economic consequences that pervade an entire financial system.

Unfortunately, this traditional definition has several problematic ambiguities. For example, at what point must the "risk" crystallize in order to be referred to as "systemic"? Is evaluation of the risk possible only after the financial institution has failed (for example, by declaring bankruptcy)? If only one financial institution fails, and others survive because of government intervention, does systemic risk arise? What type of triggering event can cause systemic risk—only the failure of financial institutions to meet their contractual obligations? The traditional definition leaves all of these questions, and others, unanswered.

These ambiguities have led John Taylor, a professor of economics at Stanford University, to develop a more structured definition. He highlights three components of any definition of systemic risk: the risk of a large triggering event; the risk of financial propagation of such an event through the financial sector; and macroeconomic risk that the entire economy will be affected. The triggering event can arise from the failure of a financial institution, as described above; however, as Taylor explains, it may also arise from an exogenous shock—such as a terrorist attack (9/11) or a natural disaster—and the contracting of liquidity in the public sector.

While Taylor's three-part definition of systemic risk leaves room for questions (for example, what is "financial propagation"?), at the very least it suggests that the term can (and should) be interpreted more broadly to include risks that not only occasion the failure of financial institutions but also destabilize an entire economy. Along these lines, Kaufman and Scott explain that the term "refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by co-movements (correlation) among most or all of the parts." Similarly, Dijkman asserts that "systemic risk usually refers to financial shocks that are likely to be serious enough to damage the real economy." Thus, a link is drawn between the financial markets and the "real economy," that is, the economy concerned with producing and consuming goods and services as opposed to buying and selling financial products.

Policy makers, it appears, have also adopted a more general understanding of systemic risk than merely the domino-style failure of financial institutions. For example, Bank of England governor Mark Carney [as he was then] refers to the "probability that the financial system is unable to support economic activity." Similarly, former Federal Reserve chairman Ben Bernanke writes that the concept of systemic risk should be broadly defined to include "developments that threaten the stability of the financial system as a whole and consequently the broader economy, not just that of one or two institutions."

Even with a broad understanding of "systemic risk," however, the question arises as to whether the existence of systemic risk is discoverable *ex ante* (before the risk arises) or only *ex post* (after a breakdown in the financial system has made the risk evident). The development of policy relating to the mitigation of systemic risk

depends on the ability to make predictions and determine whether those predictions are valid. There were moments before the crisis in the United States when regulators could have responded to systemic risk. For example, the former chair of the Commodity Futures and Trade Commission (CFTC), Brooksley Born, is widely acknowledged to have predicted the crisis in over-the-counter (OTC) derivatives before the 2007 financial market crash. Yet the U.S. Congress moved to enact legislation that prevented the CFTC from taking any pre-emptive regulatory action.

If we agree that systemic risk may in fact require regulation, then we move into the sphere of "macroprudential regulation," a term that refers to a definite intention by regulators to respond to systemic risk (above and beyond merely identifying it). The Group of Thirty has declared that "macroprudential policy is concerned not only with systemic risk but also with developing the appropriate responses to those risks in order to strengthen the financial system and avoid similar crises in the future." The focus is on "the interconnectedness of financial institutions and markets, common exposures to economic variables, and procyclical behaviors [that] can create risk." The reforms contemplated below modify this concept by seeking to ensure that any regulatory response to crises takes account of common institutions and markets.

Systemic Risk and the Canadian Financial System

Some commentators may have difficulty discussing systemic risk in the Canadian context—and not only because of the definitional issues associated with the concept. Canadian capital markets fared relatively well during the 2008 financial crisis, and it could be argued that systemic risk has not been an issue for Canadian regulators, especially given that, historically, the Bank of Canada has regulated at least the clearing and settlement process. However, there are aspects of the Canadian economy that can give rise to systemic instability—as, for example, with the asset-backed commercial paper (ABCP) crisis (discussed below).

Many commentators rightly point to the efficacy of Canada's regulatory framework in safeguarding against financial contagion. Nevertheless, a consensus seems to be emerging regarding certain sources of systemic risk, perhaps applicable in any jurisdiction, which augmented the scale of the financial crisis. These sources include regulatory capital requirements, credit ratings, derivatives trading, registration exemptions, clearing and settlement systems, and lending standards and securitization. Conflicts of interest or other moral hazard problems are also endemic in Canada—particularly those associated with creditors (bank and non-bank), rating agencies, monoline (specialized) insurance policy providers, and distribution agents (dealers and investment advisors)—which may contribute to systemic risk.

See also Anita Anand, ed, *What's Next for Canada? Securities Regulation After the Reference* (Toronto: Irwin Law, 2012).

The International Organization of Securities Commissions (IOSCO) has also published a number of papers on the topic of systemic risk, beginning with one titled *Mitigating Systemic Risk: A Role for Securities Regulators* in February 2011. (See M Condon, "Products, Perimeters and Politics: Systemic Risk and Securities Regulation" in C Williams & P Zumbansen, *The Embedded Firm: Corporate Governance, Labor and Finance Capitalism* (Cambridge, UK: Cambridge University Press, 2011).) Since 2016, it appears that IOSCO no longer issues standalone reports on systemic risk in global capital markets. Instead, it formed a Committee on Emerging Risks, whose reports are included in IOSCO's Annual Reports. See, for example, IOSCO's *2023 Annual Report* (Madrid: IOSCO) at 20 (online: <https://www.iosco.org/annual_reports/2023>). In a 2020 technical note on Systemic Risk Oversight and Macroprudential Policy, an IMF report on

Canada noted that "[s]ystemic risk oversight at the federal level appears adequately effective, in part due to strong collegial culture and inter-agency cooperation. However, such effectiveness becomes less apparent at the provincial level or with respect to federal–provincial collaboration on these issues" (*Technical Note—Systemic Risk Oversight and Macroprudential Policy* (Washington, DC: IMF, 4 January 2020), online: <https://www.imf.org/en/Publications/CR/Issues/2020/01/23/Canada-Financial-Sector-Assessment-Program-Technical-Note-Systemic-Risk-Oversight-and-48973>). Meanwhile, the CSA has begun to issue regular reports on sources of systemic risk in Canadian capital markets. See, for example, the CSA *2024 Annual Report on Capital Markets*, above.

XI. CHAPTER SUMMARY

In this chapter, we have considered a number of basic conceptual tools to analyze a securities transaction. We have seen that the definitions of "security," "trade," and "distribution" are susceptible to discretionary analysis on the part of courts and regulators as to the scope of the concepts. The analysis is heavily policy driven, with an emphasis on the investor protection goals of securities law, though it is an open question as to whether concerns of market efficiency may drive the analysis to a greater extent in the future. We have also seen that there may be important differences among investor, common sense, and judicial understandings of terms such as "efficiency" and share "value," and the ways in which those terms are employed in the academic, economic, and finance literature.