BRITISH COLUMBIA SECURITIES COMMISSION SEEKS TO LIMIT EXERCISE OF PUBLIC INTEREST POWER IN THE ENFORCEMENT CONTEXT

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Introduction

The public interest power[1] has been the subject of much controversy, and increasingly so with its more frequent use by securities regulators in Canada. There can be no doubt that, absent a breach of securities laws, [2] a securities regulator has the power to exercise its public interest jurisdiction to sanction persons. However, there has been debate as to whether the public interest power should be exercised absent a breach of securities laws only in circumstances where the conduct or transaction is clearly "abusive" of shareholders and the capital markets, or whether it may also be exercised "where the conduct engages the animating principles of" [securities legislation]".[3]We have previously suggested that neither position provides a cogent or transparent basis for the exercise of the public interest power.[4]

The recent *Carnes*[5]decision has been the most detailed examination to date of the basis for the exercise of the public interest power absent a breach of securities laws by a panel of the British Columbia Securities Commission (the "**BCSC**"). In *Carnes*, the BCSC concluded that in so-called "enforcement decisions" (being decisions not directly related to M&A or other capital market transactions) where the nature of the specific impugned conduct is subject to provisions of securities legislation, the conduct in question would generally have to be "abusive of the capital markets in order to make" a public interest order.[6]We would suggest that the BCSC, in seeking rightfully to limit the exercise of the public interest power, missed an important opportunity to create new tools to analyze this issue, which could have served to provide clarity to this area of the law.

Background

Staff of the BCSC alleged that Jon Carnes ("**Carnes**") perpetrated a fraud, contrary to the Act,[7] and engaged in conduct contrary to the public interest.[8] The allegations were focused on a report posted online by Carnes under a fake name alleging significant concerns with respect to Silvercorp Metals Inc. ("**Silvercorp**")[9] at a time when there was increasing anxiety regarding the credibility of Chinese-based companies listed on North

American stock exchanges. Carnes had shorted the stock of Silvercorp by purchasing put options, which were to expire four days after the release of the report.[10]

The report was posted immediately prior to a presentation by Silvercorp at an investment conference in order to do as much harm to Silvercorp as possible.[11] The report also received public support from a well-known person who had previously shorted other Chinese-based stocks.[12] Silvercorp's stock fell 20% on the day the report was released.[13] Carnes closed out his short position the following day, making a profit of $2.8 million.[14] Staff argued that the misstatements in the report—in terms of actual statements as well as omissions—constituted prohibited acts for the purpose of fraud.

The panel of the BCSC (the "**Panel**") found that Carnes had used a consultant's report to reinforce his own opinions by citing only the negative portions thereof while not referring to any positive comments.[15] While the Panel held that Carnes did not give a "full and fair picture of the consultant's opinion"[16] and questioned his credibility on various matters, the Panel nevertheless concluded that Staff did not produce sufficient evidence to prove fraud under the Act.

With respect to the allegation of conduct contrary to the public interest, Staff alleged that the following conduct by Carnes justified the exercise of the public interest power:

1. use of a fake name to author his reports;
2. use of a fake biography to enhance the credibility of his reports;
3. creating a fake research organization to enhance the credibility of his reports;
4. misleading investors by making his website look like an independent clearinghouse where there were multiple contributors;
5. the conduct that Staff stated constituted fraud;
6. retaining a geological consultant using a fake name, a fake company and a retainer agreement signed with the fake company that was not enforceable;
7. publishing the negative report on Silvercorp at a time that would cause the biggest drop in its share price; and
8. failing to mention that his Silvercorp report was published just four days prior to the expiry of his put options. [17]

Decision on Public Interest Allegation

The Panel observed that in previous decisions of the BCSC, where consideration was given to the exercise of the public interest power absent a breach of securities laws, the legal framework of the public interest jurisdiction was not analyzed. [18] The Panel then reviewed the two leading decisions of the Ontario Securities

Commission (the "**OSC**"), *Canadian Tire* [19]and *Asbestos,* [20] as well as the so-called enforcement decisions of *Biovail*, *Donald*, [21]*Suman* [22]and *Waheed.[23]*

The Panel focused on the enforcement decisions. It was noted that in *Biovail* and *Suman*, the OSC exercised its public interest jurisdiction without holding that the transactions were abusive, [24] while in *Donald*, a finding of abuse was made by the OSC in coming to the conclusion that its public interest power should be exercised.

The Panel noted that the *Waheed* decision suggests "a narrower use of the public interest jurisdiction in Ontario from *Biovail*, *Donald* and *Suman*."[25] The Panel summarized the *Waheed* decision as follows:[26]

In *Waheed*, an insider trading case, the panel found the respondents did not contravene the Ontario Securities Act because the confidential facts in issue, obtained during [a] consultancy arrangement, were no longer material facts at the time of trading activity by the respondents.

The OSC panel dismissed staff's application for an order in the public interest, on the grounds that it would be inappropriate to make a public interest order for using confidential information that was neither a material fact nor a material change for the issuer.

The panel also held that any breach of confidentiality provisions in Waheed's consulting arrangement or a breach of a duty of loyalty could not form the basis for a public interest order. The panel stated that the enforcement of private contractual arrangements should not form the basis of a public interest order.

The Panel then noted that the *Waheed* decision "suggests that, having failed to establish that the respondents' conduct contravened the insider trading provisions of the OSA, staff could not use the same evidence as the basis of a public interest order." [27] The Panel viewed the *Waheed* decision as being in line with *Canadian Tire*, and noted that there was a divergence of approaches by the OSC: (i) a narrow basis requiring a finding of abuse of the capital markets or a finding that a structure was established to avoid contravention of securities legislation and (ii) a broader approach represented by *Biovail* where "a range of factors should be considered but that an order may be made without a finding of abuse where the conduct is inconsistent with the animating principles of [securities legislation]."[28] The Panel concluded that in the enforcement context, where the Act prohibits specific conduct, the public interest power should only be used in "very rare circumstances" (being conduct abusive of the capital markets)[29] to sanction that type of conduct absent a breach of securities laws. However, where the Act does not prohibit the type of conduct in question, the abuse test "may or may not be the applicable test."[30]

The Panel concluded by noting that, while Carnes' conduct was "unsavory,"[31] it was not clearly abusive of the capital markets and therefore the exercise of its public interest jurisdiction was unwarranted. The Panel refused to sanction conduct merely because it was "morally unsupportable"[32] and noted that to exercise such power

in this case "would, in effect, be creating a new requirement for statements which would be something akin to 'fair presentation.'"[33]

Observations

We applaud the efforts undertaken by the Panel to provide a legal framework that can allow market participants to structure their affairs "without fear of enforcement actions alleging wrongdoing that is not encoded in the Act."[34] However, we believe that the decision fails to address certain issues or raises other concerns:

- The Panel's conclusion that the *Waheed* decision was a departure from earlier enforcement decisions of the OSC is not apparent from a reading of the *Waheed* decision. However, as we have noted before, [35] we believe the *Waheed* decision does assist in showing why the animating principles standard should be abandoned. OSC staff's arguments in *Waheed*, in being consistent with the animating principles standard set out in *Biovail*, showed that such a standard is too broad to provide any real guidance as to when the public interest power should be exercised.
- The distinction put forth by the Panel between enforcement and other decisions, in connection with the exercise of the public interest power, appears difficult to support through legal reasoning.
- The narrowing of the basis on which the public interest power is to be exercised, in certain enforcement decisions, to the abuse standard is not entirely helpful. We believe that the so-called "abuse" standard that originated under *Canadian Tire* is not (and cannot be) well-defined, but is merely shorthand; and with the passage of time has caused confusion and proved to be unhelpful. In fact, the very reasoning of the Panel shows that the standard has become merely a conclusion for determining when conduct should be sanctioned.

It is clear that the Panel was not prepared to exercise its public interest power because to do so would impose a standard of "fair presentation" that could then be imposed on numerous parties, including research analysts. Accordingly, the Panel was not focused on the meaning of the term "abusive of the capital markets" – it was just using the standard to make a conclusion.

As we have suggested before, we believe the analysis of whether the public interest power should be exercised is focused on the following core question: "would a reasonable investor lose confidence in the capital markets and be less willing to invest if the securities regulator did not take action to deter a repetition of the conduct in question?"[36] If the answer is clearly yes, then the public interest power should be exercised unless there are clear public policy reasons for not exercising the power. On the facts in *Carnes*, it is not clear that a reasonable investor would view Carnes' actions as so detrimental that it would be concerned about participating in the capital markets if such conduct was repeated. Furthermore, the public policy concerns of the Panel regarding

"fair presentation" would also lead to the conclusion that the power should not be exercised.

The decision in *Carnes* is an important part of the ongoing debate and conversation regarding the exercise of the public interest power. It is hoped that this debate and conversation will ultimately lead to the creation of a standard that moves away from labels. The public interest power is a necessary and important tool. It is incumbent on securities regulators to exercise the public interest power in a manner that is transparent and cogent, where the results are predictable and easily understood by securities law practitioners and market participants alike. It is not clear that the decision in *Carnes* has moved us closer to that goal.

by Paul Davis, and Vlad Duta and Samantha Gordon, Students-at-Law

[1] In this bulletin, we will refer to the exercise of a securities regulator's jurisdiction under section 161 of the British Columbia *Securities Act* (the "*Act*"), section 127 of the Ontario *Securities Act* (the "**OSA**"), equivalent provisions in other provincial securities legislation and their respective predecessor provisions as the "**public interest power**".[ps2id id='1' target='/]

[2] For ease of reference, we will use the term "**securities laws**" to refer to securities legislation (including the Act and the OSA), regulations thereunder (including applicable multilateral, and national instruments) and policy statements.[ps2id id='2' target='/]

[3] *Re Biovail Corp* (2010), 33 OSCB 8914 at para 382 [*Biovail*].[ps2id id='3' target='/]

[4] Paul Davis, "*Justifiable Expectations Standard: The Basis for the Exercise of the Public Interest Power of the Ontario Securities Commission*" (August 22, 2014). This paper was prepared with the assistance of Sandy Andreou (an associate at McMillan LLP); and Allison Vale, David Zhou, Jennifer Allman and Matthew Burns, each of whom was a summer student.[ps2id id='4' target='/]

[5] 2015 BCSECCOM 187 (May 14, 2015) [*Carnes*].[ps2id id='5' target='/]

[6] *Carnes*, at para 131.[ps2id id='6' target='/]

[7] Section 57(b) of the Act provides that a "person must not ... engage in ... conduct relating to securities ... if the person knows, or reasonably should know, that the conduct ... perpetrates a fraud on any person".[ps2id id='7' target='/]

[8] *Carnes*, at para 72.[ps2id id='8' target='/]

[9] *Carnes*, at para 57.[ps2id id='9' target='/]

[10] *Carnes*, at para 33.[ps2id id='10' target='/]

[11] *Carnes*, at para 47.[ps2id id='11' target='/]

[12] *Carnes*, at para 48.[ps2id id='12' target='/]

[13] *Carnes*, at paras 49.[ps2id id='13' target='/]

[14] *Carnes*, at paras 50.[ps2id id='14' target='/]

[15] *Carnes*, at para 103.[ps2id id='15' target='/]

[16] *Carnes*, at para 103.[ps2id id='16' target='/]

[17] *Carnes*, at para 133.[ps2id id='17' target='/]

[18] *Carnes*, at para 106.[ps2id id='18' target='/]

[19] *Re Canadian Tire Corp* (1987), 10 OSCB 857 [*Canadian Tire*].[ps2id id='19' target='/]

[20] *Committee for Equal Treatment of Asbestos Minority Shareholders v Ontario (Securities Commission)*, 2001 SCC 37.[ps2id id='20' target='/]

[21] *Re Donald* (2012), 35 OSCB 7383 [*Donald*].[ps2id id='21' target='/]

[22] *Re Suman* (2012), 35 OSCB 2809 [*Suman*].[ps2id id='22' target='/]

[23] *Re Waheed* (2014), 37 OSCB 8007 [*Waheed*].[ps2id id='23' target='/]

[24] *Carnes*, at paras 115, 119.[ps2id id='24' target='/]

[25] *Carnes*, at para 127.[ps2id id='25' target='/]

[26] *Carnes*, at paras 124-126.[ps2id id='26' target='/]

[27] *Carnes*, at para 127.[ps2id id='27' target='/]

[28] *Carnes*, at para 128.[ps2id id='28' target='/]

[29] *Carnes*, at para 131.[ps2id id='29' target='/]

[30] *Carnes*, at para 132[ps2id id='30' target='/]

[31] *Carnes*, at para 141.[ps2id id='31' target='/]

[32] *Carnes*, at para 141.[ps2id id='32' target='/]

[33] *Carnes*, at para 140.[ps2id id='33' target='/]

[34] *Carnes*, at para 129.[ps2id id='34' target='/]

[35] Paul Davis, Vlad Duta, and Jonathan Rajzman, "*The Exercise of the Public Interest Power by the OSC – A New Standard is Needed*" (September 2014).[ps2id id='35' target='/]

[36] *Ibid.*[ps2id id='36' target='/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.