ONTARIO COURT OF APPEAL PROVIDES GUIDANCE ON INSIDER TRADING AND TIPPING IN *FINKELSTEIN V. OSC*

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When should one ought to know that their tip is from an insider? In *Finkelstein v. Ontario Securities Commission* ("***Finkelstein***"),[1] the Ontario Court of Appeal has for the first time interpreted the definition of a "person in a special relationship" with an issuer as it applies to successive recipients of tips containing material information that has not been generally disclosed. Specifically, the Court has affirmed factors to be used in determining whether someone "ought to have known" that the information in a tip came from an insider. The Court's decision provides market participants with practical guidance on maintaining vigilance in order to avoid illegal disclosure or use of insider tips or information.

The Act

Section 76(1) of the *Securities Act*[2] (the "**Act**") provides that a person in a 'special relationship' with an issuer is prohibited from purchasing or selling securities of the issuer if that person has knowledge of a material fact about the issuer that is not publicly disclosed.[3] Section 76(2) of the *Act* provides that a person in a 'special relationship' with an issuer is also prohibited from informing others of a material fact about the issuer that is not publicly disclosed.[4]

Whether or not a person is in a 'special relationship' with an issuer is determined by reference to s. 76(5) of the *Act*. Section 76(5)(e) in particular captures a very broad class of people - those who received the tip through someone they knew, or ought to have known, stood in a special relationship with the issuer. In fact, every individual in a potentially infinite chain of tippees receiving, acting on, or passing on insider information may become a person in a 'special relationship' with the issuer under s. 76(5)(e).

Finkelstein represents the Ontario Court of Appeal's first consideration of s. 76(5)(e).

Procedural Background

Finkelstein concerned the transmission of material, non-public information about a reporting issuer through a chain of five people. This chain began with Finkelstein, a mergers & acquisitions lawyer. Finkelstein was working on a takeover bid involving his client, Masonite International Corporation ("**Masonite**"), a reporting

issuer. Finkelstein learned material, non-public information about Masonite through his work on the transaction; specifically, that a bid was about to be made for Masonite at a premium to its trading value ("**MNPI**"). Finkelstein disclosed the MNPI to his friend Azeff who was an investment advisor, who in turn shared it with another investment advisor (Bobrow) and an accountant (L.K.). L.K. in turn passed the MNPI onto Miller, also an investment advisor, and then Miller passed it on to Cheng, his associate. All of these individuals, or people close to them, purchased Masonite shares after being made aware of the MNPI.

The Ontario Securities Commission ("**OSC**") brought proceedings against Finkelstein, Azeff, Bobrow, Miller and Cheng (but not L.K.). The OSC hearing panel (the "**Panel**") found that all of the prosecuted individuals were in a special relationship with Masonite, had informed others of the MNPI concerning Masonite, and that certain of the individuals had purchased shares of Masonite after receiving the MNPI. The Panel imposed sanctions on all five individuals for their breaches of the Act.

All five sanctioned individuals appealed those decisions. The Divisional Court dismissed their appeals, but allowed Cheng's appeal, holding that the Panel had erred in determining that Cheng – who stood at the very end of the tipping chain – ought to have known the tip came from an insider. Miller sought and obtained leave to appeal the Divisional Court's decision. The OSC sought and obtained leave to appeal the Divisional Court's decision respecting Cheng. The appeals of Miller and the OSC were heard together before the Ontario Court of Appeal.

The Decision of the Ontario Court of Appeal

There was no dispute that Miller and Cheng did not have actual knowledge that their informant was in a special relationship with Masonite. Rather, the key issue before the Court of Appeal was whether they 'ought reasonably to have known' that the person providing them the tip was in a special relationship with Masonite.

The Court of Appeal set out a series of factors to be applied in order to objectively determine whether a person standing in the shoes of a successive tippee should have known that the tip originated with a personin a 'special relationship' with the issuer:

a. What is the relationship between the tipper and tippee? Is it a professional relationship?
b. What is the professional qualification of the tipper, and does his position put him in a milieu where transactions are discussed?
c. What is the professional qualification of the tippee, and does his position mean he should know that he cannot take advantage of confidential information?
d. How detailed and specific is the MNPI?
e. How long after the tippee receives the MNPI does he trade? Can it be inferred that the tippee has confidence in the source of the tip?

f. What steps does the tippee take, if any, to verify the information received before trading?
g. Has the tippee ever owned the particular stock before?
h. Was the trade a significant one given the size of his portfolio?[5]

The Court found that these factors were reasonable in order to determine whether a tippee 'ought reasonably to have known' that the tip they received came from an insider, as these factors were clearly relevant in the inference-drawing process. The Court reinforced the ability of the trier of fact to draw reasonable inferences from the facts before them.

Based on the facts presented in Finkelstein – where the tipper and tippee were known to one another for a long period of time and were both registrants in the securities market – the Court found that it was logical and reasonable for the Panel to have inferred that both Miller and Cheng ought to have known they were trading on the basis of an insider tip.

Key Conclusions

Several key conclusions for market participants can be drawn from *Finkelstein*:

1. Whether a tippee 'ought reasonably to have known' that they received insider information from a tipper in a 'special relationship' with an issuer will be an objective test, but one which can be met through the drawing of inferences based on circumstantial evidence on the specific facts of each case.
2. A regulator or court will consider both the tippee and the tipper's circumstances, the relationship between them, and each of their respective backgrounds, and also may consider the tippee's knowledge of the tipper's relationship with any other person in a special relationship with the issuer who was part of the tipper's information chain.
3. A regulator or court will be permitted to draw even stronger inferences where the tippee is a market registrant; and
4. Courts will continue to treat the OSC with deference in this area because of its specialty expertise and statutory mandate.

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[1] *Finkelstein v. Ontario Securities Commission*, 2018 ONCA 61, 2018 CarswellOnt 972 ("***Finkelstein***").
[2] *Securities Act*, R.S.O. 1990, c. S.5 ("***Act***").
[3] Act, s. 76(1).
[4] Act, s. 76(2).
[5] *Finkelstein*, para 48.

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.

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