Canadian Securities Litigation:

Trends to Watch 2024

Capital market participants in Canada face a variety of emerging securities regulatory and litigation risks, from the ongoing rise in climate disclosure-related litigation, the increase in shareholder activism, enhanced regulatory scrutiny and evolving digital asset regulation and enforcement. Our **Securities Litigation Group**, in collaboration with members of our **Capital Markets**, **Critical Situations and Shareholder Activism** and **ESG and Sustainability** groups, provides an overview of these significant developments and highlights trends to watch for in 2024.

This publication is for general information only and is not intended to provide legal advice. For further information, please contact the **Securities Litigation Group** at McCarthy Tétrault.

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Shades of Green: The Continued Push for Disclosure and Growing Wave of Litigation

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The "shift to green" in capital allocation continues even in the face of increased inflation, recessionary worries, global geopolitical turmoil and the lack of a global baseline for consistent comparable mandatory sustainability-related disclosures. Global sustainable assets topped US$30 trillion in the past two years.[1] Although Canadian sustainable assets under professional management decreased slightly in 2023, their market share continued to increase.[2] Globally, sustainable funds nearly doubled the return of traditional funds.[3] This shift in the global allocation of capital demonstrates the importance of factoring climate-related risks and opportunities into the price of investments to ensure efficient capital allocation as well as the importance of managing the concomitant increased risk for greenwashing.

Concerns about corporate greenwashing — inaccurate or misleading statements about climate-related financial and operational impacts and risks, climate-related commitments or strategies and sustainability-related attributes of products or corporate activities — remain the primary deterrent to overall growth in sustainable investments, with the lack of standardized disclosure frameworks coming in second.[4]

The spotlight on a global baseline for consistent comparable mandatory sustainability-related disclosures continued to brighten in 2023, with the release of international accounting standards for sustainability disclosures. Canadian securities regulators, however, delayed implementation of enhanced sustainability-related disclosure requirements, creating unique challenges for Canadian issuers and asset managers in an environment of increased stakeholder scrutiny of corporate sustainability efforts. A growing wave of greenwashing litigation against companies and their officers and directors continues despite the evolving disclosure landscape, with regulatory enforcement investigations and proceedings, whistleblower complaints and civil claims. Activist stakeholders are increasingly using novel climate-related litigation strategies to not only obtain monetary damages, but also to garner publicity and to drive corporate change.

GROWING CONVERGENCE ON BASELINE SUSTAINABILITY DISCLOSURE FRAMEWORKS

Last year marked a worldwide turning point in the mandatory sustainability-related disclosure requirements as a number of guidelines and reporting standards under development were released, including a long-awaited global accounting baseline.

1 Pensions and Investments **Global sustainable assets top $30 trillion, alliance finds** (November 30, 2023).
2 Responsible Investment Association, **2023 Canadian Responsible Investment Trends Report (Summary Report)**, p. 9 (October 2023).
3 Morgan Stanley, ***Sustainable Funds Beating Peers in 2023*** (August 2023).
4 Responsible Investment Association, **2023 Canadian Responsible Investment Trends Report (Summary Report)**, p. 30 (October 2023).

Climate-Related Regulatory Developments in Recent Years

2019	Canada – CSA Staff Notice 51-358 *Reporting of Climate Change-related Risks*
2020	European Union (“**EU**”) – EU Taxonomy for Sustainable Activities
2021	Canada – CSA Proposed National Instrument 51-107 *Disclosure of Climate-related Matters* USA – Climate and ESG Enforcement Task Force UK – Green Claims Code EU – Sustainable Finance Disclosure Regulation (“**SFDR**”)
2022	Canada – Competition Bureau’s 2022 Competition and Green Growth Summit Canada – CSA Staff Notice 51-364 *Continuous Disclosure Review Program Activities* USA – FTC Guides for the Use of Environmental Marketing Claims AKA Green Guides (Update) USA – SEC Proposal for ESG disclosures for Investment Advisors and Investments Companies. UK – Mandatory climate-related financial disclosures by publicly quoted companies, large private companies and LLPs EU – Proposal for a Directive Empowering Consumers for the Green Transition (the “**Greenwashing Directive**”)
2023	Global – International Sustainability Standards Board issued inaugural sustainability and climate-related disclosure standards (“**ISSB Standards**”) Canada – Establishing the Canadian Sustainability Standards Board (“**CSSB**”) Canada – Amendments to the *Competition Act* relating to greenwashing USA – Updates to the Investment Company Act’s “Names Rule” USA – ESG disclosures for Investment Advisors and Investments Companies USA – SEC Proposal – The Enhancement and Standardization of Climate-Related Disclosures for Investors USA (California) – Climate Corporate Data Accountability Act (SB 253) and Climate-Related Financial Risk Act (SB 261) UK – Sustainability Disclosure Requirements (“**SDR**”) EU – Corporate Sustainability Reporting Directive (“**CSRD**”) EU – Proposal for a Directive on Green Claims (the “**Green Claims Directive**”) EU – European Sustainability Reporting Standards (“**ESRS**”)
2024	Canada – OSFI Guideline B-15: *Climate Risk Management* in effect as of FYE 2024 Canada – CSSB publishes proposed sustainability and climate-related disclosure standards ("CSSB Standards") Canada – OSC publishes updated guidance CSA Staff Notice 81-334 on ESG Disclosures by investment funds USA – SEC adopts final rule on enhanced climate disclosures by public companies EU – Corporate Sustainability Due Diligence Directive (“**CSDDD**”) EU – SFDR Review Canada (Québec) – the Autorité des marchés financiers (the “**AMF**”) ends the consultation period for its draft *Climate Risk Management Guideline* for Québec financial institutions

Above: A non-exhaustive table of climate-related regulatory developments in recent years.

In Canada, mandatory climate-related disclosure requirements remain relatively limited, with no consistent domestic framework for all Canadian companies. Federally regulated banks and other financial institutions in Canada will be subject to the first prudential climate-related disclosure framework published by the Office of the Superintendent of Financial Institutions (OSFI) and effective year-end 2024 (for the "Big Six" chartered banks and "Big Four" insurers) and year-end 2025 for all other federally regulated financial institutions.[5] These institutions will be required to provide climate-related disclosures in compliance with this framework, including:

- their governance and strategy relating to climate-related risks and opportunities;
- the impact of climate-related risks on their businesses, strategy and financial planning;
- their climate transition plan and the resilience of their corporate strategy under different climate-related scenarios; and
- certain climate-related metrics, including greenhouse gas emissions, any climate-related commitments and the targets used to manage climate-related risks.[6]

Québec's prudential financial regulator, the Autorité des marchés financiers (AMF), also published its draft *Climate Risk Management Guideline* (the "**Draft Guideline**") for Québec financial institutions on November 30, 2023. The Draft Guideline considers the recommendations of the Task Force on Climate-related Financial Disclosures, and sets out the AMF's expectations relating to governance, risk management, quantitative disclosures (namely climate scenario analysis and stress testing) and capital adequacy. The Draft Guideline also clarifies the regulator's expectations relating to the fair treatment of clients and those relating to climate risk-related financial disclosures. The public consultation period for the Draft Guideline ended on January 30, 2024. [7]

In June 2023, the International Sustainability Standards Board issued inaugural standards (ISSB Standards) for disclosure of sustainability-related financial information to investors[8] and specifically for disclosure of climate-related risks and opportunities,[9] followed by a proposed disclosure taxonomy.[10] The ISSB Standards will be effective for annual reporting periods beginning January 1, 2024. While the ISSB Standards are not yet mandatory in Canada, regulators have been supportive of their implementation,[11] and the first step toward integration with Canadian regimes have been taken with the CSSB releasing proposed Canadian sustainability disclosure standards for public comment.[12] OSFI has also noted it will consider updating its disclosure framework based on its review of the ISSB Standards.

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5 Office of the Superintendent of Financial Institutions, ***Guideline B-15: Climate Risk Management*** (March 2023). See our review of OSFI's Guideline B-15 for more information: ***Final Guideline on Climate Risk Management and Disclosure for Financial Institutions issued by OSFI*** (March 13, 2023).

6 McCarthy Tétrault, ***A Global Sustainability and Climate-related Disclosure Baseline has Arrived: The ISSB Issues Final Standards*** (July 4, 2023).

7 For more information on the Draft Guideline, see our review: ***Québec's Prudential Regulator Releases Climate Risk Management Guideline*** (January 9, 2024).

8 International Financial Reporting Standards Foundation, ***IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information*** (June 2023).

9 International Financial Reporting Standards Foundation, ***IFRS S2 Climate-related Disclosures*** (June 2023).

10 International Financial Reporting Standards Foundation, ***Proposed IFRS Taxonomy: IFRS Sustainability Disclosure Taxonomy*** (July 2023).

11 Canadian Securities Administrators, ***Canadian Securities Administrators statement on proposed climate-related disclosure requirements*** (July 5, 2023).

12 ***Media Release – Canadian Sustainability Standards Board Announces First Canadian Sustainability Disclosure Standards for Public Consultation*** *(March 13, 2024).*

The ISSB Standards are integrated into the European Sustainability Reporting Standards (ESRS) adopted in July 2023. The ESRS mark a tightening of the European mandatory-disclosure regime and include a broad variety of topical standards on ESG issues. Their audience is broader than the investor-directed ISSB Standards, as the ESRS also explicitly require reporting on a company's impacts on people and the environment (rather than just the environmental risks to the company) and are aimed to be relevant to a broader pool of users beyond investors.

The U.S. Securities and Exchange Commission (SEC) released its mandatory climate disclosure rules in March 2024, nearly two years after it first unveiled its proposed regulations. The final rules, which come during a U.S. presidential election year, are less intensive than those initially proposed, as they no longer require "Scope 3" disclosures by reporting issuers.[13] Further, "Scope 1" and "Scope 2" disclosures are only required by certain entities where they would be material. Initial disclosures under these new rules are to be made beginning with the fiscal year beginning in 2025.

Canadian securities regulators have delayed their revision of proposed mandatory climate-related disclosure rules, due in part to the need to consider the course of action taken by both the SEC and the ISSB Standards. The Canadian Securities Administrators initially indicated an earliest final rule publication date of December 31, 2022 and later advised that they were considering international developments prior to finalizing the disclosure rule.[14] With the release of the SEC's long-awaited final rules, the Canadian Securities Regulators may now proceed in earnest with the preparation of their own revised rules.

REGULATORY ENFORCEMENT

Prior to the implementation of mandatory sustainability-related disclosure rules, regulators have begun scrutinizing companies (and their officers and directors) for inaccurate or misleading sustainability-related disclosures using a range of tools from disclosure reviews and deficiency warning letters to enforcement investigations and proceedings. Recent statements by the CEO of the Ontario Securities Commission (OSC) confirm that information relating to how companies are "identifying and responding to risks and opportunities presented by climate change" is material to investors and must be disclosed.[15]

Canadian securities regulators have made strong statements that combatting greenwashing is a priority and that enforcement will be used to address greenwashing by capital market participants. Although no securities regulatory enforcement proceedings have been commenced in Canada yet, securities regulators continue to issue warnings about sustainability-related disclosure deficiencies and conduct issue-oriented disclosure reviews of public companies and asset managers, which are often a precursor to enforcement action. The CSA conducted a focused review of ESG disclosures by investment funds and published guidance in March 2024.[16] The CSA noted that more than two thirds of fund prospectuses reviewed had unclear or inaccurate ESG investment strategy disclosures, including the extent to which ESG factors are considered. A prior disclosure review from 2022 of issuers highlighted significant deficiencies, including an increase in overly promotional and unsubstantiated sustainability-related disclosures and identified greenwashing in core regulatory filings and voluntary filings (such as sustainability or ESG reports), including unsubstantiated net-zero or carbon-neutral commitments.[17]

In contrast, the SEC and the Australian Securities and Investment Commission (ASIC) have been taking an increasingly aggressive approach to greenwashing enforcement actions. On September 25, 2023, the SEC announced that it had settled an administrative proceeding against a major investment advisor in relation to misstatements regarding ESG investments for a US$19-million civil penalty.[18] This followed the issuance of document requests and subpoenas to asset managers relating to ESG marketing[19] and a tightening of the "Name Rule" to require funds that reference an ESG focus to invest at least 80% of their assets in those investments.[20] All signals indicate that the SEC will continue its pace of activity in 2024, as it sent climate-related inquiries to more than a dozen large corporations during the last quarter of 2023.[21]

13 Scope 3 emissions are all emissions that a corporation is indirectly responsible for all along its value chain. In contrast, Scope 1 emissions are the emissions directly from a corporation's own and controlled sources and Scope 2 emissions are those from the generation of purchased energy.

14 Canadian Securities Administrators, **"Canadian securities regulators consider impact of international developments on proposed climate-related disclosure rule"** (October 12, 2022).

15 **Climate-Related Disclosures: A Material Issue** by Grant Vingoe

16 Canadian Securities Administrators, **CSA Staff Notice 81-334 (Revised) ESG-Related Investment Fund Disclosure** (March 7, 2024).

17 Canadian Securities Administrators, **CSA Staff Notice 51-364- Continuous Disclosure Review Program Activities for the fiscal years ended March 31, 2022 and March 31, 2021**, (November 3, 2022).

18 United States Securities and Exchange Commission, **Deutsche Bank Subsidiary DWS to Pay $25 Million for Anti-Money Laundering Violations and Misstatements Regarding ESG Investments**, 2023-194 (September 25, 2023).

19 Temple-West, Patrick and Madison Darbyshire, "**SEC lawyers subpoena fund managers over ESG disclosures,**" *Financial Times* (August 15, 2023).

20 United States Securities and Exchange Commission, "**SEC Adopts Rule Enhancements to Prevent Misleading or Deceptive Investment Fund Names**" 2023-188 (September 20, 2023).

21 Nicola White, "**SEC Presses Companies on Climate Risk With New Rules on Horizon**", *Bloomberg Tax* (January 2, 2024).

ASIC highlighted greenwashing as an enforcement priority in 2023 and has done so again in 2024.[22] ASIC brought three "first of their kind" civil penalty proceedings against investment fund managers for greenwashing in 2023, including claims against:

— a pension fund manager alleging misleading statements about the sustainable nature and character of pension fund investments;[23]

— a fund manager for misstatements that a fund marketed towards ethically conscious investors screened for certain ESG criteria. Importantly, ASIC successfully obtained a court ruling that the fund manager engaged in greenwashing, including failing to exclude fossil fuel investments in sustainable fund products;[24] and

— a pension fund manager that held investments in companies deriving revenue from tar sands projects or coal mining projects, despite representations to the contrary.[25] Significantly, ASIC chose to pursue civil penalties against the pension fund manager even though it had already corrected the misstatement.[26] This marks a departure from the usual regulatory approach, where companies may receive reduced penalties and avoid prosecution if they step forward and self-disclose breaches, significantly broadening corporate liability.

The Canadian Competition Bureau continues to signal that greenwashing is a high-enforcement priority, building on its enforcement momentum from prior years. It has launched several new investigations following complaints filed by environmental groups and other stakeholders, including an investigation of North America's largest forest certification scheme[27] and an investigation of six oilsands companies that claimed to be progressing toward "net-zero" emissions while expanding fossil fuel production.[28] This enforcement activity is likely to be further heightened in light of proposed amendments to the *Competition Act* announced in the federal government's *Fall Economic Statement Implementation Act, 2023*. Most significantly, the definition of misrepresentations to the public will be amended to explicitly include greenwashing: "a statement, warranty or guarantee of a product's benefits for protecting the environment or mitigating the environmental and ecological effects of climate change that is not based on an adequate and proper test, the proof of which lies on the person making the representation."[29]

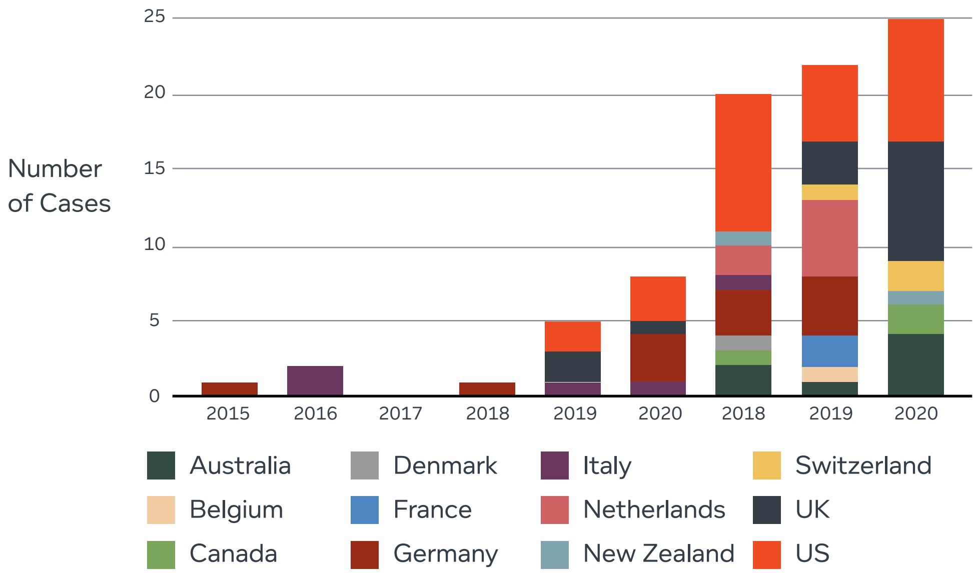
GREENWASHING CIVIL LAWSUITS

The steady increase in civil lawsuits, including class actions, against companies alleging inaccurate or misleading sustainability-related practices, commitments or product features continues. Activist stakeholders are increasingly leading such lawsuits with the primary objective of modifying corporate conduct — a marked shift in the litigation dynamic.

Securities and consumers class actions against companies for misleading climate-related disclosures, unsubstantiated "net-zero" or "carbon-neutral" commitments and misstating sustainability-related aspects of their products are also increasing.

22 Australian Securities and Investment Commission, **ASIC announces 2024 enforcement priorities** (November 21, 2023).
23 Australian Securities and Investment Commission, ASIC launches first Court proceedings alleging greenwashing (February 28, 2023); *Australian Securities and Investment Commission v. Mercer Superannuation (Australia) Limited (ACN 004 717 533)*, VID117/2023, **Concise Statement**, (February 27, 2023).
24 *Australian Securities & Investments Commission v. Vanguard Investments Australia Ltd (ACN 072 881 086)*, **Concise Statement**, VID563/2023 (July 24, 2023). **ASIC wins first greenwashing civil penalty action against Vanguard | ASIC**.
25 *Australian Securities & Investments Commission v. LGSS Pty Limited (ACN 078 003 497) as trustee for Local Government Super (ABN 28 901 371 321)*, NDS847/2023, **Concise Statement**, (August 10, 2023).
26 *Australian Securities & Investments Commission v. Vanguard Investments Australia Ltd (ACN 072 881 086)*, VID563/2023, **Concise Statement**, (July 24, 2023) at paras. 12, 18, 19.
27 Canadian Press (Bob Weber), "**Competition Bureau to investigate industry claims of sustainable forestry management**," *Vancouver Sun* (February 2, 2023)
28 Rod Nickel, "**Canada's Competition Bureau Investigates Oil Sands Group Over Advertising**," *Reuters* (May 11, 2023).
29 **Bill C-59, *Fall Economic Statement Implementation Act, 2023***, Division 6, s. 236 (November 30, 2023).

Rise in Greenwashing Cases



Above: A table demonstrating the growth in greenwashing cases across select jurisdictions.

In Europe, Australia and the U.S., a number of greenwashing claims have been commenced by activist shareholders and governments relating to corporate net-zero or carbon-neutrality commitments, climate-related financial impacts of corporate conduct and sustainability-related product features or statements. These include claims against:

— airlines alleging misleading or inaccurate claims of carbon neutrality based in part on investments in carbon offsets that are speculative, impermanent and poorly calculated;[30]

— athletic footwear and apparel companies regarding inaccurate or unsubstantiated sustainable product attributes;[31]

— a financial institution for failing to implement an effective policy to identify and mitigate risks relating to climate change as a result of its funding of fossil fuel companies;[32]

— major oil companies relating to net-zero or carbon-neutrality commitments, climate-related financial impacts and the financial value and attributes of oil reserves;[33] and

— an investment company targeted by anti-ESG politicians alleging that ESG considerations drove investment strategy for funds marketed as being focused solely on financial returns.[34]

Nor are governments immune from the risk of litigation. In August 2023, the Australian federal government settled a class action that alleged its failure to disclose the risks that climate change posed to exchange-traded

30 *Mayanna Berrin v Delta Air Lines Inc.* (C.D. Cal.), case no. 2:23-cv-04150, **Complaint** at para 3. BEUC, ***Consumer groups launch EU-wide complaint against 17 airlines for greenwashing*** (June 26, 2023); See also **discussion** on KLM defending greenwashing claims on their 'Fly Responsibly' ad campaign. The KLM verdict is anticipated on February 21, 2024. (December 19, 2023).

31 *Ellis v Nike USA Inc. et al.* (E.D. Mo.), case no. 4:23-cv-00632, **Complaint** (May 10, 2023).

32 Summons (complaint) against BNP Paribas, **French** | **English (unofficial)** (February 23, 2023).

33 *The People Of The State Of California v. Exxon Mobil Corporation et al.*, **Complaint** (September 15, 2023).

34 *State of Tennessee v. BlackRock Inc.*, case no. 23CV-618, **Civil Enforcement Complaint** (December 18, 2023).

government bonds was misleading, deceptive and in breach of Australia's securities legislation.[35] As part of the settlement, the Australian government will publish a statement that climate change is a systemic risk that may affect the value of its government bonds.

As Canadian consumer protection legislation is comparable to that in the U.S., we expect this trend to be reflected in Canada, including with the commencement of "copycat" class actions. At present, there are proposed Canadian class proceedings against retailers in relation to claims that plastic bags are "recyclable,"[36] as well as against a consumer coffee products company, again in relation to the recyclability of its products.[37] None of these have passed the certification hurdle as of yet.

The emphasis on effecting change has also led to a notable shift in litigation focus: directors and officers are now finding themselves personally targeted in greenwashing litigation. In February 2023, an environmental law charity filed a novel derivative action against the directors of an oil and gas company, alleging that they had breached their duties in relation to the company's climate change risk-management strategy by failing to set appropriate emissions targets, not adopting a strategy for the management of climate risk that would establish a reasonable basis for achieving a net-zero target (including by making investments in fossil fuels) and failing to comply with a Dutch court order imposing emission reduction obligations.[38] The United Kingdom High Court of Justice dismissed the claims on the basis that the plaintiffs effectively sought to impose specific absolute duties on the directors that would override their general duty to promote the success of company.[39] It did not rule on the plaintiffs' substantive allegations that the directors had failed to set appropriate emissions targets and provide a realistic pathway to net-zero targets.[40]

Although the plaintiffs were unsuccessful, we do not expect this to be the last attempt to pursue claims against directors and officers in relation to greenwashing allegations. While directors and officers in Canada have significant latitude as to how they direct companies in the best interests of their shareholders, they may face derivative claims for failing to consider climate change in assessing strategic risks and opportunities and integrating that assessment into their corporate governance.

OUTLOOK

Given the global focus on sustainability-related disclosures and the ongoing implementation of more prescriptive mandatory sustainability-related disclosures regimes, we expect continued growth in sustainability-related litigation, complaints and regulatory enforcement action. The new global baseline of the ISSB standards, and the clear framework they provide, are likely to prove to be a double-edged sword in terms of risk.

Canadian corporations, directors and officers can take a number of actions to reduce or eliminate the legal and reputational risks related to greenwashing. These include:

— **Implementing deliberate and process-driven disclosure and marketing practices:** Treat sustainability-related statements and the use of sustainability-related labels with the same level of care and scrutiny that is applied to other material financial and strategic disclosures or representations to ensure alignment between market representations and the action being taken. Ensure a clear, documented record of the process.

— **Being attentive and responsive to regulatory developments:** The rapid pace of regulatory and legal developments underscores the importance of putting appropriate governance and control systems in place to proactively monitor developments and ensure sustainability-related issues are being appropriately embedded and prioritized throughout your organization. Consider the use of cross-functional management and board committees to mitigate risk and maintain strategic advantages.

— **Prioritizing directorial capacity to discharge oversight obligations where greenwashing could occur:** Ensuring that directors have the resources and information required to meaningfully oversee the organization's management of sustainability-related risks and opportunities will not only benefit the organization but will also help limit director liability in an increasingly prominent area of risk.

35 *Kathleen O'Donnell v Commonwealth of Australia*, VID482/2020, **Notice as to Proposed Settlement of Class Action** (August 2023).
36 *Sonia Cohen v. Dollarama S.E.C. et al. No.* 500-06-001200-225, **Re-Amended Application to Authorize the Bringing of a Class Action and to Appoint the Status of Representative Plaintiff** (October 4, 2022).
37 Legal Wire, ***Ontario court awards carriage to Consumer Law Group to be class counsel in Keurig coffee pods case***, (January 6, 2023).
38 *ClientEarth v Shell Plc & Ors (Re Prima Facie Case)*, **[2023] EWHC 1137 (Ch)** (May 12, 2023) at paras. 2, 27.
39 *ClientEarth v Shell Plc & Ors (Re Prima Facie Case)*, **[2023] EWHC 1137 (Ch)** (May 12, 2023) at para. 25; *ClientEarth v Shell Plc & Ors*, **[2023] EWHC 1897 (Ch)** (July 24, 2023) at para. 37.
40 *ClientEarth v Shell Plc & Ors (Re Prima Facie Case)*, **[2023] EWHC 1137 (Ch)** (May 12, 2023) at paras. 37-39; *ClientEarth v Shell Plc & Ors*, **[2023] EWHC 1897 (Ch)** (July 24, 2023) at paras. 49-52.

Risk Alert: Increased Scrutiny of Auditors in 2023 and Beyond

By Dana Peebles, Wendy Berman, Christopher Hubbard, Lindsay Burgess[41], Leah Ostler and Steven Marchand

In light of recent corporate failures around the globe, regulators in Canada and the United States have placed auditors, and in particular auditors of public companies, under greater scrutiny. Trends in this regard include:

- **Trend 1:** Amendments to audit standards that create robust frameworks to strengthen audit quality;
- **Trend 2:** Increased inspection and enforcement action against auditors of public companies;
- **Trend 3:** Increased disciplinary action by provincial Chartered Professional Accountants' (CPA) bodies for failures to comply with professional standards, and in Ontario, failing to co-operate with regulatory processes;
- **Trend 4:** Increased scrutiny by securities regulatory authorities of the practices and policies of auditors and audit firms;
- **Trend 5:** Greater focus on public accounting licensing issues by Canadian regulators; and
- **Trend 6:** Increased risk of being named as a defendant in securities class actions arising out of alleged misrepresentations in financial reporting by public issuers.

Audit quality and integrity in financial reporting is at the root of all of these trends. Tasked with the mandate of protecting investors and the public interest, regulators are pushing to improve audit quality, reduce misstatements and the necessity of restatements and improve investor confidence in the financial reporting of public companies.

Auditors of public companies in Canada and the U.S. should take note of these trends, which emphasize strict adherence to audit standards and quality control, to avoid being on the receiving end of these measures.

TREND 1: AUDIT STANDARD AMENDMENTS IN RESPONSE TO FINANCIAL REPORTING FAILURES

In an ongoing effort to strengthen audit procedures to respond to financial reporting failures, the audit standard setting bodies in Canada and the U.S. continue to make changes to create a more robust audit standard framework adapted to the changing needs of the industry.

Part 1: Recent and Proposed Amendments to Canadian Audit Standards

Canada's Auditing and Assurance Standards Board (AASB) approved a new suite of quality management standards in January 2021:

- Canadian Standard on Quality Management (CSQM) 1: *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* (CSQM 1);

41 Lindsay Burgess is no longer with McCarthy Tétrault.

— CSQM 2: *Engagement Quality Reviews* (CSQM 2); and

— Canadian Auditing Standard (CAS) 220: *Quality Management for an Audit of Financial Statements* (CAS 220).

The new standards reflect a move away from a focus on quality control, which was thought to be reactive in nature, to the proactive concept of quality management that introduces a "continuous process that is to be ingrained in the firm's culture and strategy."[42] Among other things, CSQM 1 required firms to design and implement their system of quality management for audits or reviews of financial statements or other assurance engagements by December 15, 2022, and to evaluate their system of quality management within the following year, by December 15, 2023.

Regulatory assessments conducted by the Canadian Public Accountability Board (CPAB), which oversees the audits of the financial statements of all Canadian reporting issuers, have been focused on the progress of firms in implementing the new quality management standards.[43] In addition, starting in 2022, CPA Ontario (CPAO) conducted a focused review of public accounting firms that audit reporting issuers, seeking details about how they manage audit quality. In its **October 2023 report** on this review, CPAO identified five risk areas that could threaten audit quality.[44] The 15 firms that participated in the initial review will undergo an enhanced review of their quality management systems in their next inspection cycle, including with respect to these five risk areas.

Likewise, economic uncertainty and financial reporting failures around the globe have put the topic of going concern[45] in the spotlight. In response to these issues, the International Auditing and Assurance Standards Board (IAASB) issued an exposure draft[46] — ***Proposed International Standard on Auditing 570 (Revised 202X) Going Concern and Proposed Conforming and Consequential Amendments to Other ISAs*** — on April 26, 2023.

42 CPA Canada, Practitioner Alert: Canadian Standards on Quality Management (May 2021), p. 5, available for download online at: **https://www.cpacanada.ca/en/business-and-accounting-resources/audit-and-assurance/standards-other-than-cas/publications/new-quality-management-standards-practitioner-alert**.

43 *Canadian Public Accountability Board Act (Ontario), 2006*, **S.O. 2006, c. 33, Sched. D.**, s. 3 (*CPAB Act*); Pursuant to CPAB's governing document, **NI 52-108, Auditor Oversight**, auditors of Canadian reporting issuers must be registered with CPAB as a participating audit firm (s. 2(a)), and reporting issuers that file audited financial statements must have those statements audited by a CPAB participating audit firm.

44 These were: (1) governance and decision-making; (2) ethical mindset; (3) talent and technology; (4) working papers; and (5) monitoring activities.

45 Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future (see **ISA 570 (Revised), Going Concern**, p. 2).

46 An exposure draft is a draft of the proposed standard that is issued for public comment for a period of time before the final pronouncement of the standard is issued.

The IAASB's stated goal for the proposed revisions was to promote consistent practice and responses to identified risks of material restatement, to strengthen the auditor's evaluation of management's assessment of going concern (including the exercise of professional skepticism) and to enhance transparency with respect to the auditor's work related to going concern (including by strengthening communications and reporting requirements). In May 2023, the AASB issued its **Exposure Draft – Proposed Amendments to CAS 570**[47] in which it proposed, subject to comments, to adopt the IAASB's proposed ISA 570 (Revised 202X) as CAS 570 without revisions. On August 22, 2023, after considering feedback received from interested and affected parties in Canada, the AASB **responded** to the IAASB's Exposure Draft with a number of matters for further consideration.[48] Auditors who conduct audits in accordance with Canadian Audit Standards (CAS) will want to keep an eye out for the implementation of this new standard.

Part 2: Recent and Proposed Amendments to U.S. PCAOB Audit Standards

In the U.S., the Public Company Accounting Oversight Board (PCAOB) oversees the audits of public companies and SEC-registered brokers and dealers. The PCAOB has also implemented and proposed amendments to its audit standards in order to strengthen the quality of PCAOB audits and better protect market participants.

For example, on June 6, 2023, PCAOB issued for public comment a **proposal**[49] for amendments to its auditing standards related to an auditor's consideration of a company's non-compliance with laws and regulations, including fraud, in the performance of an audit. PCAOB states that the proposal seeks to enhance auditor obligations in three ways:[50]

— **Identification:** Establishing specific requirements for auditors to proactively identify applicable laws and regulations that could have a material effect on the financial statements if they are not complied with, and definitively stating that financial statement fraud is a form of non-compliance with laws and regulations.

— **Evaluation:** Strengthening the requirements related to the auditor's evaluation of non-compliance with laws and regulations and the possible effects on the financial statements and other components of the audit.

— **Communication:** Explicitly requiring the auditor to communicate non-compliance with laws or regulations that has or may have occurred as soon as possible to management and the audit committee, including a new requirement that auditors must communicate the results of their evaluation to management and the audit committee.

47 International Standards on Auditing (ISA) are adopted in Canada as Canadian Auditing Standards (CAS).

48 These included, among other things, aligning the period covered for going concern assessment between financial reporting and audit standards; additional guidance on the work required where it is clear that the entity is a going concern; and concerns that proposed changes to include explicit statements in the auditor's report about the auditor's conclusions on the appropriateness of management's use of the going concern basis of accounting and on whether a material uncertainty has been identified do not "increase transparency in a concise and understandable way," are not relevant to audited financial statement users and do not align with certain financial reporting frameworks.

49 PCAOB Release No. 2023-003, Proposing Release: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments, June 6, 2023.

50 PCAOB, "PCAOB Issues Proposal to Increase Auditor Vigilance Against Fraud and Other Forms of Noncompliance with Laws and Regulations," June 6, 2023, available online at: **https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-issues-proposal-to-increase-auditor-vigilance-against-fraud-and-other-forms-of-noncompliance-with-laws-and-regulations**.

On September 28, 2023, PCAOB adopted a **new standard**[51] on the auditor's use of confirmation[52] to reflect changes in technology, business practices and communications in the years since the interim standard was first adopted in 2003. PCAOB states that the new standard "will better protect investors by strengthening procedures that enhance an auditor's ability to identify fraud in certain circumstances and improving overall audit quality."[53]

TREND 2: INCREASED INSPECTION AND ENFORCEMENT ACTION

Both CPAB and PCAOB are tasked with protecting investors by advancing audit quality in their respective jurisdictions. Inspections and enforcement action are key components of their mandates, and both jurisdictions have seen a trend toward increased rates of audit deficiencies noted on inspection and increased enforcement action.

Part 1: CPAB Inspection and Enforcement

In accordance with its mandate to further "public confidence in the integrity of financial reporting by public companies," CPAB conducts regular inspections of participating audit firms to assess their compliance with professional standards, CPAB's rules, and quality control policies in the firms' audits of Canadian reporting issuers.[54] To date, the results of those inspections have been reported annually on an aggregate basis.

As set out in its **2022 Annual Inspection Report**,[55] CPAB uses a risk-based methodology for selecting files for inspection, with a focus on "higher-risk audit areas of more complex companies or areas where the audit firm may have less expertise." For 2022 inspections, while CPAB saw improved inspection results for most annually inspected firms, it noted a significant and concerning increase in the findings rate[56] for firms inspected non-annually.[57] Of particular concern was the increase in restatements resulting from additional procedures carried out by audit firms in response to significant findings in inspections made by CPAB – from one such restatement in 2021 to seven restatements in 2022.[58]

CPAB's **annual inspection report** on 2023 inspections noted the following key issues:

— Results were mixed with inconsistency across all categories of firms and significant findings in 34% of the files inspected

— Six restatements of the audited financial statements were made as a result of significant findings

— With respect to the implementation of CSQM 1, which required firms to evaluate their system of quality management, there was as a strong correlation between firms with a robust system of quality management and a lower level of significant findings through file inspections

Last year, 2023, also marked the beginning of the implementation of significant changes to the way CPAB publicly discloses the results of its regulatory assessments. In September 2022, CPAB published **disclosure recommendations** that would change CPAB's approach to disclosure related to enforcement actions, communications with audit committees and disclosure of the results of regulatory assessments. As part of the first phase, which took effect January 2023, CPAB began publicly disclosing:[59]

— significant enforcement actions imposed on a firm as a consequence of inspection findings; and

— disclosure recommendations that were included in a firm report but not addressed by the firm.

In 2023, CPAB reported **enforcement action** taken against eight participating audit firms further to seven regulatory inspections and one investigation. All eight enforcement actions related to breaches of various Canadian Auditing Standards, including, but not limited to: (i) CAS 500 – *Audit Evidence* (all eight firms); (ii) CAS 540 – *Auditing Accounting Estimates and Related Disclosures* (seven firms); (iii) CAS 230 – *Audit Documentation* (five firms); (iv) CAS 315 – *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Environment* (six firms); and (v) CAS 330 – *The Auditor's Responses to Assessed Risks* (six firms). In addition, CPAB also found that three firms had not adequately addressed

51 PCAOB Release No. 2023-008, The Auditor's Use of Confirmation and Other Amendments to PCAOB Standards, September 28, 2023.

52 Confirmation is the process by which the auditor verifies information about financial statement assertions with a third party.

53 PCAOB, "PCAOB Adopts New Standard, Modernizing Requirements for Auditors' Use of Confirmation to Better Protect Investors in Today's World," September 28, 2023, available online: **https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-adopts-new-standard-modernizing-requirements-for-auditors-use-of-confirmation-to-better-protect-investors-in-todays-world**.

54 *CPAB Act*, ss. 3, 6(2)(c).

55 CPAB, *CPAB Regulatory Oversight Report: 2022 Annual Inspection Results*, March 2023, p. 3.

56 The findings rate is the rate of significant inspection findings. "Significant inspection finding" means a "deficiency in the application of generally accepted auditing standards related to a material financial balance or transaction stream where the audit firm must perform additional audit work to support the audit opinion and/or is required to make significant changes to its audit approach." Furthermore, "CPAB requires firms to carry out additional audit procedures to verify there was no need to restate the financial statements due to material error, or to substantiate that they had obtained sufficient and appropriate audit evidence with respect to a material balance sheet item or transaction stream to support their audit opinion." See 2022 Annual Inspection Report, p. 4.

57 2022 Annual Inspection Report, pp. 3, 5.

58 2022 Annual Inspection Report, pp. 5-6.

59 CPAB, "CPAB disclosures project update," June 2023, available online: **https://cpab-ccrc.ca/docs/default-source/disclosure/2023-disclosures-project-update-june-en.pdf**.

concerns over audit quality raised in previous inspections. As a result, five firms were prohibited from accepting any new high-risk reporting issuer clients,[60] while two firms were prohibited from accepting any new reporting issuer clients. Another firm had its membership in CPAB **terminated** after an investigation revealed "widespread and serious violations of audit documentation standards and a fundamental absence of supervision and review."

Auditors of Canadian reporting issuers can expect further disclosure changes from CPAB in the future. CPAB is currently working on changes to its rules and legislation to permit a second phase of disclosure changes that would allow it to publish a condensed individual public inspection report for each audit firm inspected (similar to reporting of inspection results by the PCAOB) and mandatory disclosures to audit committees.[61] It is important that auditors and firms stay up to date on these changes to ensure they are meeting their obligations.

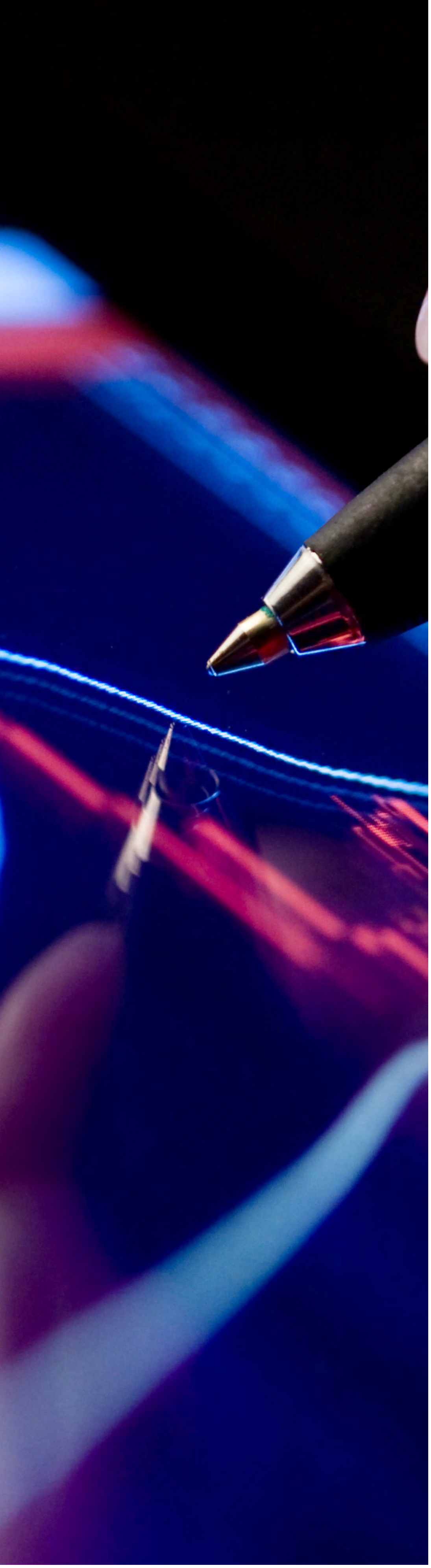
Part 2: PCAOB Inspection and Enforcement

Unlike CPAB, which applies a risk-based method of selecting audit work for inspection, PCAOB uses both a risk-based and random method of selection, generally focusing on audit areas of greater complexity, significance or a heightened risk of material misstatements, as well as areas of recurring deficiencies.[62]

In a **July 2023 staff report**,[63] PCAOB staff noted that the percentage of audit deficiencies expected for 2022 inspections rose again for the second year in a row, with approximately 40% of audits reviewed expected to have one or more Part I.A[64] deficiencies (up from 34% in 2021 and 29% in 2020), and 46% expected to have one or more Part I.B[65] deficiencies (up from 40% in 2021 and 26% in 2020). PCAOB publicly issues inspection reports on an individual audit firm basis.[66] In an **October 2023 staff report**,[67] PCAOB staff noted an upward trend in quality-control criticism coming out of PCAOB's inspections of engagement quality reviews, with 42% of firms inspected in 2022 attracting such criticism compared to 37% in 2020.

On the enforcement front, 2022 saw **47 enforcement actions**[68] (up from 22[69] in 2021 and 21 in 2020). In 2023, there were also **47 enforcement actions**,[70] most of which related to PCAOB audit and quality control standard violations.

60 Of these five firms, in addition to the prohibition on accepting any new high-risk reporting issuer clients, three were also prohibited from accepting any new medium-risk reporting issuer clients, and one was prohibited from accepting any new elevated-risk reporting issuer clients.
61 CPAB, "CPAB disclosures project update," June 2023, available online: **https://cpab-ccrc.ca/docs/default-source/disclosure/2023-disclosures-project-update-june-en.pdf**.
62 PCAOB, "PCAOB Inspection Procedures: What Does the PCAOB Inspect and How are Inspections Conducted?" available online: **https://pcaobus.org/oversight/inspections/inspection-procedures**.
63 PCAOB, "Staff Update and Preview 2022 Inspection Observations," July 2023, p. 3.
64 Part I.A of the PCAOB inspection reports discuss deficiencies, if any, related to the audit firm's failure to obtain sufficient appropriate audit evidence to support its opinion(s) on the issuer's financial statements and/or internal control over financial reporting (ICFR).
65 Part I.B of the PCAOB inspection reports discuss deficiencies, if any, related to instances of noncompliance with PCAOB standards or rules other than those where the firm had not obtained sufficient appropriate audit evidence to support its opinion(s).
66 PCAOB Firm Inspection Reports database available online at: **https://pcaobus.org/oversight/inspections/firm-inspection-reports**.
67 PCAOB, "Inspection Observations Related to Engagement Quality Reviews," October 2023.
68 Including against three Canadian audit firms, one of whom had its registration with PCAOB revoked, and two Canadian CPAs.
69 Including against five Canadian audit firms, one of whom had its registration with PCAOB revoked, and one Canadian CPA.
70 Including against three Canadian audit firms, one of whom had its registration with PCAOB revoked, and one Canadian CPA.



TREND 3: INCREASED DISCIPLINARY ACTION BY PROVINCIAL CPA BODIES

Numerous Canadian jurisdictions have seen an increase in oversight and scrutiny of CPA Members and Firms by their respective provincial regulatory bodies, which is most clearly demonstrated in Ontario. It is critical that Members and Firms be aware of their regulatory obligations – and the scope of the regulators' powers – to ensure compliance, or to understand where reasonable pushback might be available.

Part 1: Increased Disciplinary Action for Violations of Rule 206

CPAO has the authority to regulate CPAs in the public interest. Recent decisions of CPAO's Disciplinary Committee (CPAO DC) show an increase in disciplinary proceedings and sanctions for alleged violations, by a Member[71] or a Firm,[72] of their obligation to comply with professional standards.

R. 206[73] of CPAO's ***Code of Professional Conduct*** (Ontario *Code*) obliges a Member or Firm to perform professional services in accordance with "generally accepted standards of practice of the profession" (r. 206.1).

While there were only two r. 206.1-related allegations before the CPAO DC in 2022, there were 12 allegations filed in 2023 (including three claims that were settled). Some of the early trends in penalties and fines that have been handed down for r. 206.1 violations include revocation of membership with the CPAO, fines payable to the CPAO ranging from C$12,500 to C$50,000 and having the individual's name published on the CPAO's website and in *The Globe and Mail* in the region where the individual practised. However, it is important to keep in mind that the CPAO hands down singular penalties for a Member's breach of r. 206.1 *and* various other rules. In the **one decision** from 2023 where an individual was *only* charged with a r. 206.1 violation, the penalties included a permanent prohibition on accepting engagements of reporting issuers, a C$25,000 fine, entering into a Supervision Agreement and the individual's name being published on the CPAO website and in *The Globe and Mail* where the individual practised .

Overall, two trends emerge from the nature of the allegations raised in 2023:

1. **Alleged failures to obtain (or retain) a signed engagement letter setting out the scope of a Member's engagement.** Three recent claims include allegations that a Member violated r. 206.1 by failing to obtain a written engagement letter from management of the organization being engaged, which would be expected to set out the terms of the audit engagement.
2. **Alleged failures to perform the audit, assurance or review engagement with appropriate "professional skepticism."** In 2023, a total of four claims involve allegations that a Member violated r. 206.1 by failing to maintain "professional skepticism" in the auditing, assurance or review engagement process. Some of the specific allegations include the following: failure to obtain sufficient audit evidence to reduce audit risk to an acceptable level;

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71 "Member" means a member, whether or not in good standing, of CPAO as defined in CPAO's bylaws (Ontario *Code*, Definitions).

72 "Firm" means an entity registered under section 23 of the *Chartered Professional Accountants of Ontario Act, 2017*, S.O. 2017, c. 8, Sched. 3.

73 Similar provisions exist in the Codes of Conduct of other provincial CPA bodies; for example, Rule 206 in the **CPABC Code of Professional Conduct**, Rule 206 in the **CPA Alberta Rules of Professional Conduct** and Rule 206 in the **CPA Saskatchewan Rules of Professional Conduct**.

failure to take appropriate steps to address allegations of suspected fraud; failure to consider risks and errors made by the predecessor auditor; failure to properly assess material misstatements; and failure to make sufficient inquiries of and engage in communication with management and document those discussions.

Similarly, in Western Canada, CPA Saskatchewan issued one **discipline decision** in 2023 in respect of a violation of r. 206.1 (compliance with professional standards) of CPA Saskatchewan's *Rules of Professional Conduct*, while CPABC issued four **discipline decisions** in 2023 in respect of violations of r. 206.1 (compliance with professional standards) of CPABC's *Code of Professional Conduct*.

Due to this increased scrutiny, CPAs are encouraged to review the applicable provisions in their relevant Code of Conduct to ensure they are applying necessary safeguards and documentation processes to demonstrate that professional scrutiny has been appropriately exercised.

Part 2: Increased Disciplinary Action for Rule 104 Failures to Co-operate

In addition to an increase in r. 206 violations, Ontario is seeing an increase in disciplinary action against CPA Members and Firms for violations of the requirement to co-operate with — and respond to — requests for information from CPAO's Standards Enforcement branch.

R. 104 of the Ontario *Code* requires a Member or Firm to "co-operate with the regulatory processes of CPA Ontario," such that they must:

- promptly reply in writing to "any communication" from CPAO where a written reply is "specifically required;"
- promptly produce documents "when required to do so" by CPAO; and
- attend in person in the manner requested "when required to do so" by CPAO.

Generally, Standards Enforcement sends requests for information in two scenarios: 1) while investigating a complaint filed by a former client or by other Members at the same Firm, or 2) a complaint from the director of practice inspection following an inspection of the Member's practice. Under s. 50 of the ***Chartered Professional Accountants of Ontario Act, 2017*** (Ontario Act), an investigator appointed by CPAO may, among other things, require an individual to provide information and produce documents that the investigator "believes is relevant" to the investigation, for which the investigator has broad discretion.

In 2022, the CPAO DC issued seven decisions involving alleged breaches of r. 104. In 2023, that number increased — five of the CPAO DC's last 11 cases (as of January 1, 2024) involve alleged breaches of r. 104, with hearing dates pending on five.

The reasons in these decisions often provide little elaboration on what information was requested, and instead details the number of phone calls, emails and links to FileCloud (an online document sharing software) a Member received but did not respond to. The CPAO DC's recent string of r. 104-related decisions disclose the following trends:

1. **Co-operation must be full, unabridged and unqualified:** In its **reasons** sanctioning one individual, the CPAO DC found that — during an investigation of complaints from other Members at the same Firm regarding misappropriated funds — the individual attended interviews and produced most of the documentation requested but failed to produce "all of the material requested by the investigator." Despite this partial adherence, the individual was found in breach of r. 104.2. (See similar findings in these **reasons**, where the individual made partial disclosure.)
2. **The response must be sufficient:** The response must substantively address the concerns raised. In its **reasons** sanctioning an individual, the CPAO DC found that an individual did not respond to some requests for information but did respond to others, detailing personal problems that he was facing. Despite these explanations, the individual was found to be in breach of r. 104.2 because he did not respond to specific issues raised.
3. **Initial failures to respond may be punished:** In its **reasons** sanctioning an individual, the CPAO DC noted that the request for "additional information" was viewed by a party at the email address of the individual's practice, according to FileCloud records, suggesting that the request was received but ignored. Similarly, in its **reasons** sanctioning another individual, the CPAO DC found that the Standard Enforcement's requests for a response went unanswered even though the individual appeared to have viewed the correspondence on FileCloud.

   That said, the CPAO DC has indicated that it is not necessary for the CPAO to *prove* that the individual received and reviewed the request for information in order to establish a breach of r. 104. Rather, an inference can be drawn based on the number of attempts made to reach the individual and evidence that the FileCloud correspondence was accessed (see these **reasons**).

4. **Initial failures to respond may not be cured by an eventual response:** In its reasons, the CPAO DC found that while investigating an individual for providing services through an unregistered corporation, 12 attempts at contact went unanswered. The individual provided a "complete response" after the allegations were formally issued. However, this later response did not cure the individual's previous failures to respond, and she was found to be in breach of r. 104.2.

None of the decisions reference objections made by the individual to the request for information on the basis of irrelevance or over breadth. While there may be some room for negotiation with CPAO or its investigators as to what is "*relevant to*" an investigation and what must be produced, CPAO's powers are broadly worded and it appears to be taking a strict approach to failures to respond. Any instances of Firm or Member pushback to CPAO information requests must be handled with this context in mind.

TREND 4: INCREASED SCRUTINY BY SECURITIES REGULATORS

Regulatory scrutiny over auditors and audit firms of public companies continues to come primarily from CPAB in Canada and PCAOB in the U.S. However, securities regulators in both countries are starting to pay more attention to the internal processes of the largest public audit firms (even if, as it appears, enforcement action has been slow to commence).

Part 1: Trends in Canada

In September 2022, the Ontario Securities Commission (OSC) issued **a press release** stating that it would begin making "targeted inquiries" to "certain public accounting firms" as a result of ethical violations identified by regulators in Canada and other jurisdictions. The OSC's self-stated goal is to seek information about firm policies on compliance with relevant ethical requirements, the

operation of internal whistleblower programs and internal procedures related to the dating of audit work performed and training course implementation.

According to ***Canadian Accountant***, it remains an open question what the OSC would — or could — do if it is not satisfied by the results of their efforts. Typically, CPAB is responsible for inspection, compliance and internal controls. Meanwhile the OSC has "limited power" to require formal communication from CPAB. However, the OSC has circumvented the influence of CPAB in settling certain of its claims against auditing firms, such as in the C$8-million penalty paid by EY Canada in 2014 over its audit of Sino-Forest under the OSC's no-contest rules.

In June 2023, the OSC issued **a press release** publishing a report that it expects to assist public accounting firms in developing and implementing robust internal ethical policies and procedures. That report, OSC staff notice **52-724**, has not yet been mentioned in any orders, rulings or decisions of the OSC. This is likely due to its recency, as well as the fact that, as the report itself makes clear, the views provided are "based on existing requirements" in applicable professional and regulatory standards and do not create new requirements for public accounting firms.

The report also acknowledges the OSC's limitations when it comes to auditor oversight. It mentions that both CPAB and CPAO have "important mandates" that include oversight of public accounting firms that conduct financial statements audits of reporting issuers in Canada and Ontario, respectively. However, the report assures readers that the OSC has a "co-operative engagement" with both organizations and that their work on this initiative involved discussions with CPAB and CPAO "to the extent permitted by our authorities to support regulatory alignment on such matters." It will be interesting to see how these authorities interact in future matters.

In British Columbia, the B.C. Securities Commission gained **new powers** through a package of **legislative amendments** aimed at strengthening the Commission's enforcement powers and expanding its rule-making authority. The amendments, which came into force on July 17, 2023, give the Commission the power to make rules regulating auditors of *registrants*. As a result, the Commission is now enabled to place requirements on the auditors of registrants, such as requiring membership in CPAB (which is already a requirement for auditors of reporting issuers).

Part 2: Trends in the United States

In contrast to the OSC, the U.S. Securities and Exchange Commission (SEC) has recently commenced several high-profile charges against auditors and audit firms for alleged improper professional conduct. In March 2023, the SEC **charged** audit engagement partner Sean P. Tafaro and Denver audit firm Spicer Jeffries LLP, alleging that the firm determined that the valuation of investments was a significant fraud risk in certain financial statements, but did not implement the planned audit approach to respond to that risk. The SEC also alleges that the firm failed to obtain sufficient audit evidence about the method of measuring fair value.

While the matter was ultimately settled and no admission or denial was made, the SEC's unconventional scrutiny over auditors comes at the same time as PCAOB released the **July 2023 staff report** discussed above, detailing an "unsettling trend" of expected audit deficiencies.

According to **Thomson Reuters**, this rise in scrutiny — from the standpoint of both litigation and regulatory risk — demands that auditors and audit firms "double down" on a culture of integrity, developing and implementing their own quality control systems to guard against potential misconduct, the possible examples of which appear to be increasing.

TREND 5: CPAB'S INCREASED FOCUS ON LICENSING ISSUES

Licensing of public accounting work has always been a concern for provincial CPA bodies, and the approaches taken to licensing vary among the provinces and territories. Notably, the provinces do not have legislative competence to legislate extraterritorially,[74] meaning their legislative authority is limited to persons and activities within their respective jurisdiction. With the advent of technological advances and borderless service delivery, licensing issues now involve thorny issues of jurisdiction.

Notably, as of 2023, CPAB now requires participating audit firms to provide a licensing attestation in respect of all of their reporting issuer clients as part of the CPAB **registration** and renewal processes. This attestation should be very carefully considered and responded to.

CPAB has also recently begun to take enforcement action against audit firms in respect of Canadian licensing issues. In a recent **enforcement decision** against a U.S. audit firm, CPAB found that the firm "failed to properly consider the Canadian provincial licensing requirements during the [f]irm's client acceptance procedures" and, as a result, imposed certain prohibitions restricting the firm from assigning a partner to "audits of financial statements of reporting issuers in any Canadian jurisdiction" in which that partner is not properly licensed by the pertinent provincial accounting body to provide public accounting services. The jurisdictional scope of Canadian accounting regulators over foreign auditors is complex and, in many instances unclear. Foreign audit firms would be well-served to seek legal advice in navigating these issues.

74 *Unifund Assurance Co. of Canada v. Insurance Corp. of British Columbia*, **2003 SCC 40** at para. 50.

TREND 6: RISE IN SECURITIES CLASS ACTIONS AGAINST AUDITORS

Audit firms of publicly traded companies in Canada should be aware of litigation risk for alleged misrepresentations in financial statements, in particular in class action lawsuits for secondary securities market misrepresentations. There are still relatively few such cases in Canada, while in the U.S. there has been a slight uptick in class action filings involving accounting allegations in 2022 (although such filings are still well below the number of filings seen between 2014 and 2020).

Part 1: Trends in Canada

Under **s. 138.3** of the Ontario *Securities Act*,[75] when a responsible issuer (or an entity authorized to act on their behalf) releases a document that contains a misrepresentation, anyone who bought or sold shares between the time the deficiency was published and publicly corrected may have a right of action for damages against a host of parties. Those exposed parties include the issuer, directors and officers of the issuer and, crucially for auditors and audit firms, each "expert" involved in the alleged misrepresentation. This risk arises in circumstances where the misrepresentation was:

— featured in a report, statement or opinion made by the expert;

— the document in question includes, summarizes or quotes from the report, statement or opinion; and

— if the document was released by someone other than the issuer, the expert consented in writing to the use of the report, statement or opinion.

Potential liability for misrepresentation exists regardless of whether the plaintiff investor actually relied on the document or misrepresentation. Given the nature of secondary market securities, these allegations usually arise in the class action context.

Across Canada, many leading accounting firms have recently settled lawsuits relating to alleged audit deficiencies.

Part 2: Trends in the United States

According to **Cornerstone Research**, the U.S. saw an 11% increase in the number of securities class action filings involving accounting allegations, up from 46 actions in 2021 to 51 actions in 2022. This marginal increase is still well below the number of accounting-related securities class actions commenced between 2014 and 2020, which ranged from 58 on the low end (in 2017) to 70 on the high end (in 2020).

It is difficult to track if or how American audit firms are changing their behaviour based on changes in litigation risk. Notably, the 2008 U.S. Supreme Court case *StoneRidge Investment Partners v. Scientific Atlanta* held that secondary actors (including accountants and investment banks) cannot be held liable under s. 10(b) of the *Securities Exchange Act* unless their conduct satisfies six specific elements, for which the threshold is high. Many legal experts believe *StoneRidge* decreased the ability of investors to seek damages from auditors in class action lawsuits, thereby decreasing the number of class actions. On the flip side, according to **the Columbia Law School blog**, it may be the case that *Stoneridge* caused investors to place an especially high value on their ability to extract damages from auditors with deep pockets and who service clients that are especially risky or have little ability to pay damages.

OUTLOOK AND RISK MITIGATION

Overall, in pursuit of their mandate to protect the public interest, there is a trend among regulators in Canada and the U.S. toward increased scrutiny, inspection, enforcement and reporting transparency in the audits of public companies, particularly around quality control and compliance with audit and professional standards.

In light of amendments to key audit standards, and increased regulatory action, auditors and audit firms must ensure that they are implementing and applying robust internal systems, policies and procedures that advance audit quality in accordance with their obligations under applicable professional standards and regulations. Such programs should also include robust documentation processes to demonstrate the steps taken to meet these requirements.

75 Civil liability for secondary market misrepresentation is provided in the securities legislation of other provinces. For example, in B.C.: *Securities Act*, R.S.B.C. 1996, c. 418, **s. 140.3**.

Shareholder Activism Abounds: Update on Trends and Tactics

By Jennifer F. Longhurst, Shane D'Souza and Jonathan Leung

OVERVIEW

The 2023 Canadian proxy season saw an increase in shareholder activism covering a wide range of M&A , balance sheet and traditional environmental, social and governance (ESG) objectives, including board change. During the first half (H1) of 2023, 39 Canada-based companies were publicly targeted with activist demands, up from 37 during the corresponding period in 2022, marking the highest number of H1 demands since 2019.[76] Notably, demands to appoint new personnel, including to replace directors, doubled, and campaigns aimed at opposing M&A deals nearly tripled compared to prior seasons. Environmental and social shareholder proposals also increased roughly over 10%, with issuers in the financial services sector being the main targets.[77]

Canadian Activist Targets

Number of Canada-based companies publicly subjected to activist demands by time period.

	2017	2018	2019	2020	2021	2022	2023
Full Year	61	83	63	56	45	55	—
H1 YTD	42	62	51	34	33	37	39

In many respects, trends in Canada mirrored those in the United States, where activism aimed at board change was a dominant theme, in part due to the implementation of the mandatory universal proxy card (UPC) for contested elections by the U.S. Securities and Exchange Commission (SEC) in 2022.

U.S. Activist Targets

Number of U.S.-based companies publicly subjected to activist demands by time period.

	2017	2018	2019	2020	2021	2022	2023
Full Year	583	571	559	501	462	510	—
H1 YTD	436	448	423	393	362	406	403

As we head into the 2024 proxy season, public *and* behind-the-scenes shareholder activism remains robust, and activist success rates appear to be rising on both sides of the border. We expect the following three trends to continue:

76 Diligent, *Corporate Governance in Canada 2023* (2023).
77 *Ibid*.

1. **Activists will continue to privately and publicly push issuers to complete M&A transactions and/or divestitures of assets or divisions.** In several industries, this trend is being driven by the ongoing energy transition. In other cases, ongoing inflationary pressures, economic uncertainty, market volatility, financing challenges and valuation gaps, and geopolitical tensions are also driving M&A activism, all with a view to unlocking shareholder value. In fact, activism has become a consistent feature in all forms of M&A, with many buyers employing activist strategies in an effort to get a deal done and investors going activist to block contentious transactions or seek enhanced deal terms or pricing. In Canada, for instance, activism aimed at pushing for or opposing M&A transactions or divestitures of assets or divisions showed a marked increase this year relative to prior years. For example, during the first half of 2023, five Canada-based companies were publicly subject to "oppose M&A" demands, the same number in all of 2022 — and this during a period when M&A activity was down relative to last year.[78] This trend makes it critical for buyers and sellers to plan and prepare for activism when pursuing acquisitions or dispositions.
2. **Canadian public companies can continue to expect U.S. to view them as attractive investment opportunities, partly due to the relatively higher discounts in Canadian equities relative to the U.S.[79] and due to some unique shareholder-friendly tools available in Canada.** These tools include the shareholder meeting requisition right (discussed further below), the recent implementation of "true majority voting" at all Canadian public companies incorporated under Canada's federal corporate statute, the relatively more investor-friendly shareholder proposal regime in Canada and the higher 10% beneficial ownership reporting threshold under Canada's early warning reporting (EWR) regime.
3. **The universe of would-be activists continues to expand.** Several newer funds, occasional activists, private equity firms and insiders have already been targeting companies in Canada, and will likely continue to do so, in order to generate some wins to help bolster their reputations and capital building.

With activism being a consistent feature of today's capital markets, it's as important as ever for issuer boards and management to think carefully and critically about their vulnerabilities, regularly assess shareholder sentiment and maintain preparedness for a wide range of activist threats and strategies they may face.

WILL THE "WEAPONIZATION" OF ADVANCED NOTICE BYLAWS COME NORTH?

For the past couple of years, we've witnessed many U.S.-based public companies asserting technical interpretations and/or making tactical amendments to their advance notice bylaws (ANBs) to invalidate director nominations by their shareholders. This trend was followed by a wave of more recent ANB amendments purportedly implemented in response to the SEC's mandatory UPC rules. However, issuers' manoeuvres have triggered mixed results, sometimes being blessed before U.S. courts,[80] and other times inviting unwanted scrutiny, including litigation and reputational damage.

One example that attracted considerable attention this past year involved NASDAQ-listed medical device maker Masimo Corp., in the context of the engagement and subsequent proxy contest launched by investment fund Politan Capital Management LP. Masimo purported to implement controversial amendments to its advance notice bylaw, requiring, among other things, that any nominating shareholder disclose the identities of the shareholder's passive investors and their families' holdings in Masimo's competitors and litigation counterparties, and any plans the dissident had to nominate directors at other public companies within the next 12 months. In response, Politan Capital, which held an 8.9% stake in Masimo, challenged the bylaw's validity before the Delaware Court of Chancery.[81] Before the litigation reached its conclusion, Masimo reversed course and rescinded the bylaw amendments. However, by that time, much investor outrage had already been generated. Masimo's onerous bylaw was labelled "draconian" by the hedge fund industry association, Managed Funds Association.[82] The bylaw also drew the ire of Institutional Shareholder Services, Inc. (ISS). In its report to shareholders recommending that Masimo investors vote in favour of Politan Capital's director nominees, ISS condemned the ANB's requirements as "an affront to shareholders" that "did not even approach the definition of reasonable."[83]

78 *Ibid*.

79 For example, at the end of 2022, TSX-listed issuers had an average price-to-earnings (PE) ratio of 12.5 while U.S. S&P 500 Index issuers had an average PE of 22.2. Mergermarket, *Canada braces for heightened activist campaigns following buy 2023 season* (2023).

80 For example, see: *Jorgl v. Aim ImmunoTech Inc.*, 2022 WL 16543834 (Del. Ch. Oct. 28, 2022); *Strategic Investment Opportunities LLC v. Lee Enterprises Inc.*, 2022 WL 453607 (Del. Ch. Feb. 14, 2022); and *Rosenbaum v. Cytodyn Inc.*, 2021 WL 4775140 (Del. Ch. Oct. 13, 2021).

81 *Politan Capital Management LP*, 2022 WL 14813970 (Del. Ch.) (2023).

82 Reuters, *Masimo Reverses Bylaws Requiring Detailed Activist Information* (2023).

83 Bloomberg, *Leading Proxy Advisory Firm ISS Recommends Masimo Shareholders Vote FOR Both of Politan's Director Nominees* (2023).

In Canada, controversy over an ANB also erupted in the context of the engagement and subsequent proxy contest by Legion Partners Holdings, LLC at Canadian TSX- and NYSE-listed issuer Primo Water Corporation. Primo purported to disqualify Legion Partners' director nominees in reliance on certain informational requirements that Primo's board had introduced to its ANB shortly after Legion Partners had sought to engage with the company. Based on these additional requirements, which had not yet been ratified by Primo's investors, Primo rejected Legion Partners' nominees on the basis that the nomination notice contained "intentional misrepresentations" and "patently false information."[84] In response, Legion Partners commenced litigation in Ontario,[85] seeking an order validating its director nominations and a declaration that the Primo board's actions to alter its ANB were oppressive and unfairly prejudicial (under the uniquely Canadian statutory "oppression remedy") and represented a breach of the directors' fiduciary and other duties. Prior to reaching the hearing, the parties settled, resulting in Legion Partners gaining representation on the Primo board and requiring Primo to limit the scope of its ANB requirements.

Both cases highlight an emerging trend many refer to as the "weaponization" of ANBs. They also serve as reminders that issuers' use of perceived entrenchment tactics that have not been supported by shareholders carry inherent downside risks that must be carefully balanced with the anticipated benefits, particularly when issuers will be accused of using investors' capital to undermine shareholders' fundamental rights to elect and remove directors.

Historically, relative to the U.S., Canadian issuers have been less inclined to deploy their bylaws tactically, owing in part to some Canadian cases that have considered the legitimate scope and purpose of ANBs, finding that they may be used as a "shield" but not a "sword," principles that were subsequently reaffirmed by the TSX and each of ISS and Glass Lewis & Co. (GL) in their TSX-listed issuer guidelines on advance notice requirements.[86] In this respect, the Primo/Legion Partners situation may be viewed as an exception and unlikely to become a norm within the Canadian landscape, since Primo was in fact a domestic U.S. issuer and thus subject to ISS and GL's more lenient U.S. guidelines applicable to ANBs, and not the more stringent rules typically applied to Canadian-based public company ANBs. Nevertheless, we expect that issuers on both sides of the border may continue to push the boundaries, and we will eventually see courts revisit perceived overreaching bylaws in the future.

ARE VOTE "AGAINST" CAMPAIGNS A NEW CANADIAN NORM?

"Withhold" or vote "no" campaigns can be a low-cost yet effective alternative for investors to express dissatisfaction with a company's leadership or performance without undertaking the time-consuming and expensive endeavour of nominating replacement director(s) and engaging in a protracted proxy solicitation. By waging a public relations campaign encouraging shareholders to withhold votes from one or more

84 PR Newswire, *Primo Water Announces that Director Nomination Notice from Legion Partners is Invalid* (2023).
85 See Court File No. CV-23-00696613-00CL (Ontario Superior Court (Commercial List)) (2023).
86 See Glass Lewis, *Glass Lewis 2023 Policy Guidelines* (2023); Institutional Shareholder Services, *Proxy Voting Guidelines for TSX-Listed Companies Benchmark Policy Recommendations Effective for Meetings on or after February 1, 2023* (2023); *TSX Staff 2017-0001* (March 9, 2017). See also *Maudore Minerals Ltd. v. The Harbour Foundation,* 2012 ONSC 4255; *Orange Capital LLC v. Partners Real Estate Investment Trust et al*, 2014 ONSC 3793.

incumbents, activists can send a forceful message and effect change, sometimes even if they are unable to secure majority voting support.

Long-awaited amendments to Canada's federal corporate statute — the *Canada Business Corporations Act* (CBCA) — that codify "true majority voting" came into effect in August 2022, making "against" campaigns even more powerful.[87] Under the CBCA, in all uncontested elections shareholders vote "for" and "against" individual directors of CBCA-incorporated public companies, and each director must obtain majority support in order to be (re-) elected. This ups the stakes for CBCA company directors when they are targets of no campaigns as even if they run unopposed, they must receive a majority of "for" votes to be re-elected. Directors who fail to receive a majority of for votes are removed from the board, subject to up to a 90-day holdover transition period. Year-to-date 2023 has already seen at least seven "against" campaigns in Canada.

The CBCA majority voting requirement is the strictest in Canada, making CBCA directors most vulnerable to no campaigns. While the TSX has long had majority voting requirements in place that apply to all non-controlled TSX-listed issuers, the TSX rules apply as a matter of policy and require the unsupported directors to tender their resignation to the board for consideration. While the resignation is expected to be accepted absent "exceptional circumstances," the board nonetheless retains discretion to make that determination in the best interests of the company.[88]

In light of Canada's majority voting regimes, and the potential increase for "against" campaigns, the quality and experience of directors has been cast under an even brighter spotlight. Issuers should place more time on their agendas to evaluate directors' performance and skills, maintain ongoing succession planning and engage with shareholders to identify situations where directors may be at risk of not being (re-)elected. This should be done with careful regard to ISS and GL voting policies in order to avoid inadvertently facing a withhold recommendation by one or more of the leading proxy advisory firms. Ongoing engagement with investors before each annual general meeting is an imperative to ensure that articulated concerns regarding the issuer's directors or management are surfaced and may be the best defence against the prospect of a vote no campaign or proxy contest.

SHAREHOLDER MEETING REQUISITION RIGHT GETS NEW TEETH

Shareholders in Canada have long enjoyed the statutory right to requisition a special meeting of shareholders. While corporate statutes that enshrine this right vary across provinces and territories, and federally, generally, holders of at least 5% of a company's issued voting shares have the right to requisition a shareholders' meeting for whatever purpose stated in the requisition.[89] Upon receiving a requisition, and subject to certain limited exceptions, the issuer must call the meeting within 21 days, failing which the shareholder may call the meeting.[90]

This unique Canadian right has long been a powerful tool for investors. Nevertheless, the statutory requisition right only requires boards to "call" a meeting. With the exception of British Columbia's corporate statute,[91] directors need

87 See CBCA, s. 106(3.4).
88 See *TSX Company Manual*, s. 461.3.
89 See e.g. *CBCA*, s. 143(1).
90 See e.g. *CBCA*, ss. 143(3) and (4).
91 See e.g. *BCBCA*, s. 167(8).

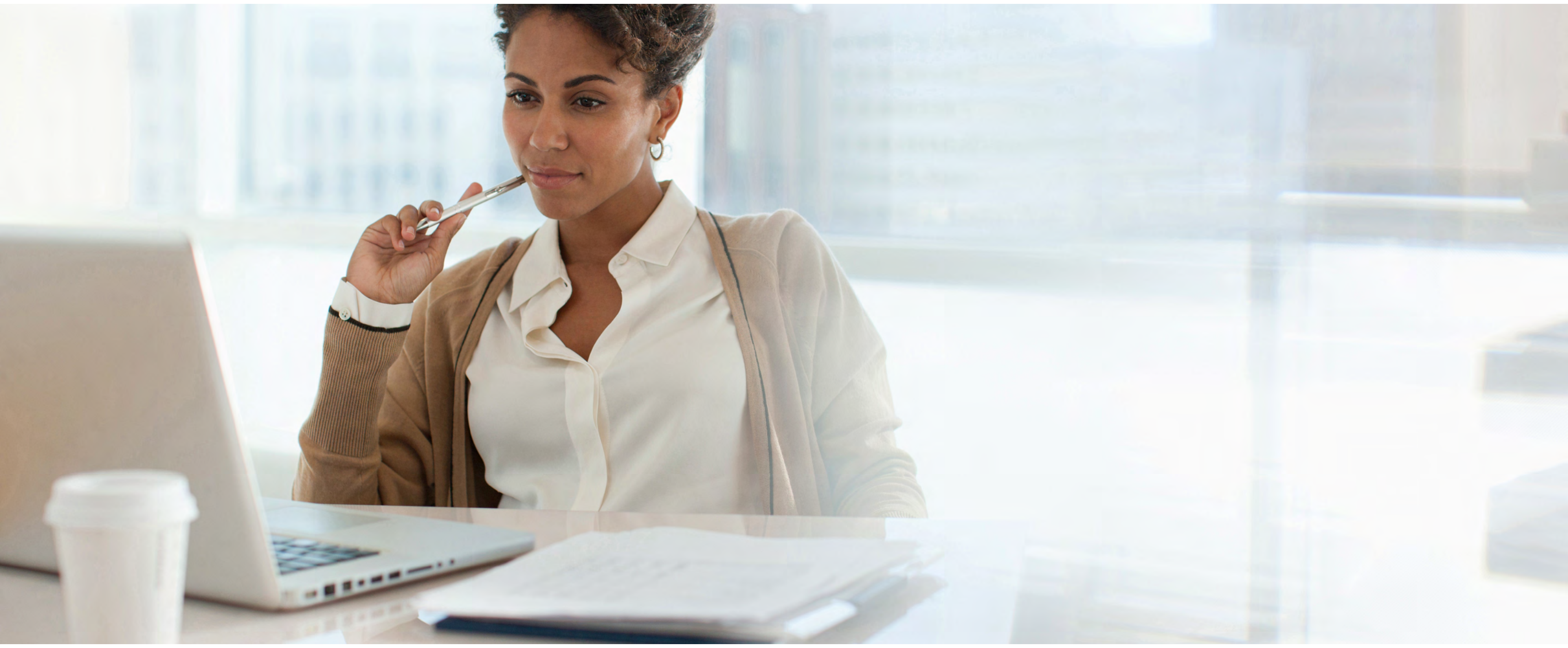
not actually send a notice of meeting within 21 days or hold the meeting within any particular time frame, provided the directors hold the meeting within a reasonable time determined in their good faith business judgment. As a result, when faced with a requisition, many boards have deferred holding the meeting for several months, and, even when challenged, Canadian courts have generally deferred to directors' business judgment in determining the appropriate date for the meeting.[92]

A recent decision from the Ontario Superior Court of Justice may, however, give ammunition to investors seeking to enforce their rights to have a meeting held forthwith. The case arose in the context of several activist engagements with TSX-listed issuer First Capital REIT, ultimately leading to Canada-based Sandpiper Group requisitioning a meeting of shareholders on December 12, 2022 to replace four members of First Capital's board with its slate of nominees, which meeting Sandpiper demanded to be held no later than March 1, 2023. In response, First Capital announced on December 30, 2022 that it would hold a combined annual and special meeting, at which Sandpiper's nominees would be considered almost five months later. Sandpiper sued to compel First Capital to hold the meeting by its requested date.[93] Ultimately, the Court sided with Sandpiper and found that the five-month delay in holding the meeting resulted in an "unreasonable or unjustifiable delay" and ordered the meeting to be held as soon as practicable after March 1, 2023. In arriving at its decision, the Court was not convinced by First Capital's justifications for selecting its meeting date, which were namely to avoid the cost and distraction of holding a special meeting followed by an annual general meeting, give its unitholders more time to consider the disclosures and engage with the board and allow its capital allocation and asset optimization plan (a central criticism of Sandpiper) time to play out.

The Court acknowledged that the business judgment rule requires courts to defer to the judgment of boards provided their decision falls within a range of reasonableness. However, it also looked to the process (or lack thereof) followed by the board as being highly relevant to determining the appropriate level of deference. Here, First Capital's board had only one meeting to discuss the requisition, which lasted approximately two hours, during which other agenda items were also discussed. On this basis, the Court concluded that the board's decision did not warrant a high level of deference and found that the board did not hold the meeting expeditiously and within a reasonable time.

The *Sandpiper* case serves as an important reminder that while boards are entitled to deference in carrying out their duties in the exercise of their business judgment, process is paramount. Undertaking a careful and deliberative process during which time is given to evaluate the decision to be made and relevant alternatives having regard to the surrounding circumstances, identifying and mitigating conflicts of interest and considering and weighing the factors relevant to the board's decisions, are all critical to defending the board business judgment.

92 See, for example: *Wells v. Bioniche Life Sciences Inc.*, 2013 ONSC 4871 (Ont. S.C.J.); and *Marks v. Intrinsyc Software International*, 2013 ONSC 727 (Ont. S.C.J.).
93 *Sandpiper Real Estate Fund 4 Limited Partnership v. First Capital Realty Real Estate Investment Trust*, 2023 ONSC 794 (Ont. S.C.J.).



BENEFICIAL OWNERSHIP REPORTING REGIMES UNDERGOING CHANGE

In October 2023, after a lengthy comment period and debate over the scope of amendments, the SEC released the long-awaited final rules that will reform the U.S.'s 13D/13G beneficial ownership reporting regime.[94] The final rules will, among other things:

- shorten the Schedule 13D filing deadline to five business days (from 10 calendar days);
- require that amendments reflecting material changes to prior reports be filed within two business days (rather than "promptly");
- shorten the Schedule 13G filing deadline to 45 days after the relevant quarter in which the threshold has passed (from 45 days after year-end) or five business days from crossing the threshold for non-exempt passive investors (from 10 days);
- revise the disclosure required for derivative securities (including cash-settled) that have reference to the issuer's equity securities; and
- clarify when a "group" may be formed via new guidance.

The final rules, which reflect significant changes from the initially proposed amendments in response to widespread investor criticism, reflect the SEC's acknowledgement of "the beneficial effects of activism to the market," balanced with the need to address perceived information asymmetries and today's fast-paced market.[95] However, with several other important SEC rule changes still on the books, including in respect of derivatives, it is too soon to call these final rules a definitive win for investors.

Canada's corresponding "early warning reporting" (EWR) regime, last updated in 2016 after a similarly lengthy debate and comment, is also currently under review by the Canadian Securities Administrators (CSA).[96] Presently, unlike the U.S.'s reporting threshold trigger of 5%, beneficial ownership reporting is not required in Canada until a person and its joint actors have acquired 10% of the voting or equity securities of a reporting issuer. Derivatives (cash-settled or otherwise) are not included for purposes of calculating the 10% threshold. However, in light of the recent and other still pending U.S. rule changes — and following a controversial 2021 decision of the Alberta Securities Commission in *Re Bison Acquisition Corp.*[97] that considered and provided commentary on Canada's EWR regime and the use of cash-settled total return swaps by bidders and shareholder activists — many are anticipating that the CSA may consider, among other things, revisiting the 10% reporting threshold and including certain derivatives for purposes of determining the reporting threshold. In the meantime, would-be acquirers and activists must exercise caution when considering entering into derivatives in the context of a bid or potential proxy contest as doing so triggers various strategic, legal and reporting considerations and risks.

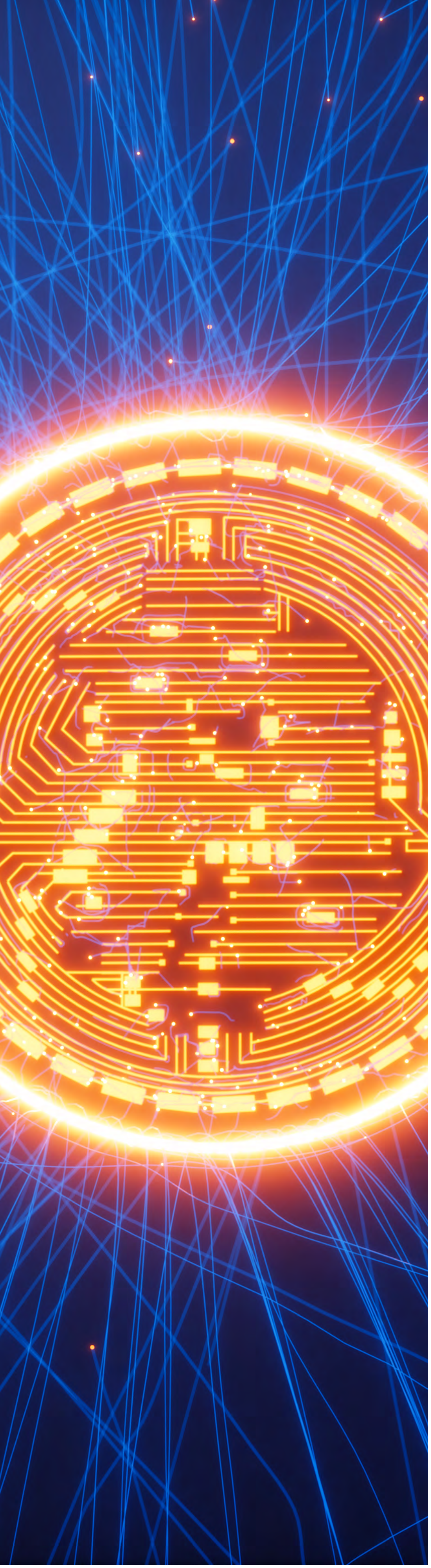
94 U.S. Securities and Exchange Commission, *Modernization of Beneficial Ownership Reporting*, 17 CFR Parts 232 and 240, October 2023.
95 *Ibid*.
96 See National Instrument 62-103 – *Early Warning System and Related Take-Over Bid and Insider Reporting Issues*, Part 3, and National Instrument 62-104 – *Take-Over Bids and Issuer Bids*, Part 5.
97 *Re Bison Acquisition Corp.*, 2021 ABASC 107.

ESG ACTIVISM CONTINUES TO RISE WITH VARIED SUCCESS

Shareholder proposals tied to climate change and other environmental-related matters continue to be put forward at a number of Canadian public companies, and not exclusively financial institutions as was historically the case. Similarly, proposals relating to social matters, particularly diversity, equity and inclusion, also continue to dominate agendas. In the first half of 2023, 34 environmental and social shareholder proposals were put to shareholder votes at Canadian-listed companies. They won an average of 20.1% shareholder support, up from 17.9% average support during the corresponding period last year.[98] For example, we saw three requests for Canada-based issuers to initiate racial equity audits, a common demand in the U.S. market, two of which targeted two major Canadian financial institutions and received more than 38% support from the issuers' shareholders.[99] ISS also announced earlier this year that following a one-year grace period, companies listed on the S&P/TSX Composite Index will be required to have at least one board member from a racially or ethnically diverse background, in addition to at least 30% women representation on their boards.

Over the last several proxy seasons, ESG activism has faced political and economic headwinds resulting in a noticeable softening of support for ESG-driven campaigns — making it critical to their success that the investor articulates a clear and coherent correlation between the ESG issues raised and the creation of shareholder value. Nonetheless, investor engagement on social and climate-related matters and disclosures remains a key focus for Canadian public companies (and globally). We anticipate many issuers will continue to face, and need to prepare for, both constructive engagement and activism on ESG matters. While many institutional investors are taking a case-by-case approach to evaluating climate- and social-related campaigns, it's never been more important for issuers and their leadership to have clear and well -articulated ESG strategies and disclosures and regularly engage with their investors to understand their concerns.

98 Diligent, *Corporate Governance in Canada 2023* (2023).
99 *Ibid*.



Crypto Cleanup: CSA Enforcement and Compliance Measures in 2023 and Predictions for 2024

By Lori Stein, Natalie V. Kolos and Khristoff Browning

Over the past year, the Canadian Securities Administrators (CSA) strengthened Canada's regulatory framework for crypto asset trading platforms (CTPs) and increased enforcement activities relating to crypto asset market intermediaries and issuers. Between July 2022 and June 2023, 56% of the CSA's 758 investor alerts were related to crypto assets. The CSA confirmed our prediction in **Crypto Crackdown: OSC Enforcement in 2022 and Predictions for 2023** that the CSA would continue to use co-operative regulatory initiatives and enforcement actions to address the risks associated with crypto asset activities in Canada.

In the first half of 2023, the CSA pushed many non-compliant foreign CTPs out of Canada and required those remaining in Canada to give pre-registration undertakings (PRUs) to come into compliance with core investor protection requirements.

During fall of 2023, the CSA rolled out a new disclosure regime for fiat-backed stablecoins (which the CSA calls Value-Referenced Crypto Assets (VRCAs)), which will impact both CTPs and issuers of VRCAs beginning in December 2023. The Ontario Securities Commission (OSC) also commenced two new enforcement proceedings against custodial CTPs, while the British Columbia Securities Commission (BCSC) advanced proceedings against a custodial CTP and a fraudster that held itself out as a CTP. The Autorité des Marches Financiers du Québec (AMF) sanctioned two foreign CTPs and the Alberta Securities Commission (ASC) issued a cease-trade order against a Calgary-based CTP.

Finally, the CSA published a comprehensive investor tool kit to help Canadians understand different types of crypto assets, their risks and the regulatory status of CTPs that may be soliciting investors in Canada.

This article summarizes enforcement and compliance measures taken by the CSA in 2023 to continue to combat the investor protection and market integrity risks posed by the crypto asset sector. While the CSA have come down hard on non-compliant crypto market participants, their stringent CTP registration framework preserves the ability for Canadians to obtain investment exposure to crypto assets through regulated channels, with increasingly strict safeguards in place.

PRE-REGISTRATION UNDERTAKINGS AND FOREIGN CTP EXITS

In February 2023, the CSA started a **30-day countdown for unregistered CTPs operating in Canada pursuing registration to provide to their principal regulator, a prescribed form of pre-registration undertaking** with strict requirements regarding custody and segregation of client assets, blanket prohibitions on offering margin or leverage and prohibitions on offering stablecoins or proprietary tokens without the consent of the CSA.

In a press release announcing the PRU deadline, the CSA implied that the impetus for their decisive action was the raft of CTP insolvencies in 2022 (including Voyager Digital, Celsius Network, the FTX group of companies, BlockFi and Genesis Global). The CSA warned that if a CTP refuses to file a PRU or breaches the terms of its PRU, the CSA will consider compliance and/or enforcement action against the CTP and its principals, including naming the CTP on a warning list, directing the CTP to withdraw from Canada or imposing a cease trade order or denial of exemptions under Canadian securities law

On March 24, 2023, **10 CTPs met the short filing deadline and had their PRUs accepted by the CSA** (of which, seven are still **active**), including United States-based Coinbase, Kraken and Gemini, long-standing Canadian CTPs NDAX and Shakepay (which has since **registered**) and several other smaller CTPs, with four from Canada and two being international platforms (collectively, the PRU Platforms). The PRU Platforms committed to operationalize the compliance commitments made in their PRU within 90 to 120 days, and become registered as securities dealers within 12 months, or otherwise exit Canada unless their principal regulator consents to an extension.

Around the time when the PRUs were published, some global CTPs announced exits from the Canadian market, most notably the world's largest CTP, Binance (which had already ceased operations in Ontario at the end of 2021). In announcing its departure from the remaining provinces and territories, Binance stated that "new guidance related to stablecoins and investor limits provided to crypto exchanges makes the Canada market no longer tenable for Binance at this time."

In May 2023, following Binance's withdrawal from Canada, the OSC obtained an investigation order of Binance Holdings Inc., the Cayman Islands parent corporation of the Binance group, and a related summons. Binance promptly **applied to the Ontario Capital Markets Tribunal** (the Ontario Tribunal) for an order revoking the investigation order and quashing the summons, on the basis that Binance had entered into an Undertaking and Acknowledgement with the OSC in March 2022 (the Binance Undertaking), which was intended to settle the OSC's concerns with respect to Binance's past conduct (reported on in **last year's article**). On July 14, 2023, the Ontario Tribunal decided that it does not have the power to revoke an investigation order of the OSC.[100]

Finally, in September 2023, the **Ontario Divisional Court dismissed Binance's application for judicial review** of the OSC's order, noting that the Binance Undertaking expressly retained "the right [for the OSC] to bring enforcement proceedings … for any past, present or future conduct contrary to the Act or the public interest,"[101] with an exception for proceedings arising from the facts set out in the Binance Undertaking. The Court held that the OSC's investigation order referenced additional facts, including allegations that Binance had not followed through with part of its agreed compliance plan and had made misrepresentations to OSC Staff, as well as the March 2023 complaint against Binance filed by the U.S. Commodity Futures Trading Commission. Consequently, Binance remains in the OSC's enforcement crosshairs almost two years after announcing its withdrawal from Ontario.

OSC Chair Grant Vingoe considers Binance's exit from Canada to be "an inflection point in the [CSA's] two-year-old crackdown on cryptocurrency-trading platforms … Binance was the last major international platform active in Canada that had neither signed an agreement to follow certain rules while pursuing registration, nor pulled out of the country … there are no more big-name crypto firms operating in a regulatory grey area."[102]

STABLECOINS (VRCAS): THE NEXT FRONTIER

In October 2023, the CSA announced **interim conditions for the trading of stablecoins (VRCAs) on CTPs that are registered as dealers under securities laws** (Dealer CTPs), with initial terms and conditions to apply in December 2023, and the full range of terms and conditions (VRCA T&C) becoming effective in April 2024.

The VRCA T&C builds upon the CSA's view, confirmed in February 2023, that **VRCAs, or VRCA arrangements, may constitute securities or derivatives**. The CSA describes a VRCA as, "a crypto asset that is designed to maintain a stable value over time by referencing the value of a fiat currency or any other value or right, or combination thereof."

The CSA identifies redemption risk, or "run" risk, as the most significant risk associated with VRCAs, followed by the stabilization mechanism, management and custodianship of reserve assets and governance of the VRCA issuer. However, the CSA does not propose an outright ban on the offering of VRCAs by registered CTPs, acknowledging that VRCAs have legitimate utility as deposit on-ramps, for trading of other crypto assets, as a store of value or as a means of payment.

Instead, the CSA significantly restricts the types of VRCAs that a Dealer CTP may offer by imposing requirements

100 In ***Binance Holdings Limited (Re)***, 2023 ONCMT 27, the Ontario Tribunal explained: "The Securities Act was changed in 2022 and as a result of those changes, the Capital Markets Tribunal was created as a 'division of the Commission.'" Before those changes, members of the Commission acted as directors of the board of the Commission and as adjudicators. Following these changes, adjudicator and board director are separate roles. An adjudicator only decides hearings of the Capital Markets Tribunal and holds no other position with the Commission.

101 *Binance Holdings Limited v. Ontario Securities Commission*, 2023 ONSC 4541 at para. 41.

102 Claire Brownell, "**With Binance's exit from Canada, OSC head says crypto crackdown has 'settled' the big issues**," *The Logic* (May 24, 2023).

for the VRCA issuer to publish audited annual financial statements and accept the jurisdiction of the CSA, including broad examination rights for the CSA to review the business, conduct, financials affair books and records and other documents of the issuer, its affiliates and control persons for the purpose of determining compliance with Canadian law. The VRCA T&C impose numerous of additional compliance requirements, including with respect to segregation of reserves, redemption rights for accountholders, public disclosure of material information, marketing disclaimers and others.

Having regard to the primary functions of VRCAs as a means of payment and a store of value, and not as an investment (no stablecoins offered by Regulated CTPs pay interest or otherwise offer yield), many global jurisdictions are proposing to regulate stablecoins as "electronic money" or a prudential deposit product and not as securities. Unfortunately, Canada does not have an alternative regime for regulating stablecoins, as the new *Retail Payments Activities Act* (Canada) does not include crypto asset payment activities within scope. As a result, the CSA appears to feel compelled to protect Canadians from the "run risk" associated with VRCAs.

Because the CSA's VRCA regime currently goes beyond most established regulatory frameworks for fiat-backed stablecoins like USDC, GUSD and PYUSD, there is a risk that VRCA issuers may refuse to comply. This would force Dealer CTPs and PRU Platforms (collectively, Regulated CTPs) to de-list such assets. For some Regulated CTPs, VRCAs are a dominant trading pair for other crypto assets listed for trading on the platform, with better liquidity and pricing than the equivalent fiat pair. More generally, VRCAs represent significant trading volumes on many CTPs. Demand for VRCAs arises from their dominant use case as a payment instrument, and not for the purpose of making speculative investments. If carried out in its current form, the CSA's aggressive position on VRCAs could have a material, negative impact on the businesses of many Regulated CTPs that have deployed significant resources to achieve compliance with the CSA's registration framework.

ENFORCEMENT ACTIONS

Ontario Securities Commission

After the success of the PRU initiative, in the fall of 2023 the OSC returned its attention to enforcement proceedings against foreign CTPs offering services to Ontarians. While the Ontario Tribunal's initial wave of orders against foreign CTPs in 2022 were based on distributions of, and dealings in, securities in Ontario without a prospectus or registration (reported on in **last year's article**), the OSC's recent allegations describe misconduct that resulted in investors losing, or losing access to, their crypto assets held on the platform.

The BCSC also progressed in enforcement actions against a custodial CTP and a fraudster that was holding itself out as a CTP.

The CoinField Proceeding

On September 27, 2023, the OSC issued a **Statement of Allegations** against Manticore Labs OÜ and Manticore Labs Inc. (CoinField), companies incorporated in Estonia and the British Virgin Islands that operate a custodial CTP on which Ontarians could deposit and trade in crypto asset products starting in 2018.

The Statement of Allegations states that the OSC had contacted CoinField about its activities in 2021, after which time CoinField published a post announcing that it would stop "onboarding new clients" from Ontario and implemented a restriction based on Ontario internet protocol (IP) addresses. Existing client investors, however, were not affected by this restriction. As of June 2023, the total value of all crypto assets and fiat currency held by all Canadian investors on the CoinField platform was approximately C$69.4 million. In August 2023, the CoinField platform became inaccessible to all investors.

Among other allegations, the OSC alleges that CoinField acted in a manner contrary to the fundamental purposes of the Ontario *Securities Act* by failing to maintain custody of investors' crypto assets, failing to honour withdrawal requests, failing to inform investors of the true reason for not honouring withdrawal requests and misleading the OSC for the true reasons for delays in honouring withdrawal requests.

The Statement of Allegations states that CoinField "did not have sufficient crypto assets in custody to satisfy investor withdrawal requests," delayed honouring withdrawal requests and gave false assurances to at least one Ontario investor that the investor's issues "should be fixed very soon." Meanwhile, the self-described "ultimate beneficial owner" of CoinField had admitted to the BCSC that the "true reason behind the withdrawal delays was because of a lack of funds and assets available to satisfy withdrawal requests." Subsequent to that admission, CoinField told the OSC that delays were "due to an ongoing audit of the company."

The OSC seeks sanctions against CoinField, including permanent bans from trading in securities or derivatives or acquiring securities in Ontario, disgorgement of all amounts obtained as a result of non-compliance with Ontario securities law, an administrative penalty of C$1 million for each failure to comply with Ontario securities law and costs of the OSC's investigation.

The Phemex Proceeding

On September 6, 2023, the OSC issued a **Statement of Allegations** against Phemex Limited and Phemex Technology Pte. Ltd. (Phemex), companies incorporated in the British Virgin Islands and Singapore that operate a custodial CTP on which Ontarians could trade in securities and derivatives based on exposure to underlying assets, which included crypto assets. The Phemex platform was accessible to Ontarians from November 2019 to January 2023.

Since January 7, 2023, Phemex is no longer accessible to investors using an Ontario IP address. According to the Statement of Allegations, prior to the implementation of the IP address restriction, there were 117 Ontario accounts from which Phemex had collected fees worth 39,712.43 USDT based on total trading volumes in excess of 74 million USDT.

The OSC alleges, among other things, that Phemex acted in a manner contrary to the fundamental purposes of the Ontario *Securities Act* by engaging in the business of trading securities without the necessary registration and prospectus requirements. Similar to CoinField, after

being contacted by the OSC in relation to its activities, Phemex added Ontario to the list of restricted locations in its terms of use and implemented a restriction based on Ontario IP addresses. However, the OSC alleges that Phemex did not notify Ontario residents of the reason for the IP address restriction and did not give Ontario residents any guidance on how to withdraw their assets in light of the IP address restriction.

The OSC seeks the same sanctions against Phemex as those sought against CoinField.

British Columbia Securities Commission

The LiquiTrade Proceeding

On November 15, 2022, the BCSC issued a **Notice of Hearing** regarding LiquiTrade Ltd. (LiquiTrade), a company incorporated in the Cayman Islands that operates a custodial CTP on which British Columbia residents can trade in derivatives based on crypto assets. The hearing on the merits was scheduled for November 27, 2023 and the Panel's findings are due April 10, 2024.

The BCSC alleges that by making the platform available to B.C. residents, and charging fees for trades and withdrawals, LiquiTrade is trading in derivatives in B.C. without registration and operating an exchange that is not recognized by the BCSC. Staff allege that LiquiTrade misled investors by marketing its "Latoken" CTP as a "regulated exchange."

In November 2022, LiquiTrade purported to have 1.5 million registered users who traded more than 240 crypto assets and processed more than US$300 million in transactions daily. No information has been publicly disclosed regarding the scale of Liquitrade's activities in B.C. or the orders sought by the BCSC.

The ezBtc Proceeding

On April 18, 2023, the BCSC issued a **Notice of Hearing** regarding David Smillie and 1081627 B.C. Ltd. operating as ezBtc (*ezBtc*). The BCSC alleges that Mr. Smillie and a B.C. corporation controlled by him perpetrated a fraudulent scheme by purporting to operate a CTP and diverting approximately C$13 million in customer assets for their own purposes. ezBtc advertised that customer assets would be held off-line in "cold storage," when in fact the vast majority of approximately 2,300 bitcoin and 600 ether transferred to ezBtc was diverted to two online crypto gambling sites. ezBtc displayed customer balances in their accounts on its website, but customers were not able to withdraw their funds. The hearing is scheduled to start on April 2, 2024.

Autorite des Marches Financiers du Québec

XT Exchange

On September 20, 2023, the Québec Financial Markets Administrative Tribunal (FMAT) issued an uncontested **Decision** against XT.com Exchange and BZ Limited, operating as XT Exchange (*XT Exchange*). XT Exchange is an online CTP based in the Seychelles and Hong Kong that presents itself as a "the leading crypto trading exchange infused with social trading capabilities," and is ranked in the Top 10 CTPs by transaction volume, and Top 40 CTPs, by Coinmarketcap.com.

The FMAT found that XT Exchange had been offering crypto asset-related investment products in Québec, including "crypto asset contracts", non-fungible tokens (NFTs) contracts, futures contracts, savings programs and staking contracts. After the AMF initiated proceedings against XT Exchange in March 2023, XT Exchange notified the AMF that it had implemented measures to block Canadian IP addresses from accessing its website. However, while Canadians were blocked from opening new accounts, AMF Staff were still able to trade in an account they had set up prior to the geo-block taking effect.

The AMF concluded that the products offered by XT Exchange were investment contracts, and therefore securities, under the *Securities Act* (Québec) and had been distributed in Québec without a prospectus. When applying the Supreme Court of Canada's four-pronged ***Pacific Coast*** test for an investment contract to the products offered by XT Exchange, the AMF noted that XT Exchange maintained custody of all crypto assets (including NFTs) underlying the products, and that XT Exchange was authorized, unilaterally and without notice to customers, to change the terms of service under which the products were provided. These features supported the AMF's finding that customers relied entirely on the efforts of XT Exchange to carry out the venture in respect of which customers expected profits.

The AMF also found that the futures contracts offered by XT Exchange were derivatives under the *Derivatives Act* (Québec), and in particular that the perpetual futures offered by XT Exchange were contracts for difference (CFDs), created and marketed in Québec without being qualified by the AMF. In addition, the AMF applied the CSA's "business trigger" guidance to the activities of XT Exchange and concluded that it had acted as a securities and derivatives dealer without being registered with the AMF.

When deciding to apply the sanctions requested by the AMF in the proceeding, the FMAT noted that XT Exchange failed to respond to numerous notifications from the AMF regarding the proceedings, and their non-cooperation resulted in a lack of mitigating factors. In addition, XT Exchange's "significant international activities … implie[d] that they must have known that such activities are subject to regulatory oversight and voluntarily chose not to comply with Canadian securities law."

FMAT imposed an administrative penalty of C$2 million against XT Exchange and ordered for it to cease all distributions and dealings in securities and derivatives in Québec, except as necessary to permit users to withdraw their assets and close their accounts. FMAT ordered for XT Exchange to block access to all Québec users within two months after the Decision, and to notify Québec users within two days after is received notice of the Decision of the timeline in which the website would become inaccessible, and that they should withdraw their assets as soon as possible.

Coinex Global

On November 14, 2023, FMAT issued an uncontested **Decision** against three affiliated legal entities named Coinex Global Limited (located in Hong Kong, Estonia and Canada) (*Coinex*), Vino Global Limited and Haipo Yang, the sole director of Coinex and Vino Global Limited. Generally, the allegations, reasoning and orders set out in Coinex closely follow, and build upon, the precedent set in *XT Exchange*.

Notably, Coinex had cooperated in an investigation with the ASC in 2022 and had blocked Alberta residents from accessing its website. However, Coinex had failed to block residents from other Canadian jurisdictions from accessing its website, after informing the ASC in the spring of 2022 that it had over 38,000 Canadian customers having a total value of approximately US$68,000 in accounts on Coinex. In addition, Coinex has a Canadian legal entity within its corporate group, and the founder of Coinex, Haipo Yang, claimed to reside in Markham, Ontario, although the AMF led evidence which showed that Mr. Yang was neither a Canadian citizen nor permanent resident.

In addition to the sanctions applied in *XT Exchange,* FMAT ordered an administrative penalty of C$300,000 against Mr. Yang, and prohibited him from acting as a director or officer of an issuer or registrant for five years.

As of December 31, 2023, Coinex Global Limited, with an address in Ottawa, Ontario, is registered as a money services business (MSB) with the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC).

Alberta Securities Commission

On December 21, 2023, the ASC issued an **Interim Cease Trade Order** against CatalX CTS Ltd. (*Catalyx*) and Jae Ho Lee (Founder and CEO of Catalyx), requiring the respondents to cease trading in or purchasing any securities and derivatives. The order was issued for a period of 15 days, and was consented to by counsel for Catalyx.

Catalyx is a Calgary-based CTP, having a stated mission, "to provide Canadian customers with a trustworthy, fast and secure trading platform with access to some of the world's most innovative blockchain projects, creating a Canadian marketplace for digital assets." Catalyx holds itself out as offering "secure [and] robust asset fund storage … in its state-of-the-art multi-factor encrypted wallets," and holdings, "bonding insurance that protects [users] funds and assets." Catalyx is registered as a MSB with FINTRAC, and had given a PRU to the ASC in March

2023 as described above under "PRUs and the Countdown to Compliance."

On December 28, 2023, Catalyx announced a security breach in connection with the holding of crypto assets on behalf of clients, and temporarily suspended withdrawals and trading on the platform.

On January 5, 2024, the Interim Cease Trade Order was **extended** for a period of 12 months on the basis that Catalyx had breached its PRU, in particular the requirement to maintain a system of controls and supervision over assets in its custody.

Regulatory Co-operation

Press releases issued by the OSC, BCSC and ASC in respect of *CoinField, Phemex, LiquiTrade* and *Catalyx* described each action as "part of the [CSA's] ongoing, coordinated effort to ensure that crypto asset trading platforms comply with securities legislation in Canada. Regardless of the location of their operations, platforms that facilitate the buying and selling of crypto assets by Canadian investors must comply with applicable requirements under Canadian securities legislation."[103] In addition, the OSC acknowledged the assistance of the BCSC in *CoinField* and the British Virgin Islands Financial Services Commission and Monetary Authority of Singapore in *Phemex*. These proceedings demonstrate the ability of CSA members to co-ordinate enforcement activities with each other and with foreign regulators.

CRYPTO SCHOOL: CSA INVESTOR TOOL KIT

While the CSA continued its co-ordinated enforcement efforts against unregulated CTPs, it also published comprehensive new online **investor tools** specifically for crypto assets. The tools have pages which assist investors to "spot crypto scams" and understand "risk associated with crypto assets." It also classifies "different types of crypto assets" including cryptocurrency, utility tokens, security tokens and NFTs. While this classification scheme does not have the force of law, it suggests the CSA's acknowledgement that many crypto assets are not, in and of themselves, securities or derivatives.

At the same time, the CSA tool explains that securities laws apply to CTPs that offer custodial services for crypto assets and derivatives based on crypto assets, even if the underlying assets are cryptocurrencies, utility tokens or NFTs that may not, in and of themselves, be securities or derivatives. The CSA states that requiring custodial CTPs to register under securities laws, "helps protect investors because registered firms and individuals are subject to certain requirements including risk management, disclosure, and dealing honestly, fairly and in good faith with clients."

The CSA tools also includes a **list** of authorized (registered) CTPs, CTPs that have filed PRUs and banned CTPs.

The CSA tools were preceded by the OSC's website: **www.getsmarteraboutcrypto.ca** launched in September 2022, which provides similar educational and outreach materials.

LOOKING AHEAD

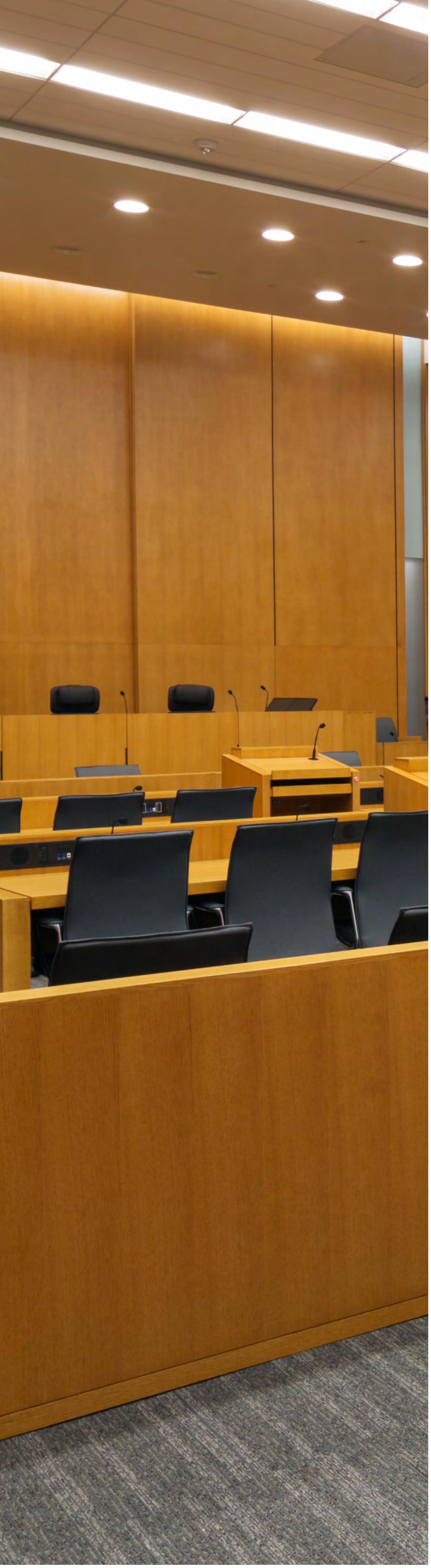
In 2024, we expect the OSC and other CSA members to continue their co-ordinated enforcement efforts against non-compliant custodial CTPs, prioritizing CTPs that engage in misconduct beyond unregistered trading. We also expect the CSA to continue to collaborate with regulators in other jurisdictions to investigate and enforce the law against bad actors in the crypto asset sector.

In the OSC's **2022-2023 Annual Report**, it stated its approach to the regulatory oversight of crypto assets is "to set clear expectations for participants in our market and to work closely with legitimate players seeking to innovate and harness the potential of blockchain technology." The OSC also noted that is has, "completed successful enforcement actions to hold accountable international crypto asset trading platforms that ignore the rules."

Having regard to the OSC's ongoing commitment to innovation, we are optimistic that the CSA will work with Regulated CTPs to address investor protection concerns associated with VRCAs without requiring the de-listing of all VRCAs. We are mindful that, while the CSA's VRCA regime would be the strictest in the world in April 2024 (when it is set to take effect), stablecoin legislation is progressing in Europe and the U.S. and may impose stringent prudential requirements on VRCA issuers that may address the CSA's investor protection concerns.

Although the CSA will continue to be tough when enforcing securities laws against non-compliant CTPs, they are likely to take a measured approach, which would not drive legitimate CTPs out of business. The CSA is aware that Canadian investors want to have access to crypto assets, and it is preferable for them to do so on Regulated CTPs. We expect the OSC to proceed in accordance with the goal expressed in its annual report: "Strong investor protection in this emerging area is necessary for maintaining confidence in our markets and supporting the long-term success of the crypto industry."

103 See press releases for: **CoinField**; **Phemex**; **LiquiTrade**.



Living in a Material World: Securities Class Action Update

By Alex Cocks, Shane D'Souza, Julie-Martine Loranger, Dana Peebles, Pierre-Gabriel Gregoire, Vincent Leduc and Karolina Kasparov

This article summarizes some important developments in securities class actions in Canada in 2023, namely: three 2023 decisions considering the question of materiality in public disclosure; a 2023 decision creating a global shareholder class; and two potential new class action risks for public issuers.

In this first section, we summarize three recent securities class action decisions which have provided additional guidance to reporting issuers on how to make judgment calls on whether a material change in an issuer's business, operations or capital has occurred, requiring prompt public disclosure.

A BROAD INTERPRETATION OF "BUSINESS, OPERATION OR CAPITAL" TO DETERMINE MATERIAL CHANGES

The plaintiff in *Markowich*[104] sought leave to commence a secondary market claim alleging that the defendant Lundin Mining Corporation (Lundin) failed to disclose its discovery of pit wall instability and a subsequent rockslide at one of its open pit mines. The Ontario Superior Court dismissed the plaintiff's motion. The Court of Appeal overturned the motion judge's decision, and allowed the lawsuit to proceed, noting that courts should apply a "generous approach" to interpreting what constitutes a "material change" under Ontario's *Securities Act*. The Supreme Court of Canada granted leave to appeal the Court of Appeal's decision which is anticipated to provide some much needed clarity to the interpretation of "material change".

The Court of Appeal endorsed a two-part test to determine whether a "material change" has occurred: first, there must be a "change in the business, operation or capital," without weighing the magnitude of the change; and second, the change must be material because it would reasonably be expected to have a significant impact on the market value of the issuer's securities.

On the first part, the Court clarified that a change in operations refers to a broad range of changes *within* a company. A material change may result from external factors, but those factors will only be considered material changes when they also lead to an internal change in the issuer's business, operation or capital, and (on the second part) where that change is also material. The Court held that the phrase "business, operations or capital" is broad and in the alleged circumstances of *Markowich*, the plaintiff did have a reasonable possibility of establishing that the wall instability and rock slide were "changes" in Lundin's "operations."

In *Peters*,[105] the plaintiff sought leave to commence a secondary market claim alleging that the defendant, SNC-Lavalin Group Inc., failed to disclose a material change in relation to a corruption prosecution. The allegation was that while SNC-Lavalin had previously disclosed the possibility of being able to negotiate a remediation agreement with Canada that would have stayed the prosecution, SNC-Lavalin knew this was not the case after a phone call on September 4, 2018 with Canada's representatives.

104 *Markowich v. Lundin Mining Corporation*, 2023 ONCA 359 [*Markowich*].
105 *Peters v. SNC-Lavalin Group Inc.*, 2023 ONCA 360 [*Peters*].

The Ontario Superior Court denied leave, noting that Canada's representatives had also advised SNC-Lavalin that it would continue to accept submissions about the appropriateness of a remediation agreement until they had completed their review. In other words, it was not certain that a remediation agreement was off the table. SNC-Lavalin continued to negotiate a remediation agreement until October 9, 2018, when Canada confirmed its decision to deny the request for a remediation agreement. SNC-Lavalin disclosed that decision promptly on October 10, 2018, following which its shares declined by over 13%.

The Court of Appeal upheld the motion decision, holding that the impugned call on September 4, 2018 only changed the magnitude of the risk — there was no actual change in the risk to the business. Prior to the call, SNC-Lavalin was at risk of being convicted for fraud or corruption. After the call, the same risk remained. Although the chances that the same risk would materialize became more likely after the call, the nature of the risk itself did not change. Thus, the first part of the two-part test was not met. There was no change to the business.

Evidence of Materiality is Important

In *Hexo*,[106] the plaintiff brought a proposed securities class action against the defendant HEXO Corp. (Hexo), a cannabis producer and distributor, alleging that Hexo made misrepresentations of material facts and material changes in its public disclosure about: a commercial agreement with the SQDC (the state-owned cannabis dispenser in Québec), a licensing deficiency and revenue projections.[107] The plaintiff argued that Hexo misled investors into thinking that it would make revenues by fulfilling its contractual commitment to sell 20,000 kg of cannabis to SQDC. This commitment ultimately never materialized, and the volume supplied to SQDC amounted to approximately 5,500 kg.

The Superior Court of Québec refused to grant the plaintiff authorization to proceed with the secondary market liability claims, holding that there were no misrepresentations for two reasons:

1. The fact that SQDC had the right to terminate the agreement under certain circumstances was disclosed in public statements; and
2. A reasonable investor would be aware of the fact that the cannabis market is new and volatile.

The Court also concluded that an investor would not have been misled to believe that the revenues in the first year were guaranteed.

The plaintiff also alleged that Hexo did not make a timely disclosure of a licensing deficiency in some of its facilities. The Court ruled that this information was not a material change because, although it was a change in the operations, it was not material. The deficiency represented only 4% of the total facilities. The Court confirmed that not all changes to operations need to be disclosed publicly — only material changes. The standard of materiality cannot be too low or the market will be inundated with too much information.

Hindsight Reasoning Should not be Applied to Disclosure Decisions

The Court in *Hexo* also cautioned against hindsight reasoning when determining whether a material change has occurred. The Court held that materiality should be assessed at the moment that a public statement is are made (or allegedly ought to have been made).The Court concluded:

— Evidence of a drop in share price does not, in itself, support a strong-enough presumption of material misrepresentation to satisfy the test for leave to proceed with a statutory secondary market liability claim.

— A downward trend in the performance of a business is not, in itself, a change in the issuer's business, operations, or capital.

— A failure to meet revenue projections is not, in itself, sufficient evidence that the documentation containing these projections contained a misrepresentation of a material fact. The revenue projections need to be reviewed at the time they were made.

— The decision of an issuer to disclose information is not an indication of the materiality of that information.

Global Classes that Overlap with Classes Elsewhere Continue to be Certified in Ontario

In *Cronos*,[108] Ontario's Superior Court certified a global class, including both Canadian and United States shareholders who purchased on the TSX and NASDAQ, even though U.S. shareholders who purchased on NASDAQ were already part of a U.S. class action.

In *Cronos*,[109] the plaintiff sought leave to commence a secondary market claim against the defendant Cronos Group Inc. (Cronos), alleging that it had overstated its revenues in 2019. Cronos is a Toronto-based company

106 *Dionne c. Hexo Corp.*, 2023 QCCS 162. Appeal expected to be heard by the Québec Court of Appeal in January 2024. [*Hexo*]
107 Par. 1 and s. 225.4 *Québec Securities Act*, CQLR, c. V.-1.1.
108 *Badesha v. Cronos Group, Inc.*, 2023 ONSC 5678 [*Cronos*].
109 *Badesha v. Cronos Group, Inc.*, 2023 ONSC 5678 [*Cronos*].

whose shares trade on the TSX and NASDAQ exchanges. The plaintiff sought leave to certify a global class — that is, all purchasers of Cronos shares during the relevant class period, regardless of where they reside or on which exchange they traded.

The Court certified a global class and dismissed Cronos' *forum non conveniens* motion seeking to stay the claims of U.S. shareholders who purchased their shares on NASDAQ. As noted in previous cross-border cases, the Court acknowledged that at some point, one of the courts involved will have to recognize a judgment or settlement from the other. For instance, in *IMAX*[110] the Court certified a global class in Ontario, which overlapped with the class in the parallel U.S. class action. However, once a court-approved settlement was reached in the U.S., the Court granted IMAX's motion to exclude individuals already covered by the U.S. settlement. As in *IMAX*, the Court must ensure that "no class member should get 'two bites at the apple' against any defendant."[111]

The Court also noted that the secondary market misrepresentation provisions in Ontario's *Securities Act* are broad enough to provide global class members' access to justice against an Ontario-based responsible issuer, regardless of where class members purchased their shares.[112]

Looking Ahead: Potential Future Trends

With Canada's *Modern Slavery Act* coming into force in January 2024, reporting issuers will be required to publicly disclose various information about their structure, supply chains, and processes to eliminate the use of forced labour and child labour, including policies and due diligence processes, identifying the parts of the business that carry a risk of forced and child labour and any steps taken to assess and manage risk. There is incremental class action risk to issuers from any new mandatory reporting requirement. This risk is highlighted by a recent putative class action against The Hershey Company,[113] albeit in the competition law context, where the plaintiff has alleged that "modern slavery" statements influenced the plaintiff's purchase of certain goods.[114]

In addition, we expect cyber-related securities class actions to arrive in Canada following much activity in the U.S. In the U.S., there appears to be an increase in lawsuits against companies and their directors and officers for allegedly making false or misleading representations about companies' cybersecurity readiness or responses to cybersecurity incidents.[115] We have not yet observed such securities class actions in Canada, but trends arising in the U.S. are often predictive of trends that will follow in Canada.

110 *Silver v. IMAX,* 2013 ONSC 6751, 117 OR (3d) 616 [*IMAX*].
111 *Cronos* at para 85 citing *IMAX* at para 31.
112 *Cronos* at para 83.
113 *Hershey Company v. Leaf,* 2023 BCCA 264.
114 The Court found it had no jurisdiction over a U.S.-based defendant.
115 See for example *In re Equifax Inc. Securities Litigation*, Stipulation and Agreement of Settlement, Case 1:17-cv-03463-TWT Document 159-2, (Filed February 13, 2020); *Alphabet Inc. v. Rhode Island,* 142 S.Ct. 1227; *Boykin v. K12, Inc.,* No. 21-2351.; *In re Zoom Securities Litigation, No. 20-cv-02353-JD; In re 360 DigiTech Securities Litigation,* 21 Civ. 6013 (AKH).

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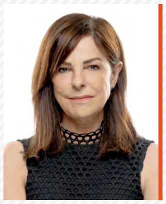

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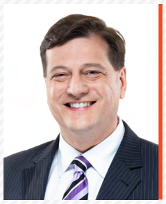

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Our Securities Litigation Group is widely recognized as a leader in the field with extensive experience in complex, high stakes matters before the courts and securities commissions, including contested mergers and acquisitions, shareholder activism, corporate governance matters, securities regulatory investigations and proceedings, securities class actions and investment products litigation. Clients trust and rely on our team to resolve matters that threaten their business and reputation.

Our lawyers have played prominent roles representing capital market participants in the largest and most complex securities litigation matters in Canada and contributed to major developments in Canadian securities laws in order to advance the interests of our clients. Our team frequently represents clients in cross-border securities regulatory investigations and proceedings and collaborates closely with counsel in multiple jurisdictions.

We maintain strong working relationships with all Canadian financial and capital market regulators, as well as with numerous foreign regulators. Our practice group lead, Wendy Berman, also offers a unique perspective on the Canadian securities regulatory regime as past Vice-Chair of the Ontario Securities Commission.

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