IN THE MATTER OF THE SECURITIES ACT
R.S.O. 1990, c. S.5, AS AMENDED

- and -

YBM MAGNEX INTERNATIONAL INC.
HARRY W. ANTES
JACOB G. BOGATIN
KENNETH E. DAVIES
IGOR FISHERMAN
DANIEL E. GATTI
FRANK S. GREENWALD
R. OWEN MITCHELL
DAVID R. PETERSON
MICHAEL D. SCHMIDT
LAWRENCE D. WILDER
GRIFFITHS MCBURNEY & PARTNERS
NATIONAL BANK FINANCIAL CORP.
(formerly known as First Marathon Securities Limited)

Hearing: November 29, 1999
December 21, 22, 1999
January 27, 2000
January 23, 26, 2001
February 22, 23, 2001
March 7, 2001
May 7, 8, 9, 10, 11, 16, 17, 2001
June 11, 18, 20, 2001
July 9, 10, 11, 12, 16, 17, 18, 19, 23, 24, 25, 26, 30, 31, 2001
August 1, 2, 13, 15, 27, 28, 29, 30, 2001
October 29, 30, 2001
November 2, 6, 7, 8, 13, 14, 15, 16, 2001
December 4, 6, 7, 13, 14, 2001
January 8, 10, 11, 15, 25, 2002
February 5, 8, 12, 14, 15, 2002
March 5, 7, 8, 19, 21, 22, 25, 26, 28, 2002
April 1, 2, 3, 4, 5, 8, 9, 12, 16, 17, 22, 23, 24, 25, 26, 29, 30, 2002
May 1, 2, 3, 6, 7, 28, 29, 30, 2002
June 10, 17, 19, 24, 26, 2002
August 6, 7, 8, 12, 13, 14, 19, 21, 22, 27, 29, 2002
November 18, 19, 20, 21, 22, 25, 27, 28, 2002

Panel:	Howard I. Wetston, Q.C.	-	Vice-Chair (Chair of the Panel)
	Derek Brown	-	Commissioner
	Robert W. Davis, FCA	-	Commissioner
Counsel:	Michael Code Jay Naster Ian Smith Kathryn J. Daniels	-	For the Staff of the Ontario Securities Commission
Counsel:	Peter Howard	-	For YBM Magnex International Inc.
	Paul Le Vay Donna E. Campbell	-	For Harry W. Antes and Frank S. Greenwald
	Bryan Finlay, Q.C. Michael Statham	-	For Jacob Bogatin
	Michael W. Kerr Derek Ferris Kelly A. Charlebois	-	For Kenneth E. Davies
	Brian P. Bellmore Karen M. Mitchell	-	For Daniel E. Gatti
	James D.G. Douglas David Di Paolo	-	For R. Owen Mitchell
	Alan J. Lenczner, Q.C. Monique Jilesen	-	For David R. Peterson
	Harry Underwood Gregory W. MacKenzie	-	For Michael D. Schmidt
	Linda L. Fuerst L. David Roebuck	-	For Lawrence D. Wilder
	John A. Keefe Julie Rosenthal Elizabeth Moore	-	For Griffiths McBurney & Partners
	James A. Hodgson Bonnie A. Tough Julia A. Evans Michael Petrocco	-	For National Bank Financial Corp.

INDEX

[PARAGRAPH]

INTRODUCTION

[1] This case raises serious questions with respect to the meaning of materiality in the prospectus and timely disclosure provisions of the *Securities Act* (the "Act"). A basic tenet of securities law is that disclosure is generally limited to *material* matters. Confronted by the dilemma of what should be disclosed to the public, the respondents relied on the concept of materiality as the cornerstone for disclosure. YBM's key disclosure documents did not, we find, contain full, true and plain disclosure of all material facts. YBM also failed to disclose a material change in its affairs forthwith. While disclosing good news with little hesitation, its practice was to restrict the disclosure of bad news.

[2] YBM's disclosure leads the reader to believe that the risks faced by YBM were no greater than the inherent risks faced by any company operating in Eastern Europe at that time. We find this to be incorrect. YBM was subject to company-specific risks. An investor in YBM's securities had the right to know what specific risks were presently threatening the issuer. Disclosure continues as the main principle for protecting investors, ensuring fairness in the trading markets and enhancing investor trust.

[3] Despite a hearing which took over 124 hearing days to complete, this case is not about organized crime, money laundering or whether the respondents believed YBM was not a real company. It is about the disclosure of risk. Materiality is reinforced as the standard for such disclosure in securities markets by taking into account the considerations associated with the exercise of judgement and reasonable diligence.

THE ALLEGATIONS

[4] Staff's first allegation is that YBM Magnex International Inc. ("YBM") filed a preliminary prospectus dated May 30, 1997 and a final prospectus dated November 17, 1997 that failed to contain full, true and plain disclosure of all material facts relating to the securities offered. Specifically, staff allege that YBM failed to disclose the mandate, information obtained by, and findings of a special committee (the "Special Committee") of its board of directors (the "Board of Directors", "Board" or "Directors"). The respondent directors and officers are alleged to have authorized, permitted or acquiesced in YBM's failure to make full, true, and plain disclosure. The respondent underwriters are alleged to have signed certificates to prospectuses which, to the best of their knowledge, information, and belief did not contain full, true, and plain disclosure.

[5] Staff's second allegation is that YBM failed to comply with its continuous disclosure obligations by not issuing forthwith a press release that disclosed the substance of a material change in the affairs of the company. Specifically, YBM should have disclosed that Deloitte & Touche LLP (U.S.) ("D&T") had advised YBM on or before April 20, 1998 that it would not perform any further services for the company, including the rendering of an audit opinion in respect of the company's 1997 financial statements, until YBM had completed an in-depth forensic investigation that addressed specific concerns to D&T's satisfaction. The members of YBM's audit committee (the "Audit Committee"), its Chief Executive Officer, Chief Financial Officer and Chief Operating Officer are alleged to have authorized, permitted or acquiesced in YBM's failure to comply with those continuous disclosure obligations.

[6] Staff's third allegation, against Lawrence D. Wilder, was settled in May 2002. Staff alleged that during the prospectus review process in July 1997, Wilder made misleading, untrue or incomplete statements to the Commission. Pursuant to the settlement agreement approved on consent by this panel on May 28, 2002, Wilder acknowledged that he acted in a manner that was contrary to the public interest by employing the language he did in his July 4, 1997 letter to staff. Wilder did not, however, admit to an intention to mislead. He offered, and staff accepted, an apology to staff. Wilder made voluntary payments of (a) $150,000 in respect of the costs awarded in connection with Wilder's application for judicial review to the Divisional Court and the subsequent appeal, and (b) $250,000 in respect of the costs of the investigation and hearing in this matter. Staff discontinued the allegation against Wilder.

THE RESPONDENTS

[7] YBM was incorporated under Alberta's *Business Corporations Act*, S.A. 1981, c. B-15, on March 16, 1994 under the name Pratecs Technologies Inc. ("Pratecs"). Pratecs changed its name to YBM Magnex International Inc. effective November 3, 1995. YBM became a reporting issuer in Ontario on January 22, 1996, and its shares began trading on the Toronto Stock Exchange on March 7, 1996. On May 13, 1998, the Commission issued a temporary cease trade order in respect of YBM shares; this order remains in effect. On December 8, 1998, pursuant to an order of the Court of Queen's Bench of Alberta, a receiver was appointed respecting the present and future assets, property and undertakings of YBM. The receiver did not defend the allegations in this matter. YBM controlled a United States subsidiary, YBM Magnex Inc. ("YBM Magnex") that had its head office in Newtown, Pennsylvania. As at May 13, 1998, YBM Magnex was either the sole or majority owner of:

(a) United Trade Limited ("United Trade"): a Cayman Islands corporation and wholly-owned subsidiary of YBM Magnex, with its head office and operations located in Budapest, Hungary;

(b) Magnex RT: a Hungarian corporation and majority-owned subsidiary of United Trade. Its offices and operations were located on Csepel Island in Budapest, Hungary;

(c) Schwinn-Csepel: a Hungarian corporation having offices and operations on Csepel Island in Budapest, Hungary; and

(d) Crumax Magnetics: operations consisting of companies that YBM acquired in 1997 and 1998: Crucible Magnetics ("Crucible") in Kentucky and Crusteel in the United Kingdom, acquired by YBM in August 1997, and the former magnetics division of Philips Electronics in the U.K., acquired by YBM in March 1998.

[8] During the period May 1, 1996 to May 13, 1998 (the "material time"), there were eight directors of the Board, two of whom were also officers of the Company:

(a) Harry W. Antes, Chairman of the Board and a member of the Audit Committee, appointed a director on April 29, 1996;

(b) Jacob G. Bogatin, President and Chief Executive Officer, appointed a director on April 4, 1994;

(c) Kenneth Davies, member of the Special Committee, appointed a director on April 4, 1994;

(d) Igor Fisherman, Chief Operating Officer of YBM, appointed a director on April 29, 1996;

(e) Frank S. Greenwald, Chair of the Audit Committee, appointed a director on April 29, 1996;

(f) R. Owen Mitchell, Chair of the Special Committee and member of the Audit Committee, appointed a director on January 26, 1996, and also a Vice President and director of First Marathon Securities Limited ("First Marathon") during the material time.

(g) David R. Peterson, appointed a director on April 29, 1996. Peterson is a partner and the Chair of the law firm Cassels, Brock & Blackwell LLP ("Cassels Brock") which was Canadian general counsel to YBM during the material time; and

(h) Michael D. Schmidt, member of the Special Committee, appointed director on April 4, 1994.

[9] Daniel E. Gatti was the Vice President of Finance and Chief Financial Officer of YBM during the material time. He was appointed an officer on January 26, 1996.

[10] In May 1997, two Canadian securities dealers agreed to act as co-lead underwriters for a financing being contemplated by YBM:

(a) National Bank Financial Corp. ("National Bank"), which acquired in August 1999, First Marathon. During the material time First Marathon was, and National Bank continues to be, registered under the Act as a broker and investment dealer; and

(b) Griffiths McBurney & Partners ("GMP"), which during the material time was, and continues to be, registered under the Act as a broker and investment dealer.

[11] Wilder is a partner at Cassels Brock, and during the material time was counsel to YBM and counsel to the Special Committee.

BACKGROUND – FIRST ALLEGATION

Corporate History

From Eastern Europe in 1990 to the Ontario Capital Markets in 1996

[12] YBM was the product of a series of incorporations, acquisitions and reverse-takeovers that transformed a closely-held company based in Eastern Europe into an international corporation, and traded in Canada on the Toronto Stock Exchange ("TSE" or "TSX").

[13] Arigon Company Limited ("Arigon") was incorporated in the Channel Islands, U.K. in May 1990. The founding shareholders recorded in the share register of Arigon were: Semeon Mogilevich, Alexei Alexandrov, Anatoly Kulachenko, Vitaly Leiba, Alexandr Alexandrov, and Semeon Ifraimov (the "founding shareholders"). In January 1991, Arigon formed Arbat International Inc. ("Arbat") in Russia as a joint venture company that conducted trading activity in Russia.

[14] In November 1991, the founding shareholders purchased magnet manufacturing equipment from a Russian company. In February 1992, Arigon acquired the equipment from them in exchange for preferred shares valued at approximately U.S. $14 million (the "Original Equipment Transaction").

[15] Arigon incorporated Magnex RT in Hungary in September 1992. Arigon held 99% of the shares; Mogilevich and Dr. Sandorne Bodonyi held the remaining 1%. The board of directors and supervisory board of Magnex RT were composed of the founding shareholders and Dr. Bodonyi. Mogilevich became chairman of the board and Kulachenko, CEO. Fisherman was appointed president.

[16] On September 15, 1992, Arigon and Magnex RT entered into three agreements which structured their relationship in the magnetics business. Arigon transferred the equipment acquired from the founding shareholders to Magnex RT and Magnex RT became responsible for all magnet manufacturing. Arigon became responsible for obtaining patents and raw materials for the manufacture of magnets, and for marketing and selling all magnets manufactured by Magnex RT. In September 1993, the scope of Magnex RT's business activity was expanded to include the "commerce of oil and fuel." Oil sales would account for 22-27% of YBM's sales in the coming years.

[17] Meanwhile, in Pennsylvania, Jacob Bogatin incorporated two private magnetics companies in April 1993: YBM Magnetics Inc. and YBM Technologies Inc. The former acted as a consultant and agent in magnet manufacturing and sales; the latter licensed magnet manufacturing patents. From April 1994, the companies provided their services exclusively to Arigon/YBM Magnex.

[18] Bogatin was invited to attend a meeting of the board of directors of Magnex RT in Budapest on January 23, 1994. He was identified in the minutes as "Assistant Director" of YBM Magnex Inc., although that company had yet to be incorporated. The minutes recorded the following:

> [Mogilevich] deems imperative to adopt strategic measures, appropriate for the business goals of Magnex RT. It would be beneficial for the introduction of industrial magnets manufactured by the Company, to the largest possible market … the United States, if the production and distribution of the product would be realized through a company incorporated under US law. For this reason the Company has engaged in negotiations with YBM Magnex Inc., willing to play an important role in this business project … He proposes that the Board of Directors authorize Director for Development Igor Fisherman to represent the Company in these negotiations…

Magnex RT's Board authorized Fisherman to conclude the required contracts.

[19] YBM Magnex Inc. was incorporated in Pennsylvania on February 10, 1994. Bogatin was appointed its sole director and president. By the end of the month, YBM Magnex's new board of directors included members of the founding shareholders and officers of Magnex RT. Kulachenko was appointed CEO; Fisherman, President; and Bogatin, Group Vice-President and Chairman of Finance. By December 1994, YBM Magnex completed a reverse take-over of

Arigon: the Arigon shareholders exchanged 100% of the common shares in Arigon for 85% of the common shares in YBM Magnex.

[20] Pratecs was incorporated in Alberta in March 1994 and issued two million shares to 15 individuals: one million shares to Bogatin and one million shares, in aggregate, to 14 others, including Davies and Schmidt. Four directors of YBM Magnex were elected directors of Pratecs, including Bogatin, Davies and Schmidt.

[21] In May 1994, Pratecs filed a preliminary prospectus in Alberta under the Junior Capital Pool Program ("the JCP program"). The JCP program required Pratecs to enter into a major transaction within 18 months of the offering. Pratecs disclosed that its major transaction would be the acquisition of Canadian distribution rights for the magnetic products of YBM Magnex. Upon filing its final prospectus on July 18, 1994, Pratecs issued four million common shares to the public and became a JCP corporation. On July 27, 1994, Pratecs applied for a listing on the Alberta Stock Exchange, which was approved one week later.

[22] Also on July 27, 1994, Pratecs entered into two letters of intent with YBM Magnex. The first dealt with the JCP major transaction and the second dealt with Pratecs' merger with YBM Magnex by way of a share exchange. Pratecs would acquire all of the shares in YBM Magnex in exchange for US$22 million in the form of 110 million shares of Pratecs. This reverse take-over was contingent on a Pratecs offering.

[23] The pending offering was threatened by court proceedings in the UK (the "UK proceedings") in the summer of 1995. On June 22, 1995, Pratecs voluntarily halted trading in its common shares on the Alberta Stock Exchange. On July 19, 1995, Pratecs explained that the halt in trading was a result of allegations concerning money laundering and fraud made in London against Arigon and two individual shareholders of YBM Magnex, Mogilevich and Konstantin Karat. Pratecs later announced that, at a hearing in the UK court on July 10, 1995, the prosecution had submitted an affidavit that withdrew all language attempting to connect the matter with Arigon or any of its officers or directors. A consent order dated July 19, 1995 dismissed all legal proceedings against the two YBM Magnex shareholders. Trading in Pratecs shares resumed on the Alberta Stock Exchange on July 24, 1995.

[24] First Marathon and GMP first became involved with Pratecs/YBM in the summer of 1995. The firms acted as co-lead underwriters for the January 1996 prospectus offering. The law firm Fogler, Rubinoff LLP ("Fogler Rubinoff") acted as underwriters' counsel. Cassels Brock acted as YBM's counsel. On October 5, 1995, Pratecs completed a private placement of approximately seven million special warrants for aggregate gross proceeds of approximately US$14 million. On October 26, 1995, Pratecs/YBM filed a preliminary prospectus to qualify the shares and the purchase warrants issuable on the exercise of the outstanding special warrants. All conditions for the reverse take-over were now satisfied. On November 3, 1995, Pratecs/YBM announced the completion of its acquisition of YBM Magnex.

[25] The company, now known as YBM Magnex International Inc., filed its final prospectus on January 19, 1996. On March 10, 1996 the common shares of YBM were listed and posted for trading on the TSE.

Corporate Activity in 1996: The Sale of Arbat and the Reorganization of Arigon

[26] YBM sold Arbat pursuant to an agreement dated April 1, 1996, between Arigon, Arbat, and two individual purchasers, Girin and Titelman. The purchasers agreed to assume Arbat's past and future liabilities.

[27] YBM then liquidated Arigon. YBM had been advised that it could achieve a tax-free reorganization by incorporating a company in the Cayman Islands and then transferring the assets and business of Arigon to this new company. Accordingly, United Trade was incorporated in the Cayman Islands in March 1996 as a wholly-owned subsidiary of YBM Magnex and as the successor company to Arigon.

[28] YBM, Arigon, United Trade and the preferred shareholders of Arigon (the founding shareholders) entered into an agreement dated April 1, 1996. The business, assets, goodwill and debts of Arigon were assigned to United Trade in exchange for United Trade assuming the debts and future liabilities of Arigon. The founding shareholders surrendered their preferred shares in Arigon in exchange for the same number of preferred shares in United Trade. The former officers, directors and employees of Arigon assumed the same positions in United Trade.

[29] Bogatin presented the sale of Arbat and the liquidation of Arigon to YBM's Board of Directors at their meeting on April 29, 1996. The minutes of the meeting record:

> The Chairman updated the board as to various other matters including the Company's plans to sell Arbat International Inc. to a group of arm's length purchasers for consideration equal to approximately (US)$250,000. The Chairman indicated that the rationale for the sale was that the Company's operations in Eastern Europe were difficult to supervise and exposed it to certain potential liability. The Chairman confirmed that Arbat will continue to render services to the Company but only on a contractual basis.
>
> The Chairman also advised the board of a proposal to relocate the Company's wholly-owned subsidiary, Arigon Co. Ltd. from the Channel Islands, U.K. to the Cayman Islands. The Chairman explained that the rationale for such move was to bring Arigon's operations closer to the Company's North American headquarters. The Chairman advised that the Royal Bank of Canada was assisting the Company and Arigon in this move. The Chairman also advised that upon completion of such move, Arigon's name will most likely be changed to United Trade Limited. The Chairman advised that this move would be accomplished by way of a tax free reorganization of assets.

[30] In July 1996, YBM acquired over 77% of the outstanding common shares in Hungarian bicycle manufacturer Schwinn-Csepel RT. The remaining minority interests were acquired in one consolidated block on October 1, 1996.

The Crucible Acquisition and the Public Offering of 1997

[31] The public offering by YBM in 1997 is at the heart of the first and principal allegation in this matter. On April 2, 1997, YBM entered into an Asset Purchase Agreement for the

acquisition of the magnetics division of Crucible Materials Corporation, which included the operations of Crucible in Kentucky and Crusteel Magnetics in London, England. The Board of Directors had authorized management to enter into discussions with Crucible at the meeting of August 15, 1996. The acquisition of Crucible was to have been financed by the proceeds of the 1997 offering. By May 1997, the underwriting syndicate was in place. Repeating their roles from the January 1996 offering, First Marathon and GMP acted as co-lead underwriters, each with 35% of the offering. Fogler Rubinoff again acted as the underwriters' counsel and Cassels Brock as YBM's counsel.

[32] The offering proceeded under the Prompt Offering Qualification System (the "POP system"); National Policy 47, "Prompt Offering Qualification System" (1993), 16 O.S.C.B. 675 ("NP47") [now National Instrument 44-101, "Short Form Prospectus Distributions" (2000), 23 O.S.C.B. (Supp.) 867 ("NI44-101")]. Under the POP system, a short form prospectus is filed that incorporates other disclosure documents by reference, one of which is the company's Annual Information Form. On May 2, 1997, YBM filed its AIF dated May 1, 1997 (the "AIF") and on June 2, 1997, filed its preliminary short form prospectus dated May 30, 1997 (the "Preliminary Prospectus"). The POP system is meant to facilitate a quick prospectus review by the Commission, usually in three days. Due to circumstances that will be discussed later in these reasons, the prospectus review concluded in November 1997, over five months later.

[33] Because of the delay in the prospectus review process, YBM sought alternative means of financing. On August 21, 1997, YBM completed a private placement of subordinated convertible notes in the amount of CDN $48 million. These proceeds funded the Crucible acquisition, which was completed the following day. The common shares underlying the convertible notes would be qualified for issuance with the final prospectus. On November 18, 1997, YBM filed its final short form prospectus dated November 17, 1997 (the "Final Prospectus"). The Commission issued a receipt for the Final Prospectus on November 20, 1997.

Visa Issues and Investigation by YBM Management in 1996

[34] In January 1996, YBM management became concerned when the U.S. embassy in Budapest denied return visas to two YBM employees. Bogatin and Gatti began an informal investigation. They made inquiries in person and through their Member of Congress (Rep. Greenwood), approaching consular officials and the State Department in the United States. YBM, through its management, retained U.S. lawyer Richard Rossman and the law firm of Pepper Hamilton to determine the U.S. Government's concerns. In August 1996, Pepper Hamilton learned that the U.S. Attorney's Office in Philadelphia was conducting an investigation into YBM.

[35] At Rossman's insistence, YBM held a special meeting of its Board of Directors on August 15, 1996. Every Director was present, as were representatives of management, YBM's auditors and various legal advisors. Following routine business matters, the Directors heard presentations from Bogatin, Gatti and Rossman about the history and results of management's inquiries to date.

[36] Gatti prepared the following document entitled "Approximate Chronology of Significant Events Leading to Notice of Investigation," which he presented at the meeting:

Approximate Chronology of Significant Events Leading to Notice of Investigation

Fall 1995:	YBM requests resignation of founding shareholders from management of YBM;
December 21, 1996:	Chris Vitanov travels to Hungary;
January 15, 1996:	Chris Vitanov delayed in getting visa from U.S. Embassy in Hungary (first indication of a problem);
January 20, 1996:	Tami Vitanov travels to Hungary;
January 22, 1996:	YBM/Vitanov's become concerned that there is some problem because visa request is taking too long;
February 7, 1996	Gabor Varga contacts U.S. embassy in regards to visa problem. Embassy implies that the company is not doing real business;
February 9, 1996:	Jacob Bogatin and Dan Gatti meet with Vice Consul Scott Boswell in Budapest to understand the reasons for the delay in getting the Vitanov's back to the U.S. Boswell states that the embassy is waiting for some response from State Department or INS. No indication that there is a problem with the company. Discussion concludes with YBM stating it will contact local congressman to try to speed things up the process;
February 12, 1996:	Jacob Bogatin contacts State Department and speaks with Katherine Gelner who says visas will not be issued because the sponsor, YBM Magnex, is conducting some illegal activity;
February 12, 1996:	YBM contacts Representative Greenwood's office requesting assistance;
February 13, 1996:	Immigration attorney, John Hykel, contacts Katherine Gelner at the State Department and is told that YBM Magnex is conducting some illegal activity;
February 26, 1996:	YBM meets with Representative Greenwood;
February 29, 1996:	Representative Greenwood writes letter to State Department requesting briefing on issue regarding YBM;
March 4, 1996:	YBM retains Pepper, Hamilton & Sheetz based upon reference from David Kirk, YBM's U.K. attorney;

March 1996:	YBM, through Jacob Bogatin, performs an internal investigation including a review of all its customer and sales representative contracts – results of investigation results in implementation of new customer acceptance procedures and the termination of one sales representative contract;
March 20, 1996:	Michael Bellows, Office of Public and Diplomatic Liaison, writes letter stating that Tami and Chris Vitanov have been found ineligible under the Immigration and Nationality Act and the reasons for ineligibility are classified;
April 1, 1996:	YBM divests itself from Arbat International, transfers net assets of Arigon to United Trade and begins process of liquidation of Arigon;
May 7, 1996:	Congressman James Greenwood briefed by State Department – staff contacts YBM to indicate that the Congressman felt the decision was justified and that he could no longer help us;
May 8, 1996:	Jacob Bogatin and Dan Gatti write Congressman Greenwood letter asking for any advice he could give and also request a meeting. Request was denied and suggestion to pursue through our attorneys was recommended;
May 21, 1996:	U.S. embassy in Russia acknowledges YBM's sale of Arbat International via letter from Minister Counsel;
June 6, 1996:	Peter Hearn retained at the advice of Pepper Hamilton for the purpose of approaching Senator Arlen Specter for assistance;
July 1996:	Peter Hearn meets with Specter aides who inform him that it would not be appropriate for a U.S. Senator to meet with YBM because of ongoing investigation…aides refer Peter Hearn to U.S. Attorney's office in Philadelphia;
August 2, 1996:	Peter Hearn and Richard Rossman (Pepper Hamilton) inform Jacob Bogatin that the U.S. Attorneys office confirmed to Peter Hearn that a highly sensitive investigation of YBM was in progress;
August 6, 1996:	YBM informs United States corporate attorney, Wolf Block, of notice; and
August 15, 1996	With the advice of Pepper, Hamilton, YBM management informs board of investigation.

[37] Gatti also told the Board that management had recently come across European press articles that linked alleged organized crime figures to YBM. One of these was a November 1995 article in *Izvestia* concerning a Mr. Mikhaylov, a reputed Russian organized crime figure who was seeking to become Honorary Consul for Costa Rica. Mikhaylov claimed to be the owner of several businesses, two of which were "Arigon" and "Magnex".

[38] Rossman presented the Board with the same information regarding an investigation of YBM that he had told Bogatin leading up to the meeting. He advised the Board to form a committee of outside Directors, advised by independent counsel, to investigate the matter. Following the presentations, the Board discussed its disclosure obligations.

[39] The Special Committee, chaired by Mitchell, was formed at a special meeting of the outside Directors on August 29, 1996. YBM management continued to play a role by providing information to the Committee and by following up issues on their own and through Rossman.

[40] In November 1996, Bogatin and Gatti brought a discrepancy in Arigon's 1994 commission payments to Mitchell's attention. One payment schedule listed a Viktor Averin as a recipient; the other listed a corporation instead, on the same date and for the same amount as the Averin commission on the other sheet. Management had no explanation for the discrepancy.

[41] Later that month, Bogatin and Gatti became aware of a new article in a Russian magazine that echoed the *Izvestia* article about Sergei Mikhaylov. They instructed Rossman to seek a retraction.

[42] On November 26, 1996, Bogatin and Gatti wrote to Ernst & Young, asking the firm to reconsider its decision not to pursue a relationship with YBM. They addressed the articles linking Russian organized crime figures to YBM, the U.K. proceedings, and the U.S. Government's monitoring of the company. They also advised that an independent committee of the Board was investigating these matters.

[43] In mid-December 1996, management became aware of an affidavit in support of an application for a wiretap on the telephone of one Ivankov, a Russian organized crime figure (the "FBI Affidavit"). It named Arbat as a vehicle for transmitting large sums of money from Moscow "to a company in Budapest, Hungary overseen by 'Seva' Mogielevich, one of Ivankov's closest associates." It also referred to Sergei Mikhaylov, Viktor Averin and Arnold Tamm as founders and leaders of a Russian organized crime group. Management shared the FBI Affidavit with Rossman and Mitchell. They confirmed to Rossman that the Mogielevich named in the FBI Affidavit was a shareholder of YBM and that Mikhaylov, Averin and Tamm had received commission payments from Arigon and United Trade.

[44] On December 18, 1996, management acted on the information in the FBI Affidavit by sending a letter and questionnaire to each of the founding shareholders and the other former shareholders of Arigon (the "December 1996 Questionnaire Letter"). They wrote:

> Our job is simple. We must determine whether there is any truth to the statements made by the FBI. To begin this process, we would like each of you and each officer of our company, including United States management, to complete the enclosed questionnaire for internal purposes only. Subsequently, the board of

> directors will evaluate the need to do a full scale internal investigation of our activities which will ultimately determine if any criminal activity exists in our companies and whether the questionnaires you submit are complete and accurate.
>
> Our western securities lawyers tell us that we are very close to having an obligation to disclose these allegations to the general public. If this were to happen, our stock would be worthless in a short period of time. Since you are now informed about these allegations, we encourage you to avoid selling any YBM stock until these issues are resolved or risk prosecution under insider trading laws.

[45] In early 1997, management dealt with two issues regarding United Trade that had been uncovered by the Special Committee's investigation. The first issue was United Trade's operation of two bank accounts ostensibly owned by other entities, Technology Distribution and Mogilevich, respectively. Gatti reviewed the accounts independently and with YBM's auditors, Parente Randolph Orlando & Carey ("Parente"). He found that United Trade was operating them legitimately, notwithstanding the names of the account holders. Parente concluded that the accounts were correctly indicated as cash on YBM's financial statements. These accounts were nonetheless closed, and new accounts were opened in the name of United Trade. The second issue concerned United Trade's offices being located in the same building as Mogilevich's office. United Trade's offices were moved to Csepel Island, near the operations of Magnex RT.

[46] In early February 1997, management received a letter from the editor of *Izvestia* with respect to the November 1995 article on Mikhaylov, more or less retracting the article:

> We hope that the publication has not inflicted any loss to the reputation and commercial interests of your firm, particularly since the law enforcement agencies of Russia and the newspaper *Izvestia* have not received any data which would support the version cited.

The Work of the Special Committee and Fairfax: 1996-97

[47] The outside Directors of YBM met by conference call on August 29, 1996. Wilder also participated, as did Rossman and Scott Godshall of Pepper Hamilton. Mitchell, Davies and Schmidt were appointed to the Special Committee, and Wilder was retained as the Committee's counsel.

[48] The Special Committee's initial work was a review of available documentation. Mitchell asked Schmidt to summarize information about the shareholders, directors and officers of YBM, Pratecs, Arigon, Magnex RT and Arbat. Mitchell himself reviewed the results of Rossman's Lexis-Nexis search, articles on YBM's public filings in Canada, articles on the U.K. proceedings, and the November 1995 *Izvestia* article.

[49] Mitchell then sought information from YBM's European operations via two letters faxed to Gatti on September 20, 1996. The first letter, addressed to Antes, stated the Special Committee's focus and proposed plan of investigation:

> Our focus has been to attempt to identify any clear correlation (including share ownership) between YBM or its subsidiaries and individuals of criminal

> background as has been suggested by articles in the European press and allegations in the London Court Case. We believe that these areas are the most likely sources of any pending investigation of the Company by US authorities.

[50] The attached letter to Bogatin requested:

(a) backgrounds of the shareholders of YBM and subsidiaries, and any business relationships that Bogatin or the senior managers may have with the shareholders;

(b) material commissions of greater than $10,000 paid by YBM and its subsidiaries, and a similar background analysis of the recipients of these payments;

(c) detailed background of the oil contract and contact persons at the counterparties; and

(d) access to Parente by the Special Committee.

Gatti responded by letter dated October 8, 1996, attaching documents compiled by management in Hungary. He informed Mitchell that there was no information from Arbat because it had been sold.

[51] On November 1, 1996, Mitchell presented the interim report of the Special Committee to a meeting of the Board of Directors held via conference call. The Board decided that the Fairfax Group ("Fairfax") would be retained to assist the Special Committee.

[52] Fairfax was retained on November 8, 1996. The Fairfax team was led by Senior Managing Director Philip Stern, a former prosecutor in New York State. The other members of the team were Clayton McManaway, a former State Department official and diplomat, and William Larkin, a forensic accountant. Fairfax's mandate was to "determine the exact nature of YBM's difficulties with the State Department and/or the U.S. Attorney's Office". Fairfax was also asked to conduct background checks on several individuals, including Mogilevich, Averin, Karat and "Mihalkov".

[53] Fairfax briefed Mitchell regularly between November 1996 and April 1997. After making initial inquiries in December 1996, Fairfax advised Mitchell that the State Department's investigation of YBM involved national security and organized crime issues. In January 1997, Fairfax was asked to conduct a broader review. McManaway and Larkin travelled to Hungary, where they reviewed United Trade and Magnex RT records and operations, and interviewed several of the founding shareholders and United Trade management. They briefed Mitchell on February 6, 1997. Fairfax's primary concern was the potential for money laundering in the Hungarian operations.

[54] Mitchell authorized Fairfax to conduct further background investigations into corporations and individuals. McManaway and Larkin briefed him on March 3, 1997. Fairfax had traced YBM's corporate evolution from Arigon and noted the involvement of the founding shareholders at each step. Fairfax's sources reported that Mogilevich, Kulachenko, Averin, Tamm and Mikhaylov were all linked to organized crime in Eastern Europe.

[55] Fairfax's major briefing took place during two meetings, on March 21 and 22, 1997. The first meeting was held in the offices of First Marathon in Toronto, attended by Stern, Larkin, McManaway, Mitchell, Antes, Wilder and Schmidt. McManaway and Larkin presented Fairfax's consolidated findings and recommendations, summarized as follows:

(a) the founding shareholders were all linked to a Russian organized crime group called "Solntzevskaia". Some of them had links to, or were former members of, the KGB;

(b) the founding shareholders retained significant ownership of YBM and exerted considerable influence over the company;

(c) although there was no evidence of money laundering found, indicia of money laundering were present in the Eastern European operations; and

(d) there were difficulties tracing significant customers and vendors.

[56] Going forward, Fairfax recommended that further work be done, including:

(a) the verification of customers, vendors, shipments, inventory and assets;

(b) interviews of the accountants and a review of their work papers and reports;

(c) further interviews of management of YBM, United Trade and Magnex RT;

(d) a review of cash management and banking arrangements; and

(e) an approach to the U.S. Government, disclosing findings and offering co-operation.

[57] Fairfax repeated the briefing in Philadelphia the following day. This time Bogatin, Gatti and Rossman were present, in addition to Mitchell, Antes and Wilder.

[58] Mitchell authorized Fairfax to verify YBM's customers and vendors. At the end of the March 22 meeting, Larkin and Gatti began assembling a customer list for this purpose. Fairfax later received a 16-page list of U.S. customers compiled by Fisherman (the "Fisherman List") and used this as a basis for its work. In June 1998, the Fisherman List was determined to have been a complete fabrication. On April 13, 1997, during a meeting with Fairfax convened by YBM management, Bogatin questioned findings that Fairfax had presented at the March 22nd meeting. Fairfax completed its engagement in April 1997 and was not asked to perform the further work that it had recommended.

[59] Mitchell and Wilder began drafting the report of the Special Committee (the "Report") in early April 1997. On April 8, Mitchell delivered a draft of the Report to Fairfax for comment. Stern, Larkin and McManaway provided feedback to Mitchell in a conference call. Mitchell incorporated Fairfax's comments into the Report, but Fairfax did not review the ensuing draft. On or around April 11, 1997, Mitchell gave copies of the draft Report (the "April 11 draft") to Lawrence Bloomberg, President and CEO of First Marathon, and Lloyd Fogler, senior partner of Fogler Rubinoff.

[60] Mitchell presented the Report, reading it verbatim, at the meeting of the YBM Board of Directors on April 25, 1997. Every Director was present, as were Gatti and Wilder. Unlike the presentation of the interim report on November 1, 1996, the Board was not provided with copies of the Report. The key points of the Report can be summarized as follows:

> (a) U.S. counsel for YBM was advised "off the record" by the U.S. Attorney's Office that there was an "ongoing investigation" involving YBM; while unable to uncover further particulars counsel confirmed that U.S. law enforcement agencies had placed a priority on uncovering infiltration of organized crime from the

former Soviet Union into U.S. business; on August 15, 1996 YBM management informed the Board of Directors of their discussions, through counsel, with the U.S. Attorney's Office;

(b) on August 29, 1996 the Special Committee was formed to investigate the situation; counsel for YBM advised that due to a lack of clarity surrounding the matter, public disclosure should not be made at that time;

(c) the mandate of the Special Committee was to independently investigate possible areas of concern arising out of the company's business operations to attempt to determine the basis for any investigation and to recommend further action to address any problems or potential problems uncovered;

(d) the initial review of the Special Committee focused on shareholder and employees/commissioned salespeople, and on contractual arrangements with customers; these two areas were chosen as a focus "as they relate to the legitimacy of YBM's core business";

(e) the Special Committee reviewed the original shareholders list; this review did not raise any concerns, nevertheless the Special Committee undertook a further review;

(f) the initial review of the Special Committee identified very substantial commission payments paid by Arbat which seemed inconsistent with Arbat's business. "In particular, the Committee was concerned about one set of parallel records which showed substantial payments to a Victor Averin on one set and the exact same payments to a corporate entity with a different name on another. Later a third version had different amounts and payees. Management had no explanation for this and, in general, accepted that their direct knowledge of Arbat activities was limited. This was one of the major reasons Arbat had been sold. The Committee noted that Arbat was not a material portion of the Company's sales or earnings."

(g) through Cassels Brock, the Special Committee retained Fairfax, "a large U.S. consulting organization operated by former senior Justice Department, State Department and F.B.I. officials; Fairfax came highly recommended and exhibited a strong track record with respect to dealings in Eastern Europe";

(h) Fairfax was requested by the Special Committee to: discover more details respecting the "ongoing investigation"; do background checks on management, salespeople, and the original shareholders; randomly examine business transactions recorded in the records of the Company to ascertain if bona fide; and review YBM operations and make recommendations regarding improved controls;

(i) the results of the Fairfax review included the following:

> i) initial background checks on management showed no concerns regarding Bogatin or other managers located in the United States. In Eastern Europe, however, a number of concerns arose; recipients of Arbat commissions in 1993-95 had clear ties to Russian organized crime. Another recipient of commissions from Arbat was incarcerated in

Switzerland. Even though Arbat was sold, it was under the operating control of Kulachenko, one of the original shareholders. Arbat was rumoured to have been a vehicle for criminal acts;

ii) the original transaction respecting the acquisition of the equipment "may not have been as originally described". The price paid by original shareholders for the equipment "was substantially below that booked at the time Magnex [RT] was formed. Management has indicated that the value of the preferred shares issued in consideration for the equipment was based on an independent appraisal of the equipment";

iii) "A second area of concern raised by Fairfax was the possible commingling of the business activities of Magnex RT, United Trade (the offshore sales arm of YBM) and those of the original shareholders resident in Budapest. The same office building was being used to transact activities for all the businesses and shareholder Simon Mogilevich in particular had taken an active interest in the activities of United Trade and Magnex RT despite not being an officer or employee of either company. There was a bank account (since terminated) through which Company business was transacted to which Simon Mogielvich was a signing officer. Management has already taken steps to relocate office activities and ensure proper separation";

iv) there were a substantial number of cash transactions, in particular payment of salaries and commissions. There was a large volume of cash on hand. Management has already taken steps to severely restrict the use of cash payments; and

v) the customer lists were reviewed and it was very difficult to establish end users for the products because of the use of intermediate agents for most sales. Where end users were specified, these proved to be business that used magnets in their production. "Management has begun to improve their client approval process and has agreed to use Fairfax in the future to check out potential customers";

(j) the Special Committee noted that its "most significant concern" was the series of payments made by Arbat "to individuals who had seemingly no tie to the Company's business." There seems to have been no basis for these payments. Management was unable to determine whether these payments were legitimate or some sort of "protection". Despite the fact that Arbat was sold, ties remained. "Simon Mogilevich and the founding shareholders have a long history of business and personal involvement extending back many years. Averin is also from the same area of the Soviet Union as many of the shareholders. Simon Mogilevich admitted that he has known Victor Averin since his youth. Simon Mogilevich and Igor Fisherman… are long standing friends. Anatoly Kulachenko, a founding shareholder, operated and may continue to operate Arbat."

(k) the conclusions of the Special Committee included the following:

i) there is no evidence that "senior management of YBM is in any way involved in any illegal or improper activities";

ii) that in respect of the questions surrounding the original shareholders, it is "not surprising that allegations should be made at successful businessmen of Russian origin trading between the Former Soviet Union and the West";

iii) YBM cannot be expected to control its shareholders and their actions. There is no tangible evidence to tie the original shareholders to any wrongdoing. The Committee directed management to eliminate any ties to the original shareholders in the "day-to-day operations of the Company";

iv) the original shareholders control in aggregate over 40% of YBM common stock; to the knowledge of the Committee there existed no formal agreements among the original shareholders governing their activities vis-à-vis YBM, but "the existence of this block of shareholders is of concern to the Committee";

v) "the Company's auditors have produced consecutive unqualified audits while clearly understanding the background of the Company and its shareholders. The Fairfax review has evidenced an active business with legitimate customers and suppliers. … [N]o forensic audit has been undertaken to attempt to track all material flow from supplier to end user as such a task would be extremely difficult in Eastern Europe";

vi) "As regards potential investigation by US regulatory agencies, the visas that prompted the whole issue have been provided without comment. Two immigration agents spent extensive time in the Newtown office attempting, it appears, to ensure that an actual business is taking place. Management believes they left completely satisfied that this was the case. Discussions with counsel have concluded that it is unlikely that any purpose would be served by approaching the FBI or the US Attorney with our conclusions and that it is unlikely that we would ever know if and when any investigation had been concluded."

(l) the recommendations of the Special Committee were as follows:

"a) Provide the Board with an action plan to address each of the following areas:

- Elimination of commingling of business activity with that of Company shareholders in Europe;

- Establish operational controls to ensure that management remains operationally independent from the founding shareholders;

- Establishment of improved cash controls in Hungary;

- The setting of more detailed customer and agent approval criteria;

- The establishment of an accurate data base on these customers and agents;

- Consolidation of accounting control in Newtown; and

- Engage a major accounting firm for the completion of future audits.

b) Establish a permanent subcommittee of the Board or the Audit Committee to supervise compliance with these recommendations and other issues surrounding corporate ethics in the future.

c) Advise the underwriters financing the acquisition of Crucible as to the background and results of this investigation."

[61] Following Mitchell's presentation, the Board and counsel discussed YBM's disclosure obligations. Counsel advised that the existence of the Special Committee should be disclosed in the AIF, to be filed in furtherance of the forthcoming public offering.

The 1997 Offering

[62] YBM filed its AIF on SEDAR on May 2, 1997. The AIF contained disclosure relating to the work of the Special Committee under the heading "Business Risks, Risks Associated with Activities in Eastern Europe". This disclosure was drafted by Wilder with input from Mitchell, Gatti and Bogatin.

[63] By early May 1997, three junior underwriters had joined co-leads First Marathon and GMP in the underwriting syndicate: ScotiaMcLeod, with 20% of the offering, and Canaccord Capital and Gordon Capital, with 5% each. The co-leads had earlier invited Nesbitt Burns to join the syndicate. On May 2, 1997, representatives of First Marathon and GMP met with Jeff Orr of Nesbitt Burns. Mitchell presented the background, formation, findings and recommendations of the Special Committee and Fairfax. Nesbitt Burns declined to join.

[64] In mid-May, First Marathon assigned its head of investment banking, Peter Jones, to lead its due diligence in the offering and sign the underwriter certificates to the preliminary and final prospectuses. On counsel's advice, First Marathon brought in Jones to offset any perception of conflict of interest in Mitchell's role as a Director of YBM and an employee of First Marathon. McBurney continued to lead GMP's due diligence in respect of the underwriting.

[65] First Marathon, later joined by GMP, engaged Price Waterhouse in May 1997 to assist in the underwriters' due diligence. Price Waterhouse reviewed Parente's audit work papers and prepared follow-up questions for First Marathon to ask Parente. In early June, following the filing of the Preliminary Prospectus, First Marathon asked PriceWaterhouse to review customer and vendor companies in Eastern Europe and obtain a valuation of the Magnex RT equipment.

[66] YBM filed the Preliminary Prospectus on SEDAR on June 2, 1997. It incorporated the AIF by reference but did not contain further disclosure about the work of Special Committee. Cassels Brock had drafted the prospectus with input from Bogatin, Gatti, Mitchell, Jones, McBurney and Gary Litwack of Fogler, Rubinoff.

[67] On June 3, 1997, staff from the Commission's Market Operations Branch ("Market Operations") commenced the prospectus review process at a meeting at the Commission attended by Jones, McBurney and Litwack on behalf of the underwriters and their counsel, and Wilder

and other members of Cassels Brock for YBM. Market Operations expressed concerns regarding YBM's financial statements and the fact that Price Waterhouse had been retained. They also discussed stories on the Internet that linked YBM to organized crime.

[68] In conjunction with the meetings, staff's prospectus review was conducted through comment letters to YBM counsel. In their first comment letter, staff raised questions respecting the AIF, one of which was about the review of the company's operations and recommendations that were being implemented:

> 10. On page 6 [of the AIF], under the heading "Risks Associated with Activities In Eastern Europe", reference is made to new standards for business practices being implemented by the Board. Please describe the circumstances surrounding the review of the Company's operations. What recommendations are being implemented? Describe the "Standards Applicable to Canadian Companies".

[69] YBM's counsel responded, without indicating the existence of the Report of the Special Committee:

> **Circumstances Surrounding the Review of the Company's Operations**
>
> Over the past year, the Company has had some difficulty in being issued certain business visas for employees. As a result, the Company decided to investigate this further in order to resolve this problem. The Company's efforts confirmed that U.S. law enforcement agencies had placed a priority on uncovering infiltration of organized crime from the former Soviet Union into U.S. businesses. Given the roots of the Company and its affiliates in Russia, and the involvement of former Russian nationals as shareholders and managers of the Company, the Company believes that it may have been examined as part of any such investigation. The visas which prompted the concerns were subsequently issued by the U.S. Government without comment.
>
> As noted in the AIF, the Company took a number of steps to address any possible concerns, including the divestiture in the first quarter of 1996 of Arbat International, Inc., the Company's Russian trading company, and the establishment of a special committee of the board to review the operations of the Company in Eastern Europe.
>
> **Special Committee Recommendations**
>
> The special Committee made the following recommendations which have been or are being implemented by the Company's management:
>
> - Establishment of improved cash controls at the Company's Hungarian facilities;
>
> - Establishment of more detailed customer and agent approval criteria;
>
> - Establishment of a more accurate data base on these customers and agents;
>
> - Establishment of new management information systems; and
>
> - Consolidation of accounting control at the Company's Newtown, Pennsylvania, head office through establishment of integrated information systems at each site of the Company's operations.

[70] On June 11, 1997, Market Operations alerted YBM's counsel to an anonymous tip suggesting that YBM may be involved in money laundering. Staff from the Commission's Enforcement Branch ("Enforcement") became involved. At the meeting of July 7, 1997, Enforcement advised the underwriters and counsel that Enforcement had "soft information" which questioned the veracity of YBM's sales, but stated that this information would not be the basis for a decision as to the prospectus receipt. In a conference call on September 24, 1997, company and underwriters' counsel were advised that Enforcement was investigating discrepancies in YBM's historical disclosure of magnet and oil sales.

[71] Numerous meetings and conference calls were held throughout the months of June and July 1997. Staff met with Price Waterhouse and reviewed various matters with them. By the end of June, staff advised the underwriters' and company's counsel that they were not prepared to issue a receipt for a final prospectus until YBM's income statement was confirmed by a "Big Six" accounting firm. Staff were not pursuing the rumours and innuendo surrounding YBM, but wanted to confirm issues of related-party transactions. In early July, staff was insisting on seeing actual customer lists for magnets and oil products, classified by location and type of customer (end user versus distributor).

[72] With some reluctance, on July 23, 1997, YBM advised staff that D&T had been retained and had commenced work on a full audit. Staff met with counsel and D&T the next day to discuss the procedures to be undertaken by D&T and staff's requirement of a clean audit opinion. Staff expressed its concerns as to (a) the existence and identity of customers and end users; (b) the tracing of cash receipts and revenue; and (c) the geographic location of customers, which could not be verified to date.

[73] D&T rendered an unqualified audit opinion on YBM's 1996 financial statements on October 13, 1997. On November 4, D&T, Peterson, Gatti, and YBM's and underwriters' counsel met with senior members of staff to discuss the audit. During a discussion on the timing of the receipt for the Final Prospectus, Wilder informed staff that YBM faced an $8 million penalty pursuant to the subordinate convertible notes in the event that a receipt was not issued by November 17. Staff then asked D&T and Gatti over 70 detailed questions about the audit. Peterson responded to questions about the Board's involvement in the audit process.

[74] On November 12, YBM's Board of Directors approved the final prospectus by written resolution. The next day, YBM filed a material change report in respect of D&T's audit and the restated financial statements, particularly the adjustments to geographic sales information. The underwriters held their "bring down" due diligence session soon thereafter. On November 17, the certificates were signed and the Final Prospectus was filed.

[75] The Commission issued a receipt for the Final Prospectus on November 20, after five months of review by Market Operations. During the course of the prospectus review, Enforcement advised YBM that they had opened an investigation file on YBM. The final prospectus disclosed that as part of its continuing review, staff of the Commission requested certain source documentation underlying YBM's disclosure record in connection with the 1996 financial statements. The final prospectus disclosed most but not all of the recommendations made in the Report of the Special Committee. Apart from the AIF, this was the only additional disclosure relating to the Special Committee.

[76] On May 13, the United States organized crime task force headed by the U.S. Attorney's Office for the Eastern District of Pennsylvania executed a search warrant on YBM's offices in Newtown. That same day, the Commission issued a temporary cease trade order in respect of the securities of YBM, which remains in effect.

Settlement of the Civil Proceedings

[77] On May 10, 2002, five civil proceedings before the Ontario Superior Court of Justice were settled, including two class action suits by shareholders who purchased YBM shares pursuant to the Final Prospectus and on the secondary market, respectively. The actions had not proceeded to trial and there were no findings nor admissions of liability. The class action plaintiffs alleged negligent misrepresentations and negligence not only against the respondents in the matter before us, but also the auditors, junior underwriters, lawyers, and officers who were involved in the public offering of shares of YBM. In the reasons for approving the settlement agreement [*CC&L Dedicated Enterprise Fund (Trustee of) v. Fisherman* (2002), 26 B.L.R. (3d) 281 at para. 13 (Ont. S.C.J.)], Cumming J. wrote:

> The plaintiffs' pleadings alleged that there was a very sophisticated, multi-layered conspiracy and massive fraud perpetrated upon the public through the utilization of YBM by organized crime. Indeed, the level of complexity and fraud of the alleged overall scheme seems unparalleled in Canadian experience and may well rival any such scheme seen on the international scene.

Cumming J. estimated the loss to purchasers under the Final Prospectus at more than $100 million, and to persons who purchased shares in the secondary market at $250 million. The total settlement through contributions by some of the defendants and third parties was $85 million. Shareholders also received $33.5 million from the YBM estate in bankruptcy.

[78] Two other civil proceedings settled that day involved actions by YBM, through its receiver and litigation supervisor, against the respondents and D&T, Parente, Cassels Brock and former YBM management. The fifth settled civil proceeding involved an action by D&T against YBM, Bogatin, Gatti, Mitchell, Cassels Brock, and First Marathon. On June 7, 1999, YBM pleaded guilty to a charge of conspiracy to commit fraud in the United States.

THE FAILURE TO MAKE FULL, TRUE AND PLAIN DISCLOSURE OF ALL MATERIAL FACTS

[79] Staff have alleged violations contrary to subsections 54(1), 56(1), 58(1) and 59(1) of the Act. They are more fully described above.

Risk-Related Disclosure in the Preliminary Prospectus and Final Prospectus

[80] YBM tended to disclose both the existence of a risk and the factual reason for it. For example:

a) because YBM depends on a small number of key employees, losing one or more of the key employees could have a material adverse effect on YBM's performance;

b) because YBM's manufacturing process is highly automated and YBM is unable to rapidly scale down its cost structure over the short to medium term, a significant reduction in orders for YBM's products would harm YBM; and

c) because the market prices of certain key raw materials are extremely volatile, a dramatic rise in those prices may have a material adverse effect on YBM's profitability.

[81] In contrast, the section on Risks Associated with Activities in Eastern Europe did not clearly state both the risks and the factual reason for those risks. The sum total of the company's disclosure respecting the mandate, information obtained by and findings of the Special Committee, is found in two paragraphs. One paragraph was in the AIF, and the other in the Final Prospectus. In the AIF the company made the following disclosure at page 6:

> **BUSINESS IN GENERAL**
>
> **Business Risks**
>
> *Risks Associated with Activities in Eastern Europe*
>
> The Company's manufacturing operations are located in Hungary. Additionally, 47% of consolidated net sales are concentrated in Eastern Europe. Economic, political and general business conditions in these regions are highly inflationary and are potentially unstable.
>
> The evolving market economies in Eastern Europe are characterized by a high level of cash transactions as well as less rigorous financial controls. The Company has and continues to implement recommendations made by independent public accountants and others with expertise in these regions to improve the Company's operations in these regions.
>
> Over the last two years the Company became aware of concerns that had been expressed in the media and by government authorities generally concerning companies doing business in Eastern Europe and, particularly, in Russia. To this end, the Company has taken a number of steps to address these concerns, including:
>
> 1. the divestiture in the first quarter of 1996 of Arbat International, Inc. ("Arbat"), the Company's Russian trading company which distributed a variety of consumer goods and materials through Eastern Europe and Russia. Upon a review of Arbat's operations, management was not satisfied that adequate customer and sales representative acceptance procedures could be implemented, including monitoring the propriety of sales commissions paid to sales representatives; and
>
> 2. the establishment of an independent committee of the board of Directors who retained experts knowledgeable with political, social and economic issues in Eastern Europe to review the Company's operations to ensure that they are consistent with the standards applicable to Canadian public companies. Recommendations resulting from such review are being implemented by the

> Company. The board of Directors, through the Audit Committee, will monitor ongoing compliance by the Company with such recommendations.

[82] The only additional disclosure made by YBM pertaining to the mandate, information obtained by and findings of the Special Committee, was in the Final Prospectus, under a general heading "Business of YBM", wherein the company disclosed the following at page 5:

> In order to address the special risks inherent in carrying on business in Hungary in particular and Eastern Europe in general, YBM:
>
> (a) has established improved cash controls at its Hungarian facilities;
>
> (b) has developed more detailed end user and distributor approval criteria;
>
> (c) is in the process of establishing a more accurate database respecting its distributors and end-users;
>
> (d) is in the process of implementing new management information systems; and
>
> (e) is in the process of improving and centralizing controls over all of its international accounting activities at its Newtown, Pennsylvania head office.
>
> The intent of the foregoing initiatives is to ensure that despite the fact that YBM carries on a substantial portion of its activities in Eastern Europe, its internal controls and financial reporting standards will be in accordance with those otherwise generally applicable to Canadian public companies…

[83] The final prospectus also stated that except for certain non-cash restatements and reclassifications to YBM's existing 1996 financial statements, "a major international accounting firm" had rendered an unqualified audit opinion regarding those financial statements.

To summarise, the parts of the AIF and the rest of the prospectus that dealt with risks other than the "special" risks connected with Eastern Europe plainly disclosed both the existence of a risk and the factual basis for the risk. The sections on Eastern Europe were considerably more opaque in describing the precise risks facing YBM and the factual basis for those risks.

Material Facts

[84] The Act defines a "material fact" for disclosure purposes, where used in relation to securities issued or proposed to be issued, as "a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of such securities." Normally, materiality, which is fact-intensive, invites considerable debate, but, in this case, so did the meaning of a fact within subsection 1(1) of the Act. For instance, it was submitted that the information Fairfax provided regarding links between the founding shareholders and organized crime was not factual and therefore not a material fact.

[85] What is "a fact" within the meaning of the Act? A fact, in and of itself, is not defined in the Act. Staff submit that the disclosure engaged herein involves the disclosure of risk which is by definition uncertain. The meaning of "a fact" should not be read supercritically; *Re Royal Trustco Ltd. and Ontario Securities Commission* (1983), 42 O.R. (2d) 147 at 152 (Div. Ct.);

NP47, Appendix A, AIF Guidelines 1 and 4 [now NI 44-101 and the accompanying forms 44-101F1 and F3]. Dictionaries were drawn in support of positions that facts must be verifiable by reference to existing objective or external sources.

[86] The respondents argue that a risk cannot be an uncertainty built upon an uncertainty. Stated somewhat differently, risk is the antithesis of fact or risks are a product of a set of underlying facts without which the probability of an outcome is not assessable. Furthermore rumour is uncertain, unverifiable and therefore is not a fact within the meaning of the Act. In *R. v. Fingold* (1999), 45 B.L.R. (2d) 261 (Ont. S.C.J.) (*Fingold*), an insider trading case, Keenan J. stated at para. 56:

> "facts" must mean more than mere rumour or gossip on the street or even an "overpowering suspicion". It must be information obtained from an identifiable source which might reasonably be expected to have such information and obtained in circumstances which would tend to support the accuracy and reliability of the information given.

Keenan J.'s approach is both normative and pragmatic.

[87] Staff submit that facts that give rise to a material risk are material facts. The facts, from a professional and reliable source, are not uncertain, only the risk. In that sense, both are facts and must be assessed for materiality. We agree with this approach, that is, that risks are facts within the meaning of the Act. Risk factor disclosure is common in prospectuses and specifically addressed in the prospectus rules under the Act. There can be little doubt that risks are facts that must be disclosed if they are material. NP47 made this clear; Item 3(2)(e) to Appendix A and Item 18 to Appendix B [now Item 3.3 of Form 44-101F1 and Item 18.1 of Form 44-101F3]. In most circumstances not only should the risk be disclosed, if material, but also the underlying facts, as YBM did in parts of the AIF.

[88] The essence of what is engaged in this case is the disclosure of risk. Were the risks faced by YBM fully, truly and plainly disclosed as simply general business risks associated with activities in Eastern Europe? Were the concerns simply those expressed by the media and government authorities generally concerning companies doing business in Eastern Europe and, particularly, Russia? If not, was YBM uniquely subject to material risks that were not disclosed?

The Materiality Assessment

[89] Disclosure in securities markets encourages investing and therefore growth. Disclosure protects investors, aids in ensuring that securities markets operate in a free and open manner and ensures that a security will nearly correspond to its actual value. Too much disclosure or information overload can be counter-productive. The boundaries are identified by the concept of "material facts". The definition appears straightforward but its assessment is nuanced.

[90] Assessments of materiality are not to be judged against the standard of perfection or with the benefit of hindsight. It is not a science and involves the exercise of judgement and common sense; *Core Mark International Inc. v. 162093 Canada Ltd.* (8 June 1989) Toronto 1220/89 at 4-5 (Ont. H.C.)

[91] The test for materiality in the Act is objective and is one of market impact. An investor wants to know facts that would reasonably be expected to significantly affect the market price or value of the securities. The investor is an economic being and materiality must be viewed from the perspective of the trading markets, that is, the buying, selling or holding of securities. Price in an open market normally reflects all available information. YBM was not a thinly traded stock. As such, its price more likely reflected the information disclosed to the public market. Full disclosure of adverse information may lower the price but it does not shut out a security from the market.

[92] There was extensive reference to the U.S. law on materiality. The reasonable investor test or substantial likelihood test is found in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (*TSC Industries*). Generally, for historic information like past financial results or completed business transactions this test frames the materiality assessment. When facts point to a future event, the U.S. courts have applied the probability/magnitude test; *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). This test analyses the current value of information as it effects the price of securities discounted by the chances of it occurring. This test has been applied by the Commission in *Re Sheridan* (1993), 16 O.S.C.B. 6345, and in *Re Donnini* (2002), 25 O.S.C.B. 6225 (*Donnini*).

[93] Disclosure is contextual. In the U.S. this has been identified as the total mix of information test; *TSC Industries* at 449. It seems sensible that the respondents must take into account the import of all extant disclosures, positive or negative, in order to assess whether a fact is material.

[94] Materiality is a question of mixed law and fact, i.e. do the facts satisfy the legal test? Some facts are material on their own. When one or more facts do not appear to be material on their own, materiality must also be considered in light of all the facts available to the persons responsible for the assessment.

[95] The materiality assessment in this case involves a consideration of whether material facts respecting the mandate, information obtained by and findings of the Special Committee were omitted from the disclosure documents. Would the disclosure of such information translate into market gains or losses? In our opinion, the critical question is whether certain undisclosed facts contained in the Special Committee Report would have revealed that YBM was, at the time, exposed to risks that would reasonably be expected to have a significant effect on the value of YBM's securities if disclosed.

[96] Peterson refers to U.S. law for the principle that uncharged criminal conduct or unadjudicated violations of the law generally need not be disclosed. *U.S. v. Mathews*, 787 F.2d 38 (2d Cir. 1986); *SEC v. Chicago Helicopter Industries*, 1980 U.S. Dist. Lexis 17214 (N.D. Ill. 1980). This is in reference to the allegation that the company had confirmed it was the subject/target of an ongoing highly sensitive criminal investigation by U.S. law enforcement authorities.

[97] According to John M. Fedders, "Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard" (1988) 48 Cath. U. L. Rev. 41 at 89:

> The rule is that corporations need not disclose unadjudicated violations of law or antisocial or unethical conduct unless the information is quantitatively significant to investors and alters the total mix of information made available. The compelled disclosure of uncharged and unadjudicated criminal conduct would violate the Fifth Amendment.

[98] The allegation in this case is not whether YBM was engaged in money laundering or some other criminal activity. There is also no allegation that any of the respondents believed the company was a fraud or was not a real company. The evidence regarding the U.S. investigation and possible criminal associations of the founding shareholders and board knowledge is relevant, according to staff, because it demonstrates that the risks facing YBM were real and were readily identifiable through reasonable investigation and diligence.

[99] The U.S. case law with respect to such disclosure is caught up in Fifth Amendment issues related to self-incrimination and testimonial compulsion. There were no such arguments in this case.

[100] In our opinion, the events in this case are extraordinary in nature, the disclosure of which would likely have a significant effect on the market price or value of the securities. The cases referred to by staff and the respondents generally involved insider trading, credible merger negotiations, proxy statements or uncharged and unadjudicated violations of the law. These cases present discrete events in which the materiality analysis is quite straightforward. Such is not the case herein. Would the disclosure of these facts likely affect the market price or value of its securities?

[101] In this regard, we agree with the respondents that the application of the probability/magnitude test to the investigation by U.S. law enforcement agencies as a discrete event is problematic. In essence, the fact of the investigation was incapable of the application of the probability/magnitude test. Probability could not be determined with perfect certainty. However, this does not mean that a fact cannot meet the test for materiality set out in the Act. One should not lose sight of the forest for the trees by assessing the materiality of individual facts piecemeal when the broader factual context suggests a risk faced by an issuer. Some facts may be material on their own, while others may only be material in the context of other facts. The probability/magnitude test is useful in assessing the occurrence of a future event, but common sense must prevail. The broader factual context, or total mix, must not be overlooked when the risk facing the company is a current one.

The Omitted Material Facts

[102] Did the Preliminary Prospectus or Final Prospectus contain any misrepresentations or omissions respecting the facts particularised in the allegations made by staff with respect to the mandate, information obtained by and findings of the Special Committee? If yes, the Commission must consider whether the misrepresentations or the omissions are material.

[103] Staff and the respondents address the alleged deficiencies in somewhat different ways. Basically, staff submit that there are 14 items of information that related to the work of the

Special Committee that were omitted. National Bank compresses these items into three essential questions:

1) Was YBM the target of an investigation and, if so, what was the unlawful conduct alleged to be taking place and who was conducting the investigation?

2) Were the founding shareholders engaged in organized criminal activities and, if so, what criminal activities?

3) If the shareholders were engaged in criminal activities were those criminal activities being co-mingled with the business of YBM?

[104] The respondents' general response to the information which was not disclosed is two-fold:

a) The information was rumour or merely speculation – i.e. the information was not fact, or

b) the issues had been resolved no longer making the facts material.

[105] Staff submit that, with the exception of the actual violations underpinning the U.S. investigation, the respondents had knowledge of material facts when the AIF and the preliminary and final prospectuses were filed. It is submitted that comparing these facts with the facts that the respondents chose to disclose demonstrates the extent to which the public was denied the benefit of full, true and plain disclosure. In short, staff's position is that investors were unaware of the specific risks facing YBM.

The U.S. Investigation

[106] Was YBM the target of an investigation? What was the unlawful conduct at issue and who was conducting the investigation? The respondents do not take the position that the findings of the Special Committee as recorded in its Report are all rumours, speculation, or give rise to concerns or suspicions. Mitchell agrees that:

a. In August 1996 there was a U.S. Government investigation involving YBM and as subsequently uncovered by the Special Committee or Fairfax;

b. prior to its divestiture by YBM, Arbat had made substantial commission payments to agents that seemed inconsistent with a trade goods business and there were two records of these payments which showed inconsistent payees;

c. background checks on Bogatin and other YBM managers located in the United States revealed no concerns; Fisherman, YBM's head of European operations, was a longstanding friend of Mogilevich, one of the founding shareholders; overall, there was no evidence that management of YBM was involved in any illegal or improper activities;

d. the founding shareholders purchased the founding equipment, which they transferred to YBM for an amount substantially less than what YBM paid for it;

e. one of YBM's business offices in Budapest was in the same building as the office of Mogilevich; Mogilevich had held signing authority on a bank account through which YBM business was transacted;

f. YBM engaged in a significant number of cash transactions, in particular payment of salaries and commissions;

g. there was a substantial production volume and level of activity at YBM's magnet manufacturing facility in Budapest;

h. end users of YBM's magnets both in Eastern Europe and North America were identified as *bona fide* businesses that utilised magnets in their production; and

i. none of the founding shareholders had been convicted of any crime.

[107] Mitchell describes these as the business operational facts. Some are disclosed in the Final Prospectus along with the existence of the Special Committee and some of the recommendations that were being implemented. However the real issue is whether any of the omitted facts were material and required disclosure.

[108] The materiality of the facts regarding the investigation, unless they are material in and of themselves, must be assessed contextually, i.e., in accordance with the other findings of the Special Committee. Staff contend that the investigation was confirmed by Rossman and Fairfax. It was generally agreed that U.S. law enforcement agencies had placed a priority on uncovering infiltration of organized crime from the Soviet Union into U.S. business. Rossman ultimately received information from the U.S. Attorney in Philadelphia that YBM was under an investigation of an unspecified nature. YBM did not specifically know the specific subject matter of the investigation. Indeed, Rossman did not know what the outcome of the investigation might be. It was unclear whether the US investigation involved issues of national security and/or organized crime. It is clear that no charges had been laid or any search warrants or target letters issued. There was no evidence that any officer or director of YBM was the target or subject of an investigation. There was no evidence that any of its employees were violating any laws. The rumoured involvement of the founding shareholders in organized crime provided a potential reason for the U.S. Government's investigation into YBM. Rossman had provided his views to the Board on August 15, 1996. The final prospectus was receipted on November 20, 1997. No action had been taken by U.S. government law enforcement authorities during this period.

[109] Rossman wrote Bogatin on August 2, 1996 and met with the Board on August 15 and August 29. In an effort to obtain information with respect to the denial of the employee visas (or the investigation), Rossman confirmed to Bogatin in his August 2 letter as follows:

> Peter Hearn was told that the Senator could not meet with us based upon information received from a staff member of the Senate Intelligence Committee…the US attorney returned Peter's call and said he could not meet with us. He confirmed that the Department of Justice was conducting a "highly sensitive" criminal investigation of YBM Magnex and that it would be inappropriate to meet with us…he said he could not discuss the nature of the investigation because it is "especially sensitive"…in view of the fact that for the first time we have a confirmation that YBM Magnex is the target of a federal criminal investigation, we must advise that this information be immediately made known to the board of directors…we have no idea how long this cloud may

> continue to linger over the company. We do know, however, that the situation is serious.

[110] Mike Rotko, an attorney, also advised Godshall (Rossman's partner) that he spoke with the Chief of the Criminal Division at the US Attorney's Office and confirmed that it was a Philadelphia case with undercover work going on. Following the meeting of outside Directors held on August 29, 1996, Wilder's notes of that meeting record Rotko's confirmation of the investigation as being out of Philadelphia. His notes also state "is it official – has been confirmed by individuals formally" and "probably initiated by FBI." The fact that YBM was advised that the U.S. Attorney's Office confirmed a highly sensitive investigation of YBM was in progress is also confirmed in the chronology prepared by Gatti, which he read aloud at the August 15, 1996 meeting.

[111] The respondents generally challenged this information as being multiple hearsay. Despite section 15 of the *Statutory Powers Procedure Act*, R.S.O. 1990, c. S.22 (the "SPPA"), the respondents argue that hearsay, even if admissible, is not reliable and in any event is not clear and convincing evidence because it is too imprecise to be considered a fact within the meaning of subsection 56(1) of the Act.

[112] There was much discussion around whether or not Rossman had indicated that YBM was the target or the subject of a criminal investigation. It is clear that they mean different things. The U.S. Attorney's Manual of the Department of Justice states as follows at section 9-11.151:

> A "target" is a person as to whom the prosecutor or the grand jury has substantial evidence linking him or her to the commission of a crime and who, in the judgment of the prosecutor, is a putative defendant. … A "subject" of an investigation is a person whose conduct is within the scope of the grand jury's investigation.

[113] Rossman conceded that he might have used the word target after speaking with Hearn even though Hearn may not have used it. What may be more significant than YBM being the subject or target of an investigation was the information that Rossman had that led him to use the word target.

[114] McManaway of Fairfax testified that he advised Mitchell in December 1996 that the concerns of the State Department were national security, organized crime or both. McManaway further testified, consistent with the March 21, 1997 Fairfax speaking notes, that he advised Mitchell and others that the FBI was investigating YBM. Fairfax provided little more information regarding the investigation. Fairfax also testified with respect to links between the founding shareholders and organized crime as well as the issue of commingling. A broad-based attack is mounted against McManaway with respect to his credibility for two principal reasons. First, it is argued that McManaway contradicted portions of his deposition given in a U.S. civil proceeding. Second, it is argued that McManaway inappropriately spoke to his own counsel during his cross-examination. We accept that the discussions with counsel were not with respect to his evidence in this proceeding. We do not find that McManaway was inappropriately influenced. Moreover, we see no reason to doubt his explanation for the alleged contradiction in his testimony as between the U.S. civil proceeding and this hearing. His preparation for this hearing was extensive. While he was to be generously paid for his evidence herein, this does not

detract from the reliability of his testimony. Witnesses cannot be expected to not have any inconsistencies nor can they be expected to have perfect recall.

[115] Mitchell confirmed that Fairfax advised him that the investigation concerned national security or organized crime. Mitchell did not regard this as new information and that it independently confirmed Rossman's information. It is clear that Mitchell did not question the reliability of the information provided by Fairfax at that time. Rather than causing his antennae to go up, he treated the facts as nothing new.

[116] Rossman and Fairfax were independently retained to assist YBM and the board in attempting to ascertain the facts with respect to the investigation. Prior to this the U.K. proceedings were ultimately withdrawn in July 1995. It would not be unreasonable to regard these proceedings together with the information contained in the pleadings and correspondence as somewhat ominous.

[117] Earlier on we asked, was YBM the target of an investigation and if so what was the unlawful conduct alleged to be taking place and who was conducting the investigation?

[118] The evidence of Mitchell, Gatti and Peterson is instructive as to whether or not there was a U.S. criminal investigation into YBM. The November 1, 1996 interim report of the Special Committee states that in August 1996, "the management of YBM … were made aware of a pending investigation of the Company and its activities through the U.S. Attorney's Office in Philadelphia." Mitchell stated that he did not view this information as rumour. He was not certain whether it was an investigation of YBM or its shareholders. Mitchell knew it was a sensitive matter which was serious in nature but not the actual subject matter. Gatti had also indicated that he knew there was a highly sensitive investigation involving the company. This was in part due to the FBI Affidavit, which identifies Arbat as a front to transmit large sums of money from Moscow to a Budapest company overseen by one Seva Mogielevich. No explicit reference to YBM was made but Gatti drafted the December 1996 Questionnaire Letter for the founding shareholders. Gatti suggested that this affidavit "most assuredly is the root of their problems." Mitchell testified that Bogatin advised him of the relevant sections of the FBI Affidavit and that it appeared consistent with the information that Fairfax was providing to him.

[119] Peterson acknowledged that while Rossman's letter of August 2, 1996 used different language than that discussed at the August 15, 1996 board meeting, the essence of what was conveyed was the same. He acknowledged that the word criminal was used but not in any particular context. Moreover, Davies testified that he was not shocked by what he heard on August 15, since he had been visited by several FBI agents in Florida in April 1996. The agents possessed a folder with Davies' and YBM's names on it. They advised him that there was an investigation but did not refer specifically to YBM. They solicited his assistance in this investigation but he declined. The information which he heard on August 15, 1996 should have confirmed Davies' view as to materiality rather than simply doing nothing.

[120] The Report notes that Rossman was unable to uncover further particulars about the investigation and that YBM had not been formally contacted by authorities with regard to it. The Report further confirms that U.S. law enforcement agencies had placed a priority on uncovering infiltration of organized crime from the former Soviet Union into U.S. business. Consequently it

was reasonable to expect given YBM's operations in Eastern Europe that they would be examined in connection with such an investigation. While the employee visas were eventually issued there was no suggestion that the investigation was not ongoing. Rossman also testified, consistent with his notes, that Bogatin advised him on March 26, 1997 that YBM was visited by an INS field worker seeking for a three-year period, a list of customers and vendors for YBM and its subsidiaries. Rossman further testified that it did not appear to be a normal immigration investigation. YBM would subsequently learn from its immigration counsel in the fall of 1997 that the INS investigation was a fraud investigation.

[121] Mitchell contends that the facts obtained as a result of the Special Committee investigation were considered in assessing the materiality of the U.S. investigation and militated against a finding of materiality and therefore disclosure. Neither Rossman nor Fairfax could bring any greater specificity to the U.S. investigation than that provided on August 15, 1996. Moreover, the Board was continuing to receive information that YBM was a legitimate business, run by honest managers with legitimate customers. The Directors never learned despite their efforts what was being investigated; what specific law or laws were engaged; how long the investigation had gone on; how long it might continue; what was the likelihood of a charge being laid; or if it would be charged with something the magnitude of which would threaten the very existence of the company? In the period from August 15, 1996 to November 20, 1997, other than the interest shown by the INS, YBM learned nothing more from the U.S. Government with respect to the investigation. Mitchell contends that the fact of the investigation was incapable of the application of the probability/magnitude test. This approach was reinforced by legal advice regarding disclosure.

[122] Staff take a different approach to materiality. It is staff's view that the assessment of materiality with respect to the investigation and the role of further inquiries was to assess whether there were overall serious risks to the company, while the reason for the further investigation by the respondents was to determine the exact nature of the investigation.

[123] It is important to note that Rossman informed YBM of two matters – (a) U.S. law enforcement agencies had placed a priority on uncovering infiltration of organized crime from the former Soviet Union into U.S. business and (b) YBM was the target (subject) of a criminal investigation. Fairfax separately and independently confirmed an FBI investigation into YBM. Neither Rossman nor Stern believed the investigation would be quietly closed although that was always a possibility.

[124] Stern testified that a problem with the company was the antecedent people involved, i.e. the founding shareholders. He was confident that the information that the investigation involved organized crime or national security was from reliable sources. It is uncontradicted that the founding shareholders and others related to them owned at least 40% of the common shares of YBM and that they were shrouded by the spectre of organized crime.

[125] We are of the opinion that there was sufficient confirmation of the aspects of the investigation to assess whether these facts are material within the meaning of the Act. In addition to the Rossman and Fairfax evidence there is: the FBI visit to Davies; the FBI Affidavit; the U.K. proceeding, the information provided to YBM by the State Department that YBM was conducting some illegal activity; Rep. Greenwood's refusal to meet with YBM given the

sensitivity of the State Department information; information from Sean Slack, Rep. Greenwood's aide, that the Senate Select Committee on Intelligence was briefed about the employee visas; and the interest shown by the INS field worker in YBM's customers, which all provide sufficient evidence to conclude that the company had confirmed that a highly sensitive criminal investigation was being conducted by the U.S. law enforcement authorities including the U.S. Department of Justice and FBI involving either national security or organized crime or both.

[126] Staff do not criticize YBM's efforts to ascertain whether or not there was an investigation by U.S. Government authorities. The further efforts provided little comfort however and should have in staff's submission triggered disclosure obligations. In essence the Board and underwriters exercised their judgement but did not do so prudently in the circumstances of the case.

[127] In our view, if the facts regarding the investigation were not material in and of themselves, they were unquestionably material as part of the broader factual context.

The Mandate of the Special Committee

[128] Staff have alleged that there was not full, true and plain disclosure of the mandate of the Special Committee. At the April 25, 1997 Board meeting, Wilder advised that YBM should disclose the existence of the Special Committee. According to the Report, the Special Committee's mandate was to independently investigate possible areas of concern arising out of the company's business operations, determine the basis for any investigation and recommend further action to address any potential problems uncovered. In a letter to Antes, Mitchell noted that the mandate of the Special Committee was to identify any correlation (including share ownership) between YBM (or its subsidiaries) and individuals of criminal background as had been suggested by articles in the European press and allegations in the U.K. court case. Mitchell believed that these areas were the most likely sources of any pending investigation of the company by U.S. authorities. The disclosure of the Special Committee is found in the AIF disclosure reproduced in the Risk Related Disclosure section above.

[129] The Special Committee requested counsel to advise it on its legal obligations with respect to disclosure and any potential legal action. There is no question that the Special Committee and the Board were alive to the issue of disclosure. We find that the disclosure leads the reader to believe that the risk faced by YBM was nothing more than the inherent risk faced by any company doing business in Eastern Europe at that time. This is not accurate. Once it was decided to disclose the existence of the Special Committee, it follows that disclosure of its mandate was also required. In this case, the disclosure was completely inadequate. In our view, if the mandate of the Special Committee was not material in and of itself, it was unquestionably material as part of the broader factual context.

Shareholder Links to Organized Crime

[130] Staff further submit that information supplied by Fairfax and senior management of YBM confirmed that there was ample justification for the criminal investigation because one or more of YBM's founding shareholders, which as a group controlled over 40% of the company's shares, were, according to Fairfax, linked to an Eastern European organized crime group. As

indicated previously, the respondents took the position that the information supplied by Fairfax was riddled with hearsay and multiple hearsay and was not reliable. Mitchell, at the time, accepted Fairfax's information and testified he had no reason to challenge it. National Bank vigorously challenges much of the Fairfax information as rumour. As indicated above, this case is not about organized crime or money laundering. However, we agree that if the quality of the information underpinning the conclusion that there were undesirable ties to YBM is the only basis for a materiality assessment, then we might agree with the respondents. However, that is clearly not the case in these circumstances.

[131] There was no information disclosed in the AIF, the Preliminary Prospectus or the Final Prospectus regarding organized crime. We take no issue with that in and of itself. However, it would appear that staff's allegations with respect to this disclosure is narrower than that argued by the respondents. Staff submit that this evidence suggests there was something percolating beneath the surface.

[132] The founding shareholders in YBM had historically been involved directly or indirectly in the business and affairs of the company. They were involved in various capacities with Magnex RT, Pratecs, United Trade, Arbat and YBM.

[133] Mitchell testified that the contents of the FBI Affidavit, which he was aware of but did not obtain a copy of, were consistent with the information being provided by Fairfax. At the very least this information corroborated some of the information from Fairfax, for example, that Mogilevich had ties to Eastern European crime. While the FBI Affidavit predated the U.K. proceedings, which were withdrawn, its significance did not disappear. For example, YBM had recently been informed of the U.S. investigation.

[134] Mitchell was of the opinion that in 1995, there were doubts about the merits of the allegations in the U.K. proceedings with respect to wrongdoing of any of its shareholders. This may also have been the view of the Alberta Stock Exchange. However, we prefer Rossman's approach to this event:

> In addition, the FBI's allegations are quite similar to those allegations of British law enforcement authorities which were withdrawn when their evidence could not stand the light of day….
>
> So – here we sit representing a company under federal criminal investigation for unspecified charges probably related to activities outlined in the FBI affidavit.

[135] Rossman testified that at his meeting with management, they did not refute that Mogilevich was linked to organized crime. This information could not be discounted despite Sergeant Wanless withdrawing the allegations in the U.K. proceedings.

[136] There remains the Izvestia article. This article is not relied upon as evidence of the founding shareholders' involvement in organized crime. It does refer to Mogilevich and Mikhailov. It was retracted privately but not publicly and not completely. The respondents placed considerable reliance on the retraction.

[137] What is the significance of all this evidence regarding the founding shareholders? In summary, it is relevant to a consideration of whether there was a US criminal investigation into

YBM and that YBM faced serious undisclosed risks. Does this information contribute to deciding whether or not there was a disclosable event? Mitchell's testimony is that he did not attribute much importance to the FBI Affidavit on the basis that the information was similar to that he was receiving from Fairfax and also because it predated the U.K. proceedings, which were withdrawn.

[138] Whether or not all of the sources were believable, much of the information was hearsay and some of the information could not be confirmed, whether or not you could disprove a negative, it was clear that Fairfax's investigation was starting to portray a more coherent picture of what was taking place around YBM. While such things as the divestiture of Arbat appeased the board to some extent, the various events in the past, in our opinion, had not rendered the concern of the U.S. Government simply historical.

[139] Mitchell indicated that he could do nothing about the founding shareholders. His idea was to put "a box around the company", to keep them out of the business. He concluded that YBM was a legitimate business. However, the Special Committee Report discussed several concerns. Rumoured involvement of shareholders in organized crime was noted from a variety of sources. Ties remained between Mogilevich and the founding shareholders. Questionable commission payments were made to Victor Averin who had known Simon Mogilevich since their youth. Fisherman and Mogilevich were friends. Kulachenko, a founding shareholder, operated and may have continued to operate Arbat. As is evident, the Committee noted that a second lingering concern was the continued substantial founding shareholder ownership of YBM. This clearly concerned the Committee on a going forward basis. Mitchell dealt with what he had, i.e., a relatively new Eastern European business with which he is inexperienced. Even if the facts regarding the founding shareholders are not material in and of themselves, they were material as part of the broader factual context. They support the likely basis of the investigation flowing from the Rossman/Fairfax evidence. They support the nature of the risks facing the company presently and specifically. They support greater disclosure, which would have significantly altered the market's perception of YBM's state of affairs.

Commingling of the Founding Shareholders in YBM's Business

[140] There was considerable evidence and argument with respect to commingling. If shareholders were engaged in criminal activities, were those activities being co-mingled with the business of YBM? The allegation around commingling involves Mogilevich, who had signing authority over a bank account through which YBM was transacting business. There was nothing in the AIF, the Preliminary Prospectus or the Final Prospectus with respect to commingling. There were two cash accounts, the Technology Distribution account and a Visa account in the name of Mogilevich. The Technology Distribution account served as United Trade's main operating account for a limited period of time. Gatti testified that United Trade began using this account in the summer of 1995 after the U.K. proceedings. Gatti and Mitchell stated that no unusual transactions went through the Technology Distribution account and any problems related to it had been resolved by closing the accounts prior to the Final Prospectus. Fairfax appeared to agree that the transactions or the cash did appear to belong to United Trade and not Mogilevich. The Mogilevich Visa account was also subsequently closed and no evidence had been found that Mogilevich was using the corporate Visa card. These efforts were part of Mitchell's desire to "box out" the founding shareholders.

[141] The Special Committee Report acknowledges that the same office building was being used to transact activities for all the businesses and Mogilevich in particular was actively involved in activities related to United Trade and Magnex RT, despite not being an officer or employee of either company. Nevertheless YBM moved United Trade's office out of the shared space by the time of the Final Prospectus. As such, despite the somewhat technical nature of the arguments associated with commingling and any inferences therefrom, the respondents deny materiality since the issues associated with them were resolved prior to the filing of the Final Prospectus. Fairfax's concern with Mogilevich's involvement and the use of these accounts was that this could be a sign of money laundering and as such another red flag for YBM.

[142] Staff contend that there was ample justification for concern because Arbat had made commission payments which management could not explain involving hundreds of thousands of dollars to persons with clear ties to Eastern European organized crime. The AIF stated that the "evolving market economies in Eastern Europe are characterised by a high level of cash transactions as well as less rigorous financial controls." This issue roughly corresponds with Mitchell's business operational fact wherein prior to its divestiture by YBM, Arbat had made substantial commission payments to agents that seemed inconsistent with the trade goods business. Mitchell testified that these commissions were paid to agents, whereas staff submit that they were paid to persons with clear ties to Eastern European organized crime.

[143] The Special Committee Report notes that Fairfax found that the commission payments were to Victor Averin and Arnold Tamm in 1993-1995. They had ties to Russian organized crime. The Report further notes that "management have been unable to establish whether these payments might have been some form of 'protection' or whether these individuals were actually active in the Company's business during this period." While the respondents agree the payments were questionable, they viewed them as not significant because Arbat paid the commissions, not YBM, and YBM sold Arbat before the Final Prospectus. Mitchell relies upon the following evidence to establish that Arbat paid the commissions: (1) Bogatin advised Mitchell that certain commission payments were indeed Arbat payments; (2) Rossman appears to confirm that in a memo to Godshall; and (3) Gatti also testified that Bogatin advised him that United Trade paid some commissions for sales that went through Arbat

[144] Staff take the position that it was unreasonable for YBM to conclude that the commission payments were paid by Arbat and consequently that these issues were resolved with the sale of Arbat. We agree for a number of reasons: (1) the payments are recorded in United Trade's ledger; (2) some of the payments post-date the sale of Arbat on April 1, 1996; and (3) Fisherman remained in charge of YBM's Eastern European operations after the sale. Staff also suggest that the Arbat sale was not at arm's length. The Special Committee Report states that Arbat was sold to a company formed by the founding shareholders and was under the operating control of one of them.

[145] It is clear that the divestiture of Arbat did not resolve all the problems associated with inappropriate commission payments. It is difficult to rationalise why there were commission payments from Arbat to Averin in the United Trade ledger after the divestiture of Arbat. Either the commission payments were actually from United Trade to Averin, or the divestiture of Arbat was not at arm's length. The AIF states that Arbat was divested due to concerns regarding

Eastern European companies. This is incorrect. Arbat was divested due to company-specific concerns not general ones surrounding companies in this region.

[146] Furthermore, the existence of a set of parallel records showing substantial payments to Averin on one set and the exact same payments to a corporate entity with a different name on another concerned both Mitchell and Gatti. It would appear that the general ledger of the company had been altered and Mitchell agreed that he never received a satisfactory explanation as to why and how it had been altered. He thought the commission payments were serious. Basically there was no satisfactory explanation for the parallel records. The argument of the respondents and in particular Mitchell was that it was not material as it was historical, having ended with the divestiture of Arbat. For the reasons indicated above, this explanation is insufficient as an answer to the concerns raised by these payments and records.

[147] We question YBM's conclusion that the commingling issues were not material as they were merely historical, and we question whether they were sufficiently historical. The shared office space and bank account issues were addressed in the months leading up to the offering. Arbat had been sold just over a year before the Preliminary Prospectus was filed. Taken together with the other facts and information of which YBM was aware, in our view, these events were still sufficiently recent such that they could reasonably be expected to have a significant impact on YBM's market price.

Equipment

[148] Staff submit that YBM faced further risks as indicated by false records of the Original Equipment Transaction (the equipment being purchased from the founding shareholders). Generally the respondents submit that any concerns regarding the false records or the value of the equipment were adequately addressed by independent valuations of the equipment. There were three valuations of the equipment – Coopers & Lybrand, Real Partners and Dr. Keverian as part of the D&T audit. Mitchell in particular noted that the valuations supported the value of the founding equipment recorded on YBM's books. While Mitchell admitted that the falsification of the equipment records always concerned him, in that they were created after the fact, his attitude with respect to them was somewhat fatalistic, i.e. "it concerned me…to this day, but it was what it was." Mitchell never received a satisfactory explanation regarding the false records. In the context of the other facts, the equipment-related facts were material. They further revealed that YBM was exposed to risks that would reasonably be expected to have a significant effect on the value of YBM's securities if disclosed.

Customers and End Users

[149] The respondents attempted to verify customers and end users on three separate occasions. Staff submit that the Special Committee's measures to address these concerns were inadequate. Moreover, Bogatin took over the process with respect to customers since Gatti was focused on the Crucible acquisition. It is not clear whether Bogatin had some role in the creation of the false Fisherman List but it is clear that Fisherman did. Fairfax had received the 16-page list, did not know it was false, confirmed the existence of at least 51 of the companies on the list and made actual telephone calls to these customers. It is submitted that Fairfax confirmed the existence of U.S. end users through electronic searches which were adequate. Stern confirmed that YBM's

North American end users were real companies. However, we believe there was a misunderstanding between Fairfax and Mitchell as indicated by Fairfax's mark-up of "? % looked @" on the draft of the Special Committee Report provided to them. They were real companies, i.e. incorporated companies but not necessarily real customers or end users of magnets. The Special Committee was concerned about confirming the existence of a customer called Diamond in Israel based upon Fairfax's work. D&T later reclassified most of YBM's U.S. sales from the U.S. to Eastern Europe. Staff submit this should have alerted the Special Committee to another risk. In addition, Fairfax had recommended a complete investigation of customers including knocking on doors and checking all invoices. This work was not pursued.

[150] First Marathon and later GMP retained Price Waterhouse on May 22, 1997 to assist with its due diligence. Price Waterhouse had reviewed Parente's working papers and reported that Parente was unable to find two U.S.-based customers. However, Price Waterhouse seemed satisfied with Eastern European customers. Jones of First Marathon called customers, which he acknowledged would not be proof of very much if a fraud was being perpetrated and Price Waterhouse visited another company, TooFsh, in Russia. Finally, First Marathon contacted Diamond's office in Israel wherein Diamond advised they were an end user of neodymium magnets, purchasing approximately $250,000 annually. Diamond was allegedly a top-five customer and later D&T reclassified sales to the Middle East as 0 during the 1996 re-audit. Moreover, Diamond was nowhere to be found in the YBM's list of 19 major customers supplied to staff and D&T. This suggested an inconsistency that is hard to miss.

[151] Customers and end users became the preoccupation of staff in June of 1997. This led to Staff's request for a re-audit of YBM's 1996 financial statements. The D&T audit was significant from a number of perspectives. YBM took the position that in many cases it had no knowledge of the actual end user. Staff's key concerns were the identity of customers, the tracing of sales and the specific identity of cash receipts to ensure that the revenue was properly recorded. No receipt would issue without further audit work. A full audit was conducted and a clean audit opinion rendered on October 13, 1997. With respect to sales, a key result was the reclassification of geographic sales. YBM did release a press release on October 22, 1997 with respect to the reclassification to reflect the ultimate end user of the company's products. These changes resulted in sales to North America being reduced from 13.6 million to 1.8 million; sales to the Middle East being reduced from 3.3 million to 0; and sales to Russia being increased from 21.8 million to 50.2 million. Of course, in this matter, Fisherman reappeared and provided the information as the basis for the reclassification. Fisherman indicated to D&T that sales recorded as being made to distributors in the United States did not necessarily mean in this instance goods being shipped to the United States. However, it was through Fisherman's insistence that the reclassification of the geographic segmentation resulted. Fisherman did not testify and did not defend the allegations in any manner whatsoever. D&T was completely unaware of the false customer list which he prepared.

[152] Despite unanswered questions raised by the reclassification, it would appear that the respondents were satisfied and took great comfort in the D&T audit.

[153] In the context of the other facts, the customer and end user facts were material. They further revealed that YBM was exposed to risks that would reasonably be expected to have a significant effect on the value of YBM's securities if disclosed.

Conclusion

[154] In our opinion, YBM's prospectus did not contain full, true, and plain disclosure of all material facts by failing to disclose that YBM was subject to unique risks. When each alleged omission is analysed in isolation, a technical argument can be made that some of them may not be material. We do not believe that is the appropriate approach to this case. The factual context cannot be ignored.

[155] In our view, when the omissions which are material on their own and the omissions which in isolation may not appear to be material are considered together, the evidence indicates that YBM was subject to a set of risks specific to itself. These risks were not disclosed. The AIF told the investing public that the mandate, information obtained by and findings of the Special Committee were connected to only general concerns expressed in the media and by government authorities that related to all companies doing business in Eastern Europe.

[156] No doubt, the facts and information unearthed by the Special Committee presented YBM with very difficult disclosure decisions. Having chosen to proceed with a public offering, which required full, true and plain disclosure of all material facts, the obscure disclosure contained in the AIF was unsatisfactory. It did not provide investors with the opportunity to adequately inform themselves regarding the specific risks facing YBM.

[157] At a minimum, we believe some disclosure regarding what YBM knew about the U.S. investigation and less muddled disclosure regarding the purpose of the Special Committee would have better informed investors about the risks facing YBM. To this end, Gatti produced draft disclosure for the AIF that was headed in the right direction, as it disclosed that YBM was aware of an unofficial inquiry by the U.S. Government into YBM's operations and that this led to the creation of the Special Committee. The following disclosure was contained in a draft response letter to staff's comment regarding YBM's operational review. In our view, the disclosure would have made the AIF less obscure. Unfortunately, the items which we have noted in bold were deleted in the final version of the response letter sent to staff:

> Circumstances Surrounding the Review of the Company's Operations
>
> Over the past year, the Company has had some difficulty in being issued certain business visas for some of its employees. As a result, the Company decided to investigate this further in order to try to gain a resolution to this problem. The Company's efforts confirmed that U.S. law enforcement agencies had placed a priority on uncovering infiltration of organized crime from the former Soviet Union into U.S. businesses. Given the roots of the Company and its affiliates in Russia, and the involvement of former Russian nationals as shareholders and managers of the Company, it was considered to be a reasonable expectation that the Company may have been examined as part of any such investigation. **Subsequent off-the-record discussions with the U.S. Attorney's Office confirmed that the Company had been examined as part of the investigation. However, the Company has never been formally contacted by authorities with regard to any investigation**, and the visas which prompted the concerns were subsequently issued by the U.S. Government without comment…

In addition, concerns were raised in media reports regarding companies doing business in Eastern Europe

As a result, the Board formed a special committee to independently investigate possible areas of concern arising from the Company's business operations, and recommended further action in order to address any problems or potential problems which are uncovered as a result of the investigation.

Special Committee Recommendations

The special Committee made the following recommendations which have been or are being implemented by the Company's management:

- **Elimination of commingling of business activity with that of its founding shareholders in Eastern Europe;**

- **Establish operational controls to ensure that management remains operationally independent from its founding shareholders;**

- Establishment of improved cash controls at the Company's Hungarian facilities;

- The establishment of more detailed customer and agent approval criteria;

- The establishment of an accurate data base on these customers and agents;

- Consolidation of accounting control at the Company's Newtown, Pennylvania, head office …

[158] In our opinion there can be no doubt that disclosure of the factual deficiencies alleged by staff would have reasonably been expected to significantly impact the market price or value of YBM's securities.

[159] A good indicator of the materiality of the deficiencies in this case is the conduct of the underwriters. One of Mitchell's first instincts as Special Committee Chair and YBM's underwriter was to disclose the Special Committee information to the other underwriters beginning with his employer, First Marathon. Moreover when Lawrence Bloomberg at First Marathon read the April 11 draft of the Report, he told Mitchell that the initial approval given by the Investment Banking Steering Committee was no longer valid.

[160] When Jones at First Marathon was made aware of the Special Committee information, he proceeded to conduct additional due diligence on behalf of First Marathon in response to the concerns raised by the information. His instinct was also that they should personally brief Jeff Orr of Nesbitt Burns as a professional courtesy before he decided whether Nesbitt should become a member of the underwriting syndicate. Nesbitt Burns did not participate and Mitchell believed it was because of the information imparted at this briefing. It was acknowledged that Nesbitt Burns had been involved in Bre-X and as such their risk profile was certainly different than the others.

[161] When McBurney eventually got the report from staff in 1999, he reacted with hostility to Mitchell for not having provided him a copy of it earlier. Counsel to the underwriters, Litwack,

testified that the concerns expressed by the Special Committee in the April 11 draft were material concerns.

[162] In addition to the conduct of the underwriters, we believe there is other evidence of the materiality of the Special Committee information. As noted, management's December 1996 questionnaire to the founding shareholders advising them of the FBI Affidavit indicated that disclosure could result in YBM's stock being worthless in a short period of time. Gatti also testified that Mitchell was angry at a meeting on or about December 21, 1996 upon discovering that the questionnaire was sent to the founding shareholders. Gatti recalled there was some concern over whether "these people would start selling their stock or something." Mitchell does not recall attending this meeting. We see no reason not to accept Gatti's evidence in this regard.

[163] In conclusion, the respondents failed to make full, true and plain disclosure of all material facts contrary to the Act.

THE AVAILABILITY OF A DEFENCE FOR DIRECTORS, OFFICERS AND UNDERWRITERS

[164] We have found a breach of subsections 54(1), 56(1), 58(1) and 59(1) of the Act. Staff submit that because each respondent had knowledge of material facts which were not disclosed, only a limited due diligence defence is available to them; *Escott v. BarChris Construction Corp.*, 283 F.Supp. 643 at 684 (S.D.N.Y. 1968) (*Escott*). Staff qualify this position as follows. If a respondent has knowledge of facts, but is mistakenly of the view that they are not material, i.e., if he or she was diligent in ascertaining their materiality but was nevertheless honestly and reasonably mistaken in this respect, the due diligence defence is available. However, Staff further assert that the application of the due diligence defence to materiality is quite remote; *Fingold* at para. 82. Staff's final argument did not specifically analyze the evidence as it relates to each individual respondent except GMP. As such, staff reviewed the facts sequentially and did not analyze their individual due diligence defences except to a limited extent in reply.

[165] Due diligence procedures "are intended to ascertain risk factors and to ferret out in advance and deal with potential problems, and to cause appropriate disclosure in this and other material respects to be made"; George R.D. Goulet, *Public Share Offerings and Stock Exchange Listings in Canada: Going Public, Staying Public, Getting Listed, Staying Listed* (Toronto: CCH Canadian, 1994) at 231.

[166] The approach to a due diligence defence has varied to some extent. In *Re Cartaway Resources Corp.* (2000), 9 A.S.C.S. 3092 (*Cartaway*), the Alberta Securities Commission considered prudence and due diligence but only in the context of whether an order in the public interest was warranted. This is identified as a regulatory test. In *Re Banco Resources Ltd.*, [1987] 51 B.C.S.C.W.S. 1, a prospectus disclosure case, the British Columbia Securities Commission adopted a due diligence defence in a public interest hearing. In *Gordon Capital Corp. v. Ontario Securities Commission* (1991), 1 Admin. L.R. (2d) 199 (Ont. Div. Ct.) (*Gordon Capital*), which was not a prospectus disclosure case, the court held that a due diligence defence was not automatically available to a registrant in a hearing under R.S.O. 1980, c. 466, subs. 26(1). That subsection became subsection 27(1) in R.S.O. 1990, was repealed under the

Financial Services Statute Law Reform Amendment Act, 1994, and was taken up in paragraph 1 of subsection 127(1) of the Act; S.O. 1994, c. 11, ss. 360, 375.

[167] In *Gordon Capital*, the issue involved the suspension or imposition of terms upon the registration of a registrant "where in [the Commission's] opinion such action is in the public interest." The court characterized proceedings under subsection 26(1) as regulatory, protective or corrective and not quasi-criminal or punitive in nature. In deciding that these types of proceedings do not automatically provide for a due diligence defence for a registrant, the court stated:

> The fact that Gordon may have acted without malevolent motive and inadvertently is not determinative of the right of the OSC to exercise its regulatory and discretionary powers to impose a sanction upon Gordon.

[168] In this case we are dealing with the conduct of an issuer, various directors and officers of the issuer and two registered investment dealers. Public interest hearings lend themselves to a number of different approaches. Regardless of which approach is taken, we recognize that the Commission maintains the discretion to impose a sanction on the respondents under section 127 of the Act.

[169] YBM's rapid growth was out-pacing its systems and controls. Business practices in its major manufacturing and sales markets differed from North American ones due, in part, to the early development of Eastern European economies. Moreover, its management was separated. It was a company nominally in Canada, with a minimal head office in Pennsylvania, and its operations and sales were primarily in Eastern Europe.

[170] Before any disclosure documents were drafted, Parente spelled out the deficiencies in YBM's financial control systems and reporting. The Special Committee Report detailed serious lapses in supervision, record keeping and decisions in Europe. The recommendations in the Report were fundamental and revealed an operation with a somewhat shaky foundation.

[171] The respondents were aware of these risks. There was also a very strong awareness, flowing from the Report, that disclosure of the information would be detrimental. It could adversely impact the Crucible acquisition. As such, this case boils down to the incentives to disclose or not disclose bad news.

[172] In *Escott*, there was little doubt that the false and misleading information was material. The case turned on the various defendants' due diligence defences. *Fingold* was an insider trading case in which the court found a reasonable mistake of fact in relation to materiality. In that case, there was little need to investigate the facts. The only defence was an honest and mistaken belief in the materiality of the known facts.

[173] We find staff's approach limiting. It is not desirable, in this case, to limit the application of a due diligence defence in the manner proposed by staff, as their approach approximates absolute liability for directors, officers and underwriters. Moreover, these are not criminal provisions and often involve difficult questions of judgement. Knowledge of the information may make it more difficult to establish a reasonable investigation or reasonable grounds, but that

is a matter of evidence. Moreover, knowledge of facts, even material facts, is different from believing that a prospectus fails to contain full, true and plain disclosure.

[174] As indicated previously, this is an extraordinary case. Our review of the case law suggests that in past cases, either the material facts were known and ignored or they were capable of being ascertained and were not. This is not this case here. There were considerable efforts undertaken by the Board and underwriters to investigate the facts, ascertain their materiality and decide what constituted full, true and plain disclosure of these facts.

[175] Normally, if an issuer breaches the Act, an order in the public interest is warranted. No one argued that a defence should be available to YBM. An order in the public interest may not be justified against a director, officer or underwriter if the investigation and belief were reasonable. In some cases, the investigation or belief may have been unreasonable but the facts will not otherwise call for an order in the public interest. In other cases, an order may be justified on the facts even if the investigation and belief were reasonable, because such considerations are not determinative of the public interest question; *Cartaway* and *Gordon Capital*. We are confident about this approach because the maintenance of high standards of fitness and business conduct is intended to ensure honest and responsible conduct by market participants; para. 2.1(2)(iii) of the Act.

[176] We recognize that in fostering high standards of fitness and business conduct we must not overly constrain the ability of the officers and directors to make rational business decisions and take measured risks. Risk taking is in the spirit of commercial activity and in the hope of greater economic reward. Risk taking is accommodated, not hampered, by care and diligence.

The Prudent Person as the Measurement of Reasonableness

[177] The corporate statutes require every director and officer of a corporation in exercising his or her duties to exercise them with the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances; *Business Corporations Act*, S.A. 1981, c. B-15, s. 117(1) [now R.S.A. 2000, c. B-9, s. 122(1)]; *Business Corporations Act*, R.S.O. 1990, c. B.16, s. 134(1); *Soper v. Canada*, [1998] 1 F.C. 124 (C.A.) (*Soper*); and generally C. Hansell, *Directors and Officers in Canada: Law and Practice* (Toronto: Carswell, 1999), c. 9. Section 132 of the Act, which applies to civil liability, notes that in determining what constitutes reasonable investigation or reasonable grounds for belief for the purposes of sections 130 and 131, "the standard of reasonableness shall be that required of a prudent person in the circumstances of the particular case."

[178] This case is not a civil action but rather a section 127 hearing. Public interest proceedings under section 127 prescribe no specific standard of due diligence or reasonable investigation. In *Soper* at para. 34, Robertson J. defined diligence as follows: "Upon reflection, it seems arguable to me that the term 'diligence' is synonymous with the term 'care'. That is, diligence is simply the degree of attention or care expected of a person in a given situation." However, this means that the determination of due diligence should differ depending on one's function; Goulet at 236.

[179] We think it best to consider the reasonableness of the respondents' diligence and their belief from the perspective of a prudent person in the circumstances. This necessarily entails both objective and subjective considerations including their degree of participation, access to the information and skill.

[180] A few additional points are worth noting about reasonableness in this regard.

Directors and Officers

[181] The standard of care for directors and officers is not a professional standard nor is it the negligence standard; *Soper* at para. 41. Each director and officer owes a duty to take reasonable care in the performance of the office and in some circumstances that duty will require a director or officer to take action. That action may in some circumstances even call for a resignation.

[182] Directors are not obliged to give continuous attention to the company's affairs; *Soper* at para. 26. However, their duties are awakened when information and events that require further investigation become known to them. The standard of care encourages responsibility not passivity; *Soper* at para. 26.

[183] Directors act collectively as a board in the supervision of a company. Directors, however, are not a homogenous group. Their conduct is not to be governed by a single objective standard but rather one that embraces elements of personal knowledge and background, as well as board processes. More may be expected of persons with superior qualifications, such as experienced businesspersons. As such, not all directors stand in the same position. *Soper* at para. 40.

[184] In addition, more may be expected of inside directors than outside directors; *Soper* at para. 44. Similarly, a CFO who is on the board may be held to a higher standard than one who is not, particularly if he or she is involved in the public offering.

[185] When dealing with legal matters, more may be expected of a director who is a lawyer. A lawyer-director may be in a better position to assess the materiality of certain facts. Due to improved access to information, more may sometimes be expected of directors depending on the function they are performing, for example those who sit on board committees, such as a special committee or audit committee. An outside director who takes on committee duties may be treated like an inside director with respect to matters that are covered by the committee's work; Victor P. Alboini, *Securities Law and Practice*, loose-leaf (Toronto: Carswell, 1984) at s. 23.4.1.

[186] Directors may rely on the members of a special committee if the committee is comprised of disinterested directors in a position to base their decisions on the merits of the issue free of extraneous considerations and influences so that the committee's integrity and processes are beyond challenge; Stephen H. Halperin & Robert A. Vaux, "The Role of the Target's Directors in Unsolicited Control Transactions" in *Critical Issues in Mergers and Acquisitions: Domestic and International Views* (Kingston: Queen's Annual Business Law Symposium, 1999) 109 at 120. In the absence of grounds for suspicion, it is not improper for a director to rely on management to honestly perform their duties; *Re Standard Trustco Ltd.* (1992), 15 O.S.C.B. 4322 at 4364-4365 (*Standard Trustco*). Directors are entitled to rely on professional outside

advisers, including legal counsel and underwriters; *Standard Trustco* at 4364-4365. Reliance would be unreasonable if the director was aware of facts or circumstances of such character that a prudent person would not rely on the professional advice.

Underwriters

[187] An issuer's certificate under subsection 58(1) of the Act must be signed by the CEO, CFO and any other two directors. It must certify that the prospectus contains full, true and plain disclosure of all material facts. The underwriter's certificate under subsection 59(1) of the Act must certify that the prospectus constitutes full, true and plain disclosure of all material facts, but only "to the best of our knowledge, information and belief". In general terms, the certificates are different due to the underwriter's access to information. Directors and officers are generally in a better position to obtain information and data that may be unavailable to the underwriter.

[188] The phrase "to the best of our knowledge, information and belief" carries with it a requirement to obtain information before an underwriter can make that affirmation; *Re A.E. Ames & Co. Ltd.*, [1972] O.S.C.B. 98 at 112 (*Ames*). Although that phrase acknowledges that an underwriter may not have the same access to corporate information that the officers and directors have, the underwriter is a gatekeeper of the public interest with professional expertise in the capital markets; Goulet at 238. An underwriter must go beyond the statements of the issuer's directors, officers and counsel and must avoid automatic reliance. In *Ames*, the Commission noted at 112:

> The underwriter stands between the issuer and the public as an independent, expert party in bringing new securities to the market. In a sense the underwriter and the issuer are joint-venturers, but in another and more important sense they must be adversaries. That is the underwriter must seek out and question all relevant and material facts concerning the issuer and reasonably ensure himself that these facts are fully and truly set before the investing public.

[189] While underwriters may be at an informational disadvantage, the essence of their role was captured in a poignant paragraph in *Feit v. Leasco Data Processing Equipment Corp.*, 332 F.Supp. 544 at 582 (E.D.N.Y. 1971), where Weinstein J. stated:

> [The duty of dealer-managers] to investigate should be considered in light of their more limited access. Nevertheless they are expected to exercise a high degree of care in investigation and independent verification of the company's representations … the underwriters must play devil's advocate.

[190] In this regard, an underwriter must challenge the disclosure the issuer proposes to make to the investing public. Otherwise, the underwriter cannot be said to have met the standard to the best of its knowledge, information and belief.

[191] Lead underwriters must be adversarial and more so in some circumstances. Reliance on counsel cannot be an excuse for failing to make an adequate examination of the facts. While legal advice will be a factor that affects an underwriter's belief that there were no omissions of material facts, if counsel did not make an adequate examination, the underwriter must bear the consequences; *Escott* at 697.

WHAT DID YBM'S DIRECTORS AND OFFICERS DO TO ENSURE FULL, TRUE AND PLAIN DISCLOSURE?

[192] Staff allege that YBM's directors and officers authorized, permitted, or acquiesced in YBM's failure to make full, true and plain disclosure. The board of directors of a company is ultimately responsible for making prospectus disclosure.

[193] Actions initiated by the Directors upon being advised about the visa problems and the U.S. investigation in August 1996 can be summarized as follows:

1. The YBM directors struck the Special Committee.

2. The Special Committee, principally through Mitchell, conducted a preliminary investigation.

3. Mitchell prepared the interim report of the Special Committee, which he delivered to a meeting of the Directors on November 1, 1996 and in which he recommended hiring professional investigators.

4. The Special Committee hired Fairfax and authorized it to travel to Hungary to review YBM's operations.

5. Mitchell received Fairfax's oral report on its findings in Hungary on February 6, 1997, and authorized it to proceed with further investigations, including investigations of customers.

6. Mitchell reported on the status of Fairfax's investigation at a meeting of the Directors on February 19, 1997.

7. Mitchell, Antes and Schmidt received a further oral report from Fairfax on March 21, 1997 in which concerns were raised about, among other things, the legitimacy of some of YBM's customers.

8. Mitchell, Antes and Schmidt invited Fairfax to repeat its March 21 report on the following day to YBM's management, at which time Mitchell made it clear to management that they must satisfy Fairfax as to the legitimacy of YBM's customers.

9. Mitchell received Fairfax's confirmation of the satisfactory results of its searches of YBM's customers and proceeded to prepare the Special Committee Report with input from Fairfax.

10. Mitchell delivered the Special Committee Report to the Board on April 25, 1997.

[194] The Directors submit that the above steps constituted both an investigation into the facts and an assessment of materiality for disclosure purposes. While they were aware of an investigation by the U.S. Attorney, the Special Committee was unable to verify sufficient particulars for disclosure. Similarly, they were aware of rumours regarding the founding shareholders, but the Special Committee could find no evidence that the founding shareholders were presently exerting undue influence over YBM. The Directors submit that the above investigation, in conjunction with their reliance upon legal advice and the D&T re-audit of the 1996 financial statements, establishes that their belief regarding materiality and disclosure was reasonable.

The Special Committee

[195] The Directors responded to the information provided by Rossman and management regarding the U.S. investigation on August 15, 1996 by creating the Special Committee. U.S. and Canadian counsel advised the Board that disclosure was not required. The directors also authorized management to continue discussions to acquire Crucible.

[196] Contrary to Rossman's advice, the Special Committee did not retain independent counsel but turned to company counsel, Wilder. Schmidt did some early work for the Committee and Davies had no involvement whatsoever. Basically, the Special Committee was Mitchell with Wilder in aid.

[197] The Committee was independent of management, but was not without a manifest conflict of interest. Mitchell chaired the Special Committee and was very active as YBM's co-lead underwriter. The Special Committee was not created as a disclosure committee, but shortly after its formation the board discussed the possibility of the Crucible acquisition. Mitchell wanted to complete the investigation before the financing. As a result, the Directors relied on the work of the Special Committee as the basis for their conclusion regarding both materiality and disclosure. Mitchell had divided loyalties. The degree of care required to secure full, true and plain disclosure leaves little room for risk.

Initial Work of the Special Committee

[198] Following Rossman's advice, the Special Committee focused on YBM itself and on any areas which might cause the U.S. investigation. An inherent shortcoming of the Special Committee was that even after its investigation, YBM still did not know if the information obtained was at the root of the U.S. investigation. The initial work of the Special Committee is described above, and demonstrates a willingness to make inquiries and obtain further information.

[199] Gatti advised Mitchell of the parallel records and, in particular, concerns regarding payments to Averin. Mitchell became aware of potential links between Averin and organized crime through the FBI Affidavit and information provided by Fairfax. As indicated earlier, we do not find that the divestiture of Arbat resolved the issues associated with commission payments. Mitchell acknowledged that he never received a satisfactory explanation for the existence of the parallel records. His explanation that they were historical is more consistent with passivity than diligence.

Retention of Fairfax

[200] The Special Committee retained Fairfax to assist with its investigation. All of Fairfax's investigation was to be co-ordinated through Mitchell.

[201] While Fairfax received much information from YBM it did not initially receive: (i) the interim report of the Special Committee dated November 1, 1996; (ii) the Arigon/United Trade sales commission schedules delivered by Gatti to Mitchell in October, 1996; (iii) the FBI Affidavit; and (iv) Bogatin's letter to the founding shareholders, enclosing the questionnaire.

[202] During the course of Fairfax's investigation, Mitchell became aware of the FBI Affidavit on or around January 1997. It required serious attention. Mitchell had no explanation for why he did not request a copy or why he never asked if Fairfax had a copy. The Special Committee Report does not even refer to it and only Davies, Mitchell, Bogatin and Gatti were aware of it.

[203] During the course of Fairfax's retainer, Mitchell approved the expansion of its inquiry as more information became available. A summary of some of the work conducted by Fairfax is found above. Fairfax found a business that manufactured magnets and found no illegal activity or evidence of money laundering. However, Fairfax concluded that the indicia of money laundering existed and expressed serious concern regarding YBM's customers. Mitchell permitted McManaway to brief the U.S. State Department on the information Fairfax was discovering about YBM.

[204] Mitchell updated the Board regarding the Special Committee's investigation at the February 19, 1997 board meeting. They discussed disclosure to the underwriters due to the Crucible deal. Mitchell was actively involved in the discussions with Crucible. In early March, he advised Fairfax that the Crucible acquisition could not proceed unless Fairfax provided favourable customer information.

[205] The most significant briefing by Fairfax occurred on March 21, 1997 in Toronto at First Marathon. Mitchell, Wilder, Antes and Schmidt were present. Fairfax's key findings and recommendations of further work are described above. Fairfax did not complete its recommended work. According to Fairfax, during the course of the meeting, a copy of their speaking notes was not requested, no one asked a substantive question and there was no request that the report be shared with third parties. Fairfax found no evidence of illegal activity but reported that there were indicia of money laundering.

[206] The directors who attended the March 21, 1997 briefing were comfortable that several of the issues Fairfax raised were already resolved. For instance: Arbat had been sold; they were already in possession of a valuation of the equipment purchased by the founding shareholders for 1/10 the value it was sold to YBM; and management was dealing with the bank account and shared office space commingling issues.

[207] Mitchell continued to have concerns regarding customers based upon the information that Fairfax provided. This was noted at the Fairfax briefing with management the following day. In attendance were Mitchell, Antes, Bogatin, Gatti and Rossman. Mitchell advised that the Crucible acquisition would not proceed unless management satisfied Fairfax as to the legitimacy of YBM's customers. Consequently, customer confirmation was critical.

[208] Fairfax recommended a complete investigation of customers (knocking on doors and checking all invoices) – a significant undertaking. However, Bogatin became involved, which resulted in Fairfax conducting only electronic searches.

[209] On April 13, 1997, the final meeting between Fairfax and YBM occurred. YBM was represented by Bogatin, Gatti, Mitchell and Antes. There are disputed accounts regarding what Fairfax reported to Mitchell between March 22 and April 13.

[210] Mitchell testified that Fairfax verified customers and end users of magnets. He relies largely upon Stern's failure to significantly mark up the draft of the Special Committee Report which he was provided. Mitchell appeared unaware that Fairfax only conducted electronic searches. Our examination of the evidence suggests that Fairfax continued to express concerns regarding YBM's customers throughout this period. This is consistent with Fairfax's recommendations as recorded in its speaking notes from the March 21 briefing as well as Larkin's notes from the April 13 meeting. It appears that the flow of information between Mitchell and Fairfax was also unsatisfactory and created the opportunity for misunderstanding.

[211] Rossman was not contacted again by the Special Committee after March 22, 1997. Moreover, Rossman was concerned that the March 26 visit to YBM by an INS field worker did not appear to be a normal immigration investigation given the request for YBM customer lists. As such, one month before YBM would contemplate disclosure for the offering, the U.S. Government continued to express specific interest in YBM.

[212] However, the Special Committee Report states, "Discussions with counsel have concluded that it is unlikely that any purpose would be served by approaching the FBI or the U.S. Attorney's Office with our conclusions and that it is unlikely that we would know if and when any investigation had been concluded". The Report further appears to overstate the INS's satisfaction with the business of YBM given the circumstances. The Special Committee's conclusion may not have been unreasonable in and of itself but is more consistent with a desire to get on with the transaction than further investigation.

The Special Committee Report

[213] Mitchell prepared the first draft of the Special Committee Report (dated April 2, 1997) from memory and without notes. Wilder commented on it as well as Fairfax. Stern's view was that Mitchell had understated Fairfax's concerns about the founding shareholders. Mitchell did a revision but Fairfax did not see the final draft. Mitchell read the Report verbatim at the critical April 25, 1997 board meeting. Neither Fairfax nor Rossman were invited to attend. A summary of the Report is found above. The minutes of this meeting are, to say the least, sketchy and uninformative. It was a poorly documented process.

[214] Mitchell expanded on the content contained in the Report to some extent. He discussed the connection of other founding shareholders to organized crime in addition to Mogilevich. Notes from this meeting suggest that YBM's segmented information was correct, that Fairfax was satisfied with YBM's U.S. customers and that an active investigation was confirmed by Fairfax. Gatti testified that Greenwald wanted to know the bottom line, to which Mitchell responded that Fairfax "was satisfied."

[215] Copies of the Report were not distributed based upon the previous advice of U.S. counsel citing concerns over libel and slander. As a result, Peterson did not ask for a copy and he understood that Fairfax signed off on the report. This is not entirely accurate as Fairfax provided initial comments, but did not see a subsequent draft of the Report.

[216] Despite the extent of the concerns expressed in the Report, the board continued to press ahead with the Crucible deal. The board did not believe that management was involved in any

illegal activity or that the founding shareholders were actively involved in the business. A noted benefit of the Crucible acquisition was that operational control would be steadily centralized at the head office and reliance on Eastern European activities would be diluted. We cannot say that the Board was oblivious to the concerns, but can it be said that it acted prudently in the face of those matters?

The Crucible Acquisition and Proposed Financing

[217] Despite not having completed the Special Committee's investigation, Mitchell wrote to Bogatin outlining certain matters regarding a proposed special warrant offering. Bogatin required the letter for the Crucible negotiations. Mitchell described First Marathon as "lead underwriter". Mitchell did not intend to proceed with this transaction until the issues raised in the Special Committee's investigation could be dealt with to the satisfaction of the underwriters. Nevertheless, on April 3, 1997, YBM announced it had agreed to purchase the magnetics division of Crucible Materials Corporation located in Kentucky.

[218] Mitchell met with Bloomberg on April 11 to discuss the underwriting, and gave him a copy of the draft Report. As such, First Marathon was given the Report before YBM's Directors.

The AIF Disclosure

[219] Disclosure was extensively discussed at the April 25, 1997 board meeting. There is no question that the board placed considerable reliance on Wilder's legal advice. Peterson testified, "We had turned it over to our lawyers to capture our intentions in words and they did that." Gatti testified that the process was not so much one of people working together as "people were funnelling information to our securities counsel." Mitchell testified that "counsel drove the bus on the AIF."

[220] Gatti provided his version of the AIF and testified that Wilder and Mitchell determined that it was inappropriate. Gatti's draft AIF flagged the recent INS inquiry into foreign nationals working at the company's headquarters in Newtown.

[221] Mitchell testified that subject to some minor editorial comments, he approved the following draft that Wilder prepared. He did not review any subsequent drafts prior to the filing of the AIF. The final disclosure in the AIF changed substantially from this draft.

> As a result of difficulties experienced by the Company in obtaining U.S. business visas for certain of its foreign employees, the board of directors constituted a Special Committee thereof consisting of Owen Mitchell, Michael Schmidt and Ken Davies, each of whom is independent of management. The mandate of the Committee was to:
>
> (i) independently investigate all possible areas of regulatory concern arising out of the Company's business operations, in particular, business operations in Eastern Europe; and

(ii) recommended further actions in order to improve, where necessary, the Company's internal financial controls.

The Committee retained independent experts to assist it in its investigations and examine the business and activities of the Company with a particular emphasis on its Eastern European operations. Each of the concerns raised by the Committee that were within the control of the Company, have been or are being, addressed by management including increased internal financial controls at Magnex RT. The business visas which precipitated the Company's original review were ultimately issued by the United States immigration authorities after an examination by such authorities of the Company's U.S. business operations which concluded without comment. On a go forward basis, the board has established the sub-committee of the Audit Committee to monitor ongoing compliance by the Company with the Committee's recommendations and to advise management with respect to any additional operational areas of concern.

[222] Gatti testified that Bogatin participated in the draft which formed the basis for the Special Committee disclosure contained in the AIF. The AIF disclosure is reproduced in the Risk Related Disclosure section above.

[223] Jones' notes of an April 29, 1997 meeting contain a reference to "nothing to disclose – no facts". Mitchell testified that management concluded that the Special Committee had developed no factual information that should be disclosed. There is no evidence that the directors questioned the disclosure. Mitchell took the position that he had a minimal role in the disclosure and understood that Wilder and Gatti were largely responsible for it. There was no subsequent review by the Board prior to filing the AIF or the Preliminary Prospectus.

[224] We have already determined the AIF was deficient. At a minimum, Gatti's draft more accurately conveyed that YBM was subject to specific risks since it reflected that the U.S. Government had expressed specific interest in YBM. Meanwhile, First Marathon received a copy of the Special Committee Report, Mitchell briefed the other underwriters regarding some of the Special Committee information, and the investing public got what it got. This is confirmed by Mitchell when he stated:

> Company's disclosure record was a subject which was often discussed by the board of directors and by company counsel. Company took guidance from its counsel, and after full and fair discussion of issues regarding disclosure, the company's disclosure record is as it is.

Offering Process and Prospectus Review

[225] Mitchell attended the May 28, 1997 due diligence session between the underwriters and Bogatin in preparation for the filing of the Preliminary Prospectus. Counsel were also present. In response to a question from counsel to the underwriters regarding whether the company was aware of any current, pending or contemplated investigation against the company by any regulatory authority or other body, the response recorded from counsel is "to the best of his knowledge, no" and "no, other than as disclosed". Mitchell testified that he did not attend this session as a director of YBM, but rather as an underwriter.

[226] The preliminary prospectus was filed on June 2, 1997 with no additional disclosure regarding the work of the Special Committee. The first meeting with staff occurred on June 3, when staff was tipped off that the underwriters were still conducting due diligence with the assistance of Price Waterhouse.

[227] On June 11, staff contacted counsel to YBM and the underwriters and advised that they had received allegations from international sources that YBM was involved in money laundering. Staff advised that they had requested the assistance of Enforcement, that there were questions regarding the integrity of YBM's sales and that staff wanted to speak to Price Waterhouse.

[228] Mitchell attended two meetings with staff on June 13 and 16, during which the Special Committee came up. Jones of First Marathon had previously advised Mitchell that staff had been told of the rumours regarding YBM, the *Izvestia* article, the formation of the Special Committee, the engagement of Fairfax and Fairfax's conclusion that there was no reason to believe that YBM was engaged in illegal or illegitimate activities. Mitchell testified that staff was uncomfortable with the disclosure and was not focusing on money laundering. Mitchell testified as to why he did not provide a copy of the Special Committee Report to staff:

> Q. Did you think, sir, at that point in time, that the contents of the report or the report itself of the Special Committee would be information that Staff would find of any value?
>
> A. I thought that the company had made disclosure consistent with what was advised by experienced securities counsel regarding the Special Committee and the work that it had done.
>
> Q. We are not talking disclosure right now. We are talking about the process of a prospectus review where there's an interchange going between Staff and the issuer and the underwriters. The question to you is did you think that the report would have been of any interest to staff? Did that thought cross your mind when you were telling them about this independent committee?
>
> A. The interchange that took place between staff on the prospectus review process, that being the comment process, is one that is fundamentally done by the company, Mr. Bogatin, Mr. Gatti who were both intimately aware of the contents of the report; by counsel, Mr. Wilder, who was certainly aware intimately of the contents of the report and those were the people who were dealing with Staff.
>
> Q. So when you get to these meetings at this point in time, for example, on the 13th you are wearing your First Marathon hat and not your director's hat?
>
> A. That's correct, yes. I didn't see any other directors at the meeting other than Mr. Bogatin, I guess, who is not even at this meeting. There's only underwriters so clearly I would be attending as an underwriter rather than as a director.

[229] At the June 16 meeting, when the Special Committee was referred to again, staff did not pursue the work of the Special Committee. Mitchell testified that he never attempted to hide the Special Committee and its work from staff. If asked for a copy of the Report, he would have asked counsel since he did not make the company's disclosure. He further stated, "The company

makes its disclosure. Company counsel and the company would decide whether that report was going to be disclosed, but I would not oppose the disclosure of that report, no."

[230] Mitchell acknowledged that, to his knowledge, neither he nor anyone on behalf of the underwriters advised staff that the U.S. Attorney had confirmed the existence of an investigation into the company.

[231] Staff issued the first comment letter on June 16. It raised a general comment regarding the Special Committee disclosure contained in the AIF. The comment and YBM's response are reproduced above. An initial draft response letter from YBM included the following items reproduced from the Special Committee Report:

> Subsequent off-the-record discussions with the U.S. Attorney's Office confirmed that the Company had been examined as part of the investigation.
>
> As a result, the board formed a Special Committee to independently investigate possible areas of concern arising from the Company's business operations, and recommend further action in order to address any problems or potential problems which are uncovered as a result of the investigation.
>
> Special Committee Recommendations
>
> Elimination of commingling of business activity with that of its founding shareholders in Eastern Europe**.**
>
> Establish operational controls to ensure that management remains operationally independent from its founding shareholders.

[232] Unfortunately, these items were deleted in the final draft response sent to staff on June 18. A fax cover sheet confirms that the initial draft was sent to Mitchell, but he does not recall receiving it or discussing the response with the possible exception of the commingling issue. Litwack testified that he recalled having some discussions with Mitchell with respect to this response.

[233] Staff requested that the Special Committee recommendations that were disclosed in the response letter be disclosed in the Final Prospectus. We have no doubt what staff's response would have been to the information deleted from the draft response letter - disclosure. In our opinion, this was a serious omission in response to staff's general comment.

[234] On June 12, the Directors held a conference call. There are no minutes of this meeting. Greenwald's notes indicate the purpose of the meeting was "to price the new stock offering":

> At a price between $12.50 and $13, they have firm commitments totalling $150 million.
>
> Since we can sell only $100 million from treasury stock, Owen would like to approach the original shareholders who now control 30% of YBM shares to convince them that it is to their advantage to sell off $50 million of their holdings.
>
> Jacob has talked to the original shareholders and is convinced that they will not sell. They did not think that they have done anything wrong even though all the allegation against the company concern their activities.

> Jacob reported that the Ontario securities commission had received a call about the report against us. Lawry Wilder went to see them immediately, armed with the Fairfax information. He believes that the commission will approve the prospectus next Monday.

[235] The prospectus receipt was delayed. On June 24, staff advised YBM that they would not issue a receipt for the prospectus unless additional work was done by Enforcement or a Big Six accounting firm. YBM decided to have a re-audit of YBM's 1996 financial statements around July 25. The directors and underwriters became increasingly concerned that a delayed receipt for the prospectus would postpone the closing date of the Crucible deal, thereby triggering an $8 million payment.

[236] Another board meeting was held on July 17, and all the Directors were present except Fisherman. Gatti, Scala, Wilder, Silfen and Kottcamp were also present. The minutes record the following amongst other items:

> Questions were presented by the underwriters May 29th. On June 2, 1997 the preliminary prospectus was filed. The road show followed. The board Special Committee lead to the underwriters doing extra due diligence (using Price Waterhouse ("PW"))…
>
> Mr. Wilder says he has never seen anything like the situation that has occurred. Re: Segment Information 1996 (the OSC is concerned with): (1) whether the product has been delivered to end users; and 2) billing addresses of invoices. The OSC is looking for other companies and the auditor's opinion. The OSC is looking to see whether the Company has real customers, and whether it is selling to missile producers. D&T will dispel all concerns.

[237] With the delay in closing the offering, on August 21, 1997, YBM announced that it had completed a private placement of subordinated convertible notes in the amount of CDN $48 million, which notes were purchased by institutional investors. The following day YBM announced the closing of the Crucible deal. Despite the concerns expressed by staff, YBM proceeded with closing the Crucible acquisition.

Deloitte & Touche Audit

[238] D&T were not provided with a copy of the Special Committee Report. Coulter and Purcell testified that had D&T been informed of the mandate, information obtained by and findings of the Special Committee, it likely would not have accepted the engagement. Furthermore, if it had accepted the engagement, they testified that the information would have been relevant to the nature of the procedures undertaken in conducting the audit.

[239] In response to whether Mitchell felt he had an obligation to provide a copy of the Special Committee Report to D&T, his testimony was as follows:

> I had no reason at the time to believe it had not been brought to their attention in a completely satisfactory manner. If I had believed it had not been brought to their attention in a satisfactory manner, I may have taken steps to bring it to their attention. However, and again, this – I am a director of the company. I'm not the

> company, not an employee of the company. I worked for First Marathon. I don't work for YBM Magnex International. To the extent that amongst the, let's say it's 20 people or 30 people that know about the contents of the Special Committee report, let's say that amongst that group of people, if it is entirely incumbent upon me to ensure that every potential person who might be interested in that report receives a copy, then I am remiss, but you know something, Mr. Naster, I'm a busy guy. I was a busy guy at that time…I worked very hard, made lots of trips back and forth to Philadelphia…I have an employer that's paying me good money not to sit on Special Committees and…expects me to make that firm money.

[240] It is clear that Mitchell's duties as a director were not free of extraneous considerations and influences and in fact were compromised by his dual role in this case.

[241] D&T understood that its audit was being relied upon as part of a public financing, that there was a risk that YBM could be involved in money laundering, that its customers may not exist and that its reported sales may be bogus. D&T had been provided with documents that contained some references to YBM employees being denied visas, the existence of an investigation and the existence of the Special Committee.

[242] Procedures conducted by D&T included site visits to brokers who accounted for $32 million of YBM's sales of $61 million, representing 52% of YBM's total magnet sales. Coulter agreed that this was a "very high sample" for a financial statement audit and explained, "…we were not relying on controls. We were performing extended procedures." D&T did extensive work in respect of 75% of YBM's consolidated net sales as well as extensive procedures in verifying sales to end users.

[243] On October 13, 1997, D&T issued an unqualified opinion in respect of the 1996 YBM financial statements. On October 22, YBM issued a press release announcing receipt of the unqualified audit report (dated October 17) on its December 31, 1996 financial statements from D&T. One non-cash adjustment made to the company's financial results pertained to a reclassification of the company's North American sales of $13.6 million (as previously reported) to $1.8 million; sales to the Middle East being reduced from $3.3 million to nil; sales to Russia being increased from $21.8 million to $50.2 million. On November 4, D&T met with staff. At staff's request, D&T's audit opinion was ultimately incorporated by reference into the Final Prospectus. Peterson attended this meeting and portrayed a serious board that wanted a high comfort level and did not want to be associated with "anything that isn't up and up."

The Final Prospectus

[244] By November 6, staff had advised YBM and the underwriters that the final prospectus could be filed. The board discussed pricing for the offering and the payment of an additional commission to First Marathon and GMP for their work on the Crucible acquisition at a November 11 meeting. The board approved the final prospectus by written resolution on November 12.

[245] YBM entered into the underwriting agreement on November 17. The offering was priced at $16.50 for 3,200,000 common shares. The syndicate consisted of 35% First Marathon, 35%

GMP, 20% Scotia McLeod, 5% Canaccord and 5% Gordon Capital. In addition, the underwriters were granted an over-allotment option of up to an additional 320,000 common shares at $16.50 for up to 60 days after closing. The over-allotment option was exercised by the dealers.

WERE YBM'S DIRECTORS AND OFFICERS DILIGENT?

YBM's Process to Ensure Full, True and Plain Disclosure

[246] Did the directors exercise their judgement reasonably in concluding that the Final Prospectus contained full, true and plain disclosure? Was the Special Committee investigation, bolstered by reliance on legal advice and the D&T audit, consistent with diligence sufficient to ground a reasonable judgement or belief that full, true and plain disclosure had been made?

[247] The directors exerted significant efforts through the creation and work of the Special Committee, including the retention of Fairfax, to ascertain further information regarding the concerns of the U.S. authorities and the company. However, there were serious weaknesses in connection with the Special Committee's investigation. Most notably, it was not independent. We indicated earlier that the degree of care required in ensuring full, true and plain disclosure leaves little room for risk.

[248] We are most concerned about Mitchell's dual role as Special Committee Chair and YBM's underwriter, particularly given that the Special Committee conducted its investigation contemporaneously with the Crucible negotiations and while planning the financing. Mitchell was active in all three of these initiatives. Despite suggestions to the contrary, his loyalties were divided.

[249] As YBM's underwriter, Mitchell's influences were clear. The underwriter's fee exclusive of any over-allotment option was $2,376,000. In addition, YBM paid $600,000 to First Marathon for advisory services on the Crucible acquisition. We further note that First Marathon together with GMP dominated trading in YBM's shares on the secondary market including approximately U.S. $12,000,000 in trades effected by the founding shareholders through an account for which Mitchell was investment advisor.

[250] If the independence of one's mandate is threatened, then the reasonableness of one's judgement becomes questionable. While this case does not engage the business judgement rule, even that rule requires directors to act reasonably, in good faith and without any conflicts of interest. Basically, it was hard to determine who was going to show up during the prospectus review – the director, the Chair of the Special Committee or the underwriter. Moreover, Mitchell provided no reasonable response as to why he did not provide a copy of the Report to staff and D&T.

[251] Other weaknesses of the Special Committee investigation are as follows:

1. The Arbat sale did not resolve the issue of questionable commission payments. The United Trade ledger contained payments to Averin after Arbat's sale. This discrepancy was not pursued even in the face of the existence of the parallel records and Fairfax's information

regarding Arbat's sale that suggested the sale did not occur at arm's length. More investigation was required.

2. The Special Committee failed to follow up or obtain a copy of the FBI Wiretap Affidavit or advise the other directors of its existence in the Report. The Report merely states, "Rumoured involvement of shareholders in organized crime was noted from a variety of sources including print articles." The FBI Affidavit provided exceptional information potentially relevant to assessing the materiality of the U.S. investigation and the rumoured involvement of shareholders in organized crime. It should have been brought to the attention of all the Directors, staff of the Commission and D&T. Moreover, Davies remained silent regarding his interview with the FBI.

3. The resolution of customer and end user identification was critical. The Special Committee relied extensively on management to satisfy Fairfax. We find that management restricted Fairfax to electronic searches and required the searches to be completed in ten days. There was no reasonable basis to conclude that the issues had been resolved. The Special Committee also left the Board with the impression that Fairfax was satisfied when, in fact, it continued to express concerns and recommend further work.

4. Gatti's draft AIF noted that the INS had begun an informal inquiry into foreign nationals working at the company's headquarters in Newtown. Mitchell and Wilder reviewed this and thus knew the U.S. authorities continued to be interested in YBM. Rossman testified that the INS's investigation was unusual given the request for customer information. YBM would subsequently learn from its immigration counsel in the fall of 1997 that the investigation was a fraud investigation. The Special Committee Report, however, stated that management believes that the INS is satisfied that there is an actual business in place.

[252] The Board relied on the Special Committee to assist with disclosure. While not created as a disclosure committee, by the April 25 board meeting at which the AIF disclosure was discussed, to some extent that is what the Special Committee had become. Indeed, YBM was now relying on the information reported by the Special Committee as the basis for its decision regarding disclosure of the U.S. investigation.

[253] Generally speaking, a board is entitled to rely on special committees. However, as indicated above, Mitchell's independence and the non-participation of the other two members were questionable. The absence of Schmidt and Davies from meetings with Fairfax or Mitchell rendered them ill-suited to discharge their role. The failure to participate, particularly given Davies' information, seriously limited the exchange of ideas and prevented the Special Committee from being a committee upon which the Board could fully rely. In addition, we note the serious nature of information conveyed to the Board by the Special Committee. This should have resulted in a call to action in light of the pending acquisition of Crucible and the public financing. Instead, we note some additional weaknesses in the process followed by the board:

1. Relying on U.S. legal advice provided months before regarding potential defamation concerns, the Directors did not even get a copy of the Report. This could have aided the questioning and decision around disclosure. More than a one shot briefing from Mitchell was required.

2. The entire Board should have requested a meeting with Fairfax to discuss Fairfax's unfiltered continuing concerns regarding YBM's end users or money laundering. Fairfax

wanted to do more work including interviewing the auditors, reviewing their work papers, conducting a complete investigation of customers and vendors including knocking on doors and checking all invoices, and explaining the actions taken by the Board to the U.S. Government. Fairfax's services were not inexpensive, but, in relative terms, the financing raised $106 million. Fairfax's additional services were not called upon.

3. Wilder was counsel to the Special Committee and YBM. Rossman advised the Board that the Special Committee should retain its own independent counsel. The Board declined this advice based upon Peterson's suggestion that "lawyers were not going to solve this problem." This advice was improvident. Despite Fairfax's expertise, the nature of the issues confronting YBM required independent legal counsel.

[254] The board relied on legal advice throughout. Good faith reliance upon legal advice that is fully informed, ostensibly credible and within the lawyer's area of expertise is consistent with the exercise of reasonable care; *Blair v. Consolidated Enfield Corp.* (1993), 15 O.R. (3d) 783 at 796-801, aff'd [1995] 4 S.C.R. 5. The board, however, cannot have it both ways. It relied on legal advice, but on the other hand, minimized the value of retaining inherently independent legal advice.

[255] Wilder's advice was to disclose the existence of the Special Committee. The approach adopted in this case was to "turn it over to counsel to capture our intentions in words and they did that." Moreover, the disclosure is based upon a draft prepared by Bogatin and the evidence indicates that management was of the view that there were no facts to disclose.

[256] The Board knew that the purpose of the Special Committee was to independently investigate concerns arising out of the company's business specifically as a consequence of the investigation of YBM by the U.S. Attorney. The Board authorized Mitchell to disclose the full details of the Special Committee to the underwriters. The Board subsequently became aware that the underwriters were conducting extra due diligence specifically as a result of the Special Committee information provided. The Board was later reminded, during its June 12, 1997 conference call, of the continued concerns regarding the founding shareholders as Mitchell attempted, through Bogatin, to persuade the founding shareholders to add their shares to the offering. Wilder also advised the Board of staff's position that YBM's sales needed to be audited and that this request was exceptional. We further note that staff requested additional disclosure based upon the minimal details of the Special Committee Report shared with them in YBM's response to their comment letter.

[257] The description of the Special Committee and its mandate was obscure. This was a less than stirring effort given the information that had been received. Given the foregoing, we question whether the Board's reliance on legal advice was reasonable in the circumstances.

[258] Lastly, we note that despite the efforts put forth and the seriousness of the information unearthed by the Special Committee, no one assumed custodianship over the Special Committee Report subsequent to the April 25, 1997 meeting. Staff and D&T should have received copies of the Report.

Reliance on D&T

[259] The respondents relied upon the clean audit opinion provided by D&T as further justification for not disclosing the mandate, information obtained by and findings of the Special Committee in the final prospectus. The Directors derived significant additional comfort regarding the legitimacy of YBM's business due to the D&T audit.

[260] The respondents submit that a reasonable and measured response to the unique risks faced by YBM was to examine YBM's financial reporting, because the information, if true, would necessarily manifest itself in some misstatement of the financial records. If, on the other hand, it could be determined that the financial reporting of sales and costs had integrity, i.e. if it was a real business and its sales as reported were real, then the information would be simply unfounded rumours and innuendo, which are not disclosable as they are not material facts. In a nutshell, the issue is whether it was a reasonable response to the information to believe that, if they were able to "harden the balance sheet", then the concerns raised by the information would be eliminated or overridden.

[261] Several efforts were made to "harden the balance sheet", but the audit undertaken by D&T was the most comprehensive and while not forensic it utilized extended procedures. D&T was fully aware of the context in which the audit was occurring, including the extent to which it would be relied upon by staff and the underwriters. Both Coulter and Purcell testified that the information contained in the Special Committee Report would have been relevant to the procedures conducted, including whether D&T would have even accepted the retainer. Their evidence was that a "high risk" audit does not entail the kind of enquiry which is intended to ferret out criminal activity. That kind of inquiry is to be made by forensic accountants.

[262] The respondents argue that the D&T audit provided a reasonable basis for their belief that the prospectus contained full, true and plain disclosure. We take issue with that for at least three reasons: (1) it was not a forensic audit; (2) even if the respondents could rely on the audit to conclude that the business was legitimate, that does not necessarily mean that the respondents were not in possession of facts that required disclosure; and (3) D&T did not have important information contained in the Report which should have affected their reliance.

[263] We further note that YBM was required to amend the geographic segmentation of sales as a consequence of the audit. This resulted in North American sales being reduced from $13.6 million to $1.8 million and sales to Russia being increased from $21.8 million to $50.2 million. Given what Mitchell had previously advised the Board regarding the work done by Fairfax in connection with YBM's North American end users and YBM's segment information, another inconsistency was evident. The Board did not pursue it.

[264] Overall, we are satisfied that significant efforts were made by the Directors to ascertain the facts and assess their materiality. However, we find that the process adopted by the Directors to support their judgement and belief that the mandate, information obtained by and findings of the Special Committee were not material, and that the disclosure provided was full, true and plain, was deficient. YBM's Directors are not a homogenous group and therefore we must consider each director according to his degree of participation, access to information and skill.

Mitchell

[265] It is clear by now that Mitchell, despite being an outside director, had a fundamental role in the affairs of YBM and was involved in the most significant issues facing the corporation. He testified for 12 days. He was assertive, confident and forthright. We take no issue with his integrity, only his judgement in these circumstances.

[266] Mitchell was an experienced investment banker. He was well versed in public financings. He was a vice-president and director of First Marathon during the material time, and until his departure in April 2001, he was a managing director of National Bank Financial. Mitchell's involvement in YBM began in mid-1994. By June 1995, First Marathon and GMP were both preparing a financing for YBM. In September 1995, First Marathon and GMP entered into an engagement agreement with Pratecs/YBM to act as agents in the raising of funds through the sale of special warrants convertible into common shares.

[267] Through the due diligence performed for the 1995 financing, Mitchell became familiar with YBM's background, including the significant role played by the founding shareholders. The underwriters specifically put an escrow agreement in place with respect to the shares of the founding shareholders. A trading account was subsequently opened by the original six founding shareholders through which they sold YBM shares. Mitchell was the investment advisor for this account. Further, Mitchell acknowledged in his testimony that from the earliest stages of his involvement with YBM, he understood that "long-distance management" of YBM was risky.

[268] Following the completion of the special warrants financing in January 1996, Mitchell agreed to join YBM's Board. First Marathon's written policy was that its employees were not to sit on the boards of its clients without the written consent of First Marathon. The policy offered no guidance regarding the factors First Marathon considered relevant to providing its consent. Mitchell obtained First Marathon's written consent in February 1996.

[269] Mitchell attended his first Board meeting on April 29, 1996. Mitchell was later appointed Chair of the Special Committee on August 29, 1996, and was appointed to the Audit Committee on April 25, 1997. Peterson testified that he was confident that Mitchell would have the time, energy and commitment to act as Chair of the Special Committee due to his background as an investment banker and the fact that "he had known this company better than anyone else."

[270] As indicated previously, the reasonableness of an investigation and belief in the completeness and accuracy of disclosure will vary with an individual's skill, access to information and degree of participation.

[271] Mitchell possessed the greatest knowledge, along with Wilder, of the mandate, information obtained by and findings of the Special Committee. He was the Chair, directed the investigation and principally drafted both the interim report and the Report presented to the board on April 25, 1997. His extensive involvement makes it difficult, though not impossible, to establish his belief that there were no material facts omitted. He was familiar with and experienced in the performance of his responsibilities regarding disclosure. Mitchell was an experienced director, analogous to an inside director in these circumstances.

[272] There are risks associated with an underwriter being a director of a public company. YBM was encountering unique risks. Mitchell's responsibility was to investigate and make recommendations. The Special Committee played a prominent role in the Board's decision to proceed with the Crucible acquisition as well as its decision regarding disclosure. Mitchell exclusively conducted the Special Committee's investigation and authored, with the assistance of counsel, the Report. While the Special Committee may not have been created as a disclosure committee, to a large extent by April 25, that is what it had become. The Board discussed disclosure in preparation for the offering at the April 25 meeting. It is clear that the Board relied upon the findings and recommendations in the Report in deciding to proceed with the offering and in fulfilling its disclosure obligations.

[273] Mitchell, as an underwriter, was largely compensated based upon a direct drive compensation scheme. Clearly, First Marathon and Mitchell would benefit if YBM completed the Crucible acquisition and the offering. Simply put, Mitchell was in a conflict of interest. We do not view the conflict of interest as a matter of intention or lack of good faith on his part. Rather, it compromised both his time and judgement. As previously discussed, a special committee must be comprised of disinterested directors in a position to base their decisions on the merits of the issue free of extraneous considerations and influences.

[274] As an experienced director and underwriter, Mitchell ought to have known better. If Mitchell was not alert to this issue on August 29, 1996 when the Special Committee was created, he should have been on November 1, 1996 when the financing for the Crucible acquisition was first discussed by the Board. Mitchell submitted that he addressed the conflict by not advising First Marathon about the Special Committee without first obtaining Board approval. Unfortunately, the Board's approval came late in the Special Committee process. In any event, it did not address the essential problem. The Board's approval did little to protect investors because the basis for Mitchell's conflict remained and the Board proceeded with its decision regarding disclosure based upon the Report. The potential for divided loyalties makes it more difficult for Mitchell to justify the reasonableness of his belief that YBM made full, true, and plain disclosure.

[275] The evidence indicates that Mitchell's conflict adversely impacted his judgement. Why would he provide a copy of the Special Committee Report to First Marathon but not to the Board? It is clear that the Board had no process for the Report's distribution (not even to itself in light of the legal advice with which it was provided), however, the Report was, in our opinion, critical to issues of disclosure as well as to the 1996 re-audit and the 1997 audit. Mitchell explained that he did not ensure that staff and D&T received a copy of the Report because he was a "busy guy" and he had an employer that was "paying [him] good money not to sit on special committees." YBM and its shareholders, however, expected Mitchell to fulfill his duty to ensure that full, true and plain disclosure was made. We note further that Mitchell did not provide the Report to First Marathon's co-lead underwriter, GMP.

[276] We have previously discussed the details of the Special Committee's investigation. Matters were brought to Mitchell's attention, which required further investigation. The United Trade commission payments, the FBI Affidavit, YBM's customers and end users, the falsification of the original equipment invoices and the continued INS interest were not pursued. With regard to the false equipment invoices Mitchell testified, "I had no reason to doubt that the

invoices had been created after the fact…. So it concerned me, concerned me to this day, but it was what it was". The failure to pursue these matters affected the reasonableness of his belief in the materiality of the facts that were omitted.

[277] As indicated previously, Mitchell failed to provide much of this information to the Board. The Board, except Bogatin and Davies, was unaware of the FBI Affidavit. The Board was not informed of the continued interest of the INS despite its being marginalized in the report. The Board was under the impression that the sale of Arbat resolved any issues associated with the commission payments. We are also dissatisfied with the fact that the Board was not informed about a number of Fairfax details. While Fairfax found no evidence of money laundering, it did find indicia of it and recommended further investigation, which was not pursued. Despite its work on end users in March and April of 1997, Fairfax continued to have concerns with North American end users.

[278] Fairfax viewed the draft report provided to it as Mitchell "attempting to portray some bad facts as well as he could, given the circumstances." We view the final Report in the same light. For instance, the Report states that the Original Equipment Transaction "may not have been as originally described," when Mitchell knew that the documentation surrounding the transaction was likely false and testified that this continued to cause him concern. Similarly, the Report states that "rumoured involvement of shareholders in organized crime was noted from a variety of sources including print articles." Mitchell had been specifically briefed about the FBI Affidavit.

[279] Similarly, Mitchell was not completely forthcoming with the public. The AIF is a critical disclosure document in a POP offering. He let Wilder and management "[drive] the bus on the AIF". We take no issue with counsel being involved in the preparation of the AIF, but the work of the Special Committee was not typical and Mitchell was the most informed. He reviewed Wilder's initial draft of the AIF but not the final draft, which was revised largely by Bogatin. He reviewed the changes to the AIF after it had been filed, but expressed no concerns.

[280] Mitchell testified that YBM took guidance from its counsel regarding disclosure and that as a result the company's disclosure record "is as it is". Despite this, Mitchell knew the Special Committee information was important. He wanted First Marathon and the underwriters briefed about it. Mitchell was unhappy with Gatti's letter to the founding shareholders regarding the FBI Affidavit because it could have caused them to trade their securities. Mitchell knew what the AIF said and what it did not say.

[281] As part of the offering process, Mitchell attended the May 28, 1997 due diligence session on behalf of First Marathon. He did not respond to a question regarding whether there were any current, pending or contemplated investigations, despite his being the Chair of the Special Committee. He had obviously switched hats. Similarly, at the June 13 and 16 meetings with staff, he testified that his role was that of underwriter not director.

[282] Mitchell took a number of positive steps towards uncovering facts that could have had an adverse economic impact on the business. However, the risks at issue left little margin for error. Mitchell had considerable skill, access to the most information and extensive participation in the offering, the investigation of the facts, their materiality and their disclosure. He developed a

belief in the legitimacy of the business. However, that did not in our view justify a reasonable basis for his belief that YBM made full, true and plain disclosure of all material facts. Consequently, a defence of due diligence is unavailable to him.

Davies

[283] Davies is a semi-retired business consultant residing in British Columbia. He has raised venture capital on at least 24 occasions. He became a director of Pratecs in April 1994. He has served on the board of four public companies. Two were on the former Vancouver Stock Exchange and two were shell companies. He was on the Pratecs board when the U.K. proceedings were initiated into money laundering involving Arigon, Karat and Mogilevich and later dismissed on consent. Davies looked on this result as a form of immunization of YBM.

[284] Davies submits that he was relatively inexperienced, that he did not bring to the board the expertise and business prominence associated with TSE 300 public companies and that he did not have a leadership role, enjoying no influence or control over the affairs of YBM or the Board. He had little experience with TSE 300 companies but he had considerable experience with other public companies. Whether the issues facing a board involve a TSE 300 company, a smaller public company or an unlisted company, a director's attention to his or her obligations is still the essence of diligence; *Soper* at para. 34. Davies may have been unfamiliar with large public boards but he has no shortage of experience with respect to raising capital for public companies.

[285] Davies was a member of the Special Committee, which he submits did not place him in a better position to make disclosure because he knew no more than other directors. Davies' role on the Special Committee was limited and virtually non-existent after Fairfax was retained. He submits that living in British Columbia, a different time zone, impaired his ability to serve effectively on the Special Committee. With respect to this latter suggestion, we disagree for the most obvious reasons.

[286] As a member of the Special Committee, the Board relied on him. While the evidence establishes that Mitchell conducted the Special Committee's investigation almost single handedly, that did not relieve Davies of his responsibilities as a member of that committee. In *Soper* at para. 26, Robertson J. stated that the law does not permit directors to "adhere to a standard of total passivity and irresponsibility." Furthermore, the law cannot "embrace the principle that the less a director does or knows or cares, the less likely it is that he or she will be held liable"; *Soper* at para. 26.

[287] Davies knew, or ought to have known, that Mitchell was in a compromised position because of his dual role as underwriter as well as Chair of the Special Committee. This fact alone should have required him to take on more responsibility. Simply put, it is irresponsible to do virtually nothing when your responsibility suggests otherwise. Davies' reasons for not taking on a greater role appear more like excuses rather than reasonable explanations consistent with care. It is not a question of honesty but rather skill and diligence.

[288] Despite what would otherwise appear, Davies had a close relationship with Bogatin. Davies was very familiar with the business of the company. They often spoke, and obviously,

we take no issue with that. However, Bogatin did inform Davies of the visa difficulties before telling the rest of the board and of the FBI affidavit.

[289] Davies was the only outside director who had a personal visit from the FBI in April 1996. While the FBI only disclosed that there was an investigation and asked no specific questions about YBM's business, it is clear that their visit related to YBM. The FBI wanted Davies to work in a somewhat clandestine manner on its behalf but he declined. Davies did not discuss this visit or the likely subject matter with the Board or its counsel, only with his daughter. He explained that the FBI advised him to keep the interview in confidence. He compared his decision to do so with staff's responsibility with respect to their public law duties. We have some difficulty understanding Davies' motivation in this situation. Having heard his testimony, we are of the opinion that having regard to his skill and business experience, he failed to act prudently. A director has a positive duty to act when he or she obtains information, or becomes aware of facts, which might lead one to conclude that there may be an issue that may adversely affect the company; *Soper* at para. 53. We must consider his belief that there were no material facts omitted. A director's belief cannot be considered reasonable when he is aware of circumstances of such a character, so plain, so manifest, that a person with any degree of prudence would not have acted in this manner.

[290] Davies was present at the August 15, 1996 meeting where Rossman recommended to the board that it form an independent committee with independent counsel. Davies supported that recommendation. It is apparent that the Board decided not to retain independent counsel. We also have considerable difficulty accepting his suggestion that retaining Fairfax was in some way the equivalent of retaining independent outside counsel. That was clearly not its role or responsibility.

[291] Davies had virtually no involvement in the work of the Special Committee. No processes were put in place to achieve that outcome. He took no part in the preparation of the interim report. It is submitted that that he had no information and therefore could not contribute. We agree to some extent but not entirely. Despite his suggestions, we do not accept that he could not have made himself available to meet with Fairfax or at least get more information. We agree that Fairfax could have and probably should have prepared a more comprehensible report but that is not an excuse for Davies' inaction. Moreover, Davies did have views and even important facts to contribute. How would counsel or the Board have reacted if they had known that he had been visited by the FBI? His knowledge of the FBI affidavit, the FBI request for assistance and earlier knowledge of the U.K. proceedings were a call to action. Even if Davies had become more involved, as we suggested above, it is possible that the disclosure would have remained the same; however, what would have changed would have been our view of his diligence and his belief. His conduct is more consistent with sophisticated inexperience than reasonable care. Once again, we find his submissions regarding distance and time unconvincing.

[292] There are no stringent prerequisites for becoming a director of a public company and the nature of that office involves the exercise of business judgement; *Soper* at para. 28. What Davies did not get by way of information, he could have asked for. The standard of care is intended to encourage responsibility not passivity. It is said that an obvious characteristic of a reasonable director is one who is prepared to ask tough questions not only of management but also of other

directors. Davies' unique knowledge and role on the Special Committee presented him with an opportunity to do so. It is apparent that he declined.

[293] As a final comment, we would like to comment on Davies' decision to provide all of his YBM documents to the Financial Post. Apparently, he was worried that the police would seize them and they would disappear. He did this because he has little faith in law enforcement in Canada because, somehow or another, documents disappear. He obtained legal advice as to what to do with these documents from a non-North American lawyer. Staff describe this as a complete absence of good judgement. We agree.

[294] Counsel for Davies, in a most persuasive and insightful manner attempted to persuade us of the reasonableness of this action. However, we are not persuaded as to its prudence. While this issue may be collateral to the essential question of full, true and plain disclosure, this conduct is inconsistent with the care and diligence expected of directors in general and Davies specifically.

[295] Mitchell did not consult with him with respect to the report of the Special Committee and Davies did not take part in drafting it nor did he receive a copy of it, although he testified that through discussions with Mitchell he was aware of its basic content. Davies concluded he had no information to provide and that the Special Committee had answered all of the major questions of concern. In addition, he was not consulted nor did he view that he had any role in preparing the AIF. He relied, as he was entitled to do, in his opinion, on the expertise of professionals and management. As such, he took no issue with the disclosure. Obviously, he took no steps to determine who should receive a copy of the Report.

[296] Davies did not fully inform himself as a member of the Special Committee regarding the investigation and the details of the Report and did not share all relevant facts of which he was aware with other Directors or counsel. These facts could have, in our opinion, had some influence on the Board's investigation and belief as to the accuracy of its disclosure.

[297] We find that Davies' belief that there was full, true and plain disclosure of all material facts was not reasonable in the circumstances and therefore a defence of due diligence is unavailable to him.

Schmidt

[298] Schmidt was a land surveyor and real estate agent with limited experience raising capital. He was the least experienced board member. He first became a director of Pratecs in March 1994. Pratecs was his first public directorship. In 1995, he learned of the U.K. proceedings and participated in the decision that resulted in the cease trade of Pratecs' shares. He remained involved and monitored documents related to the proceedings. He clearly took an active interest in the issues and was not passive in these responsibilities. Somewhat to his surprise, Schmidt continued on the YBM Board as it evolved from a shell company to a more sophisticated organization.

[299] Schmidt attended the August 15, 1996 board meeting. He was an outside director but was a member of the Special Committee. He was appointed to the Special Committee primarily

because he was an early director and had information with respect to YBM's background. Schmidt provided this background information regarding YBM to the Special Committee. He actually provided a written report to Mitchell on September 9, 1996 wherein he noted a discrepancy in Mogilevich's shareholding in Arigon. Beyond providing this written report, Schmidt was not asked to provide any further assistance in the investigation and there were no meetings of the Special Committee.

[300] Schmidt attended the November 1, 1996 meeting in Philadelphia where concerns relating to Russian organized crime were discussed. Following this meeting, Fairfax was retained and Fairfax's sole point of contact was Mitchell. At this point, Schmidt viewed his Special Committee work to be at an end. He was not advised of this. He simply concluded that he had nothing further to offer. He was, however, not asked to do anything further. In essence, he shared the same knowledge as other Board members who were updated at Board meetings. He did participate in the February 19, 1997 meeting and the March 21, 1997 meeting with Antes and Mitchell by way of a conference call wherein Fairfax made its presentation.

[301] By now, we are well aware of the concerns presented by Fairfax at this meeting. Afterwards, the outside Directors discussed their concerns as well as the fact that there were factors mitigating them.

[302] It seems that despite his passive role on the Special Committee, Schmidt did remain in contact with Mitchell during the investigation, particularly with respect to Fairfax's efforts to confirm customers. Schmidt was of the opinion that the board would walk away from the Crucible deal and pay the $8 million penalty if Fairfax's concerns were not resolved.

[303] Schmidt attended the April 25, 1997 board meeting in Toronto. Neither Bogatin, Mitchell or Davies disclosed the existence of the FBI Affidavit to the rest of the Board. Schmidt was not aware of the FBI Affidavit.

[304] Schmidt was not involved in the drafting of the AIF, but he did review it. His reasons for being satisfied conform to reasons already discussed herein. He participated in the board resolutions approving the Preliminary Prospectus and the Final Prospectus. He had no involvement in the events after April 25, including no contact with the underwriters, Price Waterhouse, staff or D&T.

[305] Generally, we do not accept Schmidt's reasons for not being more proactive on the Special Committee. This is particularly the case since he participated by phone in the briefing by Fairfax on March 21, 1997. It would also appear that he remained in contact with Mitchell despite not being active on the Special Committee. For the reasons outlined with respect to Davies' inactivity on the Special Committee, we are of a similar opinion with respect to Schmidt. Similar to Davies, we do not question Schmidt's honesty and integrity. We do question certain aspects of his diligence and care. We agree that one can exercise a reasonable degree of care and yet be wrong. However, in these circumstances it is a question of being reasonably informed. Was Schmidt's belief justified in the circumstances? It is clear that he relied on legal advice. It is also clear that he was inexperienced. While Schmidt relied on such advice, and despite his lack of experience, he also applied his own judgement to the issue of disclosure. He also relied

on the underwriters, in particular on Mitchell. His reliance was not unreasonable in this case. As others were, Schmidt was relieved at the uniformly positive D&T audit opinion.

[306] At the time, despite his passive role on the Special Committee, and given his relative age and inexperience, we would not put him in the same position as Davies. It was more reasonable for him to rely on experienced counsel and financial advisors since his level of experience would make it more difficult for him to judge the advice as being right or wrong. Schmidt considered the information, relied on other professionals with more experience in disclosure and materiality and applied his own judgement. That belief was reasonable in the circumstances for the reasons discussed earlier.

[307] Schmidt, unlike Mitchell and Davies, did not have any information that other Directors did not have or did not share with the Board. His belief in the legitimacy of the business and no managerial improprieties was not unreasonable. He admittedly gave more weight to these factors than to other risks that YBM might face. He clearly could have done more on the Special Committee and he should have. Nevertheless, he had no knowledge of any facts not known to the Directors generally and to Mitchell and Davies more specifically.

[308] As a result, we have concluded that a due diligence defence is available to Schmidt.

Peterson

[309] Peterson is the Chair of the partnership at Cassels Brock and was the Premier of Ontario from 1985 to 1990. He was called to the Bar of Ontario in 1969. He is Wilder's partner. Peterson gives strategic advice but does not have a traditional law practice. He is an experienced corporate director who serves on many public boards. He has served on special committees and signed a number of prospectus certificates on behalf of other issuers.

[310] Peterson was an outside director who had been on the Board for four months at the time of the August 15, 1996 meeting. While he was a Director of YBM he invested $50,000 in shares of the company at $6.00 per share in the beginning and later at $15.00 per share. He never traded the stock. As such, he lost his investment along with other investors. He was not on the Special Committee. He signed the prospectus certificate on behalf of the Board, but was not substantially involved in the offering process. He attended only one meeting with staff on November 4, 1997. He did attend all of the relevant board meetings and was fully aware of the mandate of the Special Committee. He also met with First Marathon on one occasion on May 12, 1997 to discuss the report of the Special Committee. At that time, he expressed his confidence in the management of YBM.

[311] The board specifically discussed disclosure on two occasions: August 15, 1996 and April 25, 1997. On both occasions, even after receiving the Special Committee Report, the legal advisors opined that no further disclosure was required. Peterson was actively involved in the decision to create the Special Committee but he was not a member. While he understood Rossman's advice that the Committee should retain independent counsel, he was of the view that "lawyers were not going to solve this problem." Independent investigators were required to "drill down" and "get the facts". The Committee could have retained independent counsel, but it decided to carry on with Wilder, his partner. While we understand his reasons for not retaining

independent counsel, we do not accept his rationale and believe that that decision was inconsistent with good process.

[312] Peterson relied on the work of the Special Committee but did not request a copy of the Report. He understood from Mitchell's presentation at the April 25 board meeting that there was an ongoing investigation but was not aware of the subject matter. He acknowledged that the Special Committee information could have provided a possible explanation why the U.S. authorities might be investigating YBM. He understood that the rumoured involvement of shareholders and organized crime was noted from a variety of sources including print articles. He also realized that ties existed between Fisherman and the founding shareholders, Mogilevich in particular. However, he concluded that no undue influence was being exerted on YBM by the founding shareholders and that the Special Committee had found no evidence of illegality. Further, there were internal controls and processes in YBM that had to be improved, but based on legal advice, no further disclosure was required.

[313] Peterson took great comfort from the Committee's conclusion that neither Fairfax nor the Committee had discovered any evidence that senior management of YBM was in any way involved in any illegal or improper activity. He thought the Report's findings and conclusions provided a reasonable response to the issues raised therein.

[314] Peterson was not as informed as Mitchell or Davies, both of whom had a longer history with YBM and were on the Special Committee. He was unaware, for example, that the Arbat commissions discussed in the Report were actually recorded in the United Trade ledger and in some cases post-dated Arbat's divestiture. He was unaware of Gatti's AIF draft disclosing that the INS had recently begun an informal inquiry into foreign nationals working at YBM. He was unaware of the FBI Affidavit and that Davies had met with the FBI. He did not attend any briefings by Fairfax and was under the impression that Fairfax had approved the Report.

[315] We have expressed concerns regarding Mitchell's dual role and reliance by the Board on the Special Committee to provide a report that would inform, in part, their obligations. Peterson's legal background and his professional board experience suggests that he should have been attuned to the potential conflicts of interest in this case. The Board nevertheless pressed ahead and decided to proceed with the offering at the April 25 meeting. It would appear that the board weighed the information and, in particular, was relieved that Fairfax found no evidence of illegality or improper activity by management.

[316] Peterson understood, based upon Wilder's advice, that there should be disclosure of the fact of the Special Committee in the AIF. He relied upon counsel and management to prepare that disclosure, as he is obviously entitled to do. He understood the delicate balance between too little disclosure and what was described as inappropriate disclosure. He realized that the Special Committee information was to be disclosed to the underwriters on the basis that "if he [an underwriter] thought there was anything unsavoury or improper, he could have withdrawn easily", while investors received less information. Peterson subsequently relied upon the D&T high-risk audit as reducing any concerns and further justifying YBM's disclosure. He did not consider whether D&T or staff received a copy of the Report.

[317] Although Peterson was an outside director, he was experienced with respect to TSE/TSX public companies. Peterson was not passive in his role. He questioned management and recommended outside assistance. Neither disclosure, nor an understanding of his duties with respect to full, true and plain disclosure were new to him. We take no issue with Mr. Peterson's integrity, his truthfulness or his motives. But, that is not the issue with respect to diligence. Our review of the evidence suggests some areas where Peterson should have not accepted the facts at face value because they required more scrutiny and analysis.

[318] First, he fell down on the process of the Special Committee particularly with respect to Mitchell's roles. Second, at the February 19, 1997 board meeting, Peterson first became aware of Mogilevich, whom he agreed was a man of unsavoury character. Peterson was less concerned because his focus was on whether there was any improper activity in the business or any undue influence by Mogilevich on the company. He came to the conclusion that this issue, as exemplified by the commingling matter, was solved by the time of the final Report. Third, on April 3, 1997, Peterson knew that despite not completing the Special Committee investigation, YBM agreed to purchase Crucible risking an $8 million fee if the deal was not completed. Peterson thought this was a reasonable risk to take.

[319] Finally, we question the manner in which Peterson considered the AIF disclosure. He agreed that it did not touch on the investigation issue. He testified that the Committee found no crime and no improprieties by management. It was discussed thoroughly and a group of well-intentioned people tried to present the truth. Peterson distinguishes between inaccuracy and incompleteness in the disclosure of the mandate of the Committee. We remind him that the duty is to make full, true and plain disclosure. Peterson was an outside director. The report raised issues, but from his perspective, it also provided answers to those concerns. He was comforted by the Special Committee's conclusions that there was no evidence of undue influence by the founding shareholders and no evidence that management was involved in any illegal or improper activities.

[320] Peterson's belief that the prospectus contained full, true, and plain disclosure must be assessed in the context of his reliance on the Special Committee, legal advice, management of YBM and the D&T audit. As indicated previously, the Special Committee process was flawed. Nevertheless, the disclosure decision was further justified, in his view, by the results of the D&T audit. While he did not inquire into whether D&T was provided with a copy of the Report, he was entitled to assume that management or the Special Committee would fulfil that task.

[321] While we believe Peterson could have done more, we have concluded that Peterson acted reasonably based on his involvement in the matter, his skill and his access to information in the circumstances. Accordingly, his due diligence defence is available to him, but just barely. We are of the view that Peterson brought a unique perspective to the board. His professional reputation as testified to by Mr. Michael Wilson, Mr. David Beatty and Mr. John Tory, and his experience in many other public company boards, was not in any way equalled by any other Director. He had unique access to counsel to the Special Committee, whom he supported as counsel both to YBM and the Special Committee. He was appointed to add to the prestige and status of YBM. While Peterson meets the legal test of due diligence, the panel remains disappointed that he did not offer more insight and leadership to the board in these circumstances.

Antes & Greenwald

[322] Antes and Greenwald are both retired scientists living in the United States. Antes is 72 and Greenwald is 77.

[323] In 1986, when the company which Antes for worked acquired the company which Greenwald worked for, they met and began working together. Soon after the acquisition, Antes hired Bogatin as the Director of Research of the magnetics division of the merged company. Bogatin had impressive credentials and experience. Antes and Greenwald considered him a brilliant scientist and both forged solid personal relationships with him, which would later bolster their belief in management's integrity and in the legitimacy of the company.

[324] In April of 1993, Bogatin approached Greenwald to join Bogatin's new company, which aimed to sell Eastern European magnets in the U.S. market. Greenwald declined, but did work as a magnet sales consultant from 1993 to 1994. In March of 1995, Greenwald joined the board of YBM Magnex. Antes joined the board three months later. It was still a private company at that time. On April 29, 1996, Antes and Greenwald became directors of the new public YBM, at which time Mitchell and Peterson also became directors. Antes became the Chair of the Board four months later.

[325] Antes and Greenwald had difficulty recalling certain meetings, conference calls and documents. Antes had much more difficulty than Greenwald. Antes' poor recollection seemed inconsistent with his excellent recall of scientific matters and his participation in the Crucible acquisition. However, we do not infer any improper motives. We found Antes and Greenwald generally to be credible witnesses. The documentary record and the evidence of other witnesses were able to fill the gaps in their recollections.

[326] Antes and Greenwald were on YBM's board because of their scientific expertise, experience, connections and standing within the magnetics industry. Although both of them had been on the boards of private companies and non-profit organizations, this was the first public company board on which either of them had ever served. While they had business experience, they were essentially scientists and knew little, if anything, about securities law. They each had a general understanding of their obligations as a Director and took comfort from the fact that Mitchell and Peterson had extensive experience with respect to public companies.

[327] Antes and Greenwald took their duties as directors seriously, and attended every general and special board meeting that occurred during the relevant period. Antes also sought advice from friends with public company experience. Antes and Greenwald did the job expected of them. They identified and recommended Crucible as a desirable acquisition target, and conducted negotiations with Crucible in Kentucky and with neodymium magnet licensors in Japan.

[328] Similar to Peterson, Antes and Greenwald were not members of the Special Committee. They were not involved in the drafting of the Report and their knowledge of its contents came from Mitchell's oral presentations. They were not aware of the FBI Affidavit or Davies' visit from the FBI.

[329] We recognize that, together with Peterson, Antes signed the Preliminary Prospectus and the Final Prospectus on behalf of all the Directors, and that Antes was more involved in YBM's affairs than Greenwald was. In 1997, Antes worked 140 days as a part-time consultant to the company and shared an office at the Newtown headquarters. He also acted as an official conduit for the Special Committee's early information requests to management, but did not see or discuss management's responses. Unlike the other non-Special Committee directors – or, for that matter, Davies – Antes heard Fairfax's findings directly. He participated in the preliminary briefing with Stern in Newtown in November 1996, the Fairfax briefings on March 21 and 22 , 1997, and the Philadelphia meeting on April 13, 1997. However, he did not play a passive role at these meetings and questioned the pertinence of Fairfax's findings and conclusions.

[330] Through his consulting work and his knowledge of Fairfax's work, Antes was more informed than Greenwald. However, Antes was not akin to an inside director for due diligence purposes. Antes worked with management in respect of acquisitions, but he did not have a meaningful involvement in YBM's day-to-day affairs in the way that management did.

[331] Greenwald had no direct exposure to the Special Committee's work, other than attending Mitchell's briefings on November 1, 1996, February 13, 1997 and April 25, 1997. He never met any of the Fairfax representatives. He often asked Antes for updates on Fairfax's progress. Greenwald stated that the content of Antes' updates essentially reflected what Mitchell reported to the whole board on April 25, 1997: "[Fairfax] haven't found anything of sufficient seriousness to explain the investigation by the U.S. Attorney's office, 'but we're finding a lot of things that we've got to do something about.'" Furthermore, in Greenwald's opinion, the Report largely repeated information that the Directors already knew from previous briefings. Still, Greenwald was not passive at the April 25 meeting, and asked Mitchell to clarify Fairfax's "bottom line". Mitchell replied that Fairfax was satisfied with the legitimacy of the business.

[332] Antes and Greenwald brought different skills to the Board than the other YBM directors. Skill is that proficiency that comes from training and experience. They did not have the public company or business experience of other YBM directors. They relied on the members of the Special Committee to fulfill the duties assigned to them. For all their involvement in identifying and recommending the acquisition of Crucible, Antes and Greenwald had no material role in the financing. They relied on counsel for the drafting of disclosure that was to comply with Ontario securities law. Legal advice must be considered in the context in which it was given, and in this context, given their level of experience and skill, it was reasonable for Antes and Greenwald to rely on counsel. They did not participate in the drafting of the AIF, the Preliminary Prospectus or the Final Prospectus, and did not participate in any of the meetings with staff. Despite the reasonableness of their reliance on counsel and even with their limited knowledge, they should have been alive to the muddled nature of the disclosure in the prospectuses when those two documents were presented for Board approval. Even without public board expertise, their knowledge of the mandate, information obtained by and findings of the Special Committee should have put them on notice.

[333] Antes and Greenwald, although members of the Audit Committee, were not involved in selecting or instructing D&T. Their knowledge of staff's concerns and the D&T engagement came from board meetings in the summer of 1997. Antes believed that the high-risk audit being performed by D&T was akin to a forensic investigation and would unearth wrongdoing.

Greenwald had no specific understanding of the investigation. When D&T's clean audit opinion emerged, they both viewed it as confirmation of their long-standing belief that YBM was a legitimate business. Their reliance on the D&T clean audit opinion was reasonable.

[334] Accordingly, their belief as to full, true and plain disclosure is justified in the circumstances of the case. Therefore, a due diligence defence is available to both Antes and Greenwald.

Gatti

[335] Gatti faces the same allegation as the directors of YBM. Did Gatti, as an officer and the CFO, authorize, permit or acquiesce in the failure of YBM to make full, true and plain disclosure of all material facts? At the relevant time he was the CFO and Vice-President of Finance. He was not a member of the Board and as such not on the Special Committee. He did attend some Board meetings but only upon invitation. His superiors, Bogatin (CEO) and Fisherman (COO), were both Directors of YBM.

[336] As an officer of the company he is deemed to have an in-depth knowledge of the affairs of the company. Thus, as stated in *Soper*, as a senior officer, he will have a higher duty to react diligently to events based on that knowledge.

[337] Gatti first became involved with YBM in 1995 when he was its audit manager at Parente. At that time he became aware of YBM's substandard accounting systems and financial reporting. In 1995, he left Parente for Ernst & Young but joined YBM shortly thereafter in January 1996 because it was an opportunity for his career "to take a bit of a quantum leap." He was relatively inexperienced in January 1996 when he became CFO of YBM, his first appointment as an officer of a public company. In addition, the Crucible transaction and the public offering were his first involvement.

[338] Gatti played a significant role at YBM. His responsibilities touched on virtually all aspects of its business – strategic planning, financings, financial reporting, accounting and control systems in Philadelphia. Staff posed the question – what would the reasonable person have done in Gatti's circumstances?

[339] As an officer, Gatti's knowledge and ability to influence the company were different and lesser than Bogatin's and Fisherman's because he was not a director and he did not regularly attend Board meetings. As suggested in *Standard Trustco* at page 4375, his role was relatively subordinate to those members of management who were also directors. However, his knowledge of the affairs of YBM was clearly greater than that of the outside directors with the exception of Mitchell. We agree that "inside directors will face a significant hurdle when arguing that the subjective element of the standard of care should predominate over its objective aspect"; *Soper* at para. 44.

[340] Staff assert an expansive view of the role of the modern CFO. It encompasses more than finance and embraces broader responsibilities including corporate governance, risk management and maintenance of effective systems of internal control. The CFO must take on the important

responsibility of being a conduit of information between the board and its auditors. Further, the CFO has an important responsibility regarding timely and accurate public disclosure.

[341] Staff contend that Gatti was an ineffective CFO. For the most part we disagree. Gatti tackled many of the issues that were within his skills as a reasonably experienced auditor and novice CFO. He did a sound job with respect to matters within his control and skills. By the end of 1997 he had gone a considerable way towards addressing the material deficiencies identified in Parente's management letters. He recruited a controller, improved internal financial reporting and records and worked with D&T to implement a proper computerized accounting system. He was also responsible for the financial disclosure that was not in issue in this case. At the same time, Gatti was somewhat overwhelmed by the demands of a company that had most of its operations in Eastern Europe. It was also growing by acquisition. He was understaffed in North America and a number of his attempts to centralize control in Newton were thwarted by Bogatin and Fisherman. It was clear that Gatti was in a subordinate role. Nevertheless, Staff submit that he should have gone directly to the Board with his concerns. In general terms we agree with this submission.

[342] Staff submit that Gatti knew all the relevant facts or should have known them. He knew YBM's corporate history since he had previously been an auditor at Parente assigned to YBM. He should have been aware of the materiality of the relevant facts since he drafted documents which clearly stated that the disclosure of the investigation, commission payments to alleged members of organized crime and founding shareholder ties to criminal activity all would have a devastating impact on YBM's share price.

[343] As an officer Gatti derives responsibility from the Act. His belief regarding the completeness and accuracy of disclosure must be dependent on a reasonable investigation, which depends in turn on the degree of his involvement, his access to pertinent information and his skill. The manner in which he arrives at an informed decision regarding disclosure is germane to his defence of due diligence. In this case, Gatti believed that there were no omissions and that the disclosure was accurate.

[344] There is no need to apply a higher standard of care to Gatti. He was not a director, nor was he on the Special Committee. Staff's allegations did not concern the expertised portions of the Preliminary Prospectus and Final Prospectus. While Gatti was the CFO, he was not called upon to use his accounting training and skills to certify the type of disclosure at issue in this proceeding. However, he was involved, as would be expected of senior management, in the preparation of the AIF along with others.

[345] Did Gatti sign a certificate that, given his knowledge of the facts, simply could not support a belief that the associated disclosure was true and that facts were neither omitted nor misstated?

[346] Gatti had considerable knowledge of the corporate history of YBM including the fact that the original shareholders had a significant role in the formation of the company but were, in his belief, not active in the company. He knew there were material weaknesses in internal controls in the accounting systems. He also was aware of the details of the U.K. proceedings. He agreed that one reason for the reorganization of Arigon and the establishment of United Trade was to

dispose of the lingering effect of the U.K. proceedings that had been dismissed. Gatti recommended Arbat's sale but left the details to Fisherman and Bogatin. We accept his evidence that he did not know the value of the continuing services that Arbat would render on a contractual basis after its sale.

[347] There can be little doubt that Gatti had considerable awareness of the facts which staff submit were material and should have been disclosed. Gatti and Bogatin initiated a management investigation into the visas that had been denied to the Vitanovs. They retained Rossman and Gatti briefed him on the investigation. They also took other steps. They contacted and co-operated with government officials, contacted Congressman Greenwood, invited and spoke to the FBI in Newtown, agreed to approach Senator Specter and hired Hearn for that purpose.

[348] Bogatin appeared to resist bringing Rossman's findings to the board but did so on August 15, 1996, on threat of Rossman's withdrawal. Gatti prepared and presented a detailed chronology as discussed above. He was aware of the highly sensitive investigation but not its scope or magnitude.

[349] Gatti knew of the State Department's interest and that there was a "large Justice Department file on YBM." He had concerns and understood the potential impact on YBM as a public company. Management agreed to send a letter detailing these concerns and the potential impact, drafted by Gatti, to U.S. Attorney Stiles. Ultimately, the board did not approve its being sent. The contents of this letter clearly demonstrate the likely materiality of this information.

[350] Rossman felt that Gatti was sincere, co-operative and forthcoming with information. We took a similar view during this hearing. We were satisfied as to his integrity. We find that he honestly believed that there were no material facts omitted. However, that does not necessarily mean that his belief was reasonable in the circumstances.

[351] Gatti assisted the Special Committee in collecting information and did so extensively. We do not attribute any negative inferences with respect to the Arbat information. His effort to provide information is evidence of his due diligence. He drew to the Special Committee's attention the issues associated with the discrepancies in the Averin sales commission statement. Management discovered the FBI Affidavit. Bogatin made Mitchell aware of its contents. Gatti prepared the letter and questionnaire to the original shareholders in December 1996 in which management tried to identify the problem. In this letter, Gatti recognized that "our western securities lawyers tell us that we are very close to having an obligation to disclose these allegations to the general public. If this were to happen our stock could be worthless in a short period of time." This letter was written on December 19, 1996. At that time Gatti was unwilling to sign off on the 1996 audit due to his concerns.

[352] Gatti was obviously not a member of the Special Committee. He forwarded information to Fairfax, including concerns regarding individuals with ties to organized crime. Neither Gatti nor the Special Committee informed Fairfax about the FBI Affidavit. After the Special Committee retained Fairfax, Gatti became more reactive. This was not unreasonable given the role of the Special Committee and Fairfax.

[353] Gatti attended with Fairfax in Hungary during their review of operations. He also highlighted for Fairfax the commission payments made to Averin. Staff submit that Gatti destroyed a commission statement. He testified that he did not do so but rather that he declined to give Larkin a copy. We accept Gatti's evidence on this matter. The conduct alleged by staff would be inconsistent with our view of his overall testimony.

[354] Gatti was briefed on March 22, 1997 by Fairfax. He provided further information regarding customers at that time. He also provided information regarding the Technology Distribution and Mogilevich bank accounts. He attended the Fairfax/YBM final meeting on April 13, 1997 and was present at the April 25 board meeting.

[355] Gatti was part of the working group that prepared the AIF and preliminary prospectus. The working group consisted of Wilder, Jordan Jacobs of Cassels Brock, Mitchell, Jones, McBurney, Litwack, Bogatin and Gatti. It would appear that the working group funnelled information to Wilder.

[356] Gatti submitted a draft AIF, which while not entirely sufficient, was more detailed than the final version. Gatti's draft demonstrates his belief in the materiality of the formation of the Special Committee, its mandate and a number of its findings. Wilder and Mitchell decided that Gatti's draft was not appropriate. Bogatin became involved and the May 1, 1997 draft was then finalized. The final version of the AIF substantially reflected Bogatin's input. Gatti clearly relied on the advice of the working group of lawyers, underwriters and Mitchell as Chair of the Special Committee.

[357] Gatti had no experience in such matters. He relied on the Special Committee. He relied on the experience of underwriters and securities lawyers for the issuer and underwriters. While Gatti knew a great deal, the Special Committee knew more. The disclosure at issue was not financial disclosure. The Special Committee was independent of management. As such, his reliance was in good faith and honest in the circumstances. As indicated previously, a material fact is a question of fact and law. The assessment of and reliance on legal advice is most pertinent to the reasonableness of the investigation. Gatti was influenced by the fact that while the investigation may have existed, counsel advised that it was not disclosable. Indeed Gatti received correspondence with regard to a Parente audit inquiry letter with a marginal note that reads: "no required disclosure – per CBB". Finally on May 28, 1997, Gatti, Bogatin and James Held of YBM participated in a due diligence conference call with the underwriters, auditors and lawyers in which it was concluded that no material fact, including the fact of any pending investigation, was omitted from the preliminary prospectus. The prospectus was signed two days later. The question is, did he reasonably believe that the disclosure was adequate and that it was true?

[358] Gatti relied on the D&T audit as verification of the legitimacy of the business. As indicated previously, appropriate reliance is a factor in due diligence. Was reliance on D&T's audit reasonable for Gatti, who was an experienced auditor? Gatti supplied considerable information to D&T. The nature of the high-risk audit has been discussed previously. We agree with staff that D&T should have been, but were not provided with, the Report, Rossman's August 2, 1996 letter to Bogatin, Mitchell's September 15, 1996 letter to Antes, Gatti's October 8, 1996 letter to Mitchell, the November 1 interim report of the Special Committee and notes

pertaining to the two Fairfax briefings. While Gatti did provide considerable information to D&T, clearly it should have been provided with more. Gatti, however, was not the only member of management who had this responsibility. Moreover, Mitchell and the entire Board were aware of the significance of the D&T audit and should have provided the above mentioned information.

[359] It was clear that Gatti was subordinate to Bogatin and to the decisions of Mitchell and Wilder. What should he have done? In our opinion, as mentioned above, in such circumstances an engaged CFO should communicate directly with the board of directors of the company.

[360] In conclusion, we find that, at the relevant time, Gatti had a reasonable belief that the prospectus disclosure was true and that no material facts were omitted. In the circumstances of this case, we find that Gatti has proved his due diligence, but just barely.

WHAT DID FIRST MARATHON AND GRIFFITHS MCBURNEY DO TO ENSURE FULL, TRUE AND PLAIN DISCLOSURE?

[361] Staff allege that First Marathon and GMP signed certificates to preliminary and final prospectuses which they knew or ought to have known failed to contain full, true and plain disclosure of all material facts. In particular, they knew or ought to have known that the prospectuses failed to disclose material facts relating to the mandate, information obtained by and findings of the Special Committee.

[362] Staff submit that the underwriters used the due diligence process selectively as a means to justify a pre-determined position by rejecting the results of due diligence that reflected adversely on the issuer and accepting the results of due diligence which supported the issuer. The underwriters submit that they conducted extensive due diligence procedures and did not merely rely on the statements and opinions of YBM's directors, officers and counsel.

[363] The actions taken by the co-lead underwriters and their counsel from April 11, 1997 (the date Mitchell gave Bloomberg the April 11 draft of the Report) to November 18, 1997 (the date the final prospectus was filed) can be summarized as follows:

1. Jones and McBurney were designated to oversee their firms' due diligence and sign the underwriter certificates to the preliminary and final prospectuses.

2. Without having a copy of the April 11 draft of the Report, Jones discussed disclosure regarding the Special Committee and its findings in the AIF.

3. Having received a copy of the April 11 draft, Litwack reviewed and commented on at least two drafts of the AIF sent to him by Wilder.

4. Based on the advice Fogler gave after reviewing the April 11 draft, Bloomberg and Jones met with Peterson on May 12 to obtain a moral reference on the quality of YBM's management.

5. Based on Fogler's advice that the balance sheet be 'hardened', the underwriters retained Price Waterhouse and Real Partners to ascertain the legitimacy of the business.

6. Steps were taken from May onwards to confirm sales, customers and both the existence of and value of equipment. These steps included document reviews, site visits in Hungary and conversations with Bogatin and Fisherman.

7. Just before the preliminary prospectus was filed, a set of 'bring down' due diligence questions was put to the company, and answers given. Mitchell and Jones participated on behalf of First Marathon. McBurney attended on behalf of GMP. Litwack was also present.

8. Starting on June 3, a variety of individuals from First Marathon, GMP, Fogler Rubinoff and Price Waterhouse participated in a series of meetings with staff regarding the sufficiency of YBM's disclosure.

9. After D&T was retained to re-audit YBM's 1996 financial statements, the underwriters ceased their efforts to harden the balance sheet because they believed that such efforts would be redundant given D&T's work.

10. After receiving the April 11 draft of the Report in July, Jones asked Mitchell about items in the Report that seemed inconsistent with the oral briefing Mitchell had provided previously. In particular, they discussed the Special Committee's stated concern about the role that the founding shareholders had with respect to the company.

11. In the wake of a clean audit opinion from D&T on October 13, bring down sessions for the Final Prospectus were held on November 14 and 18. Questions were again asked and answers given.

1995 Due Diligence and GMP/First Marathon Trading Accounts

[364] Mitchell and McBurney had conducted due diligence on behalf of First Marathon and GMP previously in connection with the 1995 offering. Litwack and Wilder had acted as counsel to the underwriters and YBM, respectively. At that time, McBurney asked who the principal shareholders were.

[365] Upon incorporation, the shares of Arigon were held in the names of nominees resident in the Channel Islands. The Arigon share register identifies the beneficial owners of these common shares as Semeon Mogilevich (40%), Alexei Alexandrov (12%), Anatoly Kulachenko (12%), Vitaly Leiyba (12%), Alexander Alexandrov (12%), and Semeon Ifraimov (12%). As consideration for the sale of equipment to Arigon, Arigon also issued preferred shares to these individuals in the same proportions.

[366] Sixteen new Arigon shareholders, together with the six founding shareholders, appear in connection with the reverse take-over of YBM Magnex Inc. by the Arigon shareholders. In February 1994, in connection with that transaction, the shareholders of YBM Magnex Inc. consented to issue shares to a total of 22 Arigon shareholders. It appears that no one shareholder beneficially owned more than 10% of YBM Magnex Inc. after the introduction of the additional 16 shareholders.

[367] The only Arigon shareholders recorded in the minutes as having participated at the May 14, 1994 meeting to ratify the share exchange agreement with YBM Magnex Inc. are the six founding shareholders. Bogatin was appointed as their agent and attorney to execute documents

in connection with the reverse take-over of Pratecs. Only the six founding shareholders of Arigon executed the authorization. The additional 16 shareholders did, however, execute the shareholders' consent dated September 28, 1994 approving the letter of intent in connection with the reverse take-over of Pratecs.

[368] The relationship between the new 16 shareholders and the original six shareholders of Arigon was explained in 2 letters from Adrian Churchward, counsel to the "founders of Arigon" in March 1995. Churchward confirmed that each of the original shareholders were holding their shares on behalf of themselves and various other unknown parties. Later, Churchward clarified that the shares in Arigon were initially issued to seven residents of the Channel Islands, who executed Declarations of Trust in favour of the true beneficial owners. Declarations of Trust were issued in favour of a Galina Grigorieva, who held the shares on behalf of the six original founding shareholders, who in turn held them on behalf of themselves plus the additional 16 shareholders. Churchward supplied a schedule breaking down the holders of 17,000 shares of YBM Magnex Inc. into six groups. Each of the six groups included one of the original six shareholders. Five of the six groups held 12% of the shares and the group with Semeon Mogilevitch held the remaining 40%. Included within the Mogilevitch group was Fisherman.

[369] In the course of the 1995 prospectus review, staff asked YBM to comply with the prospectus form disclosure requirements for principal shareholders. Wilder advised staff that "to the best of our knowledge, the disclosure contemplated by Form 12 Item 26 is not required." At the time, Mitchell and McBurney understood from management that the shareholders were separate and distinct.

[370] After the 1995 offering, a number of trading accounts were opened by the original shareholders through which they sold YBM shares between May 1996 and April 1998. Approximately 7,958,764 shares were sold through GMP accounts and proceeds of approximately CDN $90,000,000 withdrawn. Approximately 2,108,800 shares were sold through a First Marathon account and proceeds of approximately U.S. $12,148,329 withdrawn.

[371] The GMP accounts included one opened by Karat, the founding shareholder named with Mogilevich in the initial allegations in the U.K. proceedings. The new client application form directed that confirmations be sent to Bogatin. Other documentation in the account included a power of attorney executed by Mogilevich in favour of Karat and a letter from Bogatin to McBurney forwarding five share certificates, including one in Mogilevitch's name. An account called Poseidon controlled by a V. Alexandroff was opened at GMP with instructions that confirmations be sent to YBM's address. An account was also opened in the name of an Alexander Benkovich, a name that appears in various capacities, including as a former shareholder of Schwinn Csepel, a representative of Amadeus (a YBM customer) and a director of Technology Distribution.

[372] Karat also opened the Arion Investment Club cash account at First Marathon for which Mitchell is recorded as the investment advisor. The six founding shareholders of Arigon are the six partners in the Arion Investment Club. Mitchell testified that the rationale for such an account is to provide an orderly means for original shareholders to dispose of their shares while minimizing disruption in the market. Mitchell was aware that there was significant over-demand for YBM shares and that institutional buyers were available.

[373] After the 1995 offering, GMP and First Marathon dominated secondary trading in YBM shares. Until January 1998, First Marathon and GMP issued consistently favourable research reports with buy and strong buy recommendations.

The Special Committee Report

[374] Mitchell provided Bloomberg with a copy of the April 11 draft of the Report after the April 11, 1997 Investment Banking Screening Committee meeting at which First Marathon approved the proposed offering with YBM. Bloomberg sought Fogler's advice. As a result of their discussions, the following key decisions were made by First Marathon between mid-April and early May 1997:

(1) First Marathon would not proceed with the financing until it had conducted further due diligence.

(2) In order to avoid any suggestion of a conflict of interest, an additional senior investment banker would be involved in the due diligence process and would sign the prospectus on behalf of First Marathon.

(3) Bloomberg would contact Peterson to make sure that he was aware of the issues surrounding the Special Committee and to obtain Peterson's views on YBM and in particular its management.

(4) First Marathon would take steps to ensure that it was reasonable to rely on YBM's financial statements that had been audited by the firm of Parente.

[375] On or about April 14, Jones met with Mitchell to discuss YBM. Mitchell informed him of the visa problems, the Special Committee and Fairfax. Jones understood the possibility that YBM was being investigated as part of a larger investigation involving organized crime infiltrating U.S. businesses. Mitchell summarized Fairfax's findings and explained that its key conclusion was that there had been no evidence of improper activity on the part of the YBM or its management. Mitchell indicated that there were some suspicions with respect to one or more of the founding shareholders having some involvement with organized crime in the former Soviet Union.

[376] Jones was not provided with a copy of the Report at this time. He did not receive a copy until July 1997, well after the Preliminary Prospectus had been filed. Litwack, who had received a copy as underwriter's counsel, did not provide a copy of the Report to either Jones or McBurney, as he understood that they were aware of the relevant details.

[377] Bloomberg and Jones advised Mitchell that First Marathon's approval of the financing was withdrawn because they did not have all of the relevant facts at the time the approval was granted. Jones confirmed that in his view, the information regarding the Special Committee was "crucial" information for those people who were making the investment banking decisions.

[378] Some time after April 22, 1997 Mitchell spoke with McBurney in Newtown about the Special Committee. He did not provide McBurney with a copy of the Report, but he did talk to McBurney about its contents. Mitchell did not know whether McBurney was aware that a report

existed. Mitchell testified that he did not recall McBurney ever asking if the Special Committee prepared a report.

[379] McBurney understood that certain YBM employees had been denied visas. Mitchell told him that YBM had made inquiries and had discovered that certain U.S. Government organizations were concerned about the infiltration of legitimate American businesses by Russian organized crime. Mitchell further explained that it was believed that YBM had likely been examined as part of that investigation. McBurney understood that the foregoing led to the creation of the Special Committee and that its mandate was to review YBM's operations.

[380] McBurney understood that Fairfax was an internationally recognized investigative firm. McBurney understood that Fairfax had reported a rumour that one of the founding shareholders had links to organized crime, but had been unable to substantiate the rumour. Further, McBurney understood that Fairfax viewed YBM as a legitimate business and that its management was not involved in any illegal or improper activity. McBurney asked if Fairfax had prepared a written report. He did not ask if the Special Committee had produced one too.

[381] Mitchell told McBurney that Fairfax had found that, with two exceptions, there was no connection between the founding shareholders and YBM's ongoing business. The two exceptions were that YBM and Mogilevich had offices in the same building and that Mogilevich had signing authority over a dormant bank account. These issues, however, had already been addressed by management. Mitchell also told him about certain unexplained commission payments made by Arbat, but McBurney understood that Arbat had been sold.

[382] McBurney testified that he understood Mitchell's joint role had the potential for conflict, but saw no reason to doubt Mitchell. GMP's practice, however, was not to sit on the boards of its clients. His personal relationship and past business experience with Mitchell may have been partially responsible for this belief.

The AIF Disclosure

[383] Jones discussed the AIF disclosure with Mitchell before the AIF was filed and he reviewed it afterwards. Jones believed that the disclosure was accurate and that it conveyed that there were clearly risks in investing in YBM. Similarly, McBurney was comfortable with the language used in the AIF.

[384] Litwack reviewed the final draft of the AIF before it was filed. He marked up page six of the AIF, dealing with "Business Risks". Next to the section about Arbat, Litwack noted "Is this why it was sold?". He further underlined the section dealing with the establishment of the "Independent Committee" and noted a question mark. The reason for this was to "make sure they [YBM] were comfortable that there was an adequate description of Fairfax". This version of the AIF did not change again and Litwack did not advise his clients that the AIF was deficient.

Due Diligence – Preliminary Prospectus

[385] On May 2, the Orr briefing took place at the offices of Nesbitt Burns. We have already referred to this meeting and its implications in our discussion of material facts above. Mitchell believed that Nesbitt declined to participate in the syndicate based on this briefing.

[386] Jones spoke with Barry Rowland, who was the audit partner at Ernst & Young responsible for First Marathon's audit. On May 9, Rowland informed Jones that YBM's auditor, Parente, was a reputable firm. Rowland also informed him that Ernst & Young had been offered the audit of YBM but had declined after doing some due diligence work in Hungary. Rowland advised Jones to contact Ernst & Young's security people, who might be able to provide more information on a privileged basis.

[387] On May 13, Litwack reported to Jones that he had contacted Larry Bastocky at Ernst & Young and informed him that there was nothing that Bastocky said that they did not already know. He made reference to a letter that Bogatin sent to Ernst & Young on November 26, 1996 addressing the concerns of Ernst & Young. Jones received a copy of the letter on May 13. He testified that after reading the letter, he felt more comfortable.

[388] Jones and Bloomberg met with Peterson on May 12. Peterson expressed confidence in the company and its management.

[389] At some point in May, McBurney asked Litwack "whether or not we should be talking to Fairfax." Litwack replied that Fairfax does not "talk to anybody else but their client" due to privilege concerns. Litwack also advised Jones, based upon discussions with Wilder, that Fairfax would not speak to them. Stern testifed that Fairfax had advised Mitchell on April 13 that they would speak to the underwriters if contacted.

[390] On or about May 15, Jones briefed Diana Chant, the audit partner from Price Waterhouse, who were also auditors of First Marathon. Jones told her what he knew about YBM and the Special Committee and retained Price Waterhouse to visit YBM in Hungary and review Parente's working papers with respect to the audited financial statements. Jones testified that he wanted to be comfortable that he could rely heavily on the financial statements. He engaged Price Waterhouse because he was not familiar with Parente and because the existence of the rumours and the creation of the Special Committee raised unusual concerns.

[391] On May 28, Jones and Mitchell attended a due diligence session with the YBM and its auditors. McBurney and Litwack also attended.

[392] Also on May 28, Chant raised some concerns with Jones regarding the identity of YBM's customers. In particular, there were two U.S. customers that could not be found in Dun & Bradstreet listings. She also questioned whether some of the magnets could be used in missiles and noted that one third of the sample documentation to support certain sales was missing. She also indicated that certain business practices in Eastern Europe were often intended to create confusion because companies were trying to hide things from former Communist authorities. She explained that these practices were well ingrained and that it did not necessarily mean there was any deception.

[393] Jones was concerned and decided that it would be inappropriate to file the Preliminary Prospectus until they reviewed these issues. McBurney and Mitchell travelled to London around this time in preparation for YBM's road show. McBurney left a signed certificate for the Preliminary Prospectus in escrow with Litwack pending favourable resolution of the issues raised by Price Waterhouse.

[394] First Marathon met with Price Waterhouse on May 29 and Jones concluded that they should speak with Parente. A conference call with Parente occurred the following day. As a result of the call, Jones became comfortable with Parente's work, as did Chant, but she indicated that Price Waterhouse would have checked customers differently. Jones requested that Price Waterhouse conduct further customer checks. Despite the request for additional work, Jones asked Chant and Litwack if they had any reservations about filing the Preliminary Prospectus. Chant would not provide an opinion regarding filing the Preliminary Prospectus, whereas Litwack was unreserved. The prospectus was filed on June 2.

[395] Litwack advised Jones that rumours are inappropriate prospectus disclosure. Meanwhile, the collective view was that the founding shareholders were not involved in the operations of the company and that management had integrity. Jones was impressed with Bogatin after meeting and questioning him, but indicated to management that First Marathon would not complete the financing until all due diligence was completed.

[396] Jones testified that it would have been better to complete the due diligence before the Preliminary Prospectus was filed. McBurney testified that due diligence is always ongoing, right up until the final prospectus is filed. Litwack testified that the Preliminary Prospectus was filed in order to start the process of the offering and that there could have been problems with the Crucible acquisition if the "clock didn't start ticking". Jones spoke with McBurney later and gave no indication of any discomfort with filing the Preliminary Prospectus.

[397] As part of First Marathon's continuing work, Jones wanted another equipment valuation. Dan Nowlan of First Marathon and Mike Middleton, an analyst at GMP, went to Hungary.

Prospectus Review and Due Diligence for the Final Prospectus

[398] On June 3, Jones attended a meeting at the Commission with staff, Litwack, McBurney and counsel to YBM. Staff had learned about Price Waterhouse's engagement, but not from the respondents. According to McBurney, when staff indicated that they were concerned about "the integrity of the company," this got his antennae up.

[399] Notes from the meeting indicate that staff was made aware that:

- YBM was co-founded by Russian immigrants;
- there were rumours about the shareholders' links to organized crime; staff was already aware of this.
- the Fairfax group, was hired to look into the rumours and innuendo but could not find any evidence to substantiate the rumours.

- Cassels Brock did not look into whether U.S. authorities had concerns with the YBM – (didn't know where to start) - "we due diligence [everything] and have found nothing".

[400] On June 5, Nowlan reported to Jones from Hungary that he had talked to a number of customers, visited YBM's plants and observed a real magnet business in operation. McBurney indicated that Middleton reported that he had confronted Fisherman as follows: "Come on, Igor, is this a Russian mobster company?" Fisherman was taken aback and replied, "No, there's no connection whatsoever."

[401] In an effort to confirm sales, Bloomberg requested that someone visit YBM's largest customer notwithstanding Nowlan's telephone contact. Meanwhile, on June 9, Jones received a letter from Real Partners that provided an opinion on the quality of the equipment and operations at YBM's Budapest facilities. It was favourable, but Jones nevertheless requested a valuation of the equipment by Real Partners.

[402] On or about June 12, both First Marathon and GMP contemplated withdrawing from the offering because staff advised them that they had heard from international sources that YBM was involved in money laundering.

[403] On June 13, Jones attended a meeting at the Commission with Mitchell, Litwack, Wilder, McBurney and staff. Jones informed staff that First Marathon continued to make calls to YBM's customers and had conducted more due diligence than they ordinarily would have. Naster specifically advised that staff's concerns were with respect to disclosure and not money laundering.

[404] Staff was advised about articles in the media, the establishment of the Special Committee and, according to notes from the meeting:

- the Russian shareholders not being involved in the management of the company;
- control weaknesses at YBM;
- "individual mentioned in article never been shareholder or employee of the company".

[405] On June 16, representatives of First Marathon, GMP, Fogler Rubinoff and Price Waterhouse again met with staff. At staff's request, Chant provided a copy of the Price Waterhouse engagement letter, the Price Waterhouse draft report dated May 29, and notes of the Price Waterhouse manager's review of Parente's working papers.

[406] On June 18, staff received the response to its first comment letter. Litwack acknowledged that the first draft of the response letter included more information regarding the U.S. investigation and the Special Committee. McBurney saw the drafts but did not participate in the wording of the letter. We have already discussed Mitchell's involvement in the preparation of the response letter above.

[407] Meanwhile, the report from Real Partners providing an appraisal for certain of YBM's equipment valued it at U.S. $2.2 million less than the value recorded on YBM's books. This created more concerns for Jones, who took steps to investigate. Jones spoke to Fisherman, who

was confident that the equipment valuation was accurate. Like Nowlan, Jones gained a positive impression of Fisherman.

[408] Mitchell and McBurney travelled to Budapest to assess the Real Partners valuation. McBurney testified that the invoices he reviewed on this trip for YBM's equipment purchases in 1997 bothered him. He was not completely satisfied with Gatti's answer, which was that YBM was in the process of improving its controls, but McBurney eventually concluded that an appraisal would give him additional comfort.

[409] On June 24, staff advised YBM of their position that a re-audit of YBM's financial statements was required. First Marathon continued its customer verification work, including doing some site visits, until D&T's re-audit. In First Marathon's view, further investigation would be redundant given the D&T audit. McBurney testified that in June, GMP was either going to walk away from the deal or wait for the process to play itself through, i.e. wait for the completion of the re-audit.

[410] In July, Jones finally received a copy of the April 11 draft of the Report from Mitchell. Overall, Jones understood it to be consistent with the oral briefing that he had received. There were some discrepancies, but Mitchell advised him that the Report was an overstatement of the facts and would subsequently be revised. Jones understood that the revisions would constitute more than mere wordsmithing. Litwack testified that Mitchell previously advised him that significant changes to the April 11 draft were not expected.

[411] Jones inquired about the commingling concerns expressed in the Report. Jones also inquired about the "ties remain" reference to Arbat despite YBM having sold it. Jones gained comfort that the only ties that remained were social and historical. However, the Report stated that Kulachenko, a founding shareholder, operated and may continue to operate Arbat. Jones was not informed before the Preliminary Prospectus was signed that Rossman had been advised "off the record" by the U.S. Attorney's Office that there was an ongoing investigation involving YBM, as contained in the Report. It did not occur to Jones to speak with Rossman, although he understood that an investigation may have been going on in the manner previously described to him.

[412] McBurney testified that he did not learn of the existence of the Report until the fall of 1999. He was upset at not receiving the Report earlier. He testified that he said to Mitchell that it is pretty clear in the Report that there is an investigation. Neither First Marathon or Fogler Rubinoff provided a copy of the Report to staff or D&T.

[413] McBurney did not examine the GMP accounts through which Mogilevich and the other founding shareholders sold YBM shares. McBurney was aware that the six original founding shareholders had "a commonality of interest" in the Arigon/United Trade preferred shares that were subsequently exchanged for YBM common shares. Before he received the Report, Jones was aware that the founding shareholders collectively owned approximately 40% of the securities, and that one of the benefits of the offering would be to dilute the founding shareholders' ownership in YBM. Jones specifically inquired and was advised that the founding shareholders did not represent a control block and that none of them held more than 10%.

[414] Jones was unaware of the Arion Investment Club account at First Marathon. He testified that if he had been aware of this, he would have insisted that there be some disclosure of the principal shareholders or would have sought legal advice on this issue. Litwack understood that the founding shareholders were not joint actors, but when presented with the Arion Investment Club account documentation at the hearing, he testified that it might suggest that the original six founding shareholders were investing together.

[415] Litwack did report to Jones about the soft information obtained from staff on July 7. Staff had advised Wilder and Litwack of a lawsuit commenced by a disgruntled ex-employee of YBM and a concern expressed by a Paris bank employee regarding YBM's sales based upon rumour and innuendo.

[416] On July 8, a further meeting with staff was held. Jones understood that staff was concerned about the validity of the sales and the identity of the end users. He understood that staff "suspected there was the possibility of fraud." Jones recalled McBurney asking Naster if there was a staff investigation going on. Naster replied that if it were an investigation, Enforcement would want a forensic audit, not merely an audit opinion.

[417] In July 1997, Wilder sought to restructure the financing by doing a special warrant private placement in order to avoid the difficulties with the prospectus review and to ensure that the Crucible acquisition could close. Jones was not prepared to participate in the private placement because he was not yet satisfied that they had sufficient answers to various issues and did not wish to be viewed as circumventing the regulator. On August 21, due to the delay in closing the offering, YBM entered into the $48 million private placement with CC&L. Counsel to CC&L was Fogler Rubinoff, also counsel to the underwriters on the offering. CC&L acknowledged that it was relying exclusively upon its own due diligence when it retained Fogler Rubinoff. The information respecting the Special Committee was not disclosed to CC&L.

Deloitte & Touch Clean Audit

[418] Jones testified that he was pleased to learn that D&T had issued a clean audit opinion of YBM's financial statements in October, 1997. He believed that the opinion eliminated concerns with respect to fraud because he believed that D&T had been given very specific instructions on the procedures they were to follow and that those procedures were designed to detect a fraud, if one existed. Jones understood that D&T had been provided with all of the correspondence between YBM and the Commission and had also been provided with all of the documents prepared by PriceWaterhouse. McBurney was similarly comforted by the results of the D&T audit.

[419] Litwack advised Jones that, at the November 4 meeting, staff satisfied themselves that D&T had done very extensive work, that they had followed all of the agreed procedures, and that staff appeared to have no concerns with respect to the quality of D&T's work.

[420] On November 14 and 18, the underwriters held bring down due diligence sessions. The Final Prospectus was filed on November 18.

[421] The foregoing indicates that the underwriters tried to investigate YBM in response to the information provided to them regarding the Report. We are unable to accept staff's submission that the underwriters conducted their due diligence selectively. We must still consider whether the investigation conducted by First Marathon and GMP was sufficient to provide a reasonable basis for their belief that the prospectus contained full, true, and plain disclosure.

First Marathon/National Bank Financial Corp.

[422] First Marathon was at all relevant times an investment dealer registered under the Act. First Marathon was acquired by the National Bank of Canada through a concurrent merger of First Marathon and Levesque Beaubien Geoffrion Inc., then owned by the National Bank of Canada to form National Bank Financial Corp. Neither Mitchell nor Jones are currently employed at National Bank.

[423] We must consider whether First Marathon, given its knowledge, access to information, involvement and expertise, reasonably formed the view that YBM's prospectus contained full, true and plain disclosure. Did First Marathon adequately question, challenge and investigate the information put before them?

[424] First Marathon submits that there are two ways to conclude that it signed a prospectus which, to the best of its knowledge, information and belief failed to contain full, true and plain disclosure of all material facts:

1. Mitchell was aware of information and/or material facts which, though not disclosed to his colleagues at First Marathon, First Marathon is deemed to have known; and

2. the due diligence conducted by First Marathon as a result of the information contained in the draft Report was inadequate.

Mitchell's Knowledge

[425] First Marathon had already established a relationship with YBM at the time of the 1997 offering by acting as a co-lead underwriter in the 1995 offering. Mitchell, with the consent of First Marathon, subsequently accepted a position on YBM's board in early 1996 and, of course, chaired the committee whose report and investigation are at issue in these proceedings.

[426] Staff submit that Mitchell was a "directing mind" of First Marathon and, consequently, First Marathon had perfect knowledge of the alleged material facts respecting the Special Committee. National Bank submits that Mitchell was not the "governing executive authority" nor the "directing mind" with respect to the filing and certification of YBM's prospectus on behalf of First Marathon, but rather Jones was. We prefer staff's position on this matter. First, it would be untenable to conclude that only the person signing the certificate can establish liability. Second, there may be more than one directing mind in a company; *Rhône (The) v. Peter A.B. Widener (The)*, [1993] 1 S.C.R. 497. Third, despite Jones signing the certificate, Mitchell remained an integral part of First Marathon's underwriting team.

[427] National Bank acknowledges that Mitchell should not have been involved in investment banking functions in this financing. We agree, but would add that the issue is not only one of

Mitchell's involvement in the financing, but also First Marathon's reliance upon him. First Marathon was required to be adversarial with Mitchell given his position as a YBM Director and Special Committee Chair.

[428] National Bank further acknowledges that Mitchell's knowledge can be imputed to First Marathon given that there was no "Chinese wall". However, National Bank submits that imputing Mitchell's knowledge to First Marathon is more relevant to issues of civil liability than regulatory liability. While we appreciate the distinction, we do not accept it, particularly in this case, and indeed view it as imperative in a public interest proceeding.

[429] The allegation before us is with respect to the conduct of First Marathon. Consequently, we must assess the reasonableness of First Marathon's belief regarding disclosure for the purpose of determining its regulatory liability. The reasonableness of First Marathon's belief can only be assessed in the context of the collective knowledge of First Marathon, not just that of Jones.

[430] First Marathon consented to Mitchell sitting on YBM's board. It was well aware that he had chaired the Special Committee. First Marathon took no issue with this and relied upon Mitchell throughout the offering process. In this case, however, Mitchell chaired the committee whose information was the focal point of the underwriters' due diligence. First Marathon was well aware that the potential for conflict existed. Indeed, as indicated above, National Bank acknowledges that Mitchell "should not have been permitted to have been involved in investment banking functions in this financing."

[431] We believe that Mitchell's knowledge is relevant in assessing First Marathon's due diligence in this case, particularly in light of his conflict and the reliance placed upon him by First Marathon.

First Marathon's Investigation

[432] Based upon legal advice provided, First Marathon attempted to address Mitchell's conflict by getting Jones involved. Jones testified on behalf of First Marathon.

[433] At that time, Jones was the Executive Vice-President and Head of Investment Banking at First Marathon. Jones was a highly experienced and respected investment banker, having joined First Marathon from Salomon Brothers Canada Inc., where he had been President and Chief Executive Officer. Prior to Salomon Brothers, Jones had been the worldwide head of corporate finance for Wood Gundy. Jones was forthcoming, thoughtful, well prepared and we take no issue with his integrity as a witness.

[434] Significant efforts were initiated by Jones on behalf of First Marathon in an attempt to ascertain further facts regarding YBM and assess the materiality of some of the Special Committee information provided to him. Indeed, the investigation undertaken by the underwriters in this case was extensive. A significant shortcoming of Jones' investigation, however, was that he was unaware of all the facts relevant to First Marathon's investigation.

[435] For instance, Jones wanted to speak with Fairfax, but counsel advised him that Fairfax would not speak with him. Mitchell knew differently. Jones understood there were suspicions with respect to one or more founding shareholders having some involvement with organized crime. Meanwhile, Mitchell was fully aware of the FBI Affidavit and the confidence that Fairfax had expressed in its intelligence sources. It did not occur to Jones to speak with Rossman regarding the U.S. investigation as he did not believe that Rossman had any particular knowledge on the subject. Mitchell, of course, had attended Rossman's August 15, 1996 briefing. Jones was unaware that as recently as March 1997, the INS continued to demonstrate a specific interest in YBM and had requested lists of its customers. Mitchell, however, had received Gatti's AIF draft disclosing that the INS had begun an informal inquiry. Jones was unaware of the Arion Investment Club account, which would have led him to question whether disclosure of the principal shareholders was required. Mitchell was the account's investment advisor. Bloomberg, Mitchell and Litwack each had a copy of the Report. Jones did not receive a copy until well after the Preliminary Prospectus had been filed, despite being responsible for First Marathon's due diligence.

[436] Mitchell was a senior investment banker, officer and colleague. Jones testified that he was less sceptical of the information obtained from Mitchell for this reason. However, as indicated previously, in the context of their division of the corporate brain, there was clearly an issue with respect to the sharing of important facts which make it unclear how First Marathon could conduct reasonable due diligence and form a reasonable belief that full, true and plain disclosure of all material facts had been made.

[437] In addition to these failures to communicate, the evidence suggests other shortcomings in First Marathon's due diligence process. Most notably, the process was not complete at the time First Marathon agreed that the Preliminary Prospectus could be filed. The items that remained were not routine 'tying up loose ends' type due diligence. First Marathon had not completed its 'hardening of the balance sheet' in response to the concerns raised by the Special Committee information. It was still in the process of 'legitimating the business'. It is unclear how First Marathon could certify to the best of its knowledge, information and belief given the circumstances. We recognize the commercial reason for proceeding in this manner, but the desire to get on with the Crucible acquisition was simply too high-risk at this stage. This is particularly the case since the Preliminary Prospectus was filed under the POP system, which provides for an abridged prospectus review process by the Commission and an expedited closing of the financing.

[438] We have already discussed Mitchell's role in connection with the AIF disclosure and the work of the Special Committee. Indeed, Bloomberg and Jones quite correctly withdrew First Marathon's initial approval of the offering in response to the Special Committee information. Jones also felt that the information was sufficiently important that they should brief Nesbitt Burns personally before it decided to participate in the syndicate. First Marathon proceeded to conduct an exceptional amount of due diligence. In short, First Marathon and the other underwriters had an opportunity to become comfortable with the risks associated with YBM while investors only received the disclosure provided in the prospectus.

[439] Given First Marathon's knowledge of the Special Committee, its awareness of the risks associated with YBM, and its expertise with respect to public offerings generally, we are less

inclined to accept its reliance on counsel's advice regarding disclosure as being reasonable in the circumstances. We note further that while counsel expressed some concern to YBM regarding the adequacy of the description of Fairfax in the AIF disclosure, the issue was not pressed. Counsel was aware that staff had broadly questioned the Special Committee disclosure. Nevertheless, counsel appears to have allowed the watered-down version of the response letter to be filed without much resistance.

[440] Similar to the other respondents, First Marathon also places great weight on the results of the D&T audit to support the reasonableness of its belief that the Final Prospectus contained full, true, and plain disclosure. But this reasonableness is compromised by the failure to provide D&T with all information relevant to the audit. Most notably, First Marathon failed to provide the Report. We do not say that the failure to provide D&T the report was deliberate. Nor was it necessarily First Marathon's responsibility, but a more reasonable process with fewer communication failures would have been prudent in the circumstances.

[441] First Marathon was a sophisticated and experienced underwriting firm. Unlike the officers and directors of YBM, conducting public offerings was First Marathon's lifeblood. Moreover, First Marathon, through Mitchell's involvement with YBM, was more knowledgeable than the typical underwriter. As such, its obligation to investigate should be considered in the context of its greater access to information. In short, First Marathon was alerted to the specific risks associated with YBM. The expectations of an underwriter by the public cannot be taken lightly. While clearly not the guarantor of full, true and plain disclosure, the underwriter is a gatekeeper.

[442] There can be little doubt that First Marathon exerted significant efforts to investigate YBM. We do not believe it sought to deliberately mislead investors. However, given its knowledge, access to information, involvement and skill, we do not find that National Bank has established that the belief that the prospectus contained full, true and plain disclosure was justified. Accordingly a defence of due diligence is unavailable.

Griffiths McBurney & Partners (GMP)

[443] GMP is an investment dealer registered under the Act. McBurney was the directing mind of GMP. At the relevant time, McBurney was the head of investing banking in Toronto and Montreal and a member of his firm's executive committee. McBurney was called to the Ontario bar in 1979 and practised securities law for many years. He worked at Fogler Rubinoff from 1985 to 1995, at which time he left to set up GMP. At Fogler Rubinoff, McBurney was involved in approximately 200 public financings. At times he worked with Wilder and Litwack. Some time in 1990, McBurney started doing legal work for Mitchell. McBurney worked with Mitchell on approximately 16 to 20 deals as a lawyer. At the time of the 1997 offering, McBurney regarded Mitchell as one of his best friends. McBurney had also worked with Mitchell as a co-lead underwriter in connection with the 1995 offering and was already familiar with YBM as a result. This financing would have been one of GMP's early deals.

[444] GMP submits that it was in a unique position relative to the other respondents because it was not provided with a copy of the Report. The evidence does not support a finding that GMP had a copy of the Report. While GMP was less knowledgeable regarding the mandate,

information obtained by and findings of the Special Committee, it was not completely uninformed. GMP argues that underwriters are not guarantors of the content of a prospectus and submits that it was reasonably diligent based on its more limited knowledge of the Special Committee. They made some inquiries on their own and relied substantially on legal advice, the due diligence conducted by First Marathon, and most importantly, the D&T audit. We must assess whether the foregoing measures provide a reasonable basis for GMP's belief, in the circumstances, that the Preliminary Prospectus and Final Prospectus each contained full, true and plain disclosure.

[445] Staff argue that if GMP did not know the facts which staff allege were material, it was because it failed to conduct reasonable diligence. Staff argue that GMP conducted almost no due diligence before the Preliminary Prospectus was filed, and that the diligence conducted afterwards cannot be described as good faith due diligence, as negative information about YBM was ignored or explained away while positive information was accepted without adequate inquiry.

[446] GMP argues that what it knew about the U.S. investigation was neither specific or certain enough to require disclosure, and what it knew about the Special Committee was not discloseable because to the best of its knowledge, information and belief, no criminal activity involving financial impropriety was taking place. GMP knew less about the U.S. investigation, Arbat and the founding shareholders than First Marathon did. Regarding the U.S. investigation, GMP understood that YBM may have been examined as part of an investigation by U.S. government authorities like the State Department and Justice Department, who were concerned about Russian organized crime infiltrating legitimate U.S. businesses. As for Arbat, GMP knew that the Special Committee had discovered certain irregularities in Arbat's records, including some questionable commission payments, but understood that these irregularities did not give rise to any concerns, as Arbat was not part of YBM's core business and had been sold off in early 1996. As for the founding shareholders, GMP understood that all that existed were rumours of ties to organized crime.

[447] The cornerstone of GMP's belief that the Final Prospectus contained full, true and plain disclosure was its reliance on the D&T audit. McBurney's impression was that there would be a complete cradle-to-grave examination. As part of this examination, D&T would be contacting end users and obtaining an independent appraisal of YBM's equipment. Minimal reliance would be put on Parente's work. D&T's work would be done at a high-risk level using procedures which were acceptable to staff, who had advised D&T of their concerns. GMP never received a copy of the Report and believed that D&T had been given access to everything. GMP submits that, based upon its knowledge, it was reasonable to conclude that D&T's work had resolved the question of the risk of money laundering by the founding shareholders.

[448] However, we question whether GMP, as a co-lead underwriter, should have known more or made more inquiries than it did in the circumstances. While not a guarantor of YBM's disclosure, McBurney understood that a diligent investment banker would be expected to "drill down" on sensitive issues and agreed that his experience as both a securities lawyer and investment banker would help him in identifying sensitive areas of a company's business. Why did GMP possess the limited knowledge that it did? It is clear that GMP relied upon Mitchell and First Marathon. McBurney knew that Mitchell's dual roles had the potential for conflict.

McBurney relied on Mitchell even though GMP's own policy prohibited its investment bankers from acting as directors of public companies that are GMP clients. McBurney did not think that there would be a reason to doubt what Mitchell was telling him or be suspicious that Mitchell's interest as a director would compromise his role as an investment banker. That may have been because of previous experience or because of his close personal relationship.

[449] GMP's reliance on Mitchell was problematic. In Newtown, McBurney assumed that Mitchell would tell him everything he needed to know. He asked Mitchell if Fairfax had prepared a report, but never inquired as to whether the Special Committee had prepared a report. Even if, as McBurney testified, Mitchell did not read from any notes or a script of any kind at the Newtown meeting, we are troubled by this lapse in diligence. When he eventually saw the Report, McBurney believed that "it's pretty clear in the report there's an investigation." We are aware that Jones did not ask about a report, nor did GMP's own legal counsel provide its client with a copy. In our opinion, this failure is inconsistent with a process that encourages reasonable diligence.

[450] We discussed earlier some of the shortcomings of First Marathon's due diligence based upon its failure to share information internally. This affected the investigation conducted by Jones on behalf of First Marathon and the reasonableness of First Marathon's belief that the prospectus contained full, true and plain disclosure. To the extent that GMP was relying upon First Marathon as part of its due diligence, we believe that GMP was relying upon a flawed investigation. In principle, we see no reason why one member of an underwriting syndicate cannot or should not rely on another, but where a co-lead underwriter falls down in the conduct of its due diligence, the other co-lead may have to bear the risk of its reliance. We note that a similar approach was taken in *Escott*. The underwriters who relied on Drexel in that case were bound by its failure to conduct a reasonable investigation. We believe that GMP understood that its reliance on First Marathon was subject to certain risks given Mitchell's roles.

[451] GMP also relied on its counsel, Fogler Rubinoff, and in particular the work done by Litwack on the AIF. As discussed earlier, Litwack, who was counsel to both First Marathon and GMP, was insufficiently adversarial in failing to pursue his comments on the draft AIF. It is not unreasonable for an underwriter to rely on its counsel to scrutinize the issuer's proposed disclosure. However, such reliance does not automatically mean the underwriter's belief is reasonable. If counsel knows more than its client but is not sufficiently diligent, then any shortcomings of counsel may be visited upon GMP.

[452] McBurney attended the bring down session for the Preliminary Prospectus and a number of meetings with staff. It was the first of these meetings with staff that raised McBurney's antennae. Amid staff's concern about the integrity of the company, GMP sent Middleton, "an in-your-face guy," to try to resolve customer and equipment issues. In connection with the work of Price Waterhouse, McBurney met with Jones on June 2, and on June 16 he met with Chant, who viewed him as being well acquainted with Price Waterhouse's work. Despite this, no thought was given by McBurney to providing a copy of Price Waterhouse's May 29 report to staff at the June 16 meeting until staff specifically asked for it.

[453] When doubts swirled around Real Partners' equipment valuation, he went to Hungary personally and spoke to Fisherman during his visit. It was during this visit that McBurney

became concerned regarding the invoices documenting YBM's 1997 equipment purchases. McBurney testified with respect to the invoices that "I don't think you could characterize them in any way but false", "I was concerned as well with kickbacks", and "I didn't like it. I didn't like it. You know, I didn't like it at all". McBurney questioned Gatti regarding the invoices and was not satisfied with the answer provided, but concluded that an appraisal of the equipment would give him additional comfort. While D&T conducted an appraisal of the equipment as part of its audit, McBurney did not inquire of D&T about the invoices or take steps to ensure D&T was aware of them.

[454] GMP was presented with other opportunities to improve its knowledge and conduct further inquiries, which it did not fully pursue. McBurney asked Litwack about speaking to Fairfax. That was sensible. Despite Litwack's negative response GMP should have pressed harder. We question why McBurney did not read all of the fax he received from Jones on June 18, 1997 enclosing drafts of the response to staff's comment letter. McBurney wrote "file YBM due dilig" on the document and had it filed. It goes without saying that a prudent co-lead underwriter would review all materials received from its underwriting partner, especially when a document comes from the person overseeing the due diligence process. As it turned out, the drafts of the response letter stated that "subsequent off the record discussions with the U.S. Attorney's Office confirmed that the Company had been examined as part of the investigation." McBurney testified, "If I had read this, I would have -- I may have asked, 'What about the off-the-record discussions?'"

[455] Faced with the spectre of organized crime and money laundering, we are concerned that it did not occur to McBurney to investigate on whose behalf GMP had been selling YBM shares in 1996 and 1997. During the 1995 offering, McBurney had raised a question regarding the identity of the principal shareholders. Despite what was in Arigon's share register and some of YBM's material agreements, McBurney accepted the explanation that the principal shareholders were 22 individuals acting independent of one another. McBurney was aware that the six original founding shareholders were involved in the business at the time of the 1995 offering.

[456] McBurney testified that he knew that GMP had sold shares of YBM, but did not know who the sellers were. He knew that the six founding shareholders who held the Arigon preferred shares that were subsequently exchanged for common shares of YBM had a commonality of interest in those shares. He also admitted that he may have been aware that certain founding shareholders had opened accounts at GMP, but did not know the details of any accounts. He knew that during the 1996-97 period, GMP had tried to get the founding shareholders to open accounts and that some of them did. McBurney admitted that he did not examine any trading activity at GMP in which Mogilevitch may have had involvement. A review of GMP's own documentation would have revealed, for example, that Mogilevitch had granted a power of attorney to Karat, that YBM was the recipient of trade confirmations for the Poseidon account, and that the letter Bogatin sent to McBurney in 1996 indicated that shares were being pooled for subsequent sale from the Karat account on behalf of five individuals: Karat, Mila Mogilevitch, Titana Mogilevitch, Mogilevitch himself, and Vitaliy Leibya.

[457] Similar to First Marathon, in this case, we are concerned that GMP signed the certificate to the Preliminary Prospectus and allowed it to be filed while due diligence was still ongoing. McBurney's position was that due diligence is always ongoing, right up until the final

prospectus. We would agree with that statement if the remaining work only consists of tying up loose ends, but to the extent that further significant investigations would be required after a preliminary prospectus is filed, we cannot agree. McBurney and First Marathon engaged Price Waterhouse, but McBurney did not speak to Price Waterhouse or obtain a report of its findings until after the Preliminary Prospectus was signed. Nor was Price Waterhouse's work completed prior to signing the Preliminary Prospectus. As stated in *Ames*, a course of conduct must be completed before an underwriter can affirm that to the best of its knowledge, information and belief, the document contains full, true and plain disclosure.

[458] We believe that McBurney was alive to the importance and materiality of the information which he did possess. He attended the Orr briefing with Mitchell on May 2, 1997 and acknowledged that the purpose of the meeting was to advise Orr of the issues that he should be aware of in deciding whether to participate in the syndicate. Like Mitchell and First Marathon, GMP was aware that the underwriters were being told more about YBM than investors.

[459] GMP primarily relied upon the D&T audit as the basis for its belief that the Final Prospectus contained full, true and plain disclosure. This reliance is premised upon GMP's limited knowledge of the mandate, information obtained by and findings of the Special Committee. We believe that GMP must bear some responsibility for its limited knowledge based on its reliance on Mitchell and First Marathon. We find that McBurney was alert to the potential conflict associated with Mitchell's roles. As a co-lead underwriter, GMP could have been more adversarial in the circumstances. This was an error which a prudent underwriter with GMP's access to information, participation and skill would have avoided. GMP chose to rely on Mitchell and First Marathon. This implicates the reasonableness of GMP's investigation and its belief that the disclosure was sufficient.

[460] There is no doubt that GMP, along with the other respondents, drew great comfort from the D&T audit which, by all accounts, was an exceptional measure to institute in the midst of a prospectus offering. However, GMP also relied on First Marathon's flawed investigation. GMP was fully aware of those risks. If it was not it should have been. GMP should have taken certain steps that would have been consistent with its role as a co-lead underwriter. Accordingly, we find that a defence of due diligence is unavailable to GMP.

Abuse of Process Motion

[461] Mr. Edward L. Greenspan, Q.C., on behalf of GMP, seeks a stay of these proceedings pursuant to subsection 23(1) of the SPPA, wherein a tribunal may make an order to prevent an abuse of process. The allegation is one of misconduct against staff counsel. In essence it is contended that: staff have no legal basis for their attack on McBurney; Mr. Naster (staff counsel) has put his own credibility at issue; and staff's written submissions are "immoderate and intemperate" in tone.

[462] Counsel submits that because of the manner in which Mr. Naster conducted his cross-examination of McBurney, he compromised the integrity of the hearing sufficient to amount to an abuse of process. Earlier efforts by GMP to stay these proceedings on the basis of an abuse of process were unsuccessful. (OSC, February 6, 2001; Div. Ct. April 20, 2001)

[463] The standard of behaviour imposed on staff of the Commission is no higher than that of a prosecutor in criminal proceedings; *Glendale Securities Inc. v. Ontario (Securities Commission)* (1996), 11 C.C.L.S. 216 (Ont. Div. Ct.); *R. v. Felderhof*, [2002] O.J. No. 4103 (S.C.J.).

[464] Despite the adversarial nature of this proceeding, it is submitted that Commission counsel's conduct fell below the standard so that this panel is unable to assess McBurney's credibility fairly and objectively. Simply put, Mr. Greenspan says Mr. Naster was too close to it. It is argued that the panel is unable to assess McBurney's credibility where the prosecutor is at odds with him. Furthermore, it is argued that the problem, in part, flows from Mr. Naster being the senior investigator and later taking on the lead prosecutor role for the Commission. The risk is that, in Mr. Greenspan's words, the prosecutor gets pitted against the witness.

[465] Counsel further notes that staff's written submission contains little moderation and impartiality with respect to McBurney's testimony and credibility. Staff argue in various places that his testimony or conduct may be described as follows: "strains belief"; "it reveals his true colours"; "his stated belief … is absurd"; "he wanted to bury the report"; "his modus operandi"; "it defies belief" and "it was a lame excuse". Mr. Greenspan notes that these comments are not impartial and were completely unnecessary and unwarranted.

[466] He further contends that Mr. Naster's approach to this prosecution suggests that the panel should "believe me" over the witness because "I was there".

[467] Mr. Code submits on behalf of staff, and we agree, that it would be an error if a witness denies knowledge of a fact, and the panel disbelieves the witness, that disbelief results in a finding of actual knowledge of the facts. Mr. Code asserts that Mr. Naster at no time crossed the line and did not allow himself to be "baited". It is submitted that if questions appeared close, which was not admitted, Mr. Naster was attempting to establish whether or not there was a defence of reliance on staff in accordance with the Commission's previous ruling. McBurney suggested that staff lied and that issue goes to staff conduct. We have already ruled that staff conduct is not an issue in this hearing.

[468] While the case opening slip and the investigation seem to have been delayed until September 24, 1997, we agree with Mr. Code that the examination by Mr. Naster does not in any way suggest inappropriate use of personal knowledge or that he "pitted" himself against or "baited" McBurney. Moreover, while we find that GMP was not misled by that fact, it was not until September 24, 1997 that the Commission's investigation was commenced, almost two months before the receipt of the Final Prospectus on November 20, 1997.

[469] A second series of questions is also emphasised by Mr. Greenspan as revealing that Mr. Naster suggests "believe me" not McBurney because "I was there".

[470] Mr. Code submits there is no basis for that whatsoever and we agree with him. The cross-examination raises no issue as to Mr. Naster's credibility as Commission counsel. Unlike *R. v. Logiacco* (1984), 11 C.C.C. (3d) 374 at 379 (Ont. C.A.), the cross-examination of Mr. McBurney in this case was not irrelevant, distracting, repeatedly abusive or insulting. Indeed Mr. Naster was not provoked even when he was called a "liar" by McBurney.

[471] Finally, Mr. Code discusses the attack with respect to the tone of the staff's submissions, that is, were they immoderate and not impartial? We agree with Mr. Code that less colourful language could have been used. It does not advance the case nor does it assist the panel. Moreover, when the senior staff investigator also assumes the role of senior prosecutor, the risk of the appearance of being too close or giving evidence becomes even more likely. As such, in fact-intensive cases where credibility findings may be imperative, and where there is considerable interaction between staff and the issuer, we would discourage this practice. Another staff litigator should take on the prosecution role. Indeed in this case Ms. Daniels and Mr. Smith along with Mr. Code assumed significant responsibilities for the prosecution of the case. Nevertheless, we do not find Mr. Naster acted improperly or impartially.

[472] GMP submits that because staff's attack on McBurney's credibility and good faith underpins their submissions, and because Commission counsel's conduct and credibility have been put directly in issue in attacking his credibility, it is submitted that there is no remedy reasonably capable of removing the prejudice to GMP at this stage. Furthermore, the proceedings are unfair, and the administration of justice and the integrity of the Commission's hearing process require an order permanently staying these proceedings against GMP under section 23 of the SPPA.

[473] As is evident from the above, we do not accept GMP's argument that there are sufficient grounds to stay these proceedings against GMP. We would prefer that such proceedings not take 124 hearing days and be so vigorously prosecuted and defended. These are, after all, public welfare offences and not criminal matters. No doubt, there is a lot at stake for both staff and the respondents. A tribunal is expected to provide a more efficient and less adversarial alternative to the courts particularly in this specialised field; *Everyday Justice: Report of the Agency Reform Commission on Ontario's Regulatory & Adjudicative Agencies* (Toronto: Queen's Printer, 1998). However, as is evident in this case, considerable time was consumed by motions, evidentiary objections, procedural points, document productions, examination and cross-examination of witnesses, and finally, lengthy and complex submissions. As the Agency Reform Commission of Ontario has observed, "This is not an alternative to the court but an alternative court." (September 1997 at 8)

[474] Staff prosecutors do not seek convictions before the Commission. However they must meet the intermediate standard of proof and must advocate their case in a robust and at times adversarial manner. We agree with Mr. Code that in this case staff counsel have engaged in legitimate advocacy in the pursuit of a just result in an adversarial process. We do not find that the respondents were misled by the investigation. Staff conduct is not in issue in this proceeding. In any event, as indicated above, they formally notified YBM of the investigation on September 24, 1997.

[475] In conclusion, the facts herein fall short of the high standard for a finding of an abusive process and a stay of proceedings. It is not the clearest of cases in which the fairness of this hearing or its integrity has been impaired. The request to stay is denied.

THE FAILURE TO DISCLOSE A MATERIAL CHANGE FORTHWITH

[476] This second allegation is fully set out above and concerns a failure on the part of YBM, its senior officers (Bogatin, Fisherman and Gatti) and its Audit Committee (Mitchell, Antes and Greenwald) to comply with YBM's continuous disclosure obligations – specifically the requirement that material changes in the affairs of a reporting issuer be disclosed forthwith. The alleged violation is contrary to subsection 75(1) of the Act.

[477] The material change that staff allege the respondents failed to disclose was that by April 20, 1998 at the latest, D&T had notified YBM that it would not perform any further services for YBM, including the rendering of an audit opinion in respect of YBM's 1997 financial statements, until YBM had completed an in-depth forensic investigation into specific concerns to D&T's satisfaction.

[478] Pursuant to subsection 75(1) of the Act, "where a material change occurs in the affairs of a reporting issuer, it shall forthwith issue and file a news release authorized by a senior officer disclosing the nature and substance of the change." Subsection 1(1) of the Act defines a material change, where used in relation to the affairs of an issuer, as "a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer." YBM's liability is as principal. The liability of the individual directors and officers is based on having authorized, permitted or acquiesced in the company's failure to comply with subsection 75(1) of the Act.

[479] Staff urge the Commission to answer the following questions:

1) Was the audit suspension a change in the business, operations or capital of YBM?
2) If yes, was the audit suspension material?
3) If material, did YBM and the respondents make the disclosure forthwith?

The Facts

[480] On December 1, 1997, Fisherman, on behalf of United Trade, entered into a series of escrow agreements. The agreements required that United Trade place U.S. $32.2 million in escrow with the Swiss Union Bank Corporation. These contracts were not approved by the Board or Gatti. In February and March of 1998, D&T was not only completing the 1997 audit, but also had accepted a number of additional non-audit engagements on behalf of YBM. D&T was aware that YBM was the subject of an investigation by Enforcement. D&T noted, as a pervasive audit risk factor, that the company's operations were concentrated in Eastern Europe, specifically Russia and the Ukraine.

[481] Gatti learned of the escrow agreements in January, 1998 from YBM's controller. Gatti was troubled and brought the transactions to the attention of Bogatin, who then spoke to Fisherman. Gatti requested that Parker of D&T inquire into the details of the escrow arrangements. Gatti met with Bogatin and Purcell of D&T to discuss the escrow arrangements. After Parker returned from Budapest and Moscow, Purcell became concerned with the escrow arrangements and spoke to management again. D&T also sent a memo to Fisherman requesting information about the escrow arrangements.

[482] At first, Fisherman was opposed to breaking the escrow arrangements and returning the money to North America. Mitchell advised Gatti that the money should immediately be transferred back under YBM's control. In accordance with Mitchell's instructions, the vast majority of the funds, U.S. $28,499,970, were transferred to a YBM bank account at the Royal Bank of Canada between March 19 and 27, 1998. The balance of the funds, U.S. $3,720,000, had already been paid in connection with a licensing agreement entered into by YBM that was approved by the board.

[483] Purcell confirmed that during the weeks following the initial January meeting with Bogatin and Gatti, significant efforts were made to address D&T's concerns respecting the escrow transactions. However, in addition to the escrow agreements, a series of technology contracts also became a matter of concern for D&T, and on February 25, 1998, D&T sent a memo to Gatti raising a series of questions relating to them. D&T sent another memo regarding this issue on February 28. Gatti wanted D&T's questions to be answered because D&T was trying to accommodate YBM's desire to issue a press release regarding the company's 1997 earnings. On March 2, Antes responded on behalf of YBM.

[484] During this period, D&T had also been inquiring about YBM's oil business, which in 1996 accounted for U.S. $20.3 million in sales. D&T initially made inquiries of Fisherman in December 1997. No response was provided. In February 1998, Gatti forwarded the questions to Fisherman again. On February 19, Fisherman replied. YBM terminated its oil business as of January 1, 1998.

[485] Coulter remained concerned about the escrow agreements and the technology contracts. He was dissatisfied with the explanation Antes provided on March 2. He was also concerned because YBM had issued a press release on March 9 announcing the financial results for the year ended December 31, 1997. YBM reported that net income, sales and earnings per share were significantly up compared to 1996.

[486] By the middle of March of 1998, D&T had been unable to resolve its concerns with management and brought its concerns to the Audit Committee. Before a March 23 meeting with the Audit Committee, Bogatin provided copies of a change in policies and procedures to be immediately instituted by United Trade. Much of the problem was laid at the feet of Fisherman. Bogatin was upset with Fisherman, thinking he was reckless and unprofessional.

[487] YBM management were trying to introduce better controls and procedures with respect to Eastern European activities. D&T, meanwhile, unbeknownst to YBM, obtained legal advice concerning YBM, performed background checks with respect to a number of Eastern European companies with which YBM did business, and made certain inquiries into the presence of organized crime.

[488] On March 23, D&T (Coulter, Purcell and Parker) met with the Audit Committee (Mitchell, Antes and Greenwald), along with YBM's U.S. counsel Richard Silfen. At this meeting, D&T requested that YBM conduct an independent investigation into the escrow arrangements, the technology contracts, certain equipment transactions and certain resale magnet purchase contracts with a company called SKS.

[489] Transactions in the amount of U.S. $68 million were identified by D&T as problematic. A forensic investigation was not requested at this time. The members of the Audit Committee decided that Mitchell would be best suited to develop the Audit Committee's investigation plan and communicate with Coulter. Coulter confirmed that there was no discussion at that meeting with respect to suspending work on the audit. The Audit Committee believed that the audit was substantially complete as of March 23, with the exception of addressing the issues raised by D&T. At the February 20 board meeting, Gatti had indicated that the D&T audit was 80% complete.

[490] Other than attending the March 23 meeting, Greenwald had no involvement in the Audit Committee investigation.

[491] YBM continued to disclose positive changes. On March 31, YBM issued a press release announcing the acquisition of the magnetic division of Phillips. No reference was made to any problems with respect to the 1997 audit or the independent investigation by the Audit Committee.

[492] On or about April 7, Gatti provided a memo to the Audit Committee and generally remained concerned about the relevant transactions. On April 7, Mitchell sent Coulter the Audit Committee's draft investigation plan. The purpose of the investigation was to confirm that the transactions were consistent with sound business practices for a public company. They intended to complete the review over the next two weeks. The plan was extensive and was prepared with the assistance of U.S. counsel (Silfen).

[493] On April 9, the Board met and discussed D&T's concerns. The entire Board, including Fisherman, was present along with Gatti, Silfen and Wilder. At some point during the meeting, the Directors discussed matters without Gatti present. Silfen and Wilder discussed the Board's legal duties and responsibilities. Mitchell did not find the explanation that Fisherman provided at this meeting regarding the escrow arrangements to be satisfactory. The Board authorized the Audit Committee to fully investigate D&T's concerns.

[494] Around April 15, Gatti was interviewed regarding the transactions. Even as late as April 16, Gatti was still trying to obtain information from Fisherman regarding geographic segmented disclosure and oil sales. Surprisingly, even at that point, there were still unanswered financial and sales contract questions with respect to the company.

[495] On April 19, D&T by phone advised Mitchell, Antes and Abbe Fletman of Wolf, Block (who had been retained as counsel to the Audit Committee) that D&T would not perform any further audit procedures in connection with the 1997 audit. D&T had reached a high level of anxiety. It was concerned that: (1) entities involved in the forementioned transactions may not exist as legal entities; (2) certain individuals associated with these entities may have ties to organized crime; and (3) the transactions may be bogus and were being used to cover the flow of money between these companies for other purposes. It rejected the Audit Committee's extensive investigation plan as insufficient, requested that an in-depth forensic investigation be performed by outside counsel and an experienced forensic investigation firm, and that YBM management not be involved in the investigation.

[496] D&T further advised the Audit Committee that it would not perform any further audit procedures or services for YBM until the Audit Committee completed its investigation and all matters were resolved to D&T's satisfaction. Upon completion of the investigation, D&T would determine whether it would continue to be associated with YBM, whether it would be able to issue an opinion on YBM's 1997 financial statements, and whether it would continue to be associated with YBM's 1996 financial statements. D&T believed it unlikely that these issues could be resolved by YBM's filing deadline with the securities commissions, which D&T understood to be April 30. In fact, the deadline was May 20.

[497] On April 20, Coulter faxed Mitchell a letter confirming the telephone discussion. It is at this time that staff submit a press release should have been issued disclosing the audit suspension. Mitchell discussed with counsel that if YBM did not get its audit opinion, YBM's shares could be cease-traded. Mitchell relied on counsel's advice that no disclosure was required at this time.

[498] D&T gave Mitchell and Fletman additional information to investigate, including information respecting certain individuals and companies whose legal status could not be confirmed. On April 27, Mitchell updated Coulter on the Audit Committee's investigation, including the fact that Pinkerton had been retained to do a forensic investigation. Interviews were being conducted with management and with individuals in Hungary.

[499] On April 27, YBM issued a press release announcing extremely positive results from its operations for the three months ended March 31, 1998. There was no mention of D&T suspending its 1997 audit pending the completion of an in-depth forensic investigation. Mitchell testified that he was annoyed that management issued the release, but Coulter testified that Mitchell commented that YBM was not aware of any actual inaccuracy in the financial records at this point, so they decided to go ahead and release the results.

[500] Gatti had prepared the quarterly statements and left them with Bogatin before departing on vacation. He thought Bogatin would consult with the Audit Committee as they were best suited to authorize the release.

[501] D&T was concerned that YBM released its first quarter 1998 results when the 1997 financial statements had still not been finalized and significant concerns still existed. On April 28, D&T wrote the Audit Committee expressing these concerns and recommended that YBM consult with counsel to address YBM's need to disclose the audit suspension to the Commission and the public.

[502] It is apparent that there were some discussions regarding "Semeon Mogilevitch" during a call between Coulter and Mitchell on April 28. Mitchell continued to receive advice from counsel that disclosure was not required. As indicated above, D&T was mistaken that the audited statements needed to be filed on April 30.

[503] On May 3, Coulter left Mitchell a voicemail message and advised him that if disclosure was not made within the next few days, D&T would likely resign. Mitchell testified that he was in Russia at that time and did not receive this message from Coulter. On May 4, Coulter phoned Antes and Wilder. Coulter testified that Wilder "believed the company had an obligation not to

disclose the suspension of the audit." Wilder indicated that the company was conducting an extensive investigation and had not found a problem with a single company. Antes was prepared to work with D&T regarding the appropriate disclosure. Wilder provided legal advice as to the meaning of a material change under Ontario securities law. Coulter learned at this time that the filing date was May 20. Nevertheless, Coulter advised that D&T expected that the audit suspension and investigation would be disclosed.

[504] On May 7, Antes called Coulter and informed him that the company intended to file an application seeking an extension of the time to file the 1997 financial statements and that YBM would be making disclosure. He also advised that a preliminary report on the investigation was expected on May 11 and a final report on May 13.

[505] On May 8, Coulter wrote the Audit Committee reiterating D&T's concerns that YBM had released financial results but had not disclosed the audit suspension.

[506] That same day, the Board held an emergency meeting by conference call. Peterson, Davies and Fisherman were absent. Mitchell participated from hospital where he was being treated for a medical problem. The board was updated on the results of the investigation. Antes advised that Pinkerton, on a preliminary basis, had not found any material adverse information that would be likely to affect the business or operations of the company or have any significant affect on the company's historical financial statements. Antes had spoken with Fletman, who provided a similar report. Gatti did not participate in the emergency meeting of the Board, but Wilder did. Wilder advised that he was in the process of applying to the Commission for an exemption to extend the filing deadline, but that such applications were rarely granted. A draft press release was reviewed by the Board at that time.

[507] On May 8, YBM issued the news release announcing that it was in the process of filing an application with securities regulators seeking a 45-day extension from the May 20 deadline for filing and mailing its 1997 audited financial statements to shareholders. YBM disclosed that the reason for the application was that "it is possible that [YBM] will not receive an audit report on its 1997 financial statements from its auditors, Deloitte & Touche LLP, in time to meet the required filing and mailing deadline." YBM also disclosed, "As part of concluding its audit, Deloitte & Touche LLP has requested that the Board of Directors conduct an independent review of certain aspects of the Company's business and operations in Eastern Europe. The Board, through an independent committee, is in the process of concluding an extensive review and expects to report its final findings to Deloitte & Touche LLP shortly." The release goes on to state, "Management attributes the extensiveness of the audit and the requirement for this review to the fact that business practices in the Company's major market, Eastern Europe, differ from those in North America due to the relatively early stage of development of the Eastern European market economies."

[508] The release did not indicate that D&T had suspended its audit engagement or that the investigation requested was a forensic one. The actual application for the extension was filed with the Commission on May 8. On May 13, the U.S. organized crime task force headed by the U.S. Attorney's Office for the Eastern District of Pennsylvania executed a search warrant on YBM's offices in Newtown. That same day, the Commission issued a temporary cease trade order in respect of the securities of YBM, which remains in effect.

[509] On June 2, the report of the Audit Committee was issued, and on June 24, D&T informed YBM that it was not able to report on YBM's 1997 financial statements and resigned as YBM's auditor, effective immediately.

Submissions

[510] The Act requires prompt disclosure of material changes in the affairs of an issuer. Staff submit that the audit suspension constituted a "material change" in the affairs of YBM and as such triggered a reporting obligation.

[511] Staff submit that the audit suspension constituted a change in the business, operations or capital of YBM for three reasons:

1) In light of the role played by auditors of public companies, the suspension of the audit constituted a change in the business and operations of the company.

2) The demand for an in-depth forensic examination into material aspects of YBM's business cast suspicion on the business, operations and capital of the company.

3) The suspension of the audit occurred at a date close to the due date for the financial statements and created a risk that YBM would not be able to satisfy its regulatory requirements and that its securities would cease trading.

[512] Staff further submit that the issuance of the May 8 press release, 18 days after learning of the material change on April 20, cannot be "forthwith" as required by subsection 75(1) of the Act. They also refer to subsection 75(2) of the Act, which requires the filing of a material change report "as soon as practicable and in any event within ten days of the date on which the change occurs."

[513] The respondents advance a series of alternative arguments. They submit that the audit suspension was not a change in the business, operations or capital of YBM. Furthermore, even if it was, it was not material. Moreover, if it was material, then they acted in a timely fashion and issued a release forthwith.

[514] With respect to staff's three reasons why the audit suspension is a material change, the respondents submit that the first two reasons do not by their nature constitute changes in the business, operations or capital of YBM. Mitchell submits that, intuitively, it is difficult to understand how the audit suspension, in and of itself, had any impact on YBM's commercial activity (business), its organization (operations) or its overall wealth (capital). Coulter suggested during cross-examination that the audit suspension effected no change in the business, operations or capital of YBM.

[515] The respondents generally acknowledge that staff's third reason could have constituted a material change and that the probability/magnitude test discussed above must be applied. Mitchell does not dispute the importance of the role played by D&T in the affairs of YBM, but submits that his assessment of the materiality of the audit suspension was consistent with the proper application of the probability/magnitude test.

[516] Antes and Greenwald submit that it is the risk of two contingent events based upon the audit suspension (not obtaining an audit opinion by the filing deadline and the stock not trading) which potentially constituted the material change. Materiality must therefore be measured by the probability/magnitude test. Greenwald and Antes also argue that the ripeness of the future event must be interpreted in a manner that avoids undesirable and premature disclosure. This was recognized by Antes in a letter to Coulter on May 12, the day before the U.S. search warrant was executed, in which Antes stated that "any public disclosure before ascertaining the facts was premature and could have misled the public marketplace." Obviously, if the Audit Committee had been able to satisfy D&T before the filing date and obtain an audit opinion, premature disclosure of the audit suspension would have had unnecessary consequences to YBM shareholders. Antes and Greenwald further contend that the Audit Committee was diligent in examining the facts and made disclosure on May 8 which was timely, in these circumstances.

Analysis

[517] Energy levels were becoming depleted by this time in the hearing. This was likely a function of the length of the proceedings and not the importance of the issue.

[518] An issuer is obliged to disclose material changes. That enhances the fairness of the market. The definition of material change acts as a brake on premature and undesirable disclosure. The concept of material change, like that of material fact, requires an exercise of judgement. If the decision is borderline, then the information should be considered material and disclosed. In our opinion, a supercritical interpretation of the meaning of material change does not support the goal of promoting disclosure or protecting the investing public; sections 1.1 and 2.1 of the Act.

[519] The requirement for an annual audit by an independent auditor is intended to provide the public with an independent and objective check on the fairness of the presentation of the company's financial position at fiscal year end. That information is not only crucial to investors in the secondary market but also to an issuer's ability to raise capital. An auditor, while not a guarantor of financial statement accuracy, assumes a special role vis-à-vis the public. There was no disagreement with respect to the crucial role of auditors in public companies.

[520] There was also no disagreement that YBM faced a serious risk if it did not file its audited financial statements by May 20, or obtain an exemption from the filing deadline. Failure to file on time or obtain an exemption would result in the issuance of a cease trade order against YBM's securities.

[521] Was the audit suspension a change in the business, operations or capital of YBM that would reasonably be expected to have a significant effect on the market price or value of its securities? "Business, operations or capital" is not defined in the Act. In *Pezim v. British Columbia (Superintendent of Brokers)*, [1994] 2 S.C.R. 557 at 561-562 (*Pezim*), Iacobucci J. noted that:

> [t]hree elements emerge from [the definition of a material change in the B.C. legislation]: the change must be
>
> a) in relation to the affairs of an issuer,

b) in the business, operations, assets or ownership of the issuer and

c) material, i.e., would reasonably be expected to have a significant effect on the market price or value of the securities of the issuer.

[…]

This case also turns on the meaning of the words 'as soon as practicable' … as to when a material change should be disclosed to the public. The timeliness of disclosure also falls within the [B.C.] Commission's regulatory jurisdiction.

[522] It should now be obvious that a material change is a question of both fact and law. The Act is similar to the B.C. legislation except that the Act uses "capital" instead of "assets" and also does not include ownership of the issuer in the definition. Most notably, the Act also uses "forthwith" instead of "as soon as practicable".

[523] There was little evidence as to whether the audit suspension could be considered a change in the business, operations or capital of YBM. Opinion evidence on this issue would have been most helpful. Staff submit that it is implicit given the crucial role of auditors in public companies. However, Coulter testified that the audit suspension did not alter or affect the day-to-day business or operations of YBM.

[524] While Coulter testified that the suspension of the audit, in and of itself, did not alter or change any line item in the balance sheet, he did agree that if the audit opinion was not provided that would affect the business, operations or capital of YBM since YBM would fail to meet its regulatory obligations. This leads us to a critical issue associated with the audit suspension, namely its timing.

[525] We agree with the respondents that the probability/magnitude test is a useful tool in this context, as the issue is the materiality of a discrete event, namely YBM missing its filing deadline and having its securities cease-traded. We believe the potential magnitude of a publicly traded company missing its filing deadline and having its securities cease-traded is self-evident. We are left with the question of what the probability was of not obtaining an audit opinion by May 20 based upon the audit suspension on April 20. Alternatively, even if probability was difficult to determine herein, was the emergence of the present risk regarding the filing deadline and ensuing cease trade order material based on the events of April 19 and 20 as informed by earlier events?

[526] After becoming aware of D&T's concerns on March 23 and of the intended audit suspension on April 20, the Audit Committee and Gatti took the following steps:

1. They agreed to conduct a review of the transactions being questioned by D&T.
2. They obtained Board approval to proceed with a review.
3. The Audit Committee retained independent counsel (Wolf, Block), approved by D&T.
4. The Audit Committee reviewed numerous transactions and interviewed management and third parties.
5. They retained the expert forensic investigation firm Pinkerton, approved by D&T.

6. The escrow monies were recovered and deposited at the Royal Bank of Canada.

7. They specifically sought legal advice regarding their disclosure obligations with respect to the risk associated with the audit suspension. The advice was that disclosure was not required.

[527] It would appear that the audit was substantially complete by mid-March except for D&T's concerns. It is submitted that the materiality of the audit suspension could only be assessed after the Audit Committee was given a reasonable opportunity to satisfy D&T's concerns. On the one hand, the Audit Committee investigation appeared to have addressed some concerns, but on the other hand, D&T continued to insist that they be provided with auditable evidence respecting the legitimacy of the transactions.

[528] We do not accept Mitchell's explanation that the only reason that the escrow and technology contracts troubled D&T was due to the inadequate controls within the company. D&T's evidence was to the contrary and is more consistent with the documentary record.

[529] D&T's March 23 meeting with the Audit Committee was a turning point, but it was not until April 9 that the board authorized the Audit Committee to examine D&T's concerns extensively. The Board tried to address the issues, but to a certain extent ignored the impact of the information they were receiving. They continued to search for explanations rather than accept the facts provided to them. Only a year before, Fairfax had advised the Special Committee that while Fairfax found no evidence of actual wrongdoing, the founding shareholders were rumoured to have ties to organized crime and there were indicia of money laundering. Although D&T's audit opinion from October 1997 may have provided some comfort on the money laundering question, the common talk regarding organized crime continued in 1998. In addition, it was D&T, the very firm that had provided the clean opinion, that now had these concerns.

[530] The concerns presented to Mitchell and Antes on April 19 which led to the audit suspension and the request for a forensic investigation were extraordinary in nature. This was much more than a disagreement between D&T and management over the application of accounting principles, for example. D&T was concerned about (a) the validity of transactions, (b) whether counterparties to YBM's agreements were legal entities, and (c) organized crime and the possible cover-up of the flow of money.

[531] While the Audit Committee did not ignore D&T's concerns, it did not provide D&T with any indication that a number of these issues had already been examined by the Special Committee. The Audit Committee not only did not provide information to D&T, but it also did not make it available to the public.

[532] We note that during this period, YBM continued to make good news disclosure announcements. YBM had already issued its unaudited 1997 financial results on March 9, before the Audit Committee was first notified of D&T's concerns on March 23. After being notified of D&T's concerns, YBM issued a press release on March 31 announcing the Phillips acquisition. There was no mention of any problems with the audit.

[533] On April 27, YBM issued a press release announcing its results from operations for the first quarter ended March 31, 1998. These were extremely positive; for example, earnings per share increased by 53.8%. At that time, YBM shares were trading in the $18 to $19 range with significant volumes being traded. Once again nothing was said about the audit. Coulter was concerned with this release and Mitchell was displeased. In our opinion YBM's shares continued to trade well, but on an unaware and unsuspecting public.

[534] The absence of any disclosure regarding the audit suspension was a matter of increasing concern to D&T. Although D&T was mistaken as to the filing deadline (April 30 vs. May 20), it nevertheless was anxious about disclosure, among other things. In our opinion, that anxiety was well-placed.

[535] On May 8, YBM issued a press release announcing that it was seeking a 45-day extension from the May 20 deadline. It did not disclose the audit suspension, but did state it might not receive an audit opinion on the 1997 financials in time. It disclosed that D&T requested that the Board conduct an independent review of certain aspects of the company's business and operations in Eastern Europe, but did not disclose that the review consisted largely of a forensic investigation.

[536] Staff submit that this disclosure was deficient but do not press the point since this was not the allegation. We agree that the press release omitted certain key information.

[537] We have indicated that the respondents who defended these allegations did not profit directly from any trading with the exception of commissions earned by the investment dealers. Nevertheless, the public was unaware and unsuspecting. While YBM continued to try to resolve D&T's concerns, there was an essential detail missing – disclosure.

[538] In our opinion, given: (1) the extraordinary nature of the concerns expressed by D&T on April 20; (2) D&T's request for a forensic investigation on April 20; and (3) the fact that D&T advised that it would need to consider whether it was willing to continue being associated with YBM and able to issue an opinion on YBM's 1997 financial statements upon completion of the Audit Committee's investigation, it was probable as of April 20 that YBM would be unable to obtain an audit opinion and make its May 20 filing deadline. Given the events of April 19 and 20, as informed by earlier events, the emergence by April 20 of the risk regarding the filing deadline and likely cease trade order constituted a material change.

[539] The press release was issued approximately 18 days after notice of the audit suspension was provided. Staff contend this was not "forthwith", particularly in light of the ten-day period set out in subsection 75(2) of the Act. We agree with this submission.

[540] For the foregoing reasons, we find that YBM breached subsection 75(1) of the Act by failing to disclose the audit suspension forthwith.

Directors' and Officers' Role in the Failure to Make Timely Disclosure

[541] We have found that YBM failed to disclose the audit suspension forthwith and therefore failed to comply with its continuous disclosure obligations under the Act. The press release was issued approximately 18 days after notice of the audit suspension was provided.

[542] As mentioned previously, Gatti and Greenwald submitted that they did not know and could not reasonably have been expected to know the facts which staff allege constituted a material change. Meanwhile, Antes and Mitchell contend that they held an honest and reasonable belief that the audit suspension was not a change in the business, operations or capital of YBM and that they took care to ascertain the materiality of that change.

[543] Antes and Mitchell both knew about the audit suspension. They relied on the advice of counsel as to what constitutes a change in the business, operations or capital of YBM. That advice appears to have been that the audit suspension, in and of itself, was not a material change, although we have no report or written opinion to that effect. We have found, despite the argument to the contrary, that a material change occurred.

Mitchell

[544] D&T recommended to Mitchell, as a member of the Audit Committee, that the Committee consult with counsel regarding the audit suspension and disclosure to the public, given that YBM had already issued its earnings releases. This occurred more than once. Mitchell was a party to the April 19 call advising of the audit suspension. He received D&T's written confirmation on April 20 and D&T's April 28 letter expressing concern at YBM's release of the first quarter financials without disclosing the audit suspension. He also received Coulter's voicemail of May 3 telling him that the company should inform the public. While Mitchell testified that he has no recollection of this last occasion, and surmised that he may have been in Russia at the time, we prefer Coulter's evidence. It is commonplace for an honest witness to give evidence of facts as he or she believes them to be but which the panel does not accept. Coulter was pressing very hard during this period as he believed that YBM had an obligation to disclose the suspension.

[545] Mitchell testified that he had discussions with and relied on the advice of counsel regarding disclosure of the suspension. He testified that counsel consistently advised that disclosure of the audit suspension was not required unless the Audit Committee found some evidence of inaccuracy or error. We find, however, that as of April 20, Mitchell ought to have known that YBM likely would not get its audit opinion in time and that, as a consequence, the shares of the company would be cease-traded.

[546] Disclosure in this instance could not be resolved by simply relying on legal advice. This advice may be gleaned from a May 12 memo in which counsel stated that "no thought was given to a press release or material change report on April 20, 1998 because the D&T letter contained no facts, and therefore, we did not want to issue a press release based on concerns or supposition." Following that, counsel's advice with regard to D&T's April 28 letter reinforced the fact that the filing date was clearly at risk and that this was an important consideration vis-à-vis disclosure. Mitchell testified that upon learning about that letter, and the status of the

investigation, Wilder asked him if the Audit Committee believed that it could complete the investigation within sufficient time to permit D&T to review the results of the investigation and meet the May 20 filing deadline.

[547] Mitchell believed that it could for a number of reasons. First, as at April 20, Mitchell believed that D&T had effectively completed its audit procedures, although his evidence does not confirm that he specifically asked D&T whether it completed its audit procedures. Second, when D&T was asked if it had identified any inaccuracies in the 1997 unaudited financials, it responded that it had not. Third, he felt that the audit opinion for 1996 was done on a high-risk basis and would serve as a useful proxy for the 1997 financials. Fourth, Mitchell had no reason to believe that the results of the investigation would be unsatisfactory to D&T as the transactions involved were similar to the ones that were audited in 1996. D&T had not indicated that it was withdrawing or altering its audit opinion for 1996. Finally, Coulter had testified that the possibility of rendering an audit opinion was not foreclosed.

[548] Although it was technically possible that D&T would still render an audit opinion, this was highly improbable. D&T expressed doubt that the necessary investigation could be completed in time for the filing deadline. It was persistent in its requests that YBM make disclosure of the audit suspension, despite the ongoing Audit Committee investigation. Its concerns were fundamental in nature and involved the validity of millions of dollars in transactions and the legal existence of counterparties to the transactions. It had asked the Audit Committee to hire forensic investigators. Given Mitchell's background, he would have been well aware of the difference between a high-risk and forensic audit. His belief in these circumstances, including his reliance on legal advice, was not reasonable. He bears direct responsibility for the delay in issuing the press release. He was the most involved in the Audit Committee investigation along with Antes and counsel.

Antes

[549] Antes had little or no recollection of the important events associated with disclosure here. As before, for the first allegation, the documentary record and the evidence of Coulter help fill the gaps in his recollection.

[550] As was the case with Mitchell, D&T recommended to Antes, as a member of the Audit Committee, that the Committee consult with counsel regarding the audit suspension and disclosure to the public, given that YBM had already issued its earnings releases. Antes participated on the April 19 telephone call, was copied on D&T's April 20 letter and on May 4 spoke with Coulter and Wilder regarding disclosure issues. Wilder advised Coulter that YBM had an obligation not to disclose, but Coulter continued to press for disclosure of the audit suspension and forensic investigation. Although Antes testified that he did not recall this telephone conversation, he was nevertheless aware that D&T was anxious that the audit suspension and forensic investigation be disclosed. Coulter's letter of May 8 to Antes is illustrative of this. In it, Coulter stated:

> As we have <u>indicated on several occasions</u> and as we discussed yesterday, we are extremely concerned that the Company has issued its earnings release for 1997 and for the first quarter 1998 but has failed to disclose that our audit has been

> suspended until the Company completed its investigation into the validity of certain significant transactions which took place in 1997 and which may impact those earnings. (emphasis added)

[551] Antes also testified that counsel advised that "any public disclosure before ascertaining the facts was premature and could have misled the public marketplace," and that he relied on that advice. As with Mitchell, we find that as of April 20, Antes ought to have known that YBM likely would not get its audit opinion in time and that, as a consequence, the shares of the company would be cease-traded. Although his understanding of this issue came from the advice of counsel and not from any personal knowledge or experience in the capital markets, we find that he did understand the nature of the risk. Moreover, he saw D&T's April 28 letter, which should have reinforced the fact that the filing date was at risk and that this was an important consideration regarding disclosure. Regardless of his relative lack of experience in the capital markets, he was an active member of the Audit Committee, was knowledgeable of the issues and had reason to challenge the legal advice.

[552] Antes submits that he believed that the Audit Committee would be able to satisfy D&T's concerns in time for the filing deadline, and that this belief was reasonable for several reasons. YBM and D&T had faced similar issues in the 1996 re-audit with regard to finding evidence that transactions were as recorded and that counterparties existed. YBM had received a clean audit opinion, with the audit conducted on a high-risk basis, under difficult circumstances. He did not know, and could not be expected to know, the differences between an audit, a high-risk audit and a forensic investigation. Finally, Coulter had testified that the possibility of rendering an audit opinion was not foreclosed.

[553] We agree that Antes could not be expected to know the nuances between an audit, a high risk audit and a forensic investigation. But that is not the issue. The issue is one of prudence and common sense, particularly where D&T did not want to deal with management. His belief had to be reasonable, and as with Mitchell, the basis for that belief was too slim. We find that Antes did not have a reasonable basis for believing on April 20 that a material change had not occurred.

Greenwald

[554] Although Greenwald chaired the Audit Committee, he was in a different position than Mitchell and Antes. Greenwald testified that he did not recall knowing that D&T said it was in a stop position on April 19. He testified that he was not present for the April 19 telephone call with D&T and that no one called to advise him of what had happened during the call. Similarly, Greenwald did not receive D&T's April 20 letter and did not recall having a conversation with either Mitchell or Antes about the letter.

[555] We find that Greenwald did not have any direct contact with D&T after March 23 until May 13. Similarly, he did not receive the Audit Committee/D&T correspondence from April 20 to May 8 until May 11. Staff does not dispute this. Simply put, Greenwald was not presented with the risk that YBM would miss the May 20 deadline and did not have the background and experience to appreciate the emergence and probable consequences of this risk.

[556] We would have expected more from the Chair of the Audit Committee, but Mitchell was selected to oversee this process given his background and experience, and Antes, the Chair of the Board, was directly involved. Greenwald's inaction is certainly troubling, but on balance, we are unable to conclude that Greenwald should be held responsible for the delay in the press release.

Gatti

[557] There is no evidence to suggest that Gatti took part in the April 19 call with D&T. Nor is there any evidence that Gatti received D&T's April 20 letter or participated in the April 20 disclosure discussion with counsel. Gatti testified that he was unaware of the audit suspension. Staff suggest otherwise and point to certain documentary evidence in support of its position, such as Gatti's memos to Fisherman and Tsoura (of United Trade) dated April 19 to 21, 1998, and the fax from Lait (of D&T's Moscow office) to Gatti on April 21 informing him that due diligence work on the Novocherkaask transaction was suspended. In our opinion, the memos from Gatti to Fisherman and Tsoura do not demonstrate that Gatti was aware of the audit suspension. They are consistent with his being asked by the Audit Committee for further particulars with regard to transactions that, for the most part, were brought up at the March 23 meeting with D&T. Furthermore, we find that Gatti's inference that Lait's fax referred to what had happened on March 23 was reasonable. Even if Gatti knew of the audit suspension, he was unaware that Coulter had been pressing for its disclosure.

[558] Although Gatti prepared the first quarter results, he left them with Bogatin who, according to Gatti, "was going to interact with the audit committee." Similarly, we find that as Gatti was away on April 28, he would not have been aware of the communications between Coulter and Mitchell regarding D&T's concerns about the release of the first quarter results in the circumstances. He would also not have been privy to any discussions with counsel regarding disclosure. There is no evidence that Gatti was aware of or participated in any of the telephone calls or meetings leading up to the disclosure. D&T wanted to deal with the Audit Committee, not management. Gatti did participate in the drafting of the press release, but was unaware of much of the information possessed by Mitchell and Antes. As such, we cannot find that Gatti was responsible for the delay in filing the press release.

SANCTIONS

[559] We have concluded that YBM, Bogatin, Fisherman, Mitchell, Davies, First Marathon and GMP breached the prospectus disclosure provisions of the Act by failing to make full, true and plain disclosure of all material facts. There is no due diligence defence available for YBM. The other respondents have not persuaded us as to the availability of their due diligence defences. Moreover we have found that YBM, Bogatin, Fisherman, Mitchell and Antes have breached the timely disclosure provisions of the Act and that they have no defence to their failure to file forthwith. Normally, if a respondent has breached the Act and has not made out a due diligence defence, an order in the public interest is warranted. However, the respondents further submit that even if they have breached the Act, an order in the public interest is unwarranted.

[560] Section 127 is a regulatory provision, the purpose of which is neither remedial nor punitive. It is protective and preventative, intended to be exercised to prevent likely future harm

to Ontario's capital markets; *Committee for the Equal Treatment of Asbestos Minority Shareholders*, [2001] 2 S.C.R. 132 at para. 42 (*Asbestos*).

[561] As stated by Iacobucci J., the Commission's role under section 127 "is to protect the public interest by removing from the capital markets those whose past conduct is so abusive as to warrant apprehension of future conduct detrimental to the integrity of the capital markets"; *Asbestos* at para. 43, citing *Re Mithras Management Ltd.* (1990) 13 O.S.C.B. 1600 at 1610 ["We are here to restrain, as best we can, future conduct that is likely to be prejudicial to the public interest in having capital markets that are both fair and efficient. In so doing, we must, of necessity, look to the past conduct as a guide to what we believe a person's future conduct might reasonably be expected to be; we are not prescient, after all."]. Iacobucci J. noted that section 127 of the Act gives the Commission "an unrestricted discretion" to attach terms and conditions to any order made under subsection 127(1); *Asbestos* at para. 40.

[562] Participation in Ontario's capital markets is a privilege, not a right; *Manning v. Ontario Securities Commission* (1996), 12 C.C.L.S. 106 (Ont. Div. Ct.). In *Re Belteco Holdings Inc.* (1998), 21 O.S.C.B. 7743 at 7746, the Commission outlined various factors for consideration in a public interest violation: (1) the seriousness of the allegations proved; (2) the respondent's experience in the marketplace; (3) the level of a respondent's activity in the marketplace; (4) whether there has been recognition of the seriousness of the improprieties; and (5) whether the sanctions imposed may serve to deter not only those involved in the case being considered but also any like-minded people from engaging in similar abuses of the capital markets. These factors were expressly approved recently in *Erikson v. Ontario (Securities Commission)* (2003), 26 O.S.C.B. 1622 (Div. Ct.) (*Erikson*).

[563] In addition to the above factors, we would also consider whether the violations were isolated or recurrent, the degree of participation in the violations and the likelihood that a respondent's occupation will present opportunities for future violations.

[564] *Erikson* confirms the principle of both specific and general deterrence in section 127 public interest cases. General deterrence should deter others from similar misconduct and hopefully improve business standards. The sanction imposed should reflect the Commission's assessment of the measures necessary to achieve these objectives. Moreover, there must be an appropriate relationship between the seriousness of the violation and the sanctions selected to achieve compliance with the law. Sanctions should invariably be fair, proportional to the degree of participation and should have regard to any mitigating factors which may be present. In this sense, sanctions are custom-made to fit the circumstances of the particular case or to sanction a precise problem or breach.

[565] The Supreme Court has stated that the primary goal of securities law is investor protection; *Pezim* at 589, 592; section 1.1 of the Act. Moreover, the Act provides that one of the primary means for achieving its purposes is timely, accurate and efficient disclosure of information; para. 2.1(2)(i) of the Act. Sanctions derive their importance from the principles and purposes they are invoked to support.

[566] We do not view the conduct of the individual respondents who answered the allegations as deceitful. However, while not deceitful, we have found that certain respondents, in the

circumstances, failed to satisfy prospectus and timely disclosure duties under the Act. Moreover, with the exception of Greenwald, in which the trade was reversed, the Directors did not profit financially from their misconduct in this case. Finally, as part of our considerations, it is clear the respondents relied on legal advice throughout with respect to both allegations. It is also evident that the respondents believed in the legitimacy of the business as a result of the D&T audit. Generally we do not view the advice as unscrupulous because there are few concepts in securities law as vague and imprecise as materiality as the standard for disclosure.

[567] Staff seek orders as follows from the Commission:

(a) YBM: an order pursuant to paragraph 2 of subsection 127(1) of the Act that trading in any securities of YBM Magnex International Inc. cease permanently;

(b) Bogatin and Fisherman: an order pursuant to paragraph 8 of subsection 127(1) that Bogatin and Fisherman permanently be prohibited from acting as a director or officer of an issuer;

(c) Mitchell: an order pursuant to paragraph 7 of subsection 127(1) that he resign any position that he holds as director or officer of an issuer; an order pursuant to paragraph 8 of subsection 127(1) that he be permanently prohibited from becoming or acting as a director or officer of any issuer; an order that he be permanently prohibited from seeking registration since he is not currently a registrant; and an order pursuant to section 127.1 for the payment of costs;

(d) Davies: an order pursuant to paragraph 7 of subsection 127(1) that he to resign any position that he holds as a director or officer of an issuer; an order pursuant to paragraph 8 of subsection 127(1) that he be prohibited from acting as a director or officer of any issuer for a period of at least ten years; and an order pursuant to section 127.1 for the payment of costs;

(e) Antes: an order pursuant to paragraph 8 of subsection 127(1) that he be prohibited from acting as a director or officer of any issuer for a period of between five and ten years; and an order pursuant to section 127.1 for the payment of costs; and

(f) National Bank and GMP: orders pursuant to paragraph 1 of subsection 127(1), imposing a term and condition on National Bank's and GMP's registrations that each not be permitted to act as underwriter in any public financing for a period between six months to one year; orders pursuant to paragraph 4 of subsection 127(1), requiring that a person approved by staff conduct a review of National Bank's and GMP's practices and procedures, and that any recommendations made be implemented; and an order pursuant to section 127.1 against each for the payment of costs;

Analysis

Bogatin and Fisherman

[568] During the course of opening statements, counsel for Bogatin appeared in order to advise that Bogatin was unable to participate in the hearing because he could not make full answer and defence to the allegations without significantly prejudicing his Constitutional right against self-incrimination in the United States. Although neither Bogatin nor Fisherman provided any answer or defence to the allegations in this matter, there was extensive evidence of their

involvement and conduct during the hearing. They were both inside directors and senior officers. Both were involved in YBM from its inception, and they each had some involvement in YBM's antecedent companies and some relationship with the founding shareholders. At all times Bogatin was the President and CEO and Fisherman was the COO of YBM. We find that they had thorough knowledge of the company and its operations, the Fairfax investigation, and the mandate, findings and recommendations of the Special Committee.

[569] Evidence relating to Bogatin went both ways. On the one hand, he did take positive steps during management's investigation of the visa issues, and he did share the FBI Affidavit with management and Rossman. On the other hand, his later steps overshadow his positive initiatives. Bogatin rejected Fairfax's findings on organized crime but did not give Fairfax the FBI Affidavit, which corroborated Fairfax's findings. He asserted some control over the Fairfax investigation and confined Fairfax to electronic searches by prohibiting direct approaches to customers. He revised Gatti's draft AIF disclosure relating to the Special Committee, making it less than full, true and plain. In 1998, continuing his pattern of releasing only positive news in light of negative facts, he authorized the release of the unaudited first quarter financial statements in the midst of D&T's concerns. On balance, we find that Bogatin has no defence of due diligence available to him.

[570] The evidence relating to Fisherman was less ambiguous. There is no doubt that he fabricated the Fisherman List "to make Fairfax go away". Fisherman's conduct was deceitful. On this basis alone, we find that Fisherman has no defence of due diligence available to him.

Mitchell

[571] Mitchell contends that, if the Commission finds a breach, nevertheless an order in the public interest should not be made against him. He also contends that if the Commission concludes that he made one or more errors in judgement which led to a breach or breaches of the Act, the Commission should take the following into account when considering whether he poses a prospective threat to investors or the integrity of the Ontario capital markets:

(a) his previously unblemished record as a registrant;

(b) his due diligence efforts as Chair of the Special Committee;

(c) his due diligence efforts in the spring of 1998 as a member of the Audit Committee;

(d) his efforts in the summer and fall of 1998 to assist the shareholders in replacing the Board and ultimately appointing a receiver;

(e) the fact that he did not personally sell a single share of YBM stock;

(f) his genuine remorse for the losses suffered by his clients and the other shareholders of YBM; and

(g) the confidence expressed by the witnesses Gary Drummond and Rebecca MacDonald in his business acumen and integrity.

[572] These are serious allegations. Mitchell has considerable experience and was actively involved throughout. With respect to Mitchell, we find no evidence of dishonesty, deceit or a cover-up. However, his approach to this financing was high-risk and the evidence clearly

establishes serious lapses in judgement with respect to the disclosure in this case. These facts should have awakened his suspicions and would have put a prudent person on alert.

[573] Moreover, he was not prudent in failing to provide the Special Committee Report to staff as well as D&T. He failed to request a copy of the FBI Affidavit which was imprudent and the result of poor judgement. He failed to provide GMP with the Report. In this case, Mitchell's reliance on legal advice was good faith but he was aware of circumstances which made his reliance on legal advice imprudent and therefore unreasonable. In the most simple of terms, Mitchell may not have known better but he should have known better, given his background and expertise. Shareholders and investors have natural expectations and rely on the experience and skill of directors like Mitchell. Despite the testimony of Mr. Drummond and Ms. MacDonald, we believe an order in the public interest is warranted, as well as a costs order.

Davies

[574] Davies submits that the sanction sought by staff is punitive rather than prophylactic. He also argues that the sanctions are disproportional to those sought against many of the outside directors. He submits that the sanctions staff seek against him are harsher due to his role on the Special Committee, his interactions with the FBI and his safeguarding of documents. We have dealt with these matters earlier.

[575] Davies argues that the sanctions requested amount to a lifetime ban given that he is 60 years of age. Davies has no prior infractions. He argues that he dealt with the issues facing YBM in good faith, professionally and with a view to the best interests of shareholders and potential investors, and that having lived through the events of 1996 through 1998, the ensuing civil litigation and this hearing, he is better able to fulfil his duties as a director in the future.

[576] In conclusion, Davies submits that given all of the circumstances, including the massive notoriety of this case, the discipline of the marketplace for the selection of directors should be sufficient to address any public policy concerns.

[577] We have taken the above considerations into account but nevertheless we are of the opinion that Davies demonstrated a serious lapse in judgement which requires an order in the public interest, as well as a costs order.

Antes

[578] Antes submits that the evidence does not warrant making an order in the public interest against him. Furthermore, he submits that if he is wrong, that it would be difficult to anticipate the exact basis upon which the panel would decide that an order is warranted. As such, he seeks leave to make further submissions should the panel decide that a sanction in the public interest is warranted. We have found that Antes has made out a defence of due diligence regarding the first allegation. We need only consider the second allegation and see no reason for further submissions.

[579] Antes submits that the orders requested against him constitute a harsh penalty. He argues that regardless of the fact that it is unlikely that he would ever become a director of an Ontario

public issuer (given his age and the fact that he is retired and a U.S. resident), the order requested by staff amounts to its seeking a life ban. This would have an enormous impact on Antes' reputation.

[580] Moreover, it is submitted that on the evidence it cannot be found that Antes breached Ontario securities law wilfully, deliberately or recklessly.

[581] Antes submits that the best and most useful measure of an appropriate sanction is that made against Wilder: a reprimand. In addition, Wilder also paid costs in the amount of $250,000.

[582] It is clear that Antes had a significant role with respect to the decision as to when and if to issue a press release. He was the Chairman of the Board and a member of the Audit Committee. We are persuaded that an order in the public interest is warranted, as well as a costs order.

National Bank (First Marathon)

[583] National Bank submits that any restriction on its ability to carry on business would be an unwarranted and disproportionate punishment since it poses no present threat to the integrity of the capital markets for three reasons:

(1) It is a fundamentally different organization than First Marathon, which it acquired in August, 1999. Key personnel have changed. Jones has retired and Mitchell has left National Bank. National Bank has instituted a variety of changes in its compliance policies and corporate governance. It has set up a Compliance Committee composed entirely of outside directors. It has revised its investment banking screening procedures, guidelines for business conduct and compensation system. Notably, under these new policies, an employee can no longer act as a director of a public company and participate in an investment banking function relating to that company. In simple terms, the conflict issue in this case has already been effectively addressed.

(2) Even if the Commission chooses to take the principle of general deterrence into account, the evidence does not warrant the sanction requested. In this case, if there were errors, they were good faith errors in judgement and not wilful misconduct by First Marathon.

(3) Should the Commission find that Mitchell acted contrary to the public interest, it does not follow that the full measure of any regulatory sanction against him also be visited on National Bank. In the regulatory context, vicarious liability is based in fault and not the pure operation of law.

[584] In general terms we agree with the above submissions and that sanctions requested by staff against National Bank are unnecessary and inappropriate in this case to protect the public interest given that National Bank is a different organization today. However, we are of the opinion that a costs order is appropriate under section 127.1.

GMP

[585] GMP submits that the order prohibiting it from acting as an underwriter for public financings for a period of six months to one year is unprecedented, unwarranted and unduly punitive in the circumstances.

[586] GMP contends that its conduct was not "so abusive as to give rise to a fear of future misconduct." GMP approached this offering with a high degree of seriousness. If its due diligence is found to be insufficient, it was only in the circumstances of this particular case and does not display a course of conduct from which the public needs to be protected. GMP further submits that any error made on the 1997 offering is not indicative of any general compliance problems at GMP. Staff called no evidence to prove that a culture of deceit or non-compliance exists in the organization.

[587] GMP is an experienced investment dealer and its participation throughout was extensive. McBurney's experience and skill was considerable. While GMP did not have as much information as Mitchell and First Marathon, GMP's role was not sufficiently adversarial in the circumstances. GMP's reliance and diligence were questionable in the circumstances. Accordingly, we believe that an order in the public interest is warranted, as well as a costs order.

Reliance on Commission Staff

[588] Mitchell submits that the Commission should take into account, as part of the sanction, the role of staff in relation to the Final Prospectus when considering whether any order in the public interest is appropriate as against him. Other respondents made a similar argument. In particular, it is contended that the Commission should not ignore the fact that Naster misrepresented to the respondents in July 1997 the state of staff's knowledge about YBM and that he was not truthful with them about the Enforcement investigation that had been opened in June 1997. Mitchell, McBurney, Litwack and Peterson all testified that the truth would have altered their course of conduct. It is contended that if the truth had been revealed, the financing may not have proceeded. This possibility makes Naster's alleged misrepresentations and the respondent's reliance upon them a factor which the Commission should take into account when considering sanctions.

[589] Staff's reliance submission varies from respondent to respondent. National Bank submits that the relevance of staff conduct to its defence is in assessing the reasonableness of its reliance on D&T's re-audit. Peterson, in contrast, submits that while staff were in possession of more knowledge, they exercised the same judgement with respect to disclosure. It is suggested that the problem facing staff flowed from additional information provided to staff on or about November 14 before the prospectus receipt.

[590] In an evidentiary ruling on March 5, 2002, the Commission stated as follows with respect to staff knowledge:

> We believe however, that this evidence may not form the basis of an excuse, nor be used to examine the appropriateness of staff conduct….

> We conclude that the evidence is relevant to our consideration of whether or not it is appropriate to issue an order under section 127 of the Act, and it is relevant to our consideration of whether the respondents, despite the information they may have had, and irrespective of whether the allegations are made out, nonetheless acted reasonably and in good faith in relying on the Deloitte & Touche audit.
>
> Accordingly, the evidence is admissible insofar as it is relevant to the respondent's reliance defence and section 127 considerations, but it is not admissible as a basis for an assessment of materiality, an examination of staff conduct or to disclosure of informer identity.

[591] The decision with respect to the admissibility of evidence in this matter was informed by the ruling of the Divisional Court with respect to an institutional bias application made by Peterson in 2001; *Peterson v. Ontario (Securities Commission)*, [2001] O.J. No. 1495. The court noted as follows at paras. 1 and 4:

> The principal submission, ably advanced by Mr. Lenczner, was that the Commission had knowledge of the facts which Mr. Peterson failed to disclose. In our judgment, the knowledge of the Commission, as a general rule and certainly in the circumstances of this case, cannot excuse the failure to make full, true and plain disclosure of all material facts in a prospectus. In saying this, we express no opinion as to whether there was in fact sufficient disclosure in this case.
>
> Although aware in November 1997 of rumours casting doubts on the accuracy of the financial statements of YBM, Commission staff did not consider it had the necessary ground to deny a receipt for the prospectus. It would not have been appropriate in these circumstances for Commission staff to have attempted to delay the receipt, as suggested by Mr. Lenczner, by informal requests to those seeking to conclude the filing.

[592] Staff's role in receipting a prospectus must be considered in the context of the statutory framework. As such, it is not staff's duty to perform due diligence or duplicate the parties' due diligence in issuing a receipt. If anything, given the concerns around historical disclosure, money laundering, sales, customers and geographic segmentation, this might have been, on these grounds, sufficient to deny the receipt in the public interest. Nevertheless, despite the submissions by the respondents, we have found no evidence of any misrepresentation by staff or any lack of good faith. Staff did not want to impede a legitimate financing. They had considerable pressure from the issuer, the issuer's counsel and the underwriters to issue the receipt. This is evident because had the Crucible deal not proceeded, an $8 million fee would have to have been paid by YBM. On the other hand, staff wanted to ensure disclosure that was full, true and plain.

[593] As indicated previously, the respondents felt misled because they were not informed that staff had commenced an investigation earlier than September 24, 1997. A case assessment file was opened on June 6, 1997. At this time Enforcement was providing advice to Market Operations. On June 26, 1997, an e-mail was sent asking that the file be upgraded to an investigation. It is unclear what transpired after that, except that Mr. Lubic replaced Mr. Butler on the file on July 23, 1997.

[594] YBM was informed of the investigation on September 24, almost two months before the November 20 receipt. As such, it is entirely speculative as to what the Board may have done upon receiving that information earlier. Indeed, what they did after September 24 is a good indication of what they might have done in that previous period. Nevertheless the respondents knew of Enforcement's involvement in the prospectus review process, including following up on information regarding money laundering and the soft information provided to them by Enforcement on July 7, 1997.

[595] What is clear from this evidence is that if staff had confirmed a criminal investigation, they would have advised YBM. If that had been the case, they likely would have insisted on its disclosure. This is clear from Kathy Soden's November 20 memo to file when she receipted the prospectus, in that she continued to harbour serious concerns regarding the company. What was more likely is that no receipt would have been issued.

[596] As indicated previously, this is a highly exceptional case. Staff submit that, if the director of the Commission had denied a receipt to YBM for its 1997 prospectus, the issuer and other affected parties would have had a right to a hearing, to which all the rules of procedural fairness and natural justice would apply, and at which staff would have had to justify their decision to deny the receipt on the basis of certain evidence. In order to endorse the decision to deny a receipt, the Commission would have had to find that there was sufficient evidence upon which the decision to deny could be made.

[597] In the circumstances of this case, staff submit that they would have been unable to present any evidence in support of the denial of a receipt in November 1997 because that evidence could not be used by staff. That evidence could not be disclosed, either because it came from a confidential informant (who enjoys an absolute privilege which cannot be waived by law enforcement officials) or because it may have jeopardized ongoing activities by other law enforcement agencies (a result protected against by virtue of the operation of the law of public interest immunity). In other words, in declining to use the evidence in question, again, staff was honouring its public law duties.

[598] There is little doubt that Ms. Soden was confronted by a difficult legal issue at the time. In her own words:

> In discussions with Enforcement, it seems to me that the only way to get the witness testimony to a Commission panel was through an in camera, ex-parte proceeding since the witness needed to maintain confidentiality.

[599] The advice given to Ms. Soden, at the most senior level of the Commission, was that this approach was untenable on fairness principles. Indeed it appears that Enforcement was more concerned with the company's historical disclosure record and certain correspondence than with the recent confidential information received by staff.

[600] We do not intend to review the decision to receipt the prospectus. That is not the purpose of this hearing. However, we have some comments with respect to the process.

[601] The fundamental concern was one of fairness. How could the issuer persuade the Commission to make a favourable decision when it would not have access to the confidential

information? Subsection 61(4) provides that where a prospectus raises a material question involving the public interest that might result in the director refusing a receipt, the director may refer the question to the Commission for determination. This hearing is *inter partes* and as such can be utilized in appropriate cases. Subsection 61(1) provides for no receipt if it is not in the public interest to issue a receipt.

[602] The denial of a receipt does not invoke the same broad principles as the right to make full answer and defence in a section 127 case. Both require devotion to the principles of fairness, but the statutory framework within which fairness is to operate must be considered, and while rare, a limit must necessarily be implied. What is essential is substantial fairness to the company which may be accomplished by providing as much information as possible without necessarily disclosing the precise information or sources. This balances the requirements to the company of fairness without adversely affecting the scheme of the Act, which has as a paramount objective investor protection. In this regard, staff's concerns could be disclosed without necessarily revealing confidential sources or putting informants in peril and therefore providing the issuer with an opportunity to contradict the information. Not unlike the public interest, there can be no rigid rules as to the meaning, scope or extent of fairness in a particular context; *Baker v. Canada (Minister of Citizenship and Immigration)*, [1999] 2 S.C.R. 817 at para. 21. That normally depends on the subject matter. There must be provided that measure of fairness which Lord Reid described in *Ridge v. Baldwin*, [1964] A.C. 40 at 65, as "insusceptible of exact definition, but what a reasonable [person] would regard as fair procedure in particular circumstances." In summary, the clear and cogent evidence required to make a finding that a respondent has breached the Act is not the same as the evidence required on a review of a decision to deny a receipt for a prospectus. In either case there is nothing to prevent the decisions from being appealed under subsection 9(1) of the Act to the courts.

Costs

[603] The Commission has clear statutory authority to order costs under section 127.1 of the Act. These costs may include the costs of the investigation and the costs of or related to the hearing that are incurred by or on behalf of the Commission. For greater certainty the costs the Commission may order a person or company to pay include, but are not limited to: costs incurred in respect of services provided under sections 5, 11 and 12 of the Act; costs of matters preliminary to the hearing; costs for time spent by the Commission or staff of the Commission; any fee paid to a witness; and costs of legal services provided to the Commission. Costs may be ordered when a person or company has not complied with Ontario securities law or has not acted in the public interest.

[604] It appears that the Act allows for the payment of costs to a full indemnity. Staff are asking for $2,454,874.93. While they submit that this is not full indemnity, it is a substantial amount. While staff have allocated costs to each respondent in this proceeding with the exception of YBM, Bogatin and Fisherman, the amounts requested are very similar, ranging from $242,229.90 to $307,599.93. The difference flows primarily from costs associated with preliminary matters.

[605] It is clear that costs are not intended to be punitive but rather are intended to indemnify the Commission for fees and expenses incurred. Mitchell submits that the Commission does not

have jurisdiction to order costs of the proceeding and costs of the investigation because the facts at issue in the hearing took place before the amendment to the Act, and that the Notice of Hearing was issued before the amendment to the Act. In our opinion, the application of section 127.1 does not attract the presumption against retrospectivity. In general terms, costs are procedural in nature and the respondents were provided with notice. *Shea v. Miller*, [1971] 1 O.R. 199 at 203 (C.A.); *Re Tindall* (2000), 23 O.S.C.B. 6889.

[606] Staff have provided the Commission with sufficient quantifiable information to serve as a useful basis to assess costs. We are mindful that to defend oneself is not reprehensible and unless that defence is in some way or another abusive of the hearing process it should not be a factor in the costs award. Secondly, we do not believe that a costs order should vary according to the degree of misconduct of a party. However, in the costs order it may be appropriate to reflect the greater investigative/hearing costs that the specific conduct of a respondent tends to require in the case.

[607] Mitchell contends that staff's allegations are akin to allegations of fraud. There would be costs consequences if that was the case. We are of the opinion that there are no allegations akin to fraud in this matter. While there are forceful submissions regarding credibility, that does not mean that fraud is alleged.

[608] There is no question, as indicated previously, that this hearing was adversarial and virtually indistinguishable from a trial. We are most concerned with respect to the amount of time that this hearing took. We recognize its complexity and the number of respondents in the case. It is unfortunate that there appeared to be few agreements or concessions by either staff or the respondents to reduce the length of the hearing. Finally, we agree that "[i]n addition to success or failure, a discipline committee awarding costs must consider such factors as the seriousness of the charges, the conduct of the parties and the reasonableness of the amounts"; *K.C. v. College of Physical Therapists (Alta.)* (1999), 214 A.R. 28 at para. 94 (C.A.).

[609] The Commission has recently adopted a schedule of hourly rates for various members of Enforcement in respect of costs awards to be made under section 127.1. The schedule is: $175 for case assessment employees; $185 for investigation employees; and $205 for litigation employees. These figures are designed to capture fixed costs, staff salaries and a portion of corporate services. The Commission considered and approved this new costs grid in *Donnini*.

[610] Given the number of respondents in this proceeding, staff apply the following principles in calculating costs. They submit that they are not seeking full indemnity but are seeking reasonable and conservative expenses. The following principles are used: costs are calculated on an eight-hour day; no costs for non-counsel members of staff; an estimated contribution for each respondent on the preliminary motions depending on participation; costs of the investigation are calculated on a 1/13 share; costs of the hearing are calculated on a 1/10 share before the Wilder settlement and 1/9 after the Wilder settlement; and disbursements are calculated on a 1/10 share. Moreover costs are sought for five time periods, discussed below.

[611] Staff have requested costs relative to the following time periods and categories:

(a) The Investigation – September 1997 to November 1, 1999

Staff seek costs related to document gathering and review, interviewing witnesses, drafting the Notice of Hearing and allegations and making disclosure. The amount sought is $563,750 with each respondent paying $43,365.39.

(b) Preliminary Matters – November 1, 1999 to May 6, 2001

The total costs of these matters are in the order of $42,100. Some of these matters were argued before the Commission and some before the Divisional Court. Staff contend that the costs of the attendances before the Divisional Court are in the interests of finality and efficiency. While we believe their objective is laudable, we have decided not to assess these costs herein.

(c) The Hearing – May 7, 2001 to August 31, 2002

This period covers the hearing on the merits. Staff seek more than $1.7 million for these costs including costs to outside counsel.

(d) The Written Submissions – September 1, 2002 to November 15, 2002

Staff request $172,200 in this regard including reply.

(e) Final Argument – November 18, 2002 – November 29, 2002

This figure has been calculated as simply the per diem share of $4,920 for closing argument by staff in attendance.

[612] The final area requested is disbursements in the amount of $302,355.36. This is a large number because over $213,000 was paid as witness costs associated with the Fairfax evidence. About half of that was paid to Fairfax's outside counsel and the other to fees and expenses paid in respect of Ginsburg of Fairfax. We will consider these amounts due to the unusual circumstances of this case. We would not, in the normal course, expect to recover legal fees from the respondents paid to a firm acting for a witness in proceedings before the Commission. It should be noted that in the Wilder settlement, Wilder paid $250,000 for Commission investigation and hearing costs.

ORDERS IN THE PUBLIC INTEREST

[613] In our opinion, it is in the public interest to make the following orders, effective July 2, 2003, under sections 127 and 127.1 of the Act.

YBM Magnex International Inc.

[614] An order pursuant to paragraph 2 of subsection 127(1) that trading in any securities of YBM Magnex International Inc. cease permanently.

Bogatin

[615] An order pursuant to paragraph 8 of subsection 127(1) that Bogatin be permanently prohibited from becoming or acting as director or officer of any issuer.

Fisherman

[616] An order pursuant to paragraph 8 of subsection 127(1) that Fisherman be permanently prohibited from becoming or acting as director or officer of any issuer.

Mitchell

[617] An order that:

(a) pursuant to paragraph 7 of subsection 127(1), Mitchell resign any positions that he holds as a director or officer of a reporting issuer;

(b) pursuant to paragraph 8 of subsection 127(1), Mitchell be prohibited from becoming or acting as a director or officer of any reporting issuer for five years from the date the order takes effect; and

(c) pursuant to subsections 1 and 2 of section 127.1, Mitchell pay investigation and hearing costs in the amount of $250,000.

Davies

[618] An order that:

(a) pursuant to paragraph 7 of subsection 127(1), Davies resign any positions that he holds as a director or officer of a reporting issuer;

(b) pursuant to paragraph 8 of subsection 127(1), Davies be prohibited from becoming or acting as a director or officer of any reporting issuer for three years from the date the order takes effect; and

(c) pursuant to subsections 1 and 2 of section 127.1, Davies pay investigation and hearing costs in the amount of $75,000.

Antes

[619] An order that:

(a) pursuant to paragraph 7 of subsection 127(1), Antes resign any positions that he holds as a director or officer of a reporting issuer;

(b) pursuant to paragraph 8 of subsection 127(1), Antes be prohibited from becoming or acting as a director or officer of any reporting issuer for three years from the date the order takes effect; and

(c) pursuant to subsections 1 and 2 of section 127.1, Antes pay investigation and hearing costs in the amount of $75,000.

National Bank Financial Corp.

[620] An order pursuant to subsections 1 and 2 of section 127.1 that National Bank Financial Corp. pay investigation and hearing costs in the amount of $400,000.

Griffiths McBurney & Partners

[621] An order that:

(a) pursuant to paragraph 4 of subsection 127(1), Griffiths McBurney & Partners submit to a review of its practices and procedures as an underwriter by an independent person approved by staff of the Commission and institute any changes recommended by that person; and

(b) pursuant to subsections 1 and 2 of section 127.1, Griffiths McBurney & Partners pay investigation and hearing costs in the amount of $400,000.

Dated at Toronto this 27th day of June, 2003.

"Howard I. Wetston"
Howard I. Wetston

"Derek Brown"
Derek Brown

"Robert W. Davis"
Robert W. Davis