

THE AFTERMATH OF BRE-X: THE INDUSTRY'S REACTION TO THE DECISION AND THE LESSONS WE ALL HAVE LEARNED

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“An expert is someone who knows more and more about less and less until he knows everything about nothing.”

- Anonymous

The Bre-X saga began in 1993 in the headwaters of the Busang River in the jungle of Borneo with one of the biggest deposits of gold ever reported. The first half of the story ended in 1997 with allegations of wrongdoing, deaths and the loss of billions of dollars. The second half ended a decade later in 2007 with the acquittal of Mr. John Felderhof. Has the story ended? On that, the jury is still out.

1. UNRAVELING THE STORY OF BRE-X

Bre-X Minerals Ltd. (“Bre-X”) was a junior Canadian mining company based in Calgary, Alberta. David Walsh incorporated Bre-X in 1989, and it was listed on the Alberta Stock Exchange. Bre-X remained mostly dormant until 1993. In late March 1993 Mr. Walsh contacted geologist John B. Felderhof to ask about mineral deposits that might be available for Bre-X to purchase in the Pacific Rim of Fire. Mr. Felderhof suggested several properties, including one named Busang in Kalimantan, Indonesia.

David Walsh was interested, and on May 1, 1993 Bre-X hired Mr. Felderhof as its General Manager in charge of Bre-X’s Indonesian exploration. Shortly thereafter, the project manager, Filipino geologist Michael de Guzman estimated that the potential resource for the Central Zone of the Busang property might be 2 million ounces of gold.

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After Mr. de Guzman's first estimate, and with the drilling of the South East Zone, the size of the gold resource in the Busang property continued to rise, with a final estimate of over 30 million ounces. Consequently the value of Bre-X shares also rose. By the end of July 1995 the once penny stock was trading at \$14.87. In April 1996, when Bre-X began trading on the Toronto Stock Exchange ("TSX"). The stock hit a pre-split high of \$280.00.² By March 1997, some analysts were estimating that there might be as much as a 200-million-ounce resource in Busang.

As one would expect, larger mining companies started to take notice of Bre-X, and several of them sought to participate in the rich deposit. The Indonesian government favored the suggestion promoted by George Bush, Brian Mulroney and others that Bre-X share in the deposit with the large Canadian mining firm Barrick Gold Corp. ("Barrick"), in association with Indonesian President Suharto's daughter Tutut. A proposed agreement, hammered out in December 1997, would have entitled Barrick to a 67.5% stake, Bre-X 22.5% and 10% to the Indonesian government. It was rumored that Bre-X was not happy with this arrangement. However, by early January 1997 it looked as though the Barrick deal would be pushed through by the Indonesian government.

Then, at the last minute, notwithstanding Barrick's powerful lobbying, a strategic alliance was formed between Bob Hasan, an influential Indonesian businessman, and Freeport-McMoRan Copper & Gold ("Freeport") an American company. On February 17, 1997, after some questionable actions by the Indonesian government, a deal was announced between Freeport and Bre-X. Freeport, would run the mine and receive a 15% stake, Indonesian interests would share in 40% of the wealth (both directly through the government and indirectly through Indonesian-controlled companies owned by Hasan), and Bre-X would keep the remaining 45%. After the deal was announced Freeport employees went to Borneo to start its own confirmatory due-diligence and independent drilling.

² "Bre-X timeline: From boom to bust" *CBC News* 31/07/07.

Freeport was, at least initially, generally positive about the project. Following the discovery of the tampering, a note was added to Freeport's First Site Visit Report:

The bulk of this report was written prior to receiving the results of the Due Diligence drilling Program. The negative results from that program have cast the Busang "Deposit" in a far different light than it was in at the time of this trip. In hind sight some of the comments in this report may seem a bit naïve but the reader is asked to remember that the author was viewing this as a golden (pun intended) opportunity and approached the task in an optimistic light. The bucket of cold water that quenched the fire of optimism was still some weeks in the future.³

By March 10, 1997 Freeport had drilled several holes at Busang as part of its due-diligence program, and had begun to receive results showing insignificant amounts of gold. The differences between the Bre-X and Freeport drilling results were startling. The holes drilled by the two companies were less than 1.5 meters apart, yet Bre-X reported a grade of 4.39 grams of gold per tonne, while Freeport found a mere 0.01 grams.

Freeport demanded a meeting with Bre-X's chief geologist, Mr. de Guzman, to discuss their drilling results. On March 19, 1997, on his way back to Busang to meet with Freeport representatives, Mr. de Guzman fell to his death from a helicopter. There were reports that he had a complicated personal life and was suffering from Hepatitis B, and it was speculated that he therefore took his own life. However, some skeptics believe that Mr. de Guzman is still alive and in hiding, as no conclusive remains of his body were ever found. This belief was rekindled in May 2005 when one of Mr. de Guzman's widows reported that she had received \$25,000 US from Mr. de Guzman drawn from a Citibank account in Brazil.

On March 26, 1997 Freeport announced that their own core samples showed "insignificant amounts of gold" following both cyanide and fire assay tests on the Busang samples. Furthermore, Freeport reported that it had found 'visual differences' between the gold taken from the Bre-X core samples and the gold taken from the Freeport samples. Bre-X announced that an independent mining consultant, Strathcona Minerals

³ *R v Felderhof* 2007 ONCJ 345, 160.

Services Ltd (“Strathcona”), had been retained. After these announcements trading in Bre-X shares was temporarily halted.

To many in the mining world, the suggestion of “visual differences” raises a “red flag” that the samples may have been salted. The practice of salting mineral samples goes back centuries. In 1567, Captain Martin Frobisher convinced Queen Elizabeth I to sponsor two large mining expeditions to the northern Canadian coast based solely on the evidence of salted ore. Salting also occurred in the California Gold Rush of the early 18th century, with one commentator stating that “the practice became so common that purchasers were always on their guard, and it was necessary to exercise much ingenuity to deceive them”.⁴ The Ontario Securities Commission (“OSC”) would later argue in its prosecution of Mr. Felderhof that, based upon the work of one of Bre-X’s consultants, who was later retained by the OSC, “25,000 or 30,000 samples were tampered with over a three and one half year period that was unprecedented in the history of mining.”⁵

When trading resumed, Bre-X shares plunged from an opening price of \$15.20 to about \$2.50. Eight million shares changed hands in slightly more than 3000 trades. As panicked investors tried to sell their Bre-X stock, the sheer volume of the trades twice crashed TSX computers. At its peak, Bre-X had been valued at over \$6 billion; by the end of March 1997 the company’s market value had fallen to \$600 million. Nevertheless, Bre-X chief executive Mr. Walsh told reporters that he was confident that an independent examination would find gold, and Walsh stated that he was holding onto his shares in the company.

Strathcona, which had been hired by Bre-X to investigate after Freeport had failed to duplicate Bre-X’s results, released its initial results on May 4, 1997. Strathcona confirmed Freeport’s finding that there was virtually no gold in its test core. Strathcona’s report stated that the Busang core samples had been tampered with. Within two days of publishing Strathcona’s results, Bre-X’s shares fell to 80 cents and continued to fall over

⁴ Hubert Burgess “Anecdotes of the Mines”, quoted in “False Advertising: Salting a Gold Mine” by Don Baumgart. Online: http://www.ncgold.com/History/BecomingCA_Archive43.html.

⁵ *R v Felderhof* 2007 ONCJ 345, 144.

the following days. The company filed for bankruptcy protection. Deloitte & Touche was appointed trustee in bankruptcy for Bre-X.

After the initial shock of Bre-X's collapse had subsided, and just as the lawsuits were beginning to take on steam, Mr. Walsh died of a brain aneurysm in the Bahamas on June 4, 1998. This was not to be the last death in this decade-long saga, as an OSC witness, a defence lawyer, and a defence expert witness all died unexpectedly while the prosecution progressed.

2. THE INVESTIGATIONS

RCMP Investigation

The RCMP have been severely (and we believe unfairly) criticized for their actions in the Bre-X inquiry. The focus of the RCMP's two-year investigation was properly on identifying who had tampered with the gold samples in Indonesia. The RCMP left the *Securities Act* violations and trading issues up to the OSC. In 1999 the RCMP announced that they were ending their investigation without laying criminal charges against anyone. The RCMP defended their decision to end the investigation by saying that there was not enough evidence to proceed, that several important witnesses lived outside of Canada and could not be compelled to testify and that a winning case could not be made out. Numerous critics charged that the RCMP was under-funded, ill-prepared and understaffed to handle complex criminal fraud cases.

The Ontario Securities Commission

After the fall of Bre-X and the death of Mr. Walsh, the OSC chose to pursue only our client Mr. Felderhof. His prosecution was seen by many commentators and investors as the last remaining hope that someone would pay a price for the Bre-X fraud. Why every market tragedy needs a scapegoat is a point well beyond the scope of this paper, however,

it is critical to note that Mr. Felderhof was not charged with tampering with gold samples but instead was charged by the OSC with breaches of the *Securities Act*.

Eight counts of violating the *Securities Act* were laid against Mr. Felderhof. There were four counts of alleged insider trading and four counts of allegedly authorizing misleading press releases. The first four counts alleged that, during the period from April 24, 1996 to September 10, 1996, Mr. Felderhof sold 2,720,500 shares of Bre-X for \$83.9 million with the knowledge of material facts (which generally pertained to the rights of Bre-X in relation to the Busang properties) that had not been generally disclosed (an offence known as “insider trading”). The latter four counts alleged that during the period June 20, 1996 to February 17, 1997, Mr. Felderhof authorized, permitted or acquiesced in the issuance of misleading press releases by Bre-X about the resource estimates. The specific charges laid by the OSC against Mr. Felderhof are set out in Appendix A to this paper.

These charges are strict liability offences and as such did not require the OSC to prove whether Mr. Felderhof knew that there were material title issues or that he knew the resource estimates were misleading or untrue. If found guilty, Mr. Felderhof faced penalties ranging from fines of up to \$8 million, plus additional financial penalties of up to three times any profits from the alleged insider trading, and possible jail time of up to 16 years.

Mr. Felderhof pled not guilty to all eight charges.

Counsel for Mr. Felderhof argued that the nature of the charges of allegedly misleading press releases in counts 5 to 8 constituted a breach of the *Charter of Rights and Freedoms*. The defence argued that s. 122(3) of the *Securities Act* was inconsistent with sections 1, 7, and 11(d) of the *Charter*, which include the guarantee of individual rights and freedoms, the right to life, liberty and security of person, and the presumption of innocence. At the end of the day the Court rejected the defence arguments and held that section 122(3) of the *Securities Act* was not inconsistent with the *Charter*.

The Court noted, however, that for section 122(3) to apply the OSC must prove beyond a reasonable doubt that the defendant was a director or officer of the company and that the defendant “authorized, permitted or acquiesced in” the commission of an offence by that company. The Court went on to hold that if the defendant could prove on the balance of probabilities that he was not negligent, that he was duly diligent, or took reasonable care that the press releases that he allegedly “authorized, permitted or acquiesced in” were not misleading or untrue, then he would be entitled to an acquittal on that basis.

3. THE COURT PROCEEDINGS

The trial of Mr. Felderhof commenced on October 16, 2000 before Justice Peter Hryn of the Ontario Court of Justice.

It was put on hold in April 2001 with a motion filed by the OSC to have Justice Hryn removed from the case for alleged bias. After a lengthy hearing, Justice Campbell of the Ontario Superior Court of Justice ruled that there was no reasonable apprehension of bias and that Justice Hryn should continue to try the case. The OSC appealed this ruling. In late 2003 the Ontario Court of Appeal upheld Justice Campbell’s decision.

The prosecution against Mr. Felderhof resumed in December 2004. At the trial, everyone, including the OSC, conceded that Mr. Felderhof was unaware that the core samples were tainted. To make its case, the OSC contended instead that Mr. Felderhof ignored many signs of problems at the Busang site; in essence they alleged that he was negligent.

There were over 157 days of testimony, during which the Court heard from Bre-X officials, consultants, experts, independent geologists, former officials of the Indonesian government, Bre-X officers and directors, including Rolly Fransisco and Dr. Paul Kavanagh, and Peter Munk, the chairman of Barrick. Mr. Felderhof did not take the stand.

Both sides in the case produced voluminous amounts of evidence. There were over 190 binders of documents from which 1,687 exhibits were culled. The transcripts totaled over 15,000 pages. Justice Hryn noted prior to closing argument that “if I read all day, five days a week, it would still take me four or five months just to get through just the transcript”.⁶

4. THE BRE-X JUDGMENT

As befits a case of this magnitude, Justice Hryn wrote a 594-page judgment that was released on July 31, 2007. In his detailed decision, Justice Hryn concluded that Mr. Felderhof was not guilty of any of the charges brought against him by the OSC. For those of you who are interested, the entire judgment can be found on our website (www.groiaco.com).

Counts 5 to 8: The Allegedly Misleading Geological Press Releases

In his judgment, Justice Hryn began by addressing the four charges dealing with the allegedly misleading press releases.

The Court found that the statements about mineral resources in the four Bre-X press releases in question were indeed misleading or untrue.⁷

The Court then had to determine the nature of Mr. Felderhof’s role in the release of these statements. The Court considered whether the misleading or untrue statement made by Bre-X in the impugned press releases were, in substance and essence, “authorized, permitted or acquiesced in” by Mr. Felderhof acting as a director or officer of Bre-X.⁸ Justice Hryn found that Mr. Felderhof had indeed “authorized, permitted or acquiesced in” the issuance of all four of the press releases in question.⁹ Since Justice Hryn held that

⁶ John Gray, “Judgment Day: the Bre-X saga unfolds”, *Canadian Business*, 24/09/06.

⁷ *R v Felderhof* 2007 ONCJ 345, 85.

⁸ *Ibid*, 93.

⁹ *Ibid*, 94, 99, 101, 107.

the OSC had proven the elements of the offence under section 122(3) of the *Securities Act* beyond a reasonable doubt, the onus shifted to the defence to establish, on a balance of probabilities, that Mr. Felderhof had exercised due diligence in allowing Bre-X to issue the press releases.¹⁰

In considering the due diligence defence, Justice Hryn held that the test was to determine whether or not Mr. Felderhof had established that he took all reasonable care on a balance of probabilities.¹¹

It was at this stage of the legal analysis that the so-called “red flags” identified by Strathcona, and relied upon by the OSC as the cornerstone of the prosecution, were first addressed. The OSC argued that the red flags, or alleged indicators of tampering, identified by Strathcona should have alerted Mr. Felderhof about the true nature of the Busang deposits. There were several witnesses and hundreds of exhibits that the OSC relied upon, but the main thrust of its argument was based upon the evidence given by the President of Strathcona, Mr. Graham Farquharson.¹² The defence relied on a number of key expert witnesses, including Dr. Phillip Hellman and Mr. Terry Leach, as well as evidence from the many others who participated in Busang, such as Kilborn Engineering and MRDI.¹³

The Alleged Red Flags

The Case of the OSC

Mr. Farquharson helped to perform the independent analysis of the Busang deposits back in April and May of 1997. Mr. Farquharson testified that after Strathcona completed its initial analysis in October 1997, Strathcona sent a letter to Bre-X setting out a list of 20

¹⁰ *Ibid*, 107.

¹¹ *Ibid*, 108.

¹² *Ibid*, 125.

¹³ *Ibid*, 125.

alleged red flags. A summary list of these alleged red flags identified by Strathcona is attached as Appendix B to this paper.

Mr. Farquharson testified that the “most striking of the red flags” at Busang were:

- 1) the absence of a geochemical anomaly in the Southeast Zone;
- 2) the absence of physical gold in all of the core that was drilled in the Southeast Zone over two to three years of drilling in an area that was reported to have coarse gold, along with the concern that there were no core samples from either the Central Zone or the Southeast Zone with visible gold;
- 3) the fact that skeleton core from high grade intervals had very little evidence of gold mineralization;
- 4) the fact that the sample bags were opened after they left Busang and before they arrived at the laboratory, contrary to all of the rules and procedures for security of samples that apply anywhere in the mining industry.

While the OSC conceded that some of these alleged red flags may not on their own have raised any doubts or questions, the OSC argued that collectively the red flags pointed in the same damaging direction, and an officer with familiarity in the exploration and evaluation of gold deposits should have recognized these warning signs. The OSC also argued that any observer of the red flags would have needed only some experience in the mining industry and did not have to be a highly specialized scientist to realize the significance of these warning signs.

The Defence Evidence

Dr. Hellman testified to the contrary.

Dr. Hellman provided detailed evidence and analysis that addressed each of the 20 alleged red flags raised by Strathcona. For a summary of this evidence please see Appendix C to this paper.

Importantly as well, Dr. Hellman testified about the experience of other highly respected professionals at Busang. He noted that the respected mineral auditing group, MRDI Inc., in their review concluded “that the exploration work is being done to a high standard”. Other positive comments from other professionals about Bre-X were equally hard to reconcile with Strathcona’s assertion that an exploration geologist should have seen the alleged red flags. As Dr. Hellman testified, MRDI’s four highly qualified geology specialists did not identify any of the 20 alleged red flags that, according to Strathcona and the OSC, would have been “obvious” to anyone “familiar with the exploration and evaluation of gold projects”.¹⁴ Dr. Hellman testified that it was more probable that Mr. Felderhof, and many other professionals that worked on Busang, did not ignore the red flags, but rather the alleged red flags simply were not there to see.¹⁵

Another defence witness, Mr. Leach, testified that the five alleged red flags that specifically dealt with his area of expertise (petrology) were not red flags at all, and, like Dr. Hellman, Mr. Leach testified that in any event these alleged red flags would not have been apparent to Mr. Felderhof.¹⁶

In his Judgment, Justice Hryn addressed the nature of the evidence he was to consider in assessing the impact of the red flags. Most significantly, Justice Hryn had to consider the role of “hindsight” in deciding whether the alleged red flags were red flags at all. The question before Justice Hryn was whether the alleged red flags were or should have been apparent to Mr. Felderhof at the time. The Court recognized that before the Bre-X fraud was discovered the mining industry did not expect that such a sophisticated tampering scheme could occur on such a scale. It was not something anyone actively looked for or

¹⁴ *Ibid*, 128.

¹⁵ *Ibid*, 128.

¹⁶ *Ibid*, 134.

considered. Justice Hryn concluded that Mr. Felderhof was in no different position.¹⁷ Justice Hryn also concluded that Mr. Felderhof and other Bre-X employees did not have the benefit of hindsight which Strathcona had in arriving at its conclusions.

Justice Hryn considered the evidence of several defence witnesses that there was a widely-held belief in the mining industry that there was gold in Busang. Justice Hryn also focused on several mining professionals who were confident that the Busang site contained vast amounts of gold. For example, Mr. Munk, the CEO of Barrick, testified that Barrick actively pursued control of Busang on several occasions over many years. Mr. Munk and his people obviously did not see any of the alleged red flags. Justice Hryn noted that Mr. Munk had at least the same expertise in mining as Mr. Farquharson and Strathcona. Unlike Strathcona, however, Barrick did not have the benefit of hindsight.

Justice Hryn held, as the defence had argued, that “to a large extent what separates Strathcona from all those others who did not see red flags and why Strathcona largely stands alone is hindsight or knowledge of the negative drilling results and the subsequent active search for red flags. Strathcona knew of Freeport’s negative drilling results. Strathcona had its own negative drilling results. Strathcona ‘*went looking for trouble*’”.¹⁸ Simply put, Justice Hryn found that “without hindsight there would be no red flags”.¹⁹

It is noteworthy that the defence also called a significant amount of evidence from each of its main geological witnesses (and from Dr. Kavanagh, an OSC witness) that there was indeed gold, at least in the Central Zone at Busang. The greatest tragedy (and mystery) of the Bre-X saga is how the conclusion that there had been tampering at Busang (for which the evidence is overwhelming) inexorably led to the conclusion that the property was worthless, for which there is no evidence.

In his summary of Mr. Felderhof’s due diligence defence, Justice Hryn noted that the OSC relied largely on the testimony of Strathcona, a company that, unlike several others

¹⁷ *Ibid*, 155.

¹⁸ *Ibid*, 388.

¹⁹ *Ibid*, 388.

who saw gold at Busang, applied the benefit of hindsight to reach its conclusions. Justice Hryn held that “balancing the evidence specific to individual alleged red flags... and the more general considerations...and balancing the shortfalls in the OSC evidence against the shortfalls in the Defence evidence and considering the evidence of the green flags, I prefer the evidence that there were no red flags that were or should have been apparent to Felderhof.”²⁰ Justice Hryn concluded that, on the balance of probabilities, Mr. Felderhof had established his due diligence defence.

Justice Hryn found Mr. Felderhof not guilty of the four counts of issuing misleading press releases.²¹

Counts 1 to 4: Insider Trading

Section 76(1) of the *Securities Act* provides that, “any person in a special relationship with a reporting issuer shall not purchase or sell securities of the reporting issuer with the knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed”.

Therefore, in order for the Court to convict Mr. Felderhof on these charges, the following three elements had to be proven: 1) that the Mr. Felderhof was in a special relationship with Bre-X; 2) that Mr. Felderhof sold securities of Bre-X; and 3) that Mr. Felderhof had knowledge of material information about Bre-X which had not been generally disclosed at the time that Mr. Felderhof sold securities of Bre-X.

A material fact is defined in the *Securities Act* 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.” In this case the OSC alleged that there were several undisclosed material facts, none of which related to geology but rather to title concerns and disputes between

²⁰ *Ibid*, 389.

²¹ *Ibid*, 391.

Bre-X and its Indonesian partner. The particulars relied upon by the OSC to prove that Mr. Felderhof engaged in insider trading were:

- 1) due to a failure to comply with contractual obligations owed to the Indonesian government and the shareholders of PT Westralian Atan Minerals, Bre-X had not secured its interest in the property known as Busang I; and/or
- 2) Bre-X had misled the Indonesian government respecting the acquisition of an 80% interest in PT Westralian Atan Minerals; and/or
- 3) Bre-X had unjustly excluded PT Krueng Gasui (“PT KG”), and/or PT Sungai Atan Perdana (“PT SAP”), and/or Jusuf Merukh, from obtaining an interest in the exploration of the property known as Busang II;
- 4) that PT KG, and/or PT SAP, and/or Jusuf Merukh, had issued a complaint to the Indonesian government and Bre-X respecting their exclusion from obtaining an interest in the exploration of the property known as Busang II;
- 5) that the Indonesian government had cancelled the preliminary survey permit respecting the property known as Busang II.

The defence conceded that Mr. Felderhof was in a special relationship with Bre-X, the reporting issuer. For reasons that are of little interest to this audience the court also found that Mr. Felderhof had sold shares in Bre-X during the relevant period.

The OSC had to prove that the five particulars set out above were material. The court found that certain of the facts alleged in the particulars were not known to Mr. Felderhof and certain of them were known by him. However, the OSC also had to prove, beyond a reasonable doubt, that each Particular “significantly affected,” or would significantly affect, the market price of Bre-X’s shares. They called Dr. Vineta Juneja of NERA, who was qualified as an expert in the fields of securities economics and assessment of materiality.²²

²² *Ibid*, 544.

Dr. Juneja testified that the consequences of the alleged particulars had an economic impact on the price of Bre-X's shares. However, after assessing Dr. Juneja's testimony in detail, Justice Hryn concluded that there was reasonable doubt that Dr. Juneja's evidence established that the material facts set out in the particulars had significantly affected the market price of Bre-X's shares. Justice Hryn concluded that there was no direct link between the alleged particulars and the market price of Bre-X's shares.

As a result of his findings, Justice Hryn concluded that the OSC had not proven beyond a reasonable doubt that the alleged facts set out in the Particulars were in fact material, an essential element of the offence, and on that basis he concluded that Mr. Felderhof was not guilty of those charges.²³

5. CLASS ACTIONS

By May 1997, Bre-X faced a number of lawsuits from angry investors who claimed to have lost billions of dollars. Class actions were commenced in both Canada and the United States. The Bre-X class action in the United States was stalled for years as the parties awaited a decision from a Texas Court as to whether or not a proposed Settlement reached in May 2002 between the plaintiffs and Bre-X's sister company, Bresea, would be approved. On September 30, 2004, Judge Folsom approved the Amended Settlement Agreement with Bresea. The Settlement closed on February 4, 2005 when Bresea paid \$9 million to investors in the Settlement. Judge Folsom had earlier refused to certify the US class action and it has gone nowhere.

Canadian class actions were brought against certain of the analysts of Bre-X, some of the directors and officers of Bre-X, as well as the company itself. The biggest Canadian class action was brought in Ontario. It came to a standstill during the OSC's prosecution of Mr. Felderhof. A decision was made to delay discoveries in the class action until the evidence

²³ *Ibid*, 594.

in the OSC hearing was completed. This action is ongoing, though it has now been said to be on “shaky footing”.²⁴

After the decision rendered by Justice Hryn was released, Harvey Strosberg, the Ontario lawyer representing shareholders in that class action, said that the Judge’s decision that Mr. Felderhof was not negligent “obviously isn’t going to make it any easier” for his clients’ class action to succeed.²⁵ Nevertheless, Mr. Strosberg noted that the burden of proof for a civil lawsuit is lower than in a criminal trial, and that the class action still had a chance. Even if the actions are successful, the investors will likely end up with only minimal compensation after legal fees are paid.²⁶

6. THE AFTERMATH OF THE BRE-X DECISION: CONDEMNATIONS AND COMMENDATIONS

The Response of the Mining Community

As may be expected, there is a wide spectrum of opinion about the Bre-X decision within the mining community. Some were disappointed, instantly stating that Mr. Felderhof’s acquittal made the mining industry “look like the ungovernable Barbary of the capital markets”.²⁷ Others were pleased that despite the pressure for someone to pay for the fraud, the Court took a fair approach and thoroughly examined the evidence.²⁸ That being said, many still believe that though he may be innocent, Mr. Felderhof was lucky to only have his reputation wounded.²⁹

There is no question that almost everyone in the industry agrees that Justice Hryn rendered a masterful judgment, after hearing all of the evidence, and that he demonstrated an in-depth knowledge of the technical aspects of the prosecution.

²⁴ Financial Post: “Bre-X fiasco shows flaw in Canadian law”, 01/08/07.

²⁵ Report on Business: “Bre-X the end of the trial”

²⁶ Tony Seskus, “Lawyers win; Bre-X shareholders lose” *Calgary Herald* 24/05/07.

²⁷ “R v Felderhof: an industry post-mortem, Commentary” *Northern Miner* 19/08/07.

²⁸ *Northern Miner*, “R v. Felderhof: an industry post-mortem”, 13/08/07.

²⁹ *Northern Miner*, “Felderhof Acquitted”, 06/08/07.

The Response of the Legal Community

The general feeling in the legal community seems to be that the judicial system worked as it was supposed to, regardless of whether or not investors were happy with the decision.³⁰

Mr. Felderhof's acquittal resulted from a careful analysis of the evidence. Justice Hryn concluded that the OSC did not satisfy its burden of proof with respect to insider trading (which focused on the discussion of materiality), and Mr. Felderhof did satisfy his burden of proof in establishing a due diligence defence for the misleading press release charges.³¹

The legal community commented on the decision by both the RCMP and the U.S. Securities and Exchange Commission's (SEC) not to lay charges (or bring civil proceedings) against Mr. Felderhof. One commentator stated that "one might speculate that the SEC was engaged in a tighter analysis [than the OSC] up front that might have led them not to bring charges because the case was difficult to prove, time-consuming, expensive, and the results were far from clear".³² This conclusion is a little ironic because the OSC is often criticized for not pursuing cases whereas the SEC is frequently complimented for its more aggressive approach to prosecutions.

Nevertheless, there seems to be a clear consensus in the legal community that Justice Hryn rendered a carefully-considered and well-reasoned judgment. Securities lawyer Phil Anisman stated that "the trial judge's findings ... were very carefully substantiated and had a strong ring of accuracy... I don't think they'd be reversed".³³

³⁰ Law Times, "Lawyers say securities regulation system is working".

³¹ "Bre-X Lessons: In the Felderhof decision, the legal process operated as it should. There is not need to turn from the courts to OSC panels" James Baillie and Edward Waitzer, *National Post and Torys LLP* 08/08/07.

³² Law Times, "Lawyers say securities regulation system is working".

³³ Globe and Mail, "OSC will not appeal Felderhof acquittal", 23/08/07.

The strongest evidence that the judgment was thorough and well-reasoned may be the OSC's decision not to appeal the judgment as it was "heavily fact based" and commented extensively on all the issues and evidence raised in the case.³⁴

Another frequent comment was that the OSC prosecutors were simply "outgunned by defence counsel".³⁵ Former Toronto securities lawyer Arthur Cockfield said that "on the one hand, you got these experts in Toronto Bay St. law firms who are paid a lot of money to have a very sophisticated understanding of these rules... on the other hand, you've got Crown prosecutors, who may be sophisticated, but often they don't have the resources to access the information and pursue their investigation like they like to".³⁶

There was also a perception that Mr. Felderhof's lawyers caused delays in the case in order to increase their legal fees. Not only were the delays in the case caused by the OSC, but Mr. Felderhof's five defence counsel and expert witness Dr. Hellman have not been paid for a significant amount of the time that they spent working on Mr. Felderhof's case. In late 2005, well before the trial ended, Mrs. Felderhof ceased paying the legal bills for her ex-husband as she had been doing from a frozen Cayman Island account. Despite this, the defence team continued to represent Mr. Felderhof until the end of the trial. In an affidavit filed in the Ontario class action, we stated that "[notwithstanding] that we are not being paid for our services we consider ourselves duty bound to complete the OSC case through to the end of trial".³⁷ We did just that.

7. THE LARGER IMPLICATIONS OF THE BRE-X DECISION

It has been said that "Bre-X is and will remain a synonym for securities fraud", and that it has become a national symbol of corporate shame.³⁸ There is, in some quarters, a sense that the decision in this case was an injustice to the shareholders and showed the

³⁴ Globe and Mail, "OSC will not appeal Felderhof acquittal", 23/08/07.

³⁵ The Star, "Shock greets Bre-X Verdict, 01/08/07.

³⁶ The Star, "Shock greets Bre-X Verdict, 01/08/07.

³⁷ Jamie Kneen, "Bre-X lawyer on quest for fees" *MWC-News* 25/08/06.

³⁸ John Coffee of the Columbia University Law School, from National Union; and National Post, "Ruling redeems Canada's image", 01/08/07.

weakness, not only of the OSC, but also of the Canadian judicial system as a whole in failing to find justice for Bre-X's shareholders. In the articles published after Mr. Felderhof's acquittal, there was little mention of Mr. Felderhof or his actual role in Bre-X. Rather the focus was on the regulators and laws that "failed" to bring justice to those who had lost money in Bre-X.

Some blamed the RCMP for not pressing criminal charges. This is misguided to say the least. Nevertheless, since the verdict, the head of the RCMP's new IMET group, Superintendent John Silter, acknowledged that the RCMP did not respond as quickly to the Bre-X fraud as they might have in today's environment.³⁹

The Toronto Stock Exchange also came under some fire. One article says that it is inexcusable that a highly speculative company, such as Bre-X, with no production profile and no earnings history, was included in the TSX 300 Index by the "bright lights" running the exchange.⁴⁰

The criticism of the OSC was undoubtedly the most widespread. The regulator had spent millions of dollars on a prosecution that had failed on all counts. Many commented that the decision highlighted the regulator's dismal record of prosecuting white-collar crime in Canada.⁴¹ Moreover, there were criticisms that the OSC failed to present evidence which would have directly affected Justice Hryn's decision, namely evidence from other professionals in the mining industry who could have supported Mr. Farquharson's testimony and who may not have had the benefit of the 'hindsight' that Justice Hryn referred to in his judgment.

There was also a lively debate as to whether the OSC had pursued the correct charges against Mr. Felderhof in the first place. Several comments were made to the effect that the real offence in the Bre-X case was fraud, not insider trading. It was said that if Mr.

³⁹ David Clark, "Black eye seen for Canada securities enforcement; Flaherty renews call for national regulator after Bre-X verdict" *Investment News* 13/08/07.

⁴⁰ *Ibid.*

⁴¹ Red-Orbit, "Bre-X Geologist Cleared of Insider Trading Charges", 26/09/2007.

Felderhof was not aware of the fraud, he should have been. The charges of insider trading were thought to be ‘watered down’ and reflected the ‘lack of teeth’ of the OSC.⁴² Other commentators suggested that, if you were to go back and look at the Bre-X case in hindsight, maybe the best charge would have been under the public interest jurisdiction of the OSC, given the ambiguous legal issues.⁴³

This criticism relates to the OSC’s choice of proceedings. This stems from the reality that insider trading cases have proven notoriously hard to win in Canada, especially when the OSC chooses to pursue them as quasi-criminal trials in the provincial courts, rather than at tribunal hearings.⁴⁴ When laying insider trading charges, the OSC has a choice of whether to pursue quasi-criminal charges or administrative proceedings. If they choose the latter, the case is heard in front of a tribunal and not a provincial court. Tribunal hearings have a lower burden of proof, and it is easier to introduce evidence and compel testimony. However, though there may be valid reasons for choosing to bring certain cases before a tribunal, one of these should not be that obtaining a conviction in court is too difficult. One lawyer noted that “[the] burden of proof [required] is right. It’s set by the legislature. If you don’t agree with the burden of proof, then you should change the law, not decide to bring the case elsewhere”.⁴⁵

Criticism of the entire Canadian legal system

Mr. Felderhof’s acquittal has also left many questioning the resolve of Canada’s regulators in prosecuting alleged white-collared crime. Minister Jim Flaherty said that Canada’s inability to catch and convict white-collar criminals who cheat and steal from ordinary investors is an “embarrassment” internationally that must be addressed.⁴⁶ Though this statement was not directed solely to the decision in Bre-X, it showed the Minister’s clear frustration with Canada’s poor record in detecting, investigating and prosecuting securities breaches, a frustration shared by many.

⁴² Reuters, “Bre-X reveals Canada’s poor corporate crime fight”, 31/07/07.

⁴³ Globe and Mail, “Case extends OSC’s losing streak”, 01/08/07.

⁴⁴ Globe Advisor, “Case extends OSC’s losing streak” 01/08/2007.

⁴⁵ Law Times, “Lawyers say securities regulation system is working”.

⁴⁶ Canadian Press, “Flaherty decries inaction”, 03/08/07.

A report released by Nick Le Pan, former Superintendent of Financial Institutions, suggested that Canada had to rethink its approach to investigating and prosecuting securities fraud or continue to be outwitted by the smartest and best-equipped white-collar criminals in the country.⁴⁷

It is not just Canada's politicians who are criticizing the regulatory system. There is a large group of investors who express a deep loss of faith in the Canadian justice system, as it failed to hold anyone accountable for the world's largest mining fraud.

There cannot be, however, any doubt that no one, not even an injured investor, wants to see an innocent man convicted and sent to jail. In our view, any reasonable person who reads Justice Hryn's decision would have no doubt that Mr. Felderhof was innocent of the charges brought against him. His defence team merely ensured that the Court had all the relevant facts and circumstances before it in order to reach the right conclusion in Mr. Felderhof's case.

After addressing discontent with the Canadian regulatory system, the criticism usually shifts to comparisons to the U.S. system of securities regulation. The overall public consensus appears to be that U.S. securities laws protect investors better than Canadian laws. Claude Lamoureux, the President of the Ontario Teacher's Pension Plan, which lost \$60 million in Bre-X, said that "'deemed reliance' is the biggest impediment to stock cases involving fraud on the market in Canada".⁴⁸ The concept of "deemed reliance" in the United States refers to the concept in their law that the plaintiff does not have to prove that he or she actually relied on the alleged misstatement in deciding whether to purchase or sell securities. Unlike the situation in the U.S., in Canada the plaintiff bears the evidentiary burden of proving that he or she bought or sold shares in reliance upon the alleged misstatement. In Lamoureux's opinion, the best Canadian reform would be to have securities laws that entitle investors to damages if a misrepresentation is proven,

⁴⁷ Canadian Press, "New approach needed to fight securities fraud", 03/12/07.

⁴⁸ Financial Post, "Bre-X fiasco shows flaw in Canadian Law", 01/08/07.

either deliberately or through negligence, because there is a ‘deemed reliance’ on such information. We only went part way with the s 138.1 amendments to the *Securities Act*.

The Bre-X decision has left many wary of investor protection in Canada. An extraordinary 80% of those surveyed in the business community viewed the current situation in securities regulation as harming the economy and in need of urgent remedy.⁴⁹ Furthermore, according to several senior members of Canada’s business community, Canada is now seen as a haven for criminals.⁵⁰ People in the market are losing confidence and many large investors, like the Ontario Teacher’s Pension Plan, have chosen not to invest in public Canadian companies, instead preferring to invest in the U.S. where the SEC has tougher penalties, a better success rate in prosecution, and in general “more teeth” in combating white-collar crime.

8. WHAT CHANGES HAVE BEEN MADE AND WHAT ELSE CAN BE DONE?

There is general agreement that something must be done to improve securities regulation in Canada, but we lack a consensus on what changes should be made. The consensus seems to be that a single Canadian securities regulator would be more effective than the 13 provincial regulators that we currently rely upon to police the securities industry. Currently Canada is the only industrialized country without a single, national securities regulator.⁵¹ The recent announcement by Minister Flaherty that a seven-person panel had been appointed to simplify securities regulations that differ from province to province may be a necessary first step in remedying this problem.⁵²

Some have suggested that the police should be allowed to compel witnesses to speak to them during the investigation phase, thereby enhancing the ability of the police to gather evidence. This raises issues well beyond the scope of this paper. Others have said that this issue did not affect the outcome in the Bre-X case.

⁴⁹ Gale, “Black eye seen for Canada securities enforcement”, *Investment News*, 13/08/07.

⁵⁰ John Gray, “Canada’s losing war against white-collar crime” *Canadian Business* 18/01/08.

⁵¹ Reuters, “Bre-X reveals Canada’s poor corporate crime fight”, 31/07/07.

⁵² Kevin Carmichael, “Flaherty names securities panel” *Globe and Mail* 21/02/08.

Another issue that came to light in the Bre-X case were flaws in the regulation of the mining industry itself. Since the Bre-X scandal, Canada has adopted a host of new regulations that govern how mining companies conduct their businesses. For example, there is now a requirement for a qualified person to review the site. The new regulations also sets much more rigorous standards for conducting and reporting results, including a host of quality control measures.⁵³ Despite these stricter regulations, however, the recent Southwestern Resources case has shown that, notwithstanding the changes after Bre-X, “the investment community can still be fooled by a determined [participant]”.⁵⁴

9. CONCLUSION

There cannot be, in our view, any real debate that the judgment rendered by Justice Hryn was a just one given the facts of the Bre-X case. We strongly believe that the justice system worked as it should have. Mr. Felderhof was not charged with tampering; but rather insider trading and failing to recognize what, with the benefit of hindsight, were alleged to have been warning signs. While some critics were prepared to accept that Mr. Felderhof may have been unaware of the salting of the samples and was innocent of the *Securities Act* charges brought against him, most Canadians were not happy with the result. This unhappiness likely stems from the majority of market participants being shocked and disappointed by the fact that no one was held responsible for the loss of millions of dollars. It is important to bear in mind that no one was charged with the fraud. Only Mr. Felderhof was charged with any offenses arising from the collapse of Bre-X and the system rightly, in our view, acquitted him of those charges.

What remains for another day is calm reflection on why it is that Canadian market participants seem to believe that for every meltdown in the marketplace there must be a conviction, and that unless someone is sent to jail justice has not been done. Once we can

⁵³ Geotimes, “Bre-X scandal ends with acquittal”.

⁵⁴ Globe and Mail, “Southwestern lawsuit alleges former CEO masterminded falsification of results in mining scam”, 28/08/07.

get past this sense of collective retribution we believe that the task of preventing a repeat of Bre-X will be more apparent and achievable.